

Review*
Vladislav L. Inozemtsev
“Virtual” Economy in the “Virtual” World

It is obvious that Western academia abruptly lost interest in Russia in the 1990s. The end of the Cold War, the end of an ideological struggle between East and West, and the ongoing market reform in our country turned Russia into a state among many states on the path of democratic development. However, if in the old days many Westerners considered the Soviet socio-political system an anomaly, today it is the Russian economy that is the anomaly. This economy remains very difficult for objective study due to its mixed composition – characteristics of a developed market economy and elements of near feudalism. Nevertheless, there is a book published in the West, in which authors demonstrate a profound understanding of the peculiarities of the Russian economy and the scenarios of its development.

The book “Russia’s Virtual Economy,” written by Clifford Gaddy, Senior Fellow at the Brookings Institution, and Barry Ickes, Professor at the Pennsylvania State University, stands out, first and foremost, because of the clarity of their arguments and conclusions drawn from the penetrating analysis of economic processes usually hidden from academic observers.

The purpose of the authors is to “provide a method of analysis – a model that can be used to think about transition in Russia” (p. 3). The method helps to view the modern Russian economic system as both a fictitious and real economy characterized by inadequate exchange between industries and enterprises. In such an exchange, economic actors agree with prices for their products set up by other actors with prior knowledge that such prices do not reflect realities of the market situation (See pp. 5-6). Gaddy and Ickes point to the fact that domestic producers conceal “with shame.” Hidden is the reality that a virtual economy is stable, and “it does not pay for any actor to depart from the behaviors that characterize it...those who try to play by the normal market rules are penalized relative to those who play by the virtual economy’s rules.” (p. 6) The authors also elaborate clearly about many other peculiarities of the Russian economy that are surprisingly not covered in the press even though a majority of domestic researchers know about them. The authors pinpoint the fact that a large share of industries are value destroying. However, this does not mean that there is no need in those industries per se. According to the authors, “Any enterprise may produce a useful product and still destroy value. Value destruction simply means that the product’s market price is less than the price of the inputs that were purchased to make the product.” (p. 47)

The most important economic resource in the modern Russian economy happens to be informal connections that enable enterprises to obtain some competitive advantages (See p. 56). This fact is well known to everyone who has ever faced Russian economic

* The review was published in Russian in the *Pro et Contra Journal* by the Carnegie Moscow Center , Volume 8, Number 2, Spring 2003 <http://www.carnegie.ru/ru/print/69020-print.htm> (Translated by Dmitry Ivanov).

realities. However, very few economists have tried to define this resource as a type of capital, specifically “relational capital,” and to include it in the analysis of investment behavior. In the framework of the analysis, bribes are considered a type of capital investment and are included in the mathematical models of investment activity (pp. 59-61). From this point of view, there is no point in talking about “a criminal sector” of the Russian economy because a large part of that economic activity, which is not reflected in official statistics, functions as a field to promote “relational capital” organically incorporated into the whole system. However, the authors separate formal from informal profits. Both types “are inputs to economic survival, but informal profits are more difficult to appropriate because they are hidden.” (p.70).

Analyzing these and many other “exotic” facts abundantly presented in the book, its authors come to the conclusion that the modern Russian reality is characterized not by a danger of an emerging “virtual economy,” but rather the very fact of its existence. As noted, “the problem today is not the same as the one that faced the reformers of the early 1990s. Today, the virtual economy exists.” (p. 225, italics is mine)

What is a “virtual economy”? How has it evolved? What influence is it able to exert on prospects of Russia’s development? According to Gaddy and Ickes, the virtual economy is rooted in the deliberate distortion of value and price proportions of reproduction for the purpose of creating illusions of the normal functioning of, in fact, an unviable economic system. They argue that even the Soviet government “assigned priority in the economy to heavy industry, especially defense industry, and it was important that it appear that these sectors were producing value” (p. 48, italics is mine). As a result, in the 1989 Soviet economy, electrical energy accounted for 3.8 percent of industrial value added, and fuels accounted for 18.1 percent while machine building and metalworking reached 39 percent. However, in 1998, capitalization of fuel companies and energy companies accounted for 80 percent of all Russian stock market whereas manufacturing represented only 1.0 percent (See pp. 19, 18). According to the American researchers, the figures reflect more accurately a real contribution of industries to the value added creation, and the traditional statistics prove that the role of resource industries is underestimated and that of processing industries is overestimated. This distortion is the essence of the virtual economy and has two implications.

First, an ineffective economy cannot function without constant funding from outside. Given the absence of traditional investment sources, “the ultimate ‘value pump’ in Russia is the fuel and energy sector, above all one single company, Gazprom, Russia’s natural gas monopoly.” (p. 5) Moreover, “the system can continue only as long as G [this sector] is able and willing to inject value into the system.” (p. 133) This sector becomes a netto-investor, although the rents extracted from it are not considered capital investment. It follows that, on one hand, such practice can hardly be accounted for, and redistribution of the advantages gained is subjective, thus generating corruption and increasing the price of “relational capital.” (See p. 118). On the other hand, lowered prices for resources are perceived not as subsidies but as normal practices. As a result, value-destroying enterprises, which are in fact subsidy recipients, look profitable, and there is no incentive for restructuring. (See pp. 52-53, 155)

Second, for most value-destroying enterprises, even such beneficial conditions cannot guarantee survival. They need to set deliberately uncompetitive prices for their own products. For the purpose of creating an illusion of effectiveness and an illusion of competitiveness, they use fictitious prices in rubles but paid through barter (See pp. 25, 27-29), or monetary surrogates (notes or other securities) (See pp. 33-34, 36-37). Consequently, the economy falls into industrial and distributional chains, and the state begins to engage in non-monetary exchange, willing to accept almost any valuables instead of tax payments.

Thus, a formal feature of virtual economy is demonetization of the economy and turning the economic system into a purely administrative system based on relations – the system where the value of this or that product or service is determined not in money terms, but through party negotiation. Bargaining power of economic actors becomes key in such a system. The state withdraws itself from the economy and practically loses tax revenues. At the same time, the state cannot withdraw itself from the social field which cannot function without necessary funding. The formally unified country falls into separate poorly connected elements.

Once emerged, such a situation will only deteriorate because executives in any field or of any level begin to care not about the improvement of economic efficiency but the preservation of social stability as their main goal. In the 1990s, all efforts by the Russian leadership were focused on achieving this goal. Besides, the international community was also interested in preventing social cataclysms in the post-Soviet environment. In Gaddy and Icke's opinion, the preservation of social stability has become equal to the preservation of a traditional economic structure, on the societal level in general (See pp. 70, 73). Directors of enterprises even with their profits falling aspired to avoid staff cuts as they considered themselves socially responsible for their employees. (See p. 23-24); regional authorities being submissive to enterprises' dictatorial stance and ignoring their obligations to the federal authorities, attempted to fulfill their own social programs ; the federal government itself aspired to maintain on the acceptable level defense and security spending despite a more than 60-percent reduction in the real economic base over the reform years. (See p. 206) The existence and the functioning of the virtual economy has discredited economic logic.

Nevertheless, the Russian style virtual economy has achieved relative stability. Gazprom and oil companies provided investment in demand; virtual prices of processing industries were compensated with no less virtual means of payment; the state used any opportunities to borrow money; and the undeclared profits of enterprises financed the informal sector of the economy. However, there was a problem which could not be solved in the framework of the virtual economy.

The problem was economic degradation at an accelerating rate. In the conditions of the permanent lack of real capital and investment, enterprises aspired not only to use quasi-investment coming from the natural resource sector, but also squeezed everything possible from their main funds and workforce. This led to the abandonment of complex manufacturing, which requires interaction with market forces, and the reorientation toward more small-scale production, which is more primitive and, thus requires less specialization. (p. 157) More importantly, “human capital” was irreversibly shrinking, especially in those instances when workers’ capabilities were closely related to the specialization of a particular industry. (See pp. 161-162). Even though the virtual economy was able to function for a long period of time, a factor hindering its development was the primitive survival of the economic system as a whole.

However, Gaddy and Icke’s thorough analysis of the Russian economic situation in the 1990s would hardly be of interest to a Russian reader if its results were not applicable to realities that emerged after the 1998 crisis, which is often viewed as a turning point that gave birth to the economy’s recovery. The American researchers deserve special credit for sweeping away that illusion. They argue that “there is reason to believe that the Russian economy has not yet begun to escape from its trap” (p. 191) and present several arguments to prove their point.

First, the 1998 crisis, which reduced the ruble exchange rate, increased competitiveness of industrial enterprises but to a lesser extent than it made “the export-oriented part of Russia’s economy (which is predominantly value adding and cash based) larger in ruble terms relative to the dinosaur part of the economy (which is largely value subtracting and non-cash based).” (p. 195) In other words, the crisis contributed to additional inflows of money into the economy as a whole and the budget in particular and resulted in a relative reduction in non-monetary transactions creating an illusion of a disappearing virtual economy.

Second, the economy reacted only to change in the structure of domestic demand. Economic growth became no more than a response to a decline in imports, which became less affordable to both citizens and enterprises. This growth was entirely concentrated in industries oriented toward the domestic market. Gaddy and Ickes point out that exports of machinery and equipment in the ultimately successful 2000 remained on a lower level than in 1998 (See p. 194). One could also take into account growth in arms exports which injected additional money into the military-industrial complex (however, it is not clear whether sale revenues were higher than production costs). The crisis reached recently many industries oriented toward domestic consumers (for example, an automobile industry).

The third point deserves more detailed consideration. The modern Russian economy again (and even to a larger extent than before) is becoming a hostage to the desire of the country’s leadership to preserve “stability” and to ensure “security.” (See pp. 207-212). The authors persuasively explain how goals set up by reformers in the 1990s – in the shortest possible time to build up a democratic system, lay the foundation of a market economy, and preserve a welfare system – were not feasible or realistic. The authors call

them “an impossible trinity.” (See pp. 206-207). The 1998 crisis, which lessened the need for dismantling the existing virtual economy, gave new birth to hopes for the possibility of the impossible. President Putin’s approach to reform links “stability explicitly to the absence of radical policy changes,” as Gaddy and Ickes put it. However, these are radical changes necessary to overcome the virtual economy. They conclude that a Russian-style market seems to be Putin’s preferred solution. “He is in effect proposing to replace the impossible trinity, in which democracy and a market economy were defined in western terms, with a new trinity of imperatives: (1) a paramount emphasis on national security; (2) a virtual economy reformed so as to suit the priority of the security imperative; and (3) a political order based on stability, minimal personal liberties, and the “Russian Idea.” (p. 212) The authors state that “the period after the 1998 crisis has shown...that economics, and especially market economics, was not the priority of Russia’s top leadership; national security and domestic stability were.” (p. 205) Therefore, in modern conditions, the virtual economy becomes not a curse but a sort of ‘a magician’s want’ because shallow economic reforms are capable of contributing to “growth from lack of change, absence of radical transformation.” (p. 216)

What prospects does the book under review show? The virtual economy will survive even if it is modified. Its modification will primarily be state employees’ privatization of rational capital, which previously was chaotically distributed among different economic actors. Most of informal profits will be formalized and become a source of tax revenues for the budget. There will more order imposed on the resource industry (for instance, enterprises will have to make direct money transactions, which, in essence, is not different from operations with notes). Unfortunately, additional revenues will be directed not for reforming the fundamentals of the economic system but for supporting the existing structure and its output for the sake of security and stability. Such actions lead to “a reformed virtual economy,” as the authors put it. (See pp. 213-217)

How reasonable is such a course of action? The virtual economy helps “slow the deterioration of the security situation, but at the cost of undermining the long-run potential of the economy....In the virtual economy, survival is the imperative, not restructuring. It therefore ensures stability, but only in tenuous form. The country avoids collapse, but only at the cost of digging itself deeper and deeper in a dead-end system.” (p. 208)

What can be done in search for the way out? The virtual economy should be abandoned in favor of transparent redistribution of resources and industrial subsidies necessary to tackle serious problems. This would reveal a real price of ‘security’ and ‘stability.’ State control over the resources sector should be enhanced, and all of value added, which is now turned into ‘quasi-investment’ should be collected and redistributed in favor of industry, if necessary. There needs to be a well thought through policy for restructuring and an imperative to improve efficiency of even those enterprises that are considered of special importance, for whatever reason there may be. There needs to be a broad practice of bankrupting inefficient enterprises and giving them into private hands. Finally, one should “keep the value of the ruble as low as possible” (p. 239) It is possible in today’s

conditions and can contribute not only to competitiveness of market-oriented enterprises, but also to the elimination of clearly inefficient companies.

What is the probability of such a complex set of measures being implemented? One can hope but hopes will not help. The government, which has deliberately set the objective of fighting a 'virtual' adversary to achieve 'virtual' goals, is unlikely to do without a 'virtual economy.'