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Russia's Economic Strategy
(Basic Premises)

The general logic of the strategy for the country's development in the 21st century arises from the following postulates:

- The Russian economy is part of the global economy. **In the 1990s the extent of Russia's involvement in global economic processes grew significantly, and this occurred, first and foremost, as a result of the formation and development of the Russian private sector. Indeed, it was at the level of the private sector and among certain segments of the population that Russia began to resemble the rest of the world in economic and cultural respects, even if this did express itself in such exotic forms as the export of capital or the smuggling of Iraqi oil. At the state level, though, the pace of integration lagged behind considerably.** Following the collapse of CMEA [Council for Mutual Economic Assistance] and the Warsaw Pact, Russia, as a state, did not manage to define its place either on the political map of the world or the economic map, remaining an exporter of energy and raw material resources and industrial semifinished goods, and an importer of goods and services with a high degree of value added (including consumer goods). What's more, even the most general guidelines for the country's development have not been formulated to this day, and in effect the direction of the country's movement has not been identified—does the country intend in the future to seek a place in the EU, is the goal Russia's revival as a politically independent superpower, and so on. In other words, there are no clearly defined principles for the country's development in both diplomatic and geopolitical respects. As a result, Russia, as a sovereign state, stands alone both politically and diplomatically—although it does not have any clearly identified antagonists at present, neither does it have any obvious allies (with the exception only of Belarus). The country's authority in the world arena is steadily falling, which is creating certain threats not so much for the state as such, but for the development of private business, and its internationalization, and it is making things considerably more complicated for the country's average citizens, since as the country's authority declines, so does the state's ability to defend the interests of national business and private individuals at the diplomatic level[1]. The inverse correlation also holds, however. In a market environment the state cannot be strong without a strong national business sector.

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[1] The detention of a Russian ship by U.S. naval forces in the Persian gulf is yet another example providing confirmation of this.

- In addition to this, more and more of the Russian population is measuring its quality of life, and will continue in the future to compare its standard of living, the standards of everyday life, against the standards of more developed countries in the world (which, on top of all that, have by no means stopped their development). This is an objective consequence of the openness of the economy, and not just economic globalization, but cultural globalization as well. **Given the current level of openness of the Russian society and economy, the objective reality is that there will be further cultural and economic integration of Russian citizens and economic entities into the system of global cultural and economic ties. In this regard, the deepening isolation, the diplomatic "alienation" of the Russian state from the processes of making important decisions at the international level, the frequent disparity between the positions taken by the Russian state and those of the majority of countries around the world[2], the absence of a clearly formulated and at the same time realistic geopolitical doctrine that would be consistent not only with the country's potential level of development, but also its current level of development, runs counter to the trend mentioned above of increasing involvement by Russian private structures in global economic processes.** An analysis of the trends in world development over recent decades, globalization, and the ever-increasing integration of the economies of sovereign states into a single system of global economic ties, offers evidence of steady growth in the role not only of private structures (transnational corporations in particular), but also supranational entities—the EU, NATO, WTO, OPEC, ASEAN, and the like. With the exception of the United Nations, Russia does not play an active part in any such structures—in any event its voice is far from decisive in the decision-making process.

- It is obvious that **the problem of restoring the authority of the Russian state in the international arena, and improving the standard of living for the country's people with a view to bringing it gradually closer to the standard of living in the most developed countries in the world, can be resolved only if there is a strong, dynamically developing economy. Considering the current state of affairs, resolution of the problems facing the country will require rapid economic growth based on greater production efficiency, the creation of a qualitatively new economic structure, and modernization of the economy. This must occur against the backdrop of a progressive opening up of the country, since historical experience (including Russia's own experience) demonstrates that cultural and economic isolation is a sure path toward degradation of the economy, the state, and society as a whole.** Russian laws and the experience of enforcing these laws are such that at the present time the Russian economy is open at the exit points and remains fairly closed at the entry points, due to the fact that in practice the powerful limiting factor of arbitrary bureaucratic control and corruption plays a determining role. In this sense, the country

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[2] The striking disparity between Russia's positions and those of the G-7 countries, which are supported by the majority of European countries, regarding problems in the observance of human rights in Kosovo and Chechnya is a vivid example of this.

> can be considered closed to foreign capital to a certain extent—bureaucratic traditions that have been shaped over a period of decades, and corruption, which has in effect become the norm in the business world, are firm barriers blocking the penetration of foreign capital into the country. In addition, the exotic tax system and the high degree of influence wielded by criminal elements create the conditions for the export of capital out of the country—this is true both for money earned from criminal activities and for money that has been earned entirely legally. Decapitalization of the economy is the result. The gradual opening up of the economy should proceed not only through enhancement of the legislative base with a view to creating a state that is strong in legal respects and is capable of guaranteeing stability in the country, but also through the elimination of unnecessary bureaucratic hurdles, and efforts to combat corruption and criminal activity.

Point of Reference

1. The results for 1999 turned out to be the most promising figures not only of the entire reform period, but of the 1990s as a whole. According to preliminary data from the State Statistics Committee, the gross domestic product increased by 3.2 percent in 1999. Although the BEA's [Bureau of Economic Analysis] own figures show that economic growth was somewhat lower, this does not alter the overall qualitative picture of a statistically significant increase in production output in 1999. Growth in GDP was due primarily to growth in industrial output (which increased by 8.1 percent according to the official data). There was also an increase in production output in agriculture (by 2.4 percent), and investments in fixed capital grew as well (by 1 percent).

On the face of it, one can speak of substantial qualitative shifts in the economy—industrial output hasn't grown by 8 percent since the early 1970s. The last time there was an increase in investments was in the late 1980s (in 1990 investments grew by the statistically insignificant amount of 0.1 percent). It should be mentioned that in contrast to 1997, the resurgence, signs of which have emerged in the Russian economy in 1999–2000 after the prolonged slump tied to transformation processes and the profound investment crisis of the 1990s, is more sustained in nature and is due to a significant extent to the influence of internal factors, particularly the correction of the exchange rate of the national currency, which after the devaluation of 1998 corresponds more closely to the level of production efficiency that was reached in the late 1990s. In the future, however, it will not be possible to count on the devaluation effect. Growth should be tied to a reduction in costs, and an increase in production efficiency, which has not yet happened.

Although private consumption fell substantially according to the 1999 results (retail trade turnover dropped by 7.3 percent), this was the result of the sharp post-devaluation contraction of effective demand in 1998—starting in the second quarter of 1999 real income and consumer demand started to rebound steadily, creating the potential for positive dynamics in 2000. The level of aggregate consumption potentially could have been higher (both before and after devaluation) if there had been a more even structure for the distribution of income; however the reforms, in the form in which they were implemented, led to a situation in which approximately half of all current income was accumulated and is still being accumulated by the wealthiest 20 percent of the population in the highest income bracket. The concentration of a significant proportion of income in the hands of a relatively small group of Russian citizens substantially reduces the potential of mass consumer demand.

An improvement in foreign trade conditions also made a substantial contribution to the positive production dynamics and the improved financial position of a number of sectors of the economy—the rise in prices for energy resources, which began in March 1999, is continuing to this day.

Nevertheless, it is premature to offer an entirely positive assessment of the results for 1999, as well as the prospects for economic development in 2000 and subsequent years, since all of the quantitative improvements in 1999 must be viewed in the context of the profound economic crisis and production slump of 1998. In 1999, after all, the country in effect did not tackle a single one of the key economic problems, with the sole exception of the execution of the budget and shrinking the budget deficit (Figures 1–3 illustrate the relative improvement with regard to growth in the primary surplus and tax collection rate). Nevertheless, the budget crisis is far from over: all the improvements in the area of budget execution must be viewed in light of the fact that the budget is being executed under the conditions of a technical default. Considering the depth of the crisis, more substantial changes are needed.

Figure 1. Collection rate for consolidated budget tax payments

[horizontal axis:]
January
February
March
April
May
June
July
August
September
October
November
December

Figure 2. Federal budget tax revenues as a percentage of planned target (based on laws on the Russian Federation federal budget for 1998 and 1999)

[vertical axis:]
Proportion, as a percentage

[horizontal axis:]
January

February
March
April
May
June
July
August
September
October
November
December

Figure 3. Cumulative primary federal budget surplus

[vertical axis:]
billions of rubles

[horizontal axis:]
January
February
March
April
May
June
July
August
September
October
November
December

2. At the same time, **1999 is also revealing because during this period the basic contradictions and dilemmas of how Russia operates were vividly exposed, and it became obvious to the majority of experts and the public that it is impossible to maintain steady economic growth within the framework of the system that developed during the previous period (this pertains primarily to the institutional and structural aspects), which means that it also impossible not only to resolve social and geopolitical issues, but even to formulate them adequately.** One of these contradictions—the inconsistency between the depth of the private sector's integration into the global political and economic system on the one hand, and that of the state as such on the other, was mentioned above.

One can point to the substantial gap between the market exchange rate and the purchasing power parity of the ruble as an example of another contradiction that characterizes the presence of profound structural problems in the Russian economy. It should be noted that a significant gap between the market exchange rate of the national currency and purchasing power parity is typical not only of Russia, but of many other transition economies as well. The same picture can also be seen in developing countries. In Russia, however, this gap is clearly hypertrophied—according to estimates, in 1999 in terms of purchasing power parity the ruble exceeded its market exchange rate by a factor of approximately 5.5 (i.e., the same as in 1993–1994). In Eastern European countries, which have made more progress in the direction of reform than Russia has (the Czech Republic, Poland, Hungary, Slovenia), these figures differ by a factor of approximately 2. At the same time, in the majority of developed countries of the world with stable, functioning market institutions, dynamic economies, and mature financial markets, the purchasing power parity and market exchange rates are close to one another, while in the most developed European countries the market exchange rate of the national currencies exceeds the purchasing power parity, as a rule (Figure 4). This is due in large part to heightened demand for the currencies and securities of these countries on the part of nonresidents.

Figure 4. Average per capita GDP and ratio of parity to exchange rate by groups of countries

[solid bar:] per capita GDP, dollars/person

[line with diamond:] purchasing power parity/exchange rate

If the exchange rate of the national currency in nominal terms significantly exceeds the purchasing power parity, this is evidence of the presence of substantial price disparities and a distorted structure of comparative prices. In this situation prices for a number of goods and services may be comparable to world market prices, while for other groups of goods and services there is a substantial discrepancy (with regard to the Russian economy this applies, for example, to housing and municipal services or passenger transport services). This means that in effect this sort of economy is characterized by a high level of hidden subsidies, which in turn takes certain sectors of the economy beyond the boundaries of competitiveness, and deforms the structure of mass effective demand, since both consumers and producers receive distorted price signals.

A dynamically developing economy and effectively operating financial markets are the basis for stability of the national currency. Figure 4 provides an illustration of the connection between the level of a country's development, measured by the size of per capita GDP produced, and the ratio between the market exchange rate and purchasing power parity. In this regard Russia is confronted with a contradiction of the following sort: at the present time (in 1999), the country's average per capita GDP, calculated in terms of purchasing power parity, was on the order of US$6,725, that is, Russia could have been counted in the group of countries that were characterized by an approximately 2-fold gap (and not a 5- or 6-fold gap) between purchasing power parity and the market exchange rate. This approximate ratio was maintained in Russia before the 1998 crisis—in 1996–1997, when the gap between purchasing power parity and the market exchange rate was the smallest (Figure 5). It is typical that the highest level of activity on Russia's financial markets, which are an essential attribute of a market economy, occurred during this period, although the structure of Russia's financial markets during this period was extremely distorted.

Figure 5. Purchasing power parity and the market exchange rate of the ruble in 1993–1999

[left vertical axis:]
denominated rubles (1998) to the dollar

[right vertical axis:]
purchasing power parity/exchange rate

[key to symbols, left to right:]
purchasing power parity, rubles/dollar

exchange rate, rubles/dollar

purchasing power parity/exchange rate ratio

Thus, on the one hand, the ruble is clearly undervalued at the present time. On the other hand, given a stronger ruble, the real sector will not be competitive. Nevertheless, it is obvious that in the long run the ruble's exchange rate must rise in real terms, which will increase the level of competition between Russian and foreign producers of goods and services, with the greatest impact felt on the domestic market. In this sense it is entirely natural that in the context of continuing uncertainty regarding the prospects for economic policy and the potential for its implementation, and in the absence of structural reforms, the strengthening of the real exchange rate of the ruble from April through August of last year was not sustained—as soon as the growth in the money supply accelerated at the end of the year, excess liquidity appeared immediately on the exchange market, adjusting the market rate to bring it closer in line with the equilibrium rate.

The low cost of the ruble means that the volume of the ruble money supply is clearly not consistent with the scale of the economy of a country like Russia (at the end of 1999 the ruble M2 aggregate was slightly more than US$24 billion). A low level of monetization objectively means a low level of savings, it hinders development of the banking system, limits opportunities for lending to the real sector[3], and also limits opportunities for economic growth. A low level of monetization also makes the country extremely sensitive to external influences—the outflow from or inflow into the country of US$5–10 billion (which is negligible in global terms) could seriously destabilize Russia's financial system. On the other hand, it is obvious that currency emission in and of itself is not likely to revive the economy: the low level of financial and payment discipline, the lack of institutional reforms, the export of capital, and a number of other factors have created a situation in which a large proportion of settlements are effected in nonmonetary form throughout the economy as a whole, there is

[3] Of course, there are also other, more significant causes hindering the process of development of the financial system.

a lower demand for money, and there has been widespread displacement of normal monetary settlements in economic practice. As a result, excess ruble liquidity has just one place to go—the exchange market.

Macroeconomic imbalances in the monetary sphere are aggravated by the fact that against the backdrop of a low level of monetization, the outflow of capital from the country has not been halted. According to estimates based on balance of payments data, the annual export of capital from the country is on the order of US$20–25 billion. Widespread discussion of this problem, which existed throughout the 1990s, began only in 1999, after the devaluation, when the negative impact of the process of Russia's lending to the rest of the world was aggravated by an increase in the relative scale of this phenomenon compared to the scale of the country's economy (using the market exchange rate of the ruble). The export of capital continued in 1999 as well, which certainly does not reflect favorably on the government authorities that were responsible for the implementation of economic policy. In 1999 growth in GDP occurred against the backdrop of a marked reduction in domestic consumption and a negligible increase in investments, which was compensated for by gigantic net exports (according to estimates, the balance of trade in 1999 could reach around US$32 billion). Nevertheless, the country did not manage to pay off everything it owed to creditors, or to build up reserves. The direction of capital flows (financial resources flow into a country or out of a country) is an accurate indicator of the effectiveness of a state's economic policies, and a way to measure the level of confidence in the authorities. It is important for Russia not only to halt (or curtail) the outflow of capital, which theoretically could be achieved through administrative methods (within the framework of another political system, of course), but also to see a voluntary return of Russian capital back into the country in the future. This, however, will be possible only within the framework of a liberal economy and stable state authority under the conditions of a "dictatorship of the law," which will be attractive for foreign investors as well.

3. As a consequence, the crisis of authority and the economic crisis meant that the country's economy remained oriented toward the fuel and raw materials sectors, an orientation that had developed over previous decades. Rapid privatization of the mineral-raw materials and fuel and energy sectors of the economy allowed for the accumulation of significant material and financial assets in private hands, although as a consequence of the virtual impossibility of investing[4] in other, potentially promising sectors of the economy, its structure steadily deteriorated.

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[4] The Russian economy absorbed the minimum volume of investments required, which allowed it to meet the current needs of the fuel and raw materials sector of the economy, one that is oriented predominantly toward export.

Another contradiction of the economic reforms of the 1990s was the fact that a significant number of restrictions on economic activity within the country, including administrative ones[5], actually remained in place, while many of the restrictions on capital flows were lifted in a relatively short period of time. This led to a situation in which not only the import of capital into the country, but also investment in the Russian economy from domestic sources, did not make any sense; it made more sense to export capital out of Russia, which is what happened throughout the 1990s. To a significant extent this was due to the fact that as a result of the constantly smoldering internal conflict among the various branches of power[6], by the end of the 20th century the Russia state was unable to perform its primary function—to serve as a guarantor of the rule of law and stability (in one form or another), and to devise a predictable economic policy.

In spite of the failure to resolve a number of key problems, in a number of areas Russian reforms went further than in a number of other countries with transition economies. This is true for privatization and openness of the economy, in particular. Thus, the major dilemma at this point is how to eliminate the contradiction referred to above between excessive regulation of the economy, on the one hand, and its liberalization, on the other. Theoretically, this can be achieved by employing two methods: a) increasing the degree of state intervention, and b) further liberalization of the economy, eliminating the remaining barriers blocking access to markets, creating a genuinely competitive environment, simplifying the "rules of the game," and easing the conditions for economic activity.

The first of the options (which is, in effect, adoption of the concept of a mobilization economy) is not discussed in this document, since its implementation would mean new large-scale reforms not only of the economic mechanism, but the state's political system as well, which goes beyond the limits of the authors' knowledge. Proceeding from the realities that characterize the situation in the country and the world at the turn of the century, and also proceeding from historical experience, an orientation toward the creation of a liberal economic model with a fairly high level of competition, in which the state's intervention in economic life is reduced to a minimum, seems more reasonable. In this case the state has an even greater role to play as a guarantor of legal and political stability.

So far at least, the existence of these and a number of other contradictions is giving rise with increasing frequency to a desire to strengthen administrative control over economic processes—to impose administrative barriers to protect the domestic commodity producer from competition, to require exporters to surrender all of their foreign exchange earnings, to increase the ruble money supply at a faster pace in an administrative effort to cut it off from

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[5] In addition to the administrative restrictions, one should also take into account restrictions related to the activities of criminal elements, which in effect increase the tax burden on the producer, as well as corruption, the weak legislative base, and so on.

[6] Including the regional aspect of the problem.

the exchange market, and so on. One should understand, however, that if such measures do produce a positive effect, it can only be short-lived. It is not possible to lay the foundation for sustained economic growth that will continue for decades using tricks such as these. Sustained growth of the Russian economy, in the form in which its market principles were created in the 1990s, is possible only given the formation and development of all the attributes inherent in capitalism—a diversified financial market, legal and political stability, functioning legislation that provides reliable protection for shareholders' rights, and so on.

Thus, an essential condition for resolving the tasks facing the country is to provide for accelerated growth of the economy, achieved on the basis of:

- increasing the efficiency of the economy, building a market infrastructure, providing equal conditions for competition, establishing all-encompassing market relations;

- ensuring political stability and constant conditions for economic activity—stable and predictable economic policy; this applies in particular to macroeconomic policy, which should be transparent and comprehensible to all economic agents;

- fundamental improvement of the investment climate, assigning priority to the development of sectors that are capable of realizing Russia's competitive advantages (this applies in particular to sectors that are not capital-intensive, as well as production facilities where innovation potential could possibly be realized);

- balanced openness of the Russian economy and the utilization of its foreign economic potential, integration into the global economic system (including at the level of individual production facilities, which could join the system of international cooperation);

- creation of the social foundation for long-term, stable economic development—a middle class.

Basic principles of the long-term economic development strategy and objective limitations on its implementation

At the beginning of the 21st century, the country is truly faced with the real threat of ending up on the periphery of the civilized world as a consequence of its falling farther and farther behind technologically. The only way to avoid this is to move from stagnation to economic growth, which must be sustainable, and must continue to be so over a prolonged interval of time. On the other hand, the level of individual consumption (in terms of purchasing power parity) in Russia is half of what it is in the European countries, and one-fifth of the level in the United States[7]. The strategic goal must be set of narrowing the technological gap between Russia and the developed countries of Europe and America. An

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[7] This gap is even greater when evaluated in terms of the current exchange rate.

especially important factor here is that over the long term, the growth rates need to exceed the average world rates, otherwise it will not be possible to narrow the gap either in terms of the overall level of consumption or total GDP, which will limit prospects for future development.

Economic growth and the investment climate

In light of the above, from a macroeconomic standpoint the conditions were objectively created in the transformation process which make it necessary for further economic development in the near future to follow the path of accelerated growth in private investments, since the concentration of high income levels among a relatively small segment of the population creates the conditions for the formation of investment potential. The concentration of property, which also ended up in the hands of a relatively narrow segment of the population, also points to the fact that as a result of the transformation period in the 1990s, conditions were created so that in the future, at least at the initial stage, economic development would proceed primarily along the "investment" path of development, and not along the path of more rapid growth in mass demand. Bearing in mind that one should not expect a rapid transformation of the existing structure of income and property in the direction of their more even distribution, **investments, rather than expanded mass consumer demand, are becoming the catalyst of economic growth** (BEA Informational-Analytical Bulletin No. 15 for June 1999).

From another standpoint, the objective need for investments arises from the fact that by the late 1990s the country's aging production apparatus was not just obsolete, but was also showing signs of physical wear. According to data from the State Statistics Committee, the average age of manufacturing equipment in industry in late 1998 was over 16 years (as opposed to 8.4 years in 1970), while the proportion of deteriorating fixed capital throughout industry as a whole reached almost 53 percent (compared to 25.7 percent in 1970). It should be stressed that deteriorating fixed capital was distributed quite evenly throughout almost all sectors (with the exception of the food industry, where this figure was somewhat lower at 44 percent). This means that without investments and large-scale updating of fixed capital one can hardly expect sustained growth in industrial production over the long term. Things are not any better in other sectors of the economy that produce goods. Realization of the accumulated investment potential based on the state's recognition of the inalienable right of ownership, and the provision of guarantees to protect this right, should result in a sharp **increase in production efficiency, even if this is achieved, as it might seem now, at the expense of "equality and fairness."** One can expect a transformation of the structure of the Russian economy against the backdrop of just such an investment boom. One should also realize that at the initial stage in the realization of this particular concept of development, the relative gap between the rich and the poor is not going to shrink. This will occur, however, when there is overall growth in income and consumption.

In connection with this, one of the most important ideological tasks at the present moment is the need to dispel the illusions surrounding the Russian mentality, namely the idea that the country's population is committed to collectivist, public-spirited values. The spirit of collectivism was artificially implanted in the country in the 20th century, while the results of the country's development in the 1990s, as well as the experience of previous centuries, provides more convincing evidence that individualism, private property, reliance on one's own energies, and the entrepreneurial spirit are more consistent with the mentality of Russian society. In both agriculture and industry in the late 19th and early 20th centuries, for example, the driving force behind production was a relatively narrow segment of the most hard-working, industrious entrepreneurs. Contemporary economic policy should be devised with these realities in mind as well. In order to realize the creative potential of Russian citizens, which is incomparably greater than in the majority of developing countries, and to spur commercial initiative, there need to be simpler rules for entering the market, bureaucratic barriers need to be taken down, and unnecessary obstacles in the form of various types of licensing and controls need to be removed. These measures will automatically help reduce the level of corruption.

Another myth, the roots of which are intertwined with the myth of the "collectivist consciousness" of the Russian public, is the myth of the need to expand and strengthen state authority. If the thesis of the strengthening of the state, understood as the strengthening of state institutions, does not raise objections from virtually any of the groups of specialists, then we categorically need to reject intentions to expand the state's sphere of influence in both the economy and the life of society. The development of the global economy in the late 20th century points to an increase in the role of nongovernmental organizations and the strengthening of transnational companies. It is predicted that in the next few decades the process of internationalization of economic relations will continue, although the result of this sort of development is not just overall growth of the global economy, including growth in poor countries, but also a widening of the gap between poor and rich states. With its highly educated human capital, however, Russia has every opportunity to pull itself out of the group of poor countries. Thus, Russia is faced with a choice: either follow the flow of the key trends in the global economy, enjoying the advantages of integration and reducing its political and economic costs, or orient itself toward a more closed, separate type of development.

If the first course is followed, Russia will have to make significant strides in expanding its membership in various international organizations, which will allow it not only to successfully adopt the generally accepted "rules of the game," but also to change the mentality of economic agents and Russian society as a whole. This should help achieve the main goal of Russia's economic development, which is not simply to bring about a **substantial rise in the living standards in the Russian Federation, but also to advance to a qualitatively new level.**

Bearing in mind the structure of the distribution of property that developed over the years, the very uneven distribution of the Russian population in terms of income level (with the richest 20 percent of the population regularly receiving approximately half of total income), as well as the overall low level of income and consumption, conditions have been created in the country in which just a small group of citizens are able to become investors. Under these conditions, the priorities for the country's economic development will be determined predominantly by large (by Russian standards) investors. Thus, the state either needs to recognize the status quo as it applies to the current distribution of property, the legality of capital accumulated in the 1990s, and provide reliable guarantees to protect private property, or it will run up against a lack of confidence on the part of investors in the future. The chances of increasing investment activity are much higher under the first scenario. Under the second scenario, the threat of a new, nonmarket redistribution of property could slow down the country's development for many years to come.

An analysis shows that in an environment of political stability and given fulfillment of the conditions referred to above with regard to building more reliable legal foundations for a market economy, after the 2000 elections one can expect steady growth in investments. The rate of growth in investments may substantially exceed the rate of growth in consumption over a fairly prolonged period of time. The demand for investments in the country may remain fairly high as a consequence of the prolonged period of underinvestment and, in effect, the lack of structural changes in the economy over a period of decades. The capital-intensive structure of the Russian economy that was inherited from the past also points to the potentially high demand for investment: investment will be needed not only to create and develop new production operations, but also to keep Russia's traditional sectors—the extractive industries, power engineering, metallurgy, and chemistry—in working order, which should include their modernization as well. On the other hand, the supply of investment resources could grow substantially given greater certainty about the country's political future. As mentioned above, the potential for this does exist—in particular with regard to a reduction in the outflow of capital and its potential return back into the country (both under the guise of "foreign" capital, and in the form of voluntarily repatriated domestic capital).

According to estimates, in 1999 the overall accumulation of fixed capital totaled US$27 billion, which at the current exchange rate is comparable to the annual outflow of capital from the country. Even a slight improvement in the investment climate, and a reduction in the volume of export earnings not returned and other sources of money flows that can be interpreted as an outflow of financial resources from the Russian economy, could result in a significant increase in the volume of funds invested in the Russian economy. Starting in 2002, the annual growth in investment in fixed capital could be at least 10–20 percent. The period of heightened investment activity will last for 5–7 years. A period of high growth rates for investment and high growth rates for GDP was characteristic of many countries, from Japan in the 1960s to Poland in recent years.

Efficiency, competition, institutions

Over the long term, the need **to provide for economic growth and raise the standard of living not through the application of extensive factors, which was how things were done under the administrative system, but as a result of greater production efficiency**, is of critical importance to Russia. This assumes, first of all, a restoration of financial responsibility for the results of economic activity, which is correspondingly not possible without an improvement in payment discipline (including on the part of the state), activation of the bankruptcy mechanism, development of the judicial system, recovery of financial markets, particularly the corporate securities market, and so on. In other words, without development of the entire market infrastructure.

The main factor behind the need for reforms in the Russian economy is the critical drop in the efficiency of social production under centralized management and the lack of incentives for productive labor. Objectively speaking, the rejection of total directive regulation in the context of a virtual lack of economic incentives, and the move toward creating a system of production relations in Russia based on economic interest, was the key decision that could have helped to improve production efficiency. The existence of private property in the production sphere is an initial condition for the creation of such a system. Simply recognizing that the right of private property ownership is inalienable is not enough, however. Another **key condition is a competitive environment, and the creation of equal conditions for competition for all economic entities throughout the entire country**. It is competition, and the threat of losing one's place in the market, that is the driving force behind improving production efficiency. The drafting and adoption of progressive anti-monopoly legislation is a high priority in economic policy.

Special importance should also be assigned to a policy of supporting small and mid-sized business, the essence of which should not be reduced to state financing and concessional lending to this sector, which cannot realistically be expected under Russian conditions; what this policy should do is help eliminate barriers to gaining access to the markets. This is the sector of the economy that promotes the rapid creation of jobs, that serves as a "school" in the market economy for beginning participants in the market, and it practices natural selection of the most successful entrepreneurs.

The country needs institutional reform in order to realize the potential for growth within the market system. A market economy is not possible without banks and capital markets. The restructuring of the banking system and creation of a system of successfully operating banks, which would truly perform the role of intermediaries between savings and investments, must be carried out at an accelerated pace, and this effort needs to be started immediately.

If the restructuring of the banking system and development of the government securities market serves the redistribution of financial resources, the functioning of the corporate securities market also serves the redistribution of property—from one owner to another, more effective one. In this connection, the protection of shareholders' rights is one of the state's most important tasks. The development of the insurance system, which is still in the embryonic stage in Russia, should proceed in this direction.

The state's tax policy should serve as a crucial factor in the stable functioning of the economic system. A substantial simplification of the tax system needs to be carried out in the near future, with a view to reducing the total number of taxes, primarily through the elimination of taxes that have a low collection rate, and assigning a greater role to indirect taxes compared to direct taxes. Changes in the tax system in the immediate future should be accompanied later on by efforts to maintain its essential stability, stricter requirements, and the orderly passage of tax legislation at all levels of government authority. Transparent and responsible budget policy is one of the fundamental principles of state regulation of the economy. It must be realized against the backdrop of improved tax administration.

Under the current conditions, the task of **reviving the financial markets** (both the government debt instruments market and the corporate securities market) remains extremely urgent; one can hardly imagine a normally functioning market economy without these markets. Furthermore, considering the significant quantity of ruble funds that are essentially frozen in various accounts (correspondent accounts with the Central Bank, type C accounts), these resources could be brought into circulation, and if necessary, they could be used as borrowed funds for the financing of the budget deficit. It is unlikely that we can expect a repeat of the GKO [government short-term bond] story now, since the budget deficit is substantially smaller than it was in 1995–1998. New government securities could, on the one hand, replace the so-called nonmarket government bonds (OGNZ) that are being issued now, for example. On the other hand, they would make it possible to track the level of market interest rates, which is extremely important to investors. What's more, one of the current problems is that a significant volume of high-yield federal treasury bonds with long maturities are in circulation. Although the yield on these bonds has dropped somewhat recently, the price is still relatively low, however, so the state could work out a mechanism for redeeming these debt instruments accompanied by a simultaneous issue of new negotiable market instruments.

It is possible that if the Ministry of Finance should issue a limited volume of new securities with relatively short maturities (up to three months), their annual yield could be somewhere around 30 percent. This seems entirely realistic, bearing in mind the limited supply of debt instruments and the excess ruble liquidity in the economy. On the whole, this measure would make it possible to revive activity in the markets, and reduce the potential threat of pressure on the exchange rate of the national currency. Cautious measures to revive the financial markets could also facilitate the initial process of restoring confidence in the Russian economy on the part of investors (both domestic and foreign).

A revival of financial markets is also important because they are supposed to function on a continuing basis, redistributing available resources among sectors of the economy. During an economic upturn, in the event of a potential influx of foreign currency (as a result of a halt in the export of capital or the influx of foreign investments), monetary authorities are faced with the task of sterilizing this flow by issuing Central Bank financial instruments.

Macroeconomics

In the broad spectrum of issues in macroeconomic policy, the interdependence of budget policy, which is determined to a great extent by the problem of servicing foreign debt, and monetary and exchange rate policies, is of special importance. The general outlines of budget policy are obvious: the state is not supposed to spend more than it is capable of collecting in taxes, and the state should refrain from taking on excess obligations (at the level of regional budgets), so as not to increase the tax burden on the economy; it should also strive for a balanced budget, with no deficit (this possibility will depend, however, on prospects for restructuring the foreign debt). Consequently, the foreign debt servicing schedule is an exogenous factor. At the present time, the size of the foreign debt is practically the same as the GDP. As a result, every year for the next ten years the country is supposed to pay between US$15 billion and US$20 billion to its creditors. This task is clearly beyond the ability of the Russian economy. Therefore, resolution of the problems referred to above, and a predictable and consistent liberal economic policy, should also help settle the problem of the foreign debt, its restructuring, or even forgiveness of part of the debt. Forgiveness of part of the debt will make it possible to achieve a corresponding reduction in the tax burden in the economy, it will stimulate production and economic growth, and it will make it possible to increase noninterest income.

In addition to capital flight, the unavoidable outflow of money from the country tied to the need to service the foreign debt, remains and will continue to be an important limiting factor in the country's development. While a radical improvement in the investment climate aimed at creating more favorable conditions for investment in Russia than in other countries is a matter for domestic policy alone, the settlement of the foreign debt problem requires consideration of international factors as well. Figure 6 provides an illustration of the foreign debt schedule of the federal government and the country's monetary authorities in 2000–2010.

Figure 6. Schedule of foreign debt payments by the federal government and monetary authorities in 2000–2010

[vertical axis:]
millions of dollars

[colored bar:]
debt of the USSR

[white bar:]
debt of the federal government and Bank of Russia

As one can see from the available data, annual payments on the foreign debt are supposed to be approximately one-tenth of the GDP. These quantities are comparable in scale to capital flight[8] from the country (which is still somewhat higher: in 1998 estimated legal and illegal export of capital from Russia exceeded US$23 billion, and in 1999–2000 it is unlikely that there will be a decrease in this figure). These resources (or even just a portion of them) could potentially be used within the country for investments that could provide for economic growth in the future. An economy cannot survive under the conditions of such massive export of capital by the private sector and such a heavy debt burden.

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[8] The estimated volume of capital flight is based on balance of payments data and includes the change in arrears on foreign exchange and ruble export earnings not received on time for outstanding import advances, the volume of trade credits and advances granted, and net errors and omissions.

It is also important that the servicing of Soviet-era debt accounts for the bulk of the debt burden on the Russian economy, as one can see from Figure 6. The problem of servicing and repayment of the Russian share of the debt is most critical up to 2005. In connection with this, **the highest priority in the government's economic policy should be to reach agreements with creditors that would allow Russia to restructure its foreign debt, shifting part of the payments beyond the 10-year period at a minimum and gaining forgiveness of part of the debt (this should apply primarily to the debt of the former USSR).** Clearly, Russia will be most likely to succeed in reaching this type of agreement if, after the presidential elections: a) Russia lives up to its claims to be called a democratic country by preserving democratic freedoms; b) a long-range strategy is proposed that is based on the principles of a free market economy; c) the first steps, even small ones, are taken to implement this program. The problem of restructuring the foreign debt should be addressed in a comprehensive manner, involving all groups of creditors, taking into consideration not just budgetary limitations, but balance of payments limitations as well. As BEA calculations have shown (Informational-Analytical Bulletin No. 11 for December 1998 and No. 15 for June 1999), **the country's potential capacity for servicing debt over the next decade is no more than US$10–12 billion per year**.

The path to a balanced budget also lies in the improvement of tax administration and a certain redistribution of financial flows between the federal center and regions. Specifically, there should be a sharp increase in the income tax collection rate; income tax collections measured as a percentage of GDP could be increased by a factor of 2.5–3 compared to the current level. This can be achieved mainly through better compliance with tax payment requirements on the part of the more affluent segments of the population, where the level of tax evasion is the highest. Income tax (at least the bulk of it) should become a federal tax, which could increase the revenue side of the budget by 2–3 percent of GDP. Introduction of the practice of making large purchases only by means of noncash settlements, using plastic cards, could be one of the measures aimed at fighting income tax evasion (as well as the evasion of other taxes).

Table 1 shows that the structure of the revenue side of the extended government budget in Russia differs substantially from the state revenue structure in developed countries of the world. The main difference is not the state's relatively small share in GDP (this share is substantially lower in a whole group of countries), but the fact that the proportion of taxes paid on the basis of household income (income tax and payments to social funds) is much lower. Throughout the EU on average this figure is more than 52 percent, while in Russia in 1998 it was a little more than 35 percent.

Table 1. Structure of extended government tax revenues in Russia and certain countries of the world (as a percentage of total tax revenues)

	For reference: total taxes (as % of GDP)	Income tax	Profit tax	Taxes on goods and services	Other taxes	State funds of a social nature
Russia (1998)	32.8	8.1	10.9	30.4	23.4	27.2
OECD average	38.5	29.3	6.9	30.2	10.8	22.8
EU average	41.0	25.8	6.8	31.5	9.5	26.4
United States	29.7	34.5	7.9	17.2	12.4	28.0
France	43.9	13.9	3.4	26.7	15.0	40.9
Japan	29.1	25.6	14.9	14.4	14.8	30.1
Greece	41.2	9.3	5.0	43.9	12.6	29.2
Denmark	49.9	52.1	4.4	31.7	8.6	3.1
Turkey	23.5	27.1	4.9	31.8	17.6	18.6
Switzerland	23.5	32.8	5.8	16.7	21.8	22.9

It is more likely that the tax collection problem in Russia is due to ineffectual tax administration, rather than "incorrect" tax rates. For example, in spite of the fact that there is a fairly wide range of tax rates among various countries (in Switzerland the lowest rate is 1 percent and the highest rate is 13.2 percent, while in Holland the lowest and highest rates are 13 and 60 percent, respectively), the income tax accounts for the most important part of the revenue side of the budget. It hardly makes sense to lower the income tax rates to 10–20 percent, or to introduce a single income tax rate, as a number of specialists are proposing. It seems more reasonable to maintain the existing income tax rates, although the income bracket taxed at the highest rates should be raised substantially. Wealthy people, whose incomes are comparable to incomes in developed countries of the world, should pay the same amount of taxes as people pay in the rest of the world. The state should improve tax administration with regard to key taxes (the income tax, VAT and excise taxes, social funds), by concentrating the efforts of tax services on these taxes in particular. At the same time, the majority of less significant taxes, which still represent a large share of the Russian budget should be eliminated (other taxes, as one can see from Table 1, account for almost one-fourth of total tax revenues). It would also be advisable to make some reductions in contributions to the social insurance fund—those contributions which are earmarked for the maintenance (or the mothballing, in effect) of the aging sanatorium-health resort infrastructure, and are hindering the development of a competitive tourism business in Russia.

Shifting the emphasis toward the income tax and the sales tax (which is paid by the final user, in effect, and wealthier people pay more) will follow the long-range trend in the growth of personal income, as it is determined by the reform of housing and municipal services and the elimination of inefficient subsidies for housing and municipal services.

A balanced budget will help limit the money supply and, in effect, will help reduce the inflationary tax, which leads to the depreciation of ruble savings and encourages flight from the ruble. In connection with this, the role of monetary policy will grow as execution of the budget improves. The channeling of money into the economy will occur not as a result of government lending at concessional rates, but through the mechanism of lending at market rates by commercial banks, which in turn, sooner or later, will have to take up their primary activity—lending to the real sector, performing the role of serving as intermediary between savings and investments, and turning short money into long money, small deposits into large credits. Furthermore, growth in the money supply, and correspondingly the inflation rate, will be determined by growth in international reserves, as well as the ability of monetary authorities to sterilize excess ruble liquidity.

One way or another, the expected expansion of the money supply and the effect of macroeconomic factors that have come into play now give one reason to believe that the trend toward devaluation of the ruble in nominal terms will continue. Over the short term, the most reasonable situation appears to be one in which the real exchange rate of the ruble will remain stable, while over the long term, as the economy grows, the ruble will become stronger. In both cases, two different models of exchange rate dynamics are possible: steady growth or "stepped" growth. In the first case the Central Bank should operate fairly cautiously in the foreign exchange market, buying foreign exchange to build up reserves and smoothing out only major deviations from the established trend. In the second case, in the event of the "stepped" version, the Central Bank will pursue more active interventions to keep the exchange rate at the prescribed level. It will be forced to spend foreign exchange more freely, which will aggravate the problem of servicing the foreign debt. What's more, the "stepped" version is burdened with problems tied to a shift to a higher exchange rate. At the time of such a shift, economic agents may have false expectations of a stable exchange rate, and the movement to a new level could cause panic in the market, which would have a corresponding negative impact on the entire economy. Overall, the smooth growth version is preferable, since it makes exchange rate dynamics more predictable, it does not create illusions among economic agents, and it provides for greater stability in the development of the economy.

The state should ensure the stability and transparency of monetary policy. Practical experience around the world shows that the "desired" inflation rate (and not the dynamics of the money supply or the exchange rate of the national currency, for example) is being chosen as a target indicator for monetary authorities in more and more countries. Thus, the primary task of monetary policy is to provide for the corresponding price dynamics and to create predictable macroeconomic conditions, which should facilitate decision-making not only in the area of budget planning, but by economic agents at the microeconomic level as well. At the same time, monetary authorities are relatively free with regard to employing the available instruments of monetary policy (changing interest rates, reserve requirements, expansion or contraction of the money supply, and so on).

Domestic demand and demographics

Considering that investments are supposed to become a catalyst for sustained growth at the beginning of the new century, they will help create new jobs at new, more efficient production facilities. In the future, this should make it possible to **bring into play another engine of growth, such as steadily expanding mass domestic demand**. In the 1970s and 1980s the middle three quintiles of the Russian population accounted for around 56–58 percent of current income (see Table 2), while the wealthiest 20 percent of the population accounted for just 33–37 percent. Incidentally, approximately the same structure of income distribution is also typical of highly developed countries with a high overall level of income, including the United States and European countries. In these states, however, this income distribution was shaped under the conditions of a market system of economic management and serves as a guarantor of social and political stability and a driving force for growth. In the Soviet era, on the other hand, stability and a similar income distribution were achieved by entirely different methods.

Table 2. Distribution of monetary income among the population (as a percentage)

	1970	1975–1990 average	1991	1992	1993	1994	1995	1996	1997	1998	1999 – 9 mos.	for reference	
												Mada-gascar	USA
Total monetary income	100	100	100	100	100	100	100	100	100	100	100	100	100
Of which, by 20% groups:													
first	7.8	9.8	11.9	6.0	5.8	5.3	5.5	6.2	6.0	6.2	6.2	5.8	4.7
second	14.8	14.8	15.8	11.6	11.1	10.2	10.2	10.7	10.2	10.5	10.4	9.9	11.0
third	18.0	18.6	18.8	17.6	16.7	15.2	15.0	15.2	14.8	14.9	14.4	14.0	17.4
fourth	22.6	22.3	22.8	26.5	24.8	23.0	22.4	21.5	21.6	21.0	19.9	20.3	25.0
fifth (with highest income)	36.8	33.5	30.7	38.3	41.6	46.3	46.9	46.4	47.4	47.4	49.1	50.0	41.9

Sources: State Statistics Committee, World Bank

During the reforms in the 1990s the structure of income distribution among the population changed so that the middle three quintiles began to account for around 45 percent of total income (44.7 percent based on the results for January–September 1999), while, as noted above, the wealthiest 20 percent account for about 50 percent of income. This sort of income distribution curve is typical of poor, developing, and politically unstable countries. Thus, **one of the key tasks of economic policy over the long term is to make the existing income distribution more even**. This task will become most pressing in several years, when the economy could be affected by a certain amount of inertia in its growth. From the standpoint of the social orientation of reforms, the results of the transition from socialism to capitalism should lead to a situation in which the advantages of the market structure of the economy are felt by the majority of the population, rather the minority, which was the case throughout the 1990s. This will strengthen stimuli for productive labor, while providing for a stable connection between production and consumption.

Over the long term, in the implementation of its economic strategy Russia may run up against a number of objective limitations and problems. A number of these limitations and threats are the result of strictly demographic processes. From Figures 7 and 8 one can see that in several years Russia is going to encounter serious problems related to the aging of the population. The shrinking of the total population that began in the early 1990s will continue and after 2005 it will be due to a decline in the working-age population, while the level of dependents under the age of 15 will remain relatively stable. At the same time, there will be a sharp rise in the number of pensioners, and there will a corresponding increase in the so-called "demographic burden" on the working members of the population.

Figure 7. The "demographic burden" on 1,000 working-age people, at the beginning of the year

[light-colored band:]	[dark-colored band:]
aged 0-15 years	over working age

At the same time, the growth in the number of working-age people will continue up to 2005–2006, which will increase the burden on the labor market and aggravate the unemployment problem. The labor surplus will increase over the next 5–6 years, and the economy is not going to experience a shortage of manpower resources. On the other hand, the appearance in the labor market of a new generation of manpower, whose mentality and education have already been oriented toward market conditions, will mean tougher competition on the labor market, which will certainly have a positive impact on the quality of manpower resources employed in production. This is particularly important, considering that in the 1990s skilled personnel, who could not find a place for themselves in the new Russia, were lost to migration (primarily to the United States, Germany, and Israel, with approximately 80,000 people leaving to establish permanent residence there in the 1990s). In addition to those who acquired foreign citizenship, the Russian economy also lost and is continuing to lose skilled specialists who are able to compete successfully in the global labor markets and are leaving to work under contractual arrangements. Growth in the Russian population resulting from migration is due primarily to the influx of less-skilled manpower from the CIS and Baltic countries.

Figure 8. Population at the beginning of the year, millions of people

[vertical axis:]
population

[line with squares:]	[line with diamonds:]
total population	number of working-age people

A qualitative improvement in the structure of human capital occurring against the backdrop of a steadily shrinking population is one of the main threats to the Russian economy. A change in migration policy could potentially be one of the conditions for moving into a trajectory of sustained economic growth. Historical experience shows that Russia made the most pronounced spurts forward in its cultural and economic development during those periods when it was open to the rest of the world. In previous centuries German, French, and Dutch people served the Russian state. Later on many of them became Russian citizens. This meant much more than an influx of capital; it also meant an influx of culture and knowledge, which are particularly lacking in Russia today. The business culture vacuum, which was created in the country over past decades as a result of the genocide of the intelligentsia that began in the 1920s, needs to be filled. The conditions need to be created to keep people from leaving Russia, and on the contrary, to encourage them to come here. Russian citizenship should become just as desirable for investors and foreign hired workers as Canadian, American, Argentine, and other citizenship is for today's Russians. Many countries around the world offer concessions to investors and grant the right to obtain a residency permit or citizenship when candidates meet certain requirements. Strategically speaking, Russia should follow this same course.

The resolution of demographic and migration issues should not be delayed, since the influx of an industrious labor force into the country's economy will help to regenerate the segment of the population that earns a steady income, and it will help increase mass demand. In the event of a passive demographic policy, starting in 2005–2006 the rise in the number of pensioners, and particularly among the low-income segment of the population, will aggravate the problem of mass demand, and the formation of a middle class, and it will hinder the formation of a more even structure of income distribution, which means it will also limit opportunities for economic growth.

The widening technological gap is a threat to Russia's future

As noted above, the country is going to have to resolve a number of problems and it is going to encounter a number of factors restricting its freedom to maneuver. A wide range of limiting factors will be the result of external conditions—the expected dynamics of the development of the world economy, the demand for traditional Russian export goods, and prices for these goods. From this standpoint, it is extremely desirable not to drag out the reforms and to take advantage of favorable world market conditions, since a decline in world oil prices is expected as early as 2001, as a consequence of the fact that world oil production will exceed demand. It is expected that in 2001–2003 oil prices may stabilize at the level of US$17–18 per barrel, which will significantly reduce the potential foreign exchange earnings entering the country. The economic system that evolved in Russia, based on exports of natural resources, will finally exhaust itself.

In the short- and medium-term, development of the domestic market is one of the priorities of economic policy. Another priority of state policy should be to promote the development of sectors and production facilities that have the potential to gain competitive advantages over foreign producers. The world's experience in economic development shows that the most successful development occurs in those countries in which something new is created, in which new production operations appear. Of the world's ten largest companies, more than half belong to relatively new sectors of the economy, which didn't even really exist three or four decades ago. These are telecommunications, computer technologies, and so on. Russia's main path of development does not lie in the utilization of its natural resources and existing fixed capital, but in innovation. Creation of the conditions needed for this and elimination of a number of barriers preventing new business from entering the markets are at the top of the agenda for the new millennium. In all likelihood, however, the state will be able to devote the proper attention to the country's innovation potential no sooner than several years from now, after a period of economic growth has begun, and as execution of the budget stabilizes. Up until that time, and in the future as well, it is important for Russia to integrate itself into global cooperative relations, so that Russian producers of certain components and assemblies cooperate in the production of more sophisticated products of companies that are known around the world. This sort of cooperation will encourage the development of a new business ethic, and it will promote the formation of contract law in Russia.

Efforts aimed at the accelerated development of “breakthrough” sectors should be directed at the utilization of Russian potential in high-tech areas related to the defense industry. Two main areas of emphasis can be identified in this effort. First, the development of the relevant exports as the basis for expanding demand for products and strengthening the financial position of sectors in the defense complex. Second, realization of the scientific potential that still exists in this area should be based not only on direct state support for military production, but also on expanding the application of advanced scientific achievements in open sectors of the economy on a market basis. The unsatisfactory results of the conversion of the Russian defense industry are due primarily to the fact that the effort was reduced in large part to misguided measures to change the production orientation of high-tech production facilities. This meant double losses: the strictly technological losses, as well as the attempt to switch to a production operation that they knew was going to be unsuccessful, since in reality a substantial reconstruction of enterprises in the defense industry, which requires substantial investments, is needed to ensure the profitability of new products.

State support is needed for the recovery of this sector. The most important condition for providing this support, however, should be that it is limited in nature, from the very outset it should be provided simultaneously with expansion of market sales of scientific advancements. The conditions and limits of state support should be announced, and the conditions for the application of market principles of development should also be defined. In addition to the unique scientific potential that still exists in high-tech areas related to the defense industry, advanced developments in other sectors, such as medicine, for example, need to be supported as well.

State support for sectors that are capable of making a breakthrough in the development of Russian society should include a set of regulatory measures, but investments should make up the bulk of this support. Targeted redistribution of income from Russian exports, such as arms and other goods, including exports of raw materials and energy resources, could serve as one of the sources of funds for these strategic investments.

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Given the pursuit of a liberal economic strategy, by the end of the decade some structural shifts should be clearly evident in the country’s economy. At the present time the Russian economy is characterized by an extremely deformed structure of the GDP (see Tables 3 and 4 for comparison), which is reflected in net exports, which are clearly too high, and a low level of consumption.

As one can see from Table 3, the proportion of net exports in Russia is more than 16 percent, while the proportion of final consumption remains extremely low. Although data on the Russian GDP presented in Table 3 are based on calculations at the current exchange rate of the ruble, and due to the much larger gap between the ruble's current exchange rate and its purchasing power parity they are not entirely comparable to the data for other countries presented in Table 4, one can nonetheless track the general trends in the change of the structure of the GDP. Calculations show that in 8–10 years, given the implementation of a liberal reform strategy, which means the implementation of structural reforms, the transformation of budget expenditures, the implementation of housing and municipal services reform, pension reform, the development of financial markets, restructuring of the banking system, and so forth, the gap between the ruble's purchasing power parity and current exchange rate could shrink to 70–90 percent.

Table 3. Structure of use of GDP in Russia
(as a percentage)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditures on final consumption	69.4	62.6	49.9	64.2	69.7	72.8	72.9	74.7	77.1	68.6
by households (including private nonprofit institutions serving households)	48.6	45.7	35.5	46.3	47.1	52.9	52.1	53.1	57.9	53.8
by general government	20.9	16.9	14.3	17.9	22.6	19.9	20.7	21.6	19.2	14.8
Gross accumulation	30.3	37.1	35.7	27.9	25.7	23.8	23.1	22.6	15.4	15.1
of fixed capital	28.9	23.8	24.7	21.0	22.0	21.4	20.9	19.8	17.5	14.8
of inventory	1.4	13.3	11.0	6.8	3.8	2.3	2.2	2.8	-2.1	0.3
Net exports	0.2	0.3	14.5	8.0	4.6	3.4	4.0	2.7	7.5	16.3

Table 4. Structure of use of GDP in certain countries
(data for 1997, as a percentage)

	United States	Germany	Greece	Mexico	Turkey	Poland
GDP	100.0	100.0	100.0	100.0	100.0	100.0
Expenditures on final consumption	83.1	76.6	88.2	73.6	81.0	82.5
by households (including private nonprofit institutions serving households)	67.7	57.2	73.4	65.3	68.8	65.3
by general government	15.4	19.3	14.8	8.4	12.1	17.3
Gross accumulation	18.1	22.6	20.1	26.4	24.8	22.4
of fixed capital	17.2	20.1	20.0	19.5	26.1	21.2
of inventory	0.8	2.5	0.0	6.9	-1.3	1.3
Net exports	-1.2	0.9	-8.3	0.0	-5.7	-5.0

An average GDP growth rate of 5–6 percent per year over a 20-year period could be entirely realistic for the country. In some years growth could speed up to 8–10 percent. Over 20 years GDP could triple. This growth will be uneven among various sectors of the economy, which, together with the change in the price structure, would substantially change the nominal structure of GDP. By the end of the period (20 years), the proportion of consumption could exceed 80 percent, net exports would fall, and could even become negative, if Russia becomes a reliable recipient of capital.

A failure to take quick action to normalize the economic situation in the country and to create the conditions for sustained economic growth will threaten not only social stability, but Russia's survival as a state. The sluggish demographic projection speaks to the fact that in 40 years Russia's population could shrink to 90 million people. This will occur against the backdrop of rapid population growth in relatively poor non-European countries, which could have far-reaching geopolitical consequences, including a threat to the country's territorial integrity. The projected decline in population could have much more serious consequences for Russia than for Europe[9], due to its much lower level of development and its political isolation from developed countries of the West. Thus, in geopolitical respects Russia will be in a sort of buffer zone between the developed countries of the West, where the population will also be shrinking, and the poor countries of Asia and the Near and Middle East, where the population will be growing at rapid rates. One should not rule out the potential possibility that the country may also be faced with the threat of territorial claims on the part of forces with fundamentalist views[10] and supported by a number of orthodox regimes. In essence, under these conditions it is unlikely that Russia will be left with a more reasonable option than declaring its readiness in the future to become integrated as part of a united Europe and to form its own economic, foreign, and domestic policies on the basis of this strategic premise.

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[9] The threat of a decline in the native-born population in European countries also poses a serious problem for the region's economic development.

[10] The conflict in Chechnya and Dagestan is a signal of such a threat.