

## RUSSIA'S ECONOMY: PRESENT-DAY AND PROSPECTS

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(A talk at the School for Slavonic and East European Studies, University College London, May 2000)

For the first time in many long years there is no atmosphere of an ongoing or impending economic crisis in Russia. There is thus no particular need for the fire brigade measures of catastrophe alleviation that became such a standard feature of the Russian polity since the beginning of perestroika. Therefore, the decision makers should be able to afford taking a measured longer view of past developments, current state and future prospects of Russia and her place in the world community. At the same time, there is unprecedented political stability. Vladimir Putin, the new president still enjoys overwhelming support, both among the population, the Duma and at least seemingly also among the regional leaders and other crucial elite groups. He is, in all probability, able to plan for eight or possibly eleven years of Putin's regime.

Therefore, the political possibility for consistent decision making and implementation has arguably never been better during the years of Russia's new independence. There is an opportunity to be utilised. Clearly, there is also need for another wave of economic reform. Whatever the differences among observers and doers of the Russian economy concerning short-to-medium term prospects, almost everybody agrees on the most important. During a relatively short period of perhaps some fifteen years Russia has developed an institutional equilibrium, maybe even an economic system that is badly suited for sustainable growth, efficiency, and equitable welfare.

I shall start by taking a look at that system. Then I shall ask whether we might expect Putin to make a determined effort to transform the Russian market economy into a better one. Further, should one expect him to succeed? And finally, whether the answer is in the positive or the negative, what are the foreseeable implications for Europe's relation with Russia in the early 21<sup>st</sup> century?

### The Russian market economy

The Russian market economy is characterised by four determining features. They are (a) dominating insider ownership, (b) largely non-monetary settlements, (c) a continued fusion of economic and political decision making and (d) the emergence of a structure that bears uncomfortably close resemblance to the classical dual economies of – say – the large Latin American countries. Arguably, this is a characterisation that is unique to Russia and perhaps to some other post-Soviet states. It might be defined as a particular variant of the market economy, but if another terminology were preferred, we could quite as well talk of a particular institutional equilibrium.

As an aside, I might defend my seemingly all too preposterous terminology by pointing out that I have not been the only economist trying to conceptualise current Russia in somewhat similar terms. I have done that in essays collected in 1998. Jeffrey Sachs wrote an important article on these issues already in 1994 and Philip Hanson somewhat later. Richard Ericson (1999) and Clifford Gaddy and Barry Ickes (1998, forthcoming in 2000) are important recent additions to this literature. Others could be added.

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Basic economics and relevant experience from other countries seem to imply that a dual economy also based on insider ownership, largely non-monetary settlements and a continued fusion of economic and political power may be able to grow tends to generate relatively low savings and investment together with large welfare disparities. Of the savings available, an excessive share goes abroad or into various directly unproductive activities. As a dual economy, Russia is able to grow, at least when commodity prices are high, but the growth tends to be unstable, and concentrated into few sectors and regions – a consideration that has particular weight given the geography of Russia. The export-oriented part of the economy is closely linked with the world and particularly European economies, generates the available export revenue and underlies the financial sector. At the same time, it only provides a limited number of jobs. For most of the population, the dual economy offers low incomes generated by enterprises and public sector entities protected by an undervalued currency and possibly by other restrictions of foreign trade and payments.

As a predominantly insider owned economy, Russia suffers badly from the lack of investment resources held by the owners, i.e. managers and employees. They often also have the wrong incentives as they tend to regard their property rights much more as a matter of power, privilege and implicit employment guarantees than as a competition-created obligation to create additional wealth. Outside investment, even normal banking relations, are more usually than not seen as a threat to ownership position, not as a way to raise funds for development. The 1998 banking crisis tended to strengthen such attitudes at the same time as it weakened the oligarchs and their banks – that is the institutions and people that might be the foremost alternative to insider ownership. Insider ownership remains in terms of numbers of jobs and production entities the rule. The oligarchs and other outsider owners have dominated the export oriented sector. That, as noted, does generate a large share of Russia's GDP, but only few jobs in a regionally concentrated pattern.

As an economy largely based on non-monetary settlements, Russia suffers from a partial lack of the foremost benefits that Adam Smith diagnosed for the money-based economy. Transaction costs in barter are high, however much we might admire the often ingenious ways in which barter is organised in multilateral exchange chains. Even more importantly, in the extreme case of no money used, saving for future investment is next to impossible in an economy lacking the general store of value. Russia is not such an extreme case, in particular not after recent partial remonetarisation. Still, dollarisation, the use of monetary surrogates and outright barter are all hindrances in the way of developing a functioning system of financial intermediation. Like other countries, Russia would need financial intermediation for sustainable investment-based growth.

As a society based on continued fusion of economic and political decision making, Russia continues some of the characteristics of the Soviet society. True, the Politbureau is no longer in existence, but in a peculiar sense that is not only a blessing. Much economic and other decentralisation has taken place in Russia during the last ten years. As pointed out by Blanchard and Shleifer, contrary to countries like China, India or the United States, such decentralisation takes in Russia place in the context of a lacking nation-wide political system. No Politbureau, no nation-wide political parties exist to make sure that the crucial sub-national decisions are at least somewhat in line with centrally established priorities. Russia's local barons are therefore much less constrained than China's regional communist bosses or the governors of American states. They do not have to follow the party line. As Russia's regions are on the average small and poor, often dependent on a single or a few companies, the usual relation between economic and political power in the regions is all too close. The fusion of political and economic power – of might and capital – is true at the regional and municipal levels even more than in Moscow's federal centre. Here, much more even than in the centre, is the fundamental problem in Russia's admini-

stration, and this is the basic reason why Russia's regionalisation has – from the economic point of view at least – brought more negative than positive consequences.

Russia, like the outside world, has been slow in understanding that, but the conversion to the re-centralisation camp has now been surprisingly complete. There are, as well known, great political objections to attempted re-centralisation in Russia. The tensions between President Putin's political and economic goals are an issue that I must return to later on. There is also a practical issue. The Humpty Dumpty of centralised Russia has had a great fall, and the question is whether all the President's horses and all the President's men could put Humpty Dumpty in his place again.

As an emerging dual economy, Russia is deeply divided. The commodities-based export sector is closely dependent on the global economy, primarily Europe, where the harbours are and the pipelines go into. The export sector enterprises are basically outsider-owned. They used to provide the materials for Moscow's stock exchange. It is also here that expectations for the potential of foreign direct investment are the greatest – but also where the room for disappointment has been the biggest. The domestic-market sector, now protected by an undervalued exchange rate, on the other hand, is where most jobs are. This sector provides low wages and salaries, but also much of the remaining social benefits. The contrast in Russia is not as glaring as the one between the silicon valley of Bangalore and most of India's manufacturing industries – not to bring agriculture into the picture – but the structure is quite similar.

#### How might the system perform?

As just mentioned, it is possible to see this set of economic structures as a peculiar economic system, or at least as a subsystem of market economy. If this view is accepted, one must take a sombre view of Russia's economic future. If basic economics is anything to go by, the Russian market economy has characteristics that condemn the country to low productivity, at best low growth and continuing falling behind of Western and Central Europe. The welfare gap reaching from Kirkenes in Norway along the Finnish and Baltic eastern borders further south is already one of the steepest in the world. There is an incomes divide, but also a normative divide, as the rules of the game differ in crucial respects. As Russia risks missing the current industrial revolution, a digital divide is also emerging in Europe.

This is not a desirable future, neither from the point of view of the needs and aspirations of the Russian peoples, nor from the point of view of international division of labour, nor thinking about the efficient use of global resources. A Russia that continues to waste scarce resources while producing low incomes and very wide welfare differentials would be a major problem, not least to its European neighbours. Therefore, one must call for a rational utilisation of the political and economic possibilities that now exist. A new wave of economic reform to prevent Russia from remaining in the current low-productivity equilibrium just might be feasible. Feasibility would follow from the good state of the economy – that creates breathing room for choice – and political stability – which might provide the capability and willingness to take the chance. A new wave of economic reform would surely be very much necessary, if the analysis sketched above is accepted.

Naturally, not quite everybody accepts it. The alternative view, held by a vocal minority abroad and by many in Russia, argues that the specifics characterised above are basically just temporary phenomena, the birthmarks of the new Russia. This view – Russia as an ordinary market economy in the making -- would add that each country is specific. As most country specialists on Russia are not conversant in other cultures, they are all too easily misled into believing that Russia is the only peculiar country. In fact, this view argues, Russia is essentially not more different

than many others, and it is becoming less so as time passes and the laws of market economy force their way. We already see, such a proponent of this view as Yevgeny Yasin argues, a Russia where many enterprises are reacting rationally to market signals, where the federal power is no longer dependent on the oligarchs and where private investment is picking up. All is not yet normal, but everything is becoming much more so.

Which view, then, is the more justified one? Is Russia a peculiar market economy or simply an imperfect market economy? It would take a brave person to make a final judgement on this. Clearly, the following years will give a preliminary test result on this. If, for instance, the relative share of non-monetary settlements continues to decline, one celebrated Russian peculiarity would cease to be such. If Russian producers have utilised the possibilities offered by the recent undervaluation of the ruble for real restructuring, if they will be able to produce competitive industrial goods for the world markets, the clearly Russia will cease to look like a dual economy. Insider ownership may transform, and the fusion between might and capital just could be broken. These possibilities do exist. It may well be too early to tell whether Russia will remain locked in the present economic and political arrangements, but surely there should be little room for complacency. It is better to err on the side of too much rather than too little reform.

### The dangers of macroeconomic success

As incredible as it might sound given Russia's recent – and not so recent – history, complacency, however, must be the main danger at the moment. The Russian macroeconomy is in a better shape than it has been for decades. Since Summer 1999 GDP is booming, with an annual growth rate of 6-7 per cent. As the comparative base improves, growth will slow down, but the current forecasts for 2000 average 4-5 per cent growth. During the first quarter of 2000, industrial production was up by more than ten per cent, and the figure for April was still a highly respectable 5.5 per cent. Contrary to what one might expect, growth is not concentrated in the energy sector, which is actually quite stagnant. The industries booming range from the light to forestry and minerals. Current growth thus has quite a wide base.

Not only is production increasing, so are investment, real incomes, consumption, tax revenue, official reserves and the use of money in the economy. Inflation is under control, and inflation expectations are low. The exchange rate is under the keen control of the central bank, but faces pressure to appreciate. Official reserves are already high relative to imports and continue to climb. The dollar value of Russian exports during the first quarter of the year was about fifty per cent higher than the year earlier. Imports stagnated, with growth under five per cent. Net exports, which contributed a surprising 16.3 per cent into 1999 GDP, were even higher in early 2000. This is huge in comparative terms and in all probability cannot continue. But, as just mentioned, overall the growth pattern is acquiring a wider base than just import substitution. It is now also based on higher incomes, consumption and investment. Or so it at least seems at the very moment. Real consumption expenditure has now reached the average 1997 level and looks set to continue growing. Investment, however, is still lower than in 1997, and its growth does not look as stable as that in consumption. But investment does seem to be growing, and that should be a positive sign of sustainable growth.

Altogether, a five per cent GDP growth this year is feasible. Very probably, growth will remain respectable in 2001. As there must be at least some ruble appreciation, Russia as a market place will grow even faster. With imports of about 40 bln USD in 1999, it is a minor market of only marginal importance to Europe, but at least it promises finally to turn the trend after the import collapse caused by the 1998 crisis. For a few European countries at least, like mine, Russia's growth might have a macroeconomic relevance even in the short run. Finland exports about four per cent of her total exports to Russia. This might quite easily increase to – say – ten per cent.

The only complication is that Finland is already risking overheating relative to the Euroland, as the Finnish GDP is expected to grow by more than five per cent this year. But then, Russia partially demands goods other than most of our markets.

Russia's growth spurt might not be surprising for a market economy that had a 70 per cent nominal devaluation. But we should remember that only little more than a year ago expectations for Russia were quite different from today's facts. The IMF made what must be one of the major forecast errors in recent history in March-April 1999 by missing Russia's annual GDP change by ten per cent points. GDP did not decline by 7 per cent as expected, it grew by 3.2 per cent. Such a mistake by the institution with unrivalled access to economic data and huge experience across almost all the economies in the world calls for an explanation. As an IMF self-analysis does not seem to be available, I must provide my own guesses. At the same time we get one possible basis for assessing Russia's immediate economic future.

### The peculiarities of Russia's economic growth

The first mistake made by observers was to underestimate the degree to which there is a macroeconomic consensus in Russia. Whatever the actual implications of the proposals put forward by such economic luminaries as Academician Dmitry Lvov or Dr. Sergey Glaziev, the main Communist spokesman for economic policy, no politically responsible force – and that includes the parliamentary communists – would in a position of power any longer argue in favour of high and variable inflation, unstable exchange rates and large budget deficits. That is a major positive change compared with the early-to-mid 1990's. At that time influential decision makers still argued that large budget deficits would not lead to inflation but to growth. Such a bastard Keynesianism must have made bones roll even in Cambridge. Fortunately, there has been a learning process since. This was a learning process that would have unnecessary without various Soviet inheritances and was surely one of the most expensive ones imaginable, but at least it is one that seems to be a past concern now. I cannot really imagine a future Russian government that would knowingly repeat the mistakes of the early-to-mid 1990's. Recent history offers a good illustration of this.

When the Primakov-Maslyukov government came into power in Autumn 1998 it promised all kinds of things. A most severe macroeconomic imbalance was in the offering, but fortunately the promises given were not kept. Partly therefore, the Russian economy did not collapse. But real incomes did collapse, and so did private consumption. The willingness of the government to preside over these developments with little actual effort to change matters was a great surprise. This was, after all, the most leftist Russian government so far. Accepting the collapse in incomes did away with the risk of a proper inflationary spiral, and the real exchange rate has remained depressed. It seems to be almost globally accepted now that the ruble was overvalued before the crisis. It is however very difficult to determine equilibrium exchange rate for a commodities-based economy. The evidence for an overvalued ruble before October 1998 should not be regarded binding. But quite clearly, the ruble is now undervalued. An undervalued currency leading to import substitution that more recently has fed into consumption and investment is the basic explanation of Russian growth. The Russian governments have handled the post-devaluation situation much better than the IMF or others could expect. In the case of the Primakov-Maslyukov government, they did that by abandoning their announced principles. This is one source of the recent forecast errors.

But the growth has another pillar as well. The Russian government has provided major indirect subsidies for industries, municipalities and households by keeping domestic energy and utilities prices very low indeed. This subsidy is major cost in shadow prices sense, and it should not be continued, as it creates perverse incentives for energy users. The price of oil is less than half of

the world price, and elsewhere the difference is even greater. There has been progress in that payment arrears and barter – always concentrated around the energy and utilities sectors – have diminished. Much of that implicit subsidy – earlier estimated at about ten per cent of the GDP -- has disappeared. But as the world market energy prices are now high, the price subsidy has ballooned and still remains huge in spite of the quite modest price increases of May.

It may be remembered that Yegor Gaidar later deemed two of his 1992 mistakes the most serious of all. One was to have Viktor Gerashchenko as the central bank governor. Gerashchenko has changed in many respects, but is still the governor in 2000. The other main mistake Gaidar diagnosed was to keep energy and utilities prices frozen. The implicit subsidy is also still here.

The third pillar of recent growth, naturally, are high commodity prices. The importance of oil price alone for Russia is easy to exaggerate, but taking into account oil products one can crudely estimate that one dollar in the barrel price of oil equals a billion dollars in Russian export revenue. As the oil price increased from around ten dollars to almost thirty dollars, that created about half of Russia's trade surplus. The prices of minerals, metals and round wood – as a whole almost as important for Russia's exports as oil and gas – are also high.

Russia has thus had good luck – high commodity prices -- and good policies – the willingness to maintain a depressed income level and real exchange rate -- but also good institutions at least in the sense that many enterprises have been willing and able to utilise the market signals created by devaluation and the policies that followed. Clearly, many enterprises have acted as normal market agents should. This is the fourth pillar of recent growth. But adaptation is not true of all the enterprises. Yevgeny Yasin, the godfather of Russian economic reformers, estimates that up to forty per cent of industry and most agriculture is a non-market sector with little attempt at adaptation. These enterprises make a loss and only remain afloat because of indirect and direct subsidies. They are a drag on Russia's growth perspectives but also a major social problem.

Also, while many enterprises have been good at import substitution after a huge devaluation, there is little if any evidence of new competitive export products. That in fact would be the final evidence in favour of true restructuring in Russian industry. But for the time being the jury is still out.

World commodity prices will not remain at their current heights for ever. Actually they are probably too high for Russia's true best. With high export and tax revenue, the feeling of complacency may well overtake the perceived need for further economic reforms. Lower oil prices would be better for Russian reforms.

Neither should current subsidies via low energy and utilities prices and otherwise be continued. A number of observers claim that energy availability might well become a growth constraint in the absence of very major investment in the sector, if both current energy use patterns and economic growth continues. Better incentives in the form of higher prices – and an obligation to pay the bills – are therefore badly needed. More sensible prices and a reform of the energy and utilities sectors must be a high priority for Putin's government.

Last but not least, though the authorities seem to plan for the current real exchange rate for the next year or two, maintaining undervaluation might prove impossible if the economy continues to grow and attracts possibly major inward capital flows. Managing inward capital flows will prove particularly difficult given the dearth of monetary policy instruments available to the authorities. Real appreciation probably must be accepted, as growth based on undervaluation is also undesirable from efficiency, structural and welfare points of view, as a large amount of evidence from various countries shows.

Though the current macroeconomic situation is positive to an unprecedented degree, managing it in the immediate future will provide major challenges. One issue is the degree to which the Ministry of Finance and the Central Bank will be able to cooperate.

### Sources of Russia's future growth

There are three competing views on the possible sources of economic growth in Russia. One view is held by such leading economist academicians as Dmitry Lvov and also by many on the political left, like Sergey Glaziev – formerly Lvov's star pupil. This view argues that the USSR did leave Russia a valuable and until now sufficiently competitive capital stock, especially in the military industries – or high technologies, as the proponents usually prefer to put it. The task, therefore, is to increase capacity utilisation, which happens through demand management and increased money supply. Somewhat paradoxically perhaps, the proponents of this view argue that the “so-called” – as they would put it – reforms in Russia have failed on a tragic scale. Still, increased capacity utilisation is possible as long as the Soviet inheritance continues to exist.

Another view might seem a variant on the first one, but actually leads to very different implications. The McKinsey Global Institute report of October 1999 argued that indeed it is possible to increase capacity utilisation in a major part of Russian industry with only minor investment. Contrary to Lvov and Glaziev, however, McKinsey underlined that better capacity utilisation can only happen if there is fundamental microeconomic reform that produces much better management and corporate governance than exist today.

In spite of the important difference there is a communality as well. Both of these views argue that similarly to an arch-typical Central European transition economy – say Poland – in Russia as well growth can be driven by exports and domestic consumption. Capacity utilisation will be improved first and investment will follow. The third view, proposed in Russia among others by the above-mentioned Yevgeny Yasin, challenges this comparison. The distance of the USSR from the market economy was much wider than that of Poland. Structurally, much of the inherited capital stock is now useless, and the low level of investment recently implies that much is also becoming technically obsolete. Therefore, contrary to Poland, most growth in Russia should be investment-led.

The devaluation of 1998 was such a shocking intervening factor that the experience so far does not make it possible to choose between the three hypotheses. Investment has grown, but not very steadily. One should also note that almost all investment is financed out of retained earnings. There is no functioning financial intermediation, as the still unreformed banking system only settles payments. Almost all savings are in the Sberbank. It is majority owned by the central bank and does supply credits, but in a way lacking all transparency. As almost all investment is financed from retained earnings, the productive structure of the economy tends to suffer from inertia. In particular, it is very difficult to establish new entities, as it is hugely easier to have finance – say -- for forest harvesters than internet companies.

Therefore, those are very wrong who argue that the last two years show that Russia can grow without a banking system. Banking sector reform should not have a low but a high priority. It is not something that can be left waiting for the future. Doing that would not only carry all the usual risks of postponed decisions. It would also tend to freeze the existing industrial structure, largely inherited from the Soviet past. The problem is that reforms that include bank recapitalisation are quite expensive, that the Russian Central Bank is not particularly co-operative or innovative in these or other matters, that banking is a highly political industry in Russia, and that

some vocal voices, like the present economic advisor of the president, call for ending any official supervision of banks.

### The Putin factor

Let me, for a moment, leave the purely economic aspects of Russia and turn for a moment to the current political ramifications. They simply cannot be left out of the picture, given the political and possibly political economy turning point that Russia is experiencing. The key question is the person of President Vladimir Putin.

Sufficiently is probably known about President Putin to facilitate some hesitant conclusions about the impact that his person might have on economic policy making and the political economy of Russia. Clearly, he is a person who believes much more in order and discipline than in the Schumpeterian evolutionary processes. He thinks in terms of hierarchy, obedience and loyalty, not in terms of competition, creative destruction and creation of information. Quite as clearly, he is not a person with strong economic convictions of his own. True enough, his recent curricula do claim that he has an economic education, from the St. Petersburg Gornyi Universitet, with a degree dated as recently as in 1996. This interesting detail seems to be recent addition to his earlier exploits.

Putin aims at a greater Russia, and sees himself as the vehicle for that. Therefore, anything that promotes Russia's greatness by improving his control of the nations and the state is a useful tool. At the moment at least that means mainstream liberal views, probably not because Putin would be a convinced liberal even in the economic sense of the word, but because the trusted people from St. Petersburg fundamentally are economic liberals -- or security specialist. If they fail to deliver results, Putin will change horses. That is probably one thing that Putin might do when policies fail to produce the hoped-for results. The other alternative in face of adversaries -- given what would seem to be Putin's psychology -- is to push harder, to give stricter commands. This will be Putin's problem for the first time in his career. He has failed before, like in the end of his intelligence career in East Germany. But that -- like failures in St. Petersburg -- was overwhelmed by the collapse of the environment. Now the policies will be decided by him, not by a superior bureaucrat.

Vladimir Putin, as has been pointed out often, was never before an independent decision maker. It remains to be seen whether he will actually become one. He probably became president because he offered better promises of a secure future for the Yeltsin circle than Stepashin was willing to do. Putin is also stronger in other respects. He has established a government with no personalities nearly strong enough to compete with the president but with a coalition of different backgrounds and views. He clearly wants to be in control himself. The promised dictatorship of the law is therefore in the end highly personalised. Russia's greatness is the ultimate goal. Putin is the chosen tool for that. What is good for him, must be good for Russia. Breaking an opponent that does not understand that becomes not only a matter of honour but also a matter of destiny. Even worse, Putin the lawyer has claimed that those breaking the law should not expect to be handled in a legally based way. Worrisome examples of that have already been seen.

Like all politicians, Putin made any number of contradictory promises before becoming the president. Most importantly, he has offered the perspective of post-revolutionary stabilisation to a society that can -- he argued in the Internet Manifesto -- no longer take any additional shocks or convulsions. But such a promise, as understandable as it is, ends up being in conflict with his view in the very same manifesto that given the present system and structures, Russia risks becoming a third world country. If the current state of affairs needs replacing, the only way to try and do that without any shocks probably is through a well thought-out and consistent gradual



reform strategies. Step-wise change over eight or eleven years, not a one-time second wave of reform, seems therefore to be the best that might be in the offering. The worst, no doubt, would be a withering away of reform efforts after a few more or less inconsistent beginnings. But the Putin presidency seems insistent on doing something, perhaps even a lot. Therefore expecting the worst at this point of time would be premature.

There are naturally other reasons as well for expecting a step-wise effort rather than a second wave of economic reform than the possibly inconsequential conflict between the different promises given. The government now in place is a coalition, and expecting much radicalism from it would probably be unrealistic. Even the mainstream economic liberals share the rejection of additional shocks at the moment. In fact, few among them subscribe on the policy level – though they might well do so on a more theoretical level -- to the view of Russia as a peculiar market economy. Most tend to think that basically Russia is on the right tracks. The one true radical among the liberals, Andrei Illarionov, is quite isolated and probably without much influence.

Prime Minister Kosygin and General Secretary Gorbachev failed in their attempts at gradual reform, partly for lack of political support, partly due to muddled thinking. In Putin's case, the crucial political problem should be the relation between the centre and the regions.

Putin has made, with good economic grounds, an economic re-centralisation of Russia a prime priority. Russian decentralisation is fiscally unsustainable. It risks further dissolution of the Russian economic space. The fusion of might and capital at the sub-national level contributes greatly to insidership, corruption, the prevention of new private activities and other prominent economic (and political) problems of the country. Politically, re-centralisation is a much more risky endeavour. From the economic point of view the crucial question is whether it will be possible to re-establish centralised order after everything that has taken place since the second half of the 1980's. Whether attempted re-centralisation will not lead to additional political uncertainty is also an economically relevant question. This is after all also – perhaps primarily -- an issue of power, wealth and privilege, not only an issue of economic technocratic rationalism.

In all probability, Putin as a person is a mediocrity. None among those who came across him in past years remembers him as a brilliant personality. This is not a de Gaulle. He is remembered as somebody who is the colour of the wall, a good listener, and one that keeps his promises. Loyalty is the supreme virtue expected from others as well. Putin spent at least sixteen years in a profession of his dreams, witnessing collapses: of the USSR, of East Germany, of Sobchak, and of Yeltsin. He had a modest career until very recently. But perhaps he will prove to be a Stalin or a Helmut Kohl, one of those who thrive by being underestimated.

Putin has been criticised for having been very slow to get his policies started. It is true that until the tax reform programme was presented very recently, he had done next to nothing for the economy. Even the tax reform is a policy that he very much inherited from the previous governments. The unfriendly interpretation says that Putin has been primarily involved in various publicity gimmicks: flying in a jet fighter, spending a night in a submarine, trying to ride a Russian-made tractor – which failed to run and was substituted by a German make. The friendlier interpretation would say that he has been planning: planning a campaign against the regional bosses, against the oligarchs, perhaps planning what to do with the bureaucracies. At least the campaign against the regional bosses is underway just as it probably should: keeping the opponent unaware of the next step.

### Programmes

Programmes, even reform programmes have never been in short supply in Russia. The Moscow chattering class is able to produce any number of them, for almost anyone. The main end-result is not the lengthy document written. More than anything else, the process of programme writing is a chance to re-establish the pecking order of the advisory establishment. This has been true this Spring as well.

Quite simply, Putin seems to have had the choice between liberal and ultra-liberal views. Though the left-wing, populist and nationalist views remain, as seen above, prominent in the academia and in the Duma, very little of their offering has entered the economic policy forum of the government. As mentioned above, there is a widely-shared consensus on basic macroeconomics. It seems that views have been converging on structural reform issues as well. Or perhaps the non-liberal forces are just incompetent enough to be unable to challenge current Russian reform thinking. They might also be biding their time.

The probability is that the Gref programme will be adopted by the government in some further diluted form. This programme – which I have not seen – might have two major problems. While its underlying thinking is probably correct, the programme might suffer from a lack of clear priorities and sequencing. It aims to do everything. All too often, that implies being unable to do much of anything. That is in particular the danger if the campaign against regional bosses – which seems to have the political priority now -- ends up creating instability and tying up too much time and effort.

There are bound to be different views on what the economic priorities should be. There is much commonly shared emphasis on the need for a tax reform. The tax reform programme is probably more ambitious than was generally expected. It also has a fair chance of being accepted. This is an issue on which views have been converging and the proposals now presented have been written in consultation with the Duma. Two other structural reform issues that should have a high priority are the banking sector and non-monetary settlements. These might well prove harder ones to crack. The first issue faces, as pointed out above, lack of resources, a foot-dragging central bank and a highly political environment. The second one is an issue of large-scale subsidies, of well-established behavioural patterns and of the energy and utilities sector, the largest and most obvious source of wealth of Russia. Both the banking sector and non-monetary settlement also present notable reform problems of a purely technical character.

### The lure of the authoritarian temptation

The second underlying weakness of the Gref programme and related thinking is an instance of the lure of the authoritarian temptation. Economic policy debates in 2000 have been notably technocratic. The tensions between Putin's promises of political authoritarianism and political liberalism have been largely bypassed, though there have been some notable exceptions. That may prove dangerous, also from the purely economic point of view.

Since the 1980's, there has been much talk in Russia about the Pinochet option. In short that is an appellation to combine political authoritarianism with economic liberalism. But, as we know, Russia is no Chile. In Chile, securing the support of the middle classes for political authoritarianism was possible given the thorough way in which the Allende socialist experiment failed. In Russia, the politically active segments of the society have for a long time very much preferred to have political and social freedoms, and the Yeltsin years were not for them such a failure that would seem to justify the loss of gains won in those respects. It is also more than questionable whether Putin would have the necessary support of the power ministries for a true political crackdown. If the argument above about Russia as a peculiar market economy has any truth, economic liberalisation á la Pinochet comes nowhere near to accomplishing what should be done.

Russia needs both domestic and foreign resources for investment, and neither is likely to be available in a necessarily unstable authoritarian environment – especially after the lessons of Southern and South Eastern Asia. But on the other hand Russia's predicament is potentially much more dangerous than that of Chile. Russia is a former superpower, now a lopsided great power in the state of humiliation and involved in a regional civil war. The risks are quite different from those in Chile.

Neither, as was discussed above, is Putin a Pinochet, not to mention a de Gaulle. But the most convincing argument against the lure of the authoritarian temptation must be elsewhere. Quite simply, successful combinations of political authoritarianism and economic liberalism are rare. Usually the leaders who want to be authoritarian in politics end up being that – or at least practising cronyism – in the economy as well. There is nothing in Putin's person that would indicate his regime as being potentially one of those rare exceptions. The authoritarian temptation naturally assumes that Russia will in the end indeed be one of those exceptions. It would end up being much closer to Chile or China than to Indonesia or the populist states of Latin America. But there is no visible evidence to support such an optimism.

Perhaps the main background for such optimism is elsewhere. The mainstream liberals, now posting up as Putin's advisors, are the very same people that served Boris Yeltsin in various capacities. They do not admit having failed, but they do admit that there is some work left to be done. Why not be the one pushing it through, even in a politically risky environment. And at least some of them would have preferred a strong arm solution in the first place, as an anti-communist expediency. Now the enemy may be elsewhere, but he still exists.

#### Europe and Russia in the early 21<sup>st</sup> century

My working hypothesis in early June thus is that we shall see more step-wise reform measures than any second wave of economic reform in the beginning of the Putin regime. If the known facts change, I reserve the right to change my hypothesis as well.

While Russia's economic growth would seem to be certain for the next couple of years, what happens after that is a matter of guesses only. The sources of growth so far -- undervaluation of the currency, subsidised production, and high commodity prices – will probably not remain for long. Neither should they, for reasons briefly outlined above. The questions then are a few. How much real structural reform is taking place in Russian industries? Will a system of financial intermediation be established? What will be the saving behaviour of Russians, and where will they invest their resources? What happens in the interface between Putin's political authoritarianism and current economic liberalism? How does he react when challenged and defeated – be that by inertia, policy failures or active opponents? Surely, none of us can claim to know the answers. The years ahead will be hugely interesting.

But they will also be challenging and may even turn dangerous. The question again is what should the international community and in this case Europe in particular do – remembering that doing nothing is also an act, and therefore best done consciously.

To start with an utterly unfashionable statement: the Russia-policies of the international community during the last ten years have in many respects been successful. The potential threats posed by the Soviet collapse have been minimised reasonably well: Russia's nuclear arms control record is much better than it could have been, her relations with neighbours remain basically peaceful, and in spite of a few well-known frictions Russia has basically been a responsible member of the world community. This is obviously for the most part the work of Russians themselves, but the least that can be said of the outsiders is that we probably have not made matters much worse.

Saying that does not mean denying that we could have done much better. The prostitution of the international financial institutions by handing de facto almost free money to Russia is a prime example of the kind of mistakes that were committed.

One can continue with the list of mistakes: overzealous support of almost any of Yeltsin's policies, based on the utterly mistaken assumption that there is a serious risk of communist comeback; uncritical support of Russia's regionalisation assuming that being more local means being more democratic and therefore better; the failure of the European Union to adopt any meaningful common policies in the case which must be the prime challenge to common foreign and security policies; and the inconsistency of our trade policies. Our track record is not a brilliant one, and the major consolation must be that probably none of the failures mentioned had a major impact on Russia. Russia was never ours to lose. We should proceed with great humility in the future as well. Our potential impact is probably a very minor one, and we have the tendency to commit mistakes.

There will, naturally, be another IMF stand-by facility by the Autumn. Given her current balance of payments position, Russia does not really qualify for the money. The IMF exposure in Russia, on the other hand, has declined from almost 20 bln USD to less than 15 bln USD. The IMF is currently not short of money, and they can well afford to have another programme. They also want to continue economic policy dialogue with Russia. The USA and possibly the rest of the G7 also want the IMF to stand by, in case a real need would arise. The Russians, on their side, understandably want to have the stamp of policy acceptance that an agreement with the IMF will provide. They also volunteer for the money, if it is cheap enough.

Europe has, as far as I can tell, never had a common actively pursued policy line vis-a-vis Russia at the IMF. I would be surprised if such a line would be available this year. The Paris club negotiations promise to become another test of European solidarity. As Germany owns almost one half of the old Soviet debt under discussion, their reluctance to accept a write-off is understandable. The case against a write-off becomes overwhelming as one looks again at Russia's balance of payments, and compares her with many of the other countries in the world, for whom a write-off is not in the discussions. But there is always the possibility that one or another European country, lacking almost any debt under discussion but having the need to be seen establishing a special relation, just might join US on this issue. The alternative to write-off is another debt restructuring. Surely there will be another restructuring, and then another after that...

### Lessons of the Cheshire-Cat

These are questions of the immediate future, but my adopted title asks me to cast a longer look. The key, naturally, comes from Oxford, from a one-time observer of Russia all the way down to Nizhnyi Novgorod. That, naturally, was Charles Lutwidge Dodgson, the mathematician at Christ Church for forty-seven years, also known as Lewis Carroll. You will remember that long after Alice had fallen down the rabbit-hole, she becomes acquainted with the Cheshire-Cat. "Would you tell me, please, which way I ought to go from here?", she asks. The Cat, sensibly enough, counters that the answer "depends a good deal on where you want to get to". Alice just wants to get somewhere, anywhere from where she is just then. "Then it doesn't matter which way you go", the Cat sums up the basic lesson of goal-oriented management. – I wish to point out that the relevance of the Cheshire-Cat for Russian studies was pointed out to me by the past Alec Nove many years ago.

The transition record so far is divided into two wide groups. The Central Europeans, naturally including the Balts, knew where they wanted to get to. They wanted to become again ordinary European nations, to return to Europe, as the slogan put it. In practice that implied the willing-

ness to join the Euro-Atlantic alphabet soup of organisations as soon as possible. To join any of these clubs – the EU, OECD, NATO and so on – the candidate has to obey the rules, and commit herself to the goals earlier adopted by the incumbent members. In the case of the EU alone that is, as we well know, the *acquis communautaire* of some 80'000 pages. Candidates, as we also know, are monitored more closely than established members, and operationally the goal of joining the clubs creates a conditionality of policies and institutions that is hugely wider, deeper and more comprehensive than anything that the international financial institutions could ever offer. The *acquis* may not be God's words – being on these Isles I am ready to admit that much -- but it is a relatively consistent model of large parts of an economy and society. The model has been proven feasible and is probably not without all merit. Therefore, if a ready-made model exists, why should the Central European have done else than adopt it. Doing otherwise would actually have amounted to a dangerous experiment *in vivo*.

What the existing economic research on determinants of transition performance probably primarily shows is the usefulness of policy consistency. The perspective of EU membership, with the self-adopted conditionality provided by the *acquis*, is the only available outside policy anchor that is truly encompassing. But contrary to the Central Europeans, that was a conditionality not available to Russia. Almost all Russians think that she was never an ordinary European country; most of them think that she will never become one. That would seem to exclude the possibility of adopting the conditionality of the *acquis* as the policy anchor. Unfortunately all the talk of Russian exceptionalism – the core of Russian letters during the last two centuries – has never come close to offering an intelligible answer to what the proper goal then might be. Russia has been like Alice, not knowing where to go, but usually unwilling to stay where she is. It has not been like choosing any road, as there has been a large degree of learning, as emphasised earlier. Still the lack of a visible operational goal has surely contributed to policies that have been short-sighted and easily captured by the currently dominating elite group interests. The Cheshire-Cat has an important message to Russian policy makers.

I have no intention to argue that the sketch just offered comes anywhere near to catching the complexities of the Russian policy process. Even so, I remain convinced that it matters whether one has a goal or not. The kind of goals pronounced in the 1980's and the 1990's in Russia – becoming a normal society etc – are far too devoid of contents to fulfil the role of a consistent outside anchor. In this respect, EU membership is the only game in Europe.

In 1997 Boris Yeltsin actually said that membership in the Union is Russia's goal. Few took that seriously, and in deed most of us share the idea that Russia will never become an ordinary European nation. There has again been much discussion in terms of Westernizers vs Eurasians in and about Russia. By now it clearly seems that the musings of Eurasianism will have little if any relevance under Putin's regime. Whatever else he may be, he is a European. So is Russia: just look at the statistics of trade, investment, finance – almost anything excepting the self-orientation of Russia's youth, which is quite American. But so is the self-orientation of other European youths' as well.

Naturally, one should be careful here. Some 70 per cent of Algeria's exports go into the Union. Few would characterise Algeria as a particularly European nation, and fewer still would argue that she should be offered the perspective of EU membership. But then cat of a wide Union is out of the bag. People will argue whether she escaped when Britain and others became members almost a generation ago or whether that happened when the accession perspective of Turkey was reconfirmed very recently. But as we say that Turkey could become a member, what rational grounds exist for saying that Russia will never become a member? I for one cannot think of any such grounds. But what we have been saying for years is exactly that Russia will never, never, never become a member. Hopefully we have been doing that without understanding that actually

we have sent the message that Russia should not even aim to become a truly European nation. Can we seriously think of a signal creating worse incentives than that one? I hardly can.

Saying what I have said leaves room for fatal misinterpretations and I wish to clarify at least some of them. What I – and some of the best European experts on the Russian economy that have said this before me – am saying should not be construed as a membership offer. Neither Russia nor the Union would be ready for that. Such an offer would be utterly unrealistic. It would also be irresponsible, as nobody should make promises that are unrealistic. Honestly, I do not think Russia will become an EU member in any time perspective that might be of interest to us. As a Finn, even the idea of free mobility of labour makes me shudder. As an economist, I can see the remaining complexities before Russia can even become a WTO member, a first step on a very long road forward. But the issue, I want to underline once more, is not about promising membership. The idea is about signals and incentives, about saying that if you fulfil the same membership criteria as all the others, you will become a member. We may not believe in Russia's capability to fulfil such criteria, but we should send the right messages. Saying that you will never, never, never become a member is just saying that you are not one of us. They could not be EU members in the foreseeable future, but still that is the distant goal towards which to aim.

In fact, the relevant goal might not be EU membership. A better goal might be, as argued by Vladimir Mau, becoming consistent with the *acquis*, where the political choice is finally made for membership or not. Like in the case of Norway, there may be reasons why a country may not choose to become a member. It would make little sense for Russia to aim at copying Common Agricultural Policies or regional cohesion funds. There is little reason why the Union should even contemplate common security policies in Northern Caucasus. In the end, there may be numerous areas where Russia may judge that the *acquis* is simply not suitable for a country with Russia's dimensions and resource endowments. But still, as a general goal for the Russian society, nothing better is available.

If there were a choice between a Russian Russia and a European Russia, my preference is for the latter. I know that the chance may be a small one, but I remain convinced that we should still aim at it.