

THE STATE OF THE RUSSIAN ECONOMY AND THE ECONOMY OF THE RUSSIAN STATE:
SOME SIMPLIFIED COMMENTS ON A COMPLEX SUBJECT

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I. Introduction

Among the familiar characterizations of economics and economists, two are relevant to the remarks I'll be presenting on this formidably complex subject:

- (1) The first characterization is sometimes made by non-economists: namely, that: "half of what economists know is right--the trouble is they don't know which half!"
- (2) The second characterization is sometimes made by economists referring to non-economists--namely, that: "you only realize how much of economics is simply common sense when you talk to someone who doesn't have it!"

* Remarks prepared for delivery at a Pomona College conference on "The Russian State and the State of the Russians," April 21 - 22, 1995. This paper has benefited from comments and suggestions--not all of which were adopted--by my RAND colleague, Dr. John Tedstrom.

II. Structure

Structure of my talk:

- (1) Brief background on the legacy of unreliable economic statistics in the Soviet period, and the not infrequently erroneous assessments of the Soviet economy that were made in that period by putative experts, based on these data.
- (2) A partly digressive outline of a conceptual framework--a systems approach--for evaluating the process and progress of economic transformation and marketization in formerly "command" economies, like that of Russia.
- (3) Finally, an abbreviated treatment of some of the recent economic data covering the period from 1991 to the present, the serious shortcomings of these data, and the positive and negative inferences that can be drawn about the Russian economy, from these data and from other considerations--including political ones.

III. Background

Prior to the dissolution of the Soviet Union at the end of 1991, most experts on the then-Soviet economy erred in their generally favorable--even if diminishingly favorable--assessment of the economy's status, accomplishments, and performance. In the decade preceding Gorbachev's assumption of power in March 1986, official Soviet data provided estimates of the economy's growth above 4 percent annually, although the growth rate was reported to be decreasing in the years immediately preceding 1986. Official U.S. government sources had estimated the Soviet economy's annual rate of growth at 5.3 percent between 1966 to 1970, at 3.7 percent in the first half of the 1970s, at 2.7 percent in the second half of the 1970s, and at 1.9 percent in the first half of the 1980s. In retrospect, it seems probable, from the testimony of Soviet economists and from more recent data, that these estimates provided a more favorable picture of the performance of the Soviet economy than was actually warranted.¹

The earlier estimates were misleadingly high for many reasons: they made insufficient allowance for hidden inflation, for diminishing product quality, and for simple distortion and falsification in data reporting. The previous evaluations of the Soviet economy also made insufficient allowance for the extent to which the overriding priority given to the military left the Soviet nation economically, as well as socially and politically, impoverished.

¹ See CIA *Handbook of Economic Statistics*, 1983 and 1987, and John Tedstom "Perestroika, Radical Reform, and Soviet Economic Disintegration," in Ian Elliot, editor, *The Soviet Union After the Coup*, London, St. Martin's Press, 1992, Table 1, p. 5.

In contrast to the generally overoptimistic consensus of bygone years about the performance of the former Soviet economy, the more recent consensus about economic performance in Russia has been almost uniformly pessimistic. This pessimistic consensus has been based on official data sources reporting reductions in GNP in 1991, prior to the Soviet Union's dissolution, of about 15 percent in real terms, and in Russia in 1992, 1993, and 1994 of further reductions of 19 percent, 12 percent, and 15 percent, respectively. The same sources reported rates of inflation of 1,300 percent in 1992, somewhat less than that extraordinary rate in 1993, and about 500-600 percent in 1994!

Based on these and similarly indicative data, the currently prevailing consensus--both in the U.S. and in Russia--is distinctly "bearish": for example, Reddaway and Goldman in the U.S.; Yavlinsky, Fedorov, and Gaidar in Russia. On the other hand, there is a relatively small group that adopts a somewhat more "bullish" (optimistic) stance: for example, Anders Aslund and, within Russia, Chubais and Yasin.

I will return later to these differing views and what lies behind them. Before doing so, I'll digress briefly to suggest an appropriate framework for thinking about, and ultimately evaluating, the process and progress of fundamental economic reform and marketization in Russia, and other formerly "command" economic systems.

IV. Marketization as a Systems Problem

4 charts

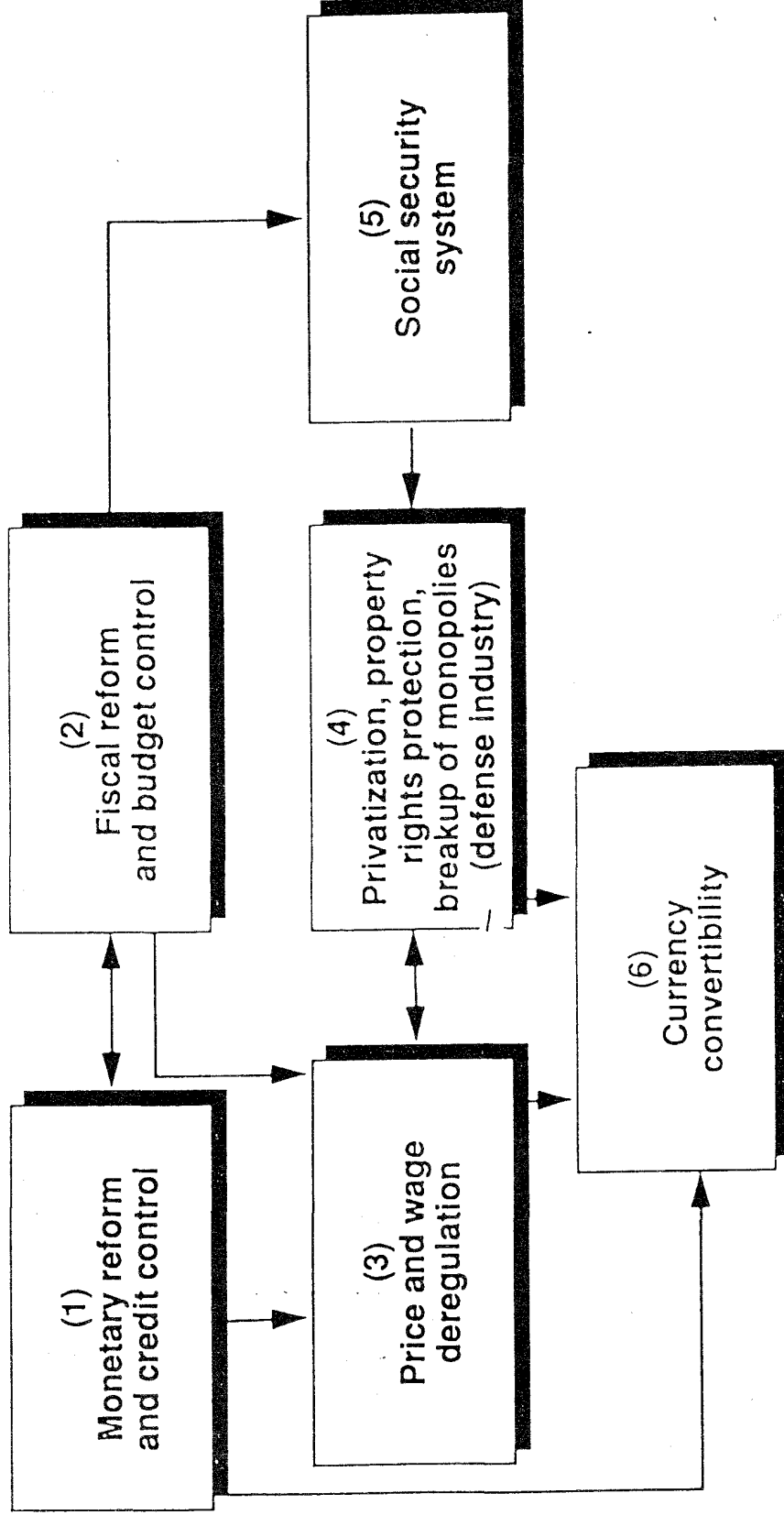
Transforming Command to Market Economies

- Multiple components (6)
 - Interactions and interdependencies
 - Probability of success depends on synergy among components
 - Political and institutional/organizational constraints
-

Transforming Command to Market Economies

- Components of transformation:
 - monetary reform
 - fiscal control
 - price, wage deregulation
 - privatization, property rights, breakup of monopolies (including defense industry)
 - social safety net
 - currency convertibility
 - Transformation as a systems problem
-

Market Transformation as a Systems Problem



Modeling the Transformation Process

- **Small number of equations (2 – 4) for each component**
 - **Connections among the components**
 - **Embedding the components in a reduced-form macroeconomic model**
 - **Simulations with some fitted parameters, values of other parameters and variables selected for sensitivity testing**
-

V. Recent Data, Why They're Misleading,
and the Uncertain Economic Outlook

The data produced by official Russian sources describe an unimpressive economic picture. They also miss a lot because the canvas is sketched in only a few principal dimensions--while the more complex reality has many more dimensions.

According to the official data, real manufacturing output in 1994 was 28 percent below that in 1993; agriculture did better--only 8 percent below 1993. Unemployment has continued to rise--official employment figures are only 3 percent of the labor force, but the ILO estimates the actual figure closer to 9 percent. Inflation has been running at a monthly rate of 10 - 15 percent, and the ruble has depreciated to over 4000 per U.S. dollar since October 1994.

These data do not describe a successful, transforming, marketizing economy!

The inference typically drawn by many experts is that the Russian economy is in dire straits, sometimes even characterized as "freefall!"

But these data and the inferences drawn from them are almost surely wrong and no less misleading than were the relatively favorable assessments of the Soviet economy in bygone days. The current data and assessments are wrong because they ignore, or at best only partly include, production, sales, and employment in the growing private sectors of the Russian economy. These sectors often don't report, or underreport, their real output and sales to avoid business turnover, income, and profit taxes. According to several sources, including

Russia's Minister of Economics, Dr. Evgeny Yasin, nearly half Russia's 150 million people derived their livelihoods from the private economy by the end of 1994, compared with about 8 million only two or three years earlier.

The reported declines in aggregate output are misleading for several additional reasons. First, the levels of prior output, against which the more recent performance has been measured, were probably exaggerated to start with, for reasons noted earlier. Because the economy's previous performance was overestimated, the consensus estimates of how far the economy must have fallen to get to its present condition are probably also excessive!

Second, much of the real decreases in aggregate output have been in the military sector, including military end items. For example, spending on military procurement decreased by more than 70 percent between 1992 and 1995. It is therefore important to make a distinction between aggregate output, on the one hand, and economic well-being, on the other: the effect of reduced output of these military goods and services on living standards is limited. Personal consumption is more directly affected by agricultural output, and other consumer goods and services, and these have fared considerably better.

A third reason is both important and almost totally overlooked in most assessments of the economy's status. The reported data invariably neglect the real output of the services sectors. It's worth recalling that, according to Soviet accounting standards, services were deliberately excluded from the estimation of "material product," for reasons I won't go into here. But the output of services--marketing services, distribution services, financial services, legal services, construction services, even "security" services--are bound to be of growing importance in economies like that of Russia, undergoing marketization. As a guess, I'd opine their volume may approach at least 20 percent of the Russian GDP, all or most of this representing an

addition to officially reported GDP! The legacy of Soviet accounting, as well as inherent difficulties of measuring real output in services, have resulted in their neglect in the official economic data.

None of this implies that the performance of the Russian economy has been buoyant. The transformation process has been and will continue to be fitful, impeded by frequently recurring obstacles, and often accompanied by setbacks. Furthermore, the outcome of the entire transformation process is clouded by a fundamental asymmetry between the prospective “winners” and “losers” of the transformation itself. By and large, the prospective losers know who they are and what they stand to lose, while the potential winners will be less certain about who they are as well as what they stand to gain. As a result, those who stand to lose—ex-Communist apparatchiks, state enterprise managers, the military, the bureaucracy, etc.—may often obstruct and undermine the transformation process with more vigor and concentrated effort than its potential beneficiaries will bring to bear in pressing forward. Roadblocks, breaches of law and order, and criminality feed on these sources.

On the other hand, it is also possible that some of these prospective “losers” may jump headlong into the new environment, and use their influence and previous positions to take advantage of new economic opportunities.

In any event, and notwithstanding the recent setbacks and those to be expected in the future, there are reasons for believing that the pessimistic views of many experts concerning the Russian economy and its prospects may be no more reliable than was the corresponding overoptimistic consensus in the past.

In fact, there are several reasons for adopting a stance of limited optimism, rather than unalloyed pessimism.

First, as noted earlier, development of the private market economy has proceeded more rapidly and more effectively than had been anticipated. According to data provided by the first deputy prime minister, Anatolii Chubais, more than 60,000 smaller factories (over 30 percent of the total number) with employees of less than 200 have been privatized, and 5,000 large factories were privatized in 1993 and 1994. By the end of 1994, more than 50 percent of Russia's GDP was expected to be provided by the private sector.²

Second, economic developments in Moscow itself have proceeded very favorably--a circumstance that did not prevail in 1993--albeit more unevenly elsewhere in the Russian Federation.³ Also, in the outlying rural regions of Russia, according to the previously cited privatization data sources, there are now 230,000 private farms, including many small private plots that were never in state hands.

Third, there has evidently been a modest, but discernible, growth of professionalism within the Russian government. To be sure, there are major forces of inertia within the bureaucracy, as well as substantial elements of direct opposition to the reform process. Nevertheless, Western observers, and some businessmen and women who have been in contact with the administrative apparatus, have noted at least mildly encouraging signs of pragmatism and flexibility in their dealings with some parts of the bureaucracy. Although the legacy of rigidity and hierarchy from seventy years of communist rule will not be expunged quickly,

² See unpublished paper and data sources from Dmitry Mikheyev in correspondence with Charles Wolf, Jr., May 1993.

³ Although Moscow has experienced considerable privatization in small business and service industry, the major declines have occurred in heavy industry and military output.

there are some signs of an emerging professionalism within the Russian government that provide hope for the future.

Finally, the progress of contacts between the military establishments—both uniformed and civil—of the U.S. and other Western countries with their counterparts in the Russian military have increased in frequency and significance. For instance, one high official of the British Ministry of Defense recently recounted a series of meetings between British MOD and Russian Defense Ministry representatives in which matters relating to military budgeting, transparency of the budget process, the importance of assuring a fair competition for resources both within the military and between it and other public sector expenditures, have been proceeding with encouraging substantive results.

None of this warrants great optimism about the prospects, and all of the foregoing hopeful signs depend on a modicum of sustained political and social stability. The past and recent conflicts between the Yeltsin government and the Duma, between Moscow and the periphery, between Russians and ethnic minorities within the Russian Federation--as disastrously reflected by the war against Chechnya--create profound risks and uncertainties.

In addition to the risks and uncertainties reflected by Yeltsin's military move against the Duma in 1993, and against the Chechens in 1994 and 1995, there are some circumstances that affect positively, and others that affect negatively, the pace and trajectory of the transformation process in Russia.

The positive side of the ledger includes the prospect of sustained reform measures—although these may be somewhat diluted and delayed—under the guiding hands of Prime Minister Chernomyrdin, deputy prime minister Chubais, and economics minister Yasin. And there is some chance that the new Duma to be elected in December 1995 can function in

a more constructive and negotiatory role, as a counterweight to Russia's president, than did its predecessor. Prospects for political stability, and for a more salutary change in the general economic climate, would thereby be enhanced.

The negative auguries include the unpredictability bordering on irresponsibility of Yeltsin himself, the continued disruptive and tragic effects of Chechnya, and the large uncertainties posed by the presidential election scheduled in 1996.

Russia was characterized in the distant past as a riddle inside an enigma. Candor warrants a similar characterization of the prospects for successful transformation in the future. While acknowledging the ample grounds for being cautious and tentative, a limited degree of optimism about Russia's economic prospects is warranted for several reasons:

First, some of the several elements of the transformation process—specifically, privatization and price deregulation including foreign trade liberalization—have proceeded reasonably well, and surely better than was anticipated.

Second, if the forthcoming parliamentary elections and subsequent presidential elections can provide a modicum of political stability, other components of the reform process have a good chance of proceeding.

And finally, the experts' consensus has so often erred in the past that it is not unreasonable to expect that its currently pessimistic tenor may be wrong again!

Nevertheless, I'd observe in conclusion that a quite different scenario envisaged by Professor Shlapentokh is also a distinct possibility. This scenario would entail more or less permanent instability in Russia, without a strong or effectively reforming central administration, and with various functional and regional groups intermittently dominant, in a more or less

feudal manner, based on their control over economic, natural, or military resources. This is not a pretty picture, but also not an implausible one.

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