

# The Economic Situation in Russia: Economic Policy Must Create Incentives to Invest

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Since 1992 the DIW, the IfW and the IWH have reported biannually on the economic situation in Russia. In their last report in the spring of 1996 the Institutes noted that the initial successes achieved in monetary and fiscal stabilisation had not yet made their mark on the real economy. In particular the Institutes drew attention to the serious weakness of investment, ascribing this weakness to fundamental failings on the part of economic policy. At the political level, the uncertainty surrounding the outcome of the presidential elections caused economic policy decisions to be postponed further. Yet, even since the elections, there have been no clear signs that the government is pushing ahead with institutional reforms and is taking effective steps to counter the fiscal crisis, evidence of which is becoming increasingly evident. On the contrary, there is the real danger that 1997 will be another year passing without real economic recovery.

## Output, investment and prices

The optimism expressed in 1995 by various international organisations regarding economic recovery in Russia during 1996<sup>1</sup> has proved unfounded. Indeed, the decline in output was actually greater than in the previous year (cf. table 1). During the first three quarters GDP fell by 6% compared with the same period the previous year (1995 as a whole: -4%). Given falling turnover in retail trade and service industries, private consumption is likely to have fallen by around 2 to 3%.

The decisive factor behind the poor performance, however, was investment in equipment. During the first three quarters of 1996 investment in equipment declined by 17% (1995: -13%), significantly faster than in the previous year and again to a far greater extent than GDP. The volume of investment by now has declined to

around one quarter of its 1990 level. Investment accounted for just 13.4% of output in current prices (1995: 15.1%). Investment in the "producer sector" (excluding agriculture and services) fell by 20%, in the remaining sectors by 13%; within the latter, housing construction declined by 10%.<sup>2</sup>

Comparable figures on investment trends in the various sectors of the economy are only available for the first two quarters of 1996. As in previous years the decline in investment in agriculture (-39%) and light industry (-36%) far exceeded the average figure. Investment in the fuel and energy sector, which in 1995 had increased slightly, fell by 8%. Against the general trend, investment in the communications (+30%) and the construction and building materials sector (+10%) increased. Given the less than proportional decline in investment in the fuel and energy sector, this area of the economy, accounting for 27% of total investment (1990: 14%; 1995: 21.4%), has further increased in relative importance. Almost three-quarters of industrial investment occurs in this sector. By the first half of 1996 agriculture's share of total investment had declined to just 2% (1990: 15.8%). As in 1995, around a quarter of total investment was accounted for by housing construction in 1996 (1990: 16.6%). The most notable of the structural shifts in investment are the steadily increasing share of investment occurring in the export-oriented sectors (fuel and energy) and the decline to almost complete insignificance of agriculture.

Industrial output during the first three-quarters of 1996 declined by 5% on the same period the previous year (1995: -3%), and the loss of output was again more than proportional in large and medium-sized firms. Whereas in 1995 three industrial branches (iron and steel, non-ferrous metallurgy and chemicals and petrochemicals) experienced output growth, in the first three quarters of 1996 all branches without exception suffered a decline in output (cf. table 2).

The output loss was comparatively minor in the electricity industry (-0.6%) and the fuel industry (-3%). The output of natural gas (+1.0%) rose for the first time since 1991, whereas oil production again declined (-2%). Given the rise in oil exports, output in the oil-refining industry (-4%) fell more sharply than crude oil output. Unlike in 1995, the iron and steel and non-ferrous metallurgy sectors proved unable to offset the decline in domestic demand, resulting from the lower level of output in the metal-processing industry and the fall in investment, by raising exports; in consequence the output of these branches declined (-4% and -5%, respectively). Lower output in the chemical and petrochemical

<sup>1</sup> The OECD, for example, forecast GDP growth of 2% for 1996 and did not preclude the possibility of growth of 10%. Cf. *OECD Economic Surveys*, The Russian Federation 1995, Paris 1995, p. 23.

<sup>2</sup> Unless otherwise stated, all the statistical data are derived from Goskomstat.

Table 1

## Selected Economic Indicators

Change on previous year or share in %

	1990	1991	1992	1993	1994	1995	1996 I to III
Gross domestic product <sup>1)</sup>	-3.0	-5.0	-14.5	-8.7	-12.6	-4	-6
Industrial output <sup>1)</sup>	-0.1	-8	-18	-14	-21	-3	-5
Agricultural output <sup>1)</sup>	-3.6	-5	-9	-4	-12	-8	-8
Gross fixed capital formation <sup>1)</sup>	0.1	-15	-40	-12	-24	-13	-17
Volume of goods transport <sup>1)</sup>	-4.3	-7	-14	-12	-14	-2	-5
Retail trade turnover <sup>1)</sup>	10.0	-3.2	-3.5	1.9	0.1	-7	-3
Marketed services to end-user <sup>1)</sup>	10.2	-17	-18	-30	-38	-17	-7
Nominal monetary income of private households	18.0	120	750	1 030	360	158	58
Nominal wages and salaries	15.0	81	994	878	276	119	71
Real wages		-3	-33	0	-8	-28	8
Consumer prices <sup>2)</sup>	6	160	2 510	840	215	131	33
Industrial producer prices <sup>2)</sup>	4	240	3 280	895	233	175	32
Unemployment rate at end of period <sup>3)</sup>	.	.	4.7	5.5	7.4	8.8	9.0

1) Real. — 2) 1990: annual average; 1991 to 1995: December to December of previous year; 1996: September 1996 to September 1995. — 3) On ILO definitions.  
Source: Goskomstat.

industry reflected both the lower exports of many basic chemical products and falling domestic sales. Engineering and metal-processing output (-14%) again fell markedly, due both to the lower demand for investment goods and competition from imports of consumer durables. Output has come to a virtual standstill in some sections of these branches. In the investment-good sector, the output losses were more than proportional in tractors and agricultural machinery (-43%) and machine tools (-34%); among consumer durables there were massive losses in cassette recorders (-70%), television sets (-68%) and video recorders (-60%). There was only a slight decline in the production of plant for the metallurgy industry (-2%). Completely against the trend, out-

put of personal computers rose by 307%, although the absolute volume of production - 114 000 units - remains modest, consisting primarily of production under licence in which the imported components are assembled in Russia. The industrial branch suffering the most serious output loss was light industry (-27%). Due to its lack of competitiveness, the domestic textile industry now has a market share of just 25%.

The crisis of Russian agriculture continues. In the first three quarters of 1996 agricultural output was down 8% on the previous year's level. The grain harvest amounted to an estimated 70 million t. Although this represents an increase of 10% on the previous year, it is still the third worst result of the past 30 years. Animal

Table 2

## Industrial Output by Branch

Real change on same period the previous year in %

	1990	1991	1992	1993	1994	1995	1996 I to III
Industry, total <sup>1)</sup>	-0.1	-8.0	-18.0	-14.1	-20.9	-3.3	-5
Electricity industry	2.0	0.3	-4.7	-4.7	-8.8	-3	-0.6
Fuel industry	-3.3	-6.0	-7.0	-11.6	-11.0	-2	-3
Iron and steel industry	-1.9	-7.4	-16.4	-16.6	-17.4	9	-4
Non-ferrous metallurgy	-2.4	-8.7	-25.4	-14.1	-9.1	2	-5
Chemical and petrochemical industry	-2.2	-6.3	-21.7	-21.5	-28.9	8	-13
Engineering and metal-processing	1.1	-10.0	-14.9	-15.6	-38.1	-10	-14
Wood, wood processing, cellulose and paper industry	-1.2	-9.0	-14.6	-18.7	-31.2	-7	-20
Building materials industry	-0.9	-2.4	-20.4	-16.0	-28.9	-8	-25
Light industry	-0.1	-9.0	-30.0	-23.0	-47.3	-31	-27
Food industry	0.4	-9.5	-9.0	-9.2	-21.9	-9	-8

1) 1990 to 1993: only large and medium-sized enterprises. 1994 to 1996: including small firms and joint ventures. The data for the various branches refer only to large and medium-sized firms in all years.  
Source: Goskomstat.

products also declined (meat and eggs: -7%; milk -9%), as have animal stocks. On 1 September 1996 there were 10% less cattle than a year earlier; the stocks of pigs fell by 13% and of sheep and goats by 18%. Agricultural policy has reacted to the problems in the sector largely by means of structure-conserving measures, including the granting of subsidies and preferential loans, in some cases financed out of the budget, in order to enable farmers to purchase fertiliser and fuel or to lower the price of electricity. In addition agricultural enterprises were allowed to postpone interest and principal payments on loans granted in the years 1992 to 1995.

The easing of inflation observed since the spring of 1995 continued during 1996. The monthly rate of consumer price inflation has been under 5% each month since August 1995. Indeed, in August 1996 the price level actually declined for the first time since price liberalisation at the start of 1992, although this was solely due to seasonal factors. The monthly rate of increase of industrial producer prices has also been under 5% since October 1995 (cf. table 3).

## Labour market

The official figure for the economically able-bodied population in 1996 was 73 million. In August 1996 just under 66 million were in employment, a decline of 1% on the same month the previous year. During the first two quarters of 1996 employment fell in light industry, the wood, cellulose and paper industry, engineering, construction and science. The electricity sector, oil refining, natural gas, trade and hotel and catering, the housing sector, local authorities, the public administration, education and culture reported employment growth.

Using the methodology of the International Labour Office (ILO), the State Committee for Statistics calculated unemployment to be 6.6 million for September 1996, representing an unemployment rate of 9.0%. The number of persons registered with the employment offices as out of work is far lower, however, as not all job-seekers register with the authorities. In September 1996 2.7 million people were registered as job-seekers, representing an unemployment rate of 3.7%. Of these, 2.5 million were recognised as "unemployed persons", i.e. they had been out of work for at least three months. At the end of September 1996 333 000 vacancies were registered with the employment offices.

State-owned enterprises and the large companies reconstituted as joint-stock companies continued their efforts to avoid mass redundancies by means of short-time working. In June 1996 a total of 5.3 million workers were on short time; a further 2 million were on unpaid leave. Around 70% of the short-time workers were

Table 3

## Monthly Price Inflation

Change on previous month in %

	Consumer prices			Industrial producer prices		
	1994	1995	1996	1994	1995	1996
January	18	17.8	4.1	19	21.5	3.3
February	11	11.0	2.8	16	16.9	2.8
March	7	8.9	2.8	10	10.7	2.6
April	8	8.5	2.2	10	14.8	2.4
May	7	7.9	1.6	7	8.9	1.1
June	6	6.7	1.2	8	6.1	1.6
July	5	5.4	0.7	8	6.7	1.2
August	5	4.6	-0.2	6	6.8	2.1
September	8	4.5	0.3	7	5.7	1.8
October	15	4.7	1.2	11	4.6	
November	15	4.5	1.9	13	2.9	
December	16	3.2		13	1.8	

Source: Goskomstat.

employed in industry, with 37% of all short-time employees concentrated in engineering alone.

## Private household incomes

Real monetary household income in the first three quarters of 1996 remained constant compared with the same period the previous year, following a 12% decline during the first three quarters of 1995. Indeed, real wages actually rose by 8%, compared with a decline of 29% over the same period in 1995. In real terms the average old age pension increased by 7%.

Given the precarious financial position of many firms and the serious fiscal deficits, it is not surprising that there has been an increase in outstanding wage payments. Since the start of 1996 there has been a sharp climb in the number of firms and organisations with outstanding wage dues and in the volume of wages not paid on schedule. During the first three quarters of 1996 the number of firms and organisations with outstanding wage dues rose by 145% to 98 400; the volume of wages not paid on time rose to more than 40 000 billion rouble. This implies a doubling of unpaid wages in real terms (cf. table 4). On top of this come outstanding wage payments in the army of 7 000 billion rouble, outstanding pension payments of 17 000 billion rouble and unpaid social benefits totalling 5 000 billion rouble. The outstanding volume of unpaid wages amounts to virtually a month's wages.

The provision of bonus wage payments to offset price increases and higher charges was continued, although the value of these bonuses declined from 11% of the average wage in 1995 to 4% in 1996 (in each case January to August). On average for the period January

Table 4

### Distribution of Outstanding Wage Payments\*

Sectors/Public sector areas	Share in %
Total	100.0
of which:	
Industry	49.2
Construction	13.7
Agriculture	13.0
Transport	8.6
Budget-financed organisations	15.5
of which in the area of:	
Education	7.3
Health	5.5
Culture and art	0.9
Science	1.8

\* As of 23 September 1996.  
Source: Goskomstat.

to July 1996, the bonuses varied from 2% of the average wage in agriculture to 13% in banking, insurance and finance. The minimum wage was raised to 63 000 rouble in January and to 75 000 rouble in April; in June it amounted to 27% of the statistically determined minimum subsistence income.

The minimum pension (including compensation payments) was set at 113 000 rouble in January 1996; since February it has amounted to 138 000 rouble. In June the minimum pension amounted to around 50% of the minimum subsistence income required for a single person of pensionable age. In September 1996 the average pension amounted to 122% of minimum subsistence income for pensioners (cf. table 5).

According to the official statistics there has been no further increase in income disparities. The differences in average per capita income, measured in terms of the ratio of the highest to the lowest income decile for the period January to September 1996 (12.9 times) remained virtually unchanged on the same period the previous year (13.4 times). The 10% of the population with the highest incomes drew 31% (1995: 31%) of the income, the lowest 10% received 2.4% (1995: 2.3%). While the proportion of the population in receipt of monetary income below the minimum subsistence level declined by almost one-fifth between the period January to September 1995 and the same period in 1996, the figure was still 22%.

## Government budgets

The decline in government revenues observed since 1995 accelerated further during the first eight months of 1996, primarily due to a substantial increase in unpaid tax dues. At the end of 1995 outstanding tax dues

amounted to 3.3% of GDP; by the end of August 1996 they were of the order of 9%. Meanwhile the budget deficit widened further (cf. table 6). Despite spending cuts the deficit of the consolidated budget after the first eight months of 1996 amounted to 5.4% of GDP (1995: 3.2%); if tax dues had been paid on schedule, government budgets would have posted a substantial surplus

All the same, the revenue problems facing government budgets are partly a consequence of political decisions: at the start of 1996 firms owing tax dues were allowed to spread payments on the tax arrears accumulated to the end of 1995 over a period of several years. Yet since the law came into force there has been no improvement in firms' ability or willingness to pay. Given the high real rates of interest on the money and capital market and banks' reluctance to grant corporate loans, firms have an incentive to delay payments as long as possible. While some firms justify their tax arrears with the state's failure to pay outstanding debts to them, the available data show that the government is in the position of net creditor vis à vis the corporate sector. At the end of June 1996 government debts to firms amounted to 0.9% of GDP; outstanding business tax arrears, by contrast, amounted to 8.1% of GDP.<sup>3</sup> In addition, firms owe debts to the extra-budgetary funds amounting to 5.8% of GDP. Together this means that, at the end of June 1996, corporate debts to the public sector totalled more than the entire revenue of the federal budget from the start of the year to that point in time. Firms have retained around 5% of GDP in profit tax and VAT alone. Large firms, in particular, are exploiting the tax authorities' limited scope to gain access to enterprise funds in order to improve their own liquidity position.<sup>4</sup>

Against this background the receipts of the consolidated budget during the first eight months of 1996 amounted to just 23% of GDP (1995: 26%). The decline in revenue from excise duties would have been much greater following the liberalisation of foreign trade had not substantial duties on imports of alcoholic beverages been imposed. The most important source of revenue during the first seven months of 1996 was value-added tax (5.6% of GDP). Receipts from privatisation lagged far behind the budgeted targets. By the end of August 1996 just 4% of the revenue expected to be derived from privatisation had been realised at the federal level.

Fiscal policy reacted to the revenue crisis by imposing spending cuts and delaying payments. Spending by the consolidated budget to the end of August 1996 amounted to 28.4% of GDP (1995: 29.4%). The various

<sup>3</sup> The *business sector* encompasses industrial, agricultural, construction and transport firms.

<sup>4</sup> According to the figures available, the 80 largest firms account for 73% of the outstanding payments.

Table 5  
Pensions 1996

	Average pension	Average pension as a proportion of average wage	Average pension as a proportion of minimum subsistence income of a pensioner
	in 1 000 rouble	in %	in %
January	241.9	37	99
April	267.8	36	102
June	310.3	37	115
September	311.2	37	122

Source: Goskomstat.

spending items were affected to a varying degree by the spending cuts and delayed payments. The resources made available to industry were cut more than proportionately, although it must be recognised that a rise in tax arrears amounts to a form of hidden subsidisation. If outstanding corporate taxes are added to direct government financial support, government subsidisation of the business sector amounted to more than 10% of GDP. In this the tax authorities have no influence on the distribution and utilisation of these financial resources. Given the government's problem of enforcing the law, firms with high turnover and profits benefited most from this quasi-subsidisation. Due to the cuts in direct financial support to firms, spending for social and cultural purposes, as a share of total spending, rose significantly (from 7 to 8.8% of GDP) during the first eight months of the year. The fact that this increase did not prove even more pronounced is almost certainly due to delayed wage payments. According to the figures available the government's debt to private households in the form of unpaid wages amounted in mid-August to 0.5% of GDP.

The deficit on the consolidated budget of 5.4% of GDP was financed by issuing government securities and borrowing from international organisations. For the first time since the start of the transition process, after the first eight months of 1996 it was not merely the federal budget that was in deficit (4.2% of GDP), but also those of the regional and local authorities. Financing the deficit on the domestic capital market, to which various authorities now have access, imposes a heavy burden of debt service costs due to the high real rate of interest and thus restricts the future scope for fiscal policy action. The high real rate of interest on government securities also serves to crowd out private investment. The financial requirements of the public sector are thus a drag on economic development.

Attempts have been made to defuse the fiscal policy crisis. According to a presidential decree the means of bringing about an improvement in the revenue situation of the government budgets are seen primarily in a

reduction in the number of taxes, curtailing the tax concessions currently granted and new regulations on calculating corporate profits. From January 1997 onwards the tax deductibility of interest payments, business travel and training costs from tax is to be limited. In the case of depreciation, existing concessions are to be cut back while at the same time allowances are to be increased. The net effect of these contrary measures cannot be determined at this point. In addition, since October 1996 taxes on sales are due on delivery and not, as previously, on payment. Yet the fiscal crisis facing the Russian Federation is due less to the way in which taxes are calculated than to the inadequate enforcement of existing taxation laws and the limited ability and willingness of firms to pay taxes. These problems are not addressed by the new decree. Instead the government is being ordered to draw up a tax amnesty law in order to improve tax collection and tax payers' honesty. Moreover, the interest on tax arrears to the federal budget is to be abolished and those for other tax dues substantially reduced.<sup>5</sup>

Recently efforts have been intensified to improve tax collection. There has also been increased pressure from abroad to enforce tax legislation. In the face of the delays in allocating IMF loans, Russia has committed itself to taking a harder line against tax evaders in future. To this end, lasting and credible steps to enforce existing demands against firms, including the closure of bankrupt firms are required.

<sup>5</sup> For tax arrears to government tiers below central government, a penalty of 0.3% per day is imposed; this represents an annual interest rate of 110%. Previously the rate had been 0.7%. Although the current real interest rate is extremely high, the regulation still permits firms to gain a financial room for manoeuvre in the face of the restrictive credit policy pursued by the banks vis à vis firms. Given the length of time required to enforce the taxation legislation and the fact that, in the past, tax amnesties have been granted in similar situations, the extremely high formal rate of penalty interest on tax arrears probably does not constitute an incentive to pay.



Table 7

## Money Supply and Credit Aggregates

Change on previous quarter in %

	1992	1993	1994	1995	1996	
	I to IV	I to IV	I to IV	I to IV	I	II
Cash	82	68	29	25	7	20
Monetary base	.	66	31	22	10	13
M2 (rouble)	63	51	32	22	10	10
M2 <sup>1)</sup>	.	.	33	21	8	10
Bank loans <sup>2)</sup>	.	.	36	13	9	5
Memo item:						
Producer prices	221	79	36	30	9	5
Consumer prices	177	76	33	24	10	5

These figures may deviate from those in earlier publications due to data revision. 1992 to 1995: average quarterly figures. — 1) Rouble money supply plus foreign currency holdings. — 2) Bank loans to firms and private households.

Sources: International Monetary Fund (IMF), International Financial Statistics, Washington D.C., October 1996; Government of the Russian Federation, Russian Economic Trends, Monthly Update, different issues, London and Moscow; Central Bank of the Russian Federation, Bulletin of Banking Statistics, Moscow 1996; calculations by the participating Institutes.

they are still significantly positive. The credit auctions offer the commercial banks a chance to make profits, as at times the rate of interest on government bonds (GKO) were above the auction rate. Indirectly the central bank has, through this scope for interest rate arbitrage, contributed to financing the budget deficit.

The fact that, in spite of the high level of real interest rates, the monetary base was able to expand strongly is due to a temporary inflow of currency reserves during the first quarter of 1996. From April to August, on the other hand, there was – except in June – a consistent outflow of currency reserves. In the second quarter, in particular, a relatively inelastic demand for credit by private households was the driving force behind the growth of the money supply (cf. table 8).<sup>9</sup> In June, too, this increase in accounts receivable from the government remained strong (4%).

In view of the precarious fiscal position and the still unresolved liquidity and solvency problems facing firms and banks, great efforts will be required in order to maintain the monetary stabilisation course. During 1996 it proved possible to offset, at least partially, the fiscal revenue losses by means of foreign loans and emitting government bonds. Yet domestic credit financing imposes heavy costs on the government in the form of interest obligations. A relaxation of the monetary stance would ease the pressure on government budgets by reducing interest payments and – if higher inflation resulted – a fall in the real value of the outstanding

debts. Considerable political pressure on the central bank to increase the money supply emanates from this mechanism. In June 1996 the government attempted to undermine the – at least formal – independence of the central bank. The government ordered the bank to transfer its 1994 profits to the public purse, despite the fact that the central bank law stipulates that the bank may decide autonomously on the creation of reserves and on the extent to which it transfers profits to the government. Although the central bank reacted by raising the minimum reserve ratios for the commercial banks<sup>10</sup> and suspending auction credits, it is all too clear that government organs are seeking to exert pressure on the central bank.

Besides the fiscal problems facing government budgets, the rising indebtedness of the corporate sector also poses a threat to monetary stability. Between January and July 1996 outstanding corporate debts increased in real terms by almost 40%.<sup>11</sup> High real rates of interest, the delays in implementing a bankruptcy law and the lack of structural change within the corporate sector have all contributed to the payment crisis.

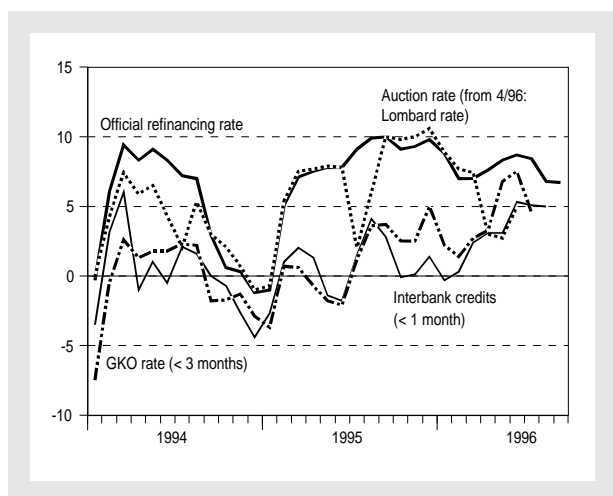
The fact that even the banks are now being affected by the inability of firms to pay their debts is shown by the increasing number of banking insolvencies. During the first half of 1996 non-performing loans and overdue

<sup>9</sup> One possible explanation for this is that foreign loans were passed on, via the central bank, to government. On acceptance of such loans the central bank's claims on the government would rise and its foreign assets decline. However, only a part of the increase in claims on government can be explained in this way.

<sup>10</sup> The minimum reserve ratios on giro and time-deposit accounts with a duration of up to 30 days were increased from 18 to 20%, for deposits with a duration of between 31 and 90 days from 14 to 16%, for deposits with a duration of more than 90 days from 10 to 12%, and for foreign exchange deposits from 1.25 to 2.5%.

<sup>11</sup> These debts include both those to the budget and the extra-budgetary funds and to suppliers. Over the year the relative shares of these two types of debt remained more or less unchanged at about 50% each.

Figure 1  
**Monthly Real Interest Rates**  
 in %



1) Calculated on the basis of the change of consumer prices in the month in question.

GKO rate = Interest rate on Russian government bonds.

Sources: International Monetary Fund (IMF), International Financial Statistics, Washington D.C., October 1996; Government of the Russian Federation, Russian Economic Trends, Monthly Update, different issues, London and Moscow; Central Bank of the Russian Federation?, Bulletin of Banking Statistics, Moscow 1996; calculations by the participating Institutes.

interest payments rose substantially faster than loans as a whole.<sup>12</sup> By mid-1996 21% of the credit volume consisted of overdue debts and interest arrears (end of 1995: 18%).<sup>13</sup> Since the start of the transition process the central bank has revoked the operating licences of a total of 463 banks (as of August 1996) – almost 40% of these in the course of 1996 alone.<sup>14</sup> While most of the banks closed were very small and of no supra-regional importance, in July one of the larger banks, the *Tveruniversalbank*, was closed for the first time. An open banking crisis has been avoided so far, however. The deposits of the *Tveruniversalbank* were assumed and guaranteed by the state-owned *Sberbank*, and the central bank made short-term liquidity credits available.

These observations clearly show that the central bank is walking on a tightrope. On the one hand a cut in the level of real interest rates is necessary in order to promote credit-financed production and investment

<sup>12</sup> Central Bank of the Russian Federation, *Bulletin of Banking Statistics*, no. 8(39), Moscow 1996.

<sup>13</sup> Cf. Central Bank of the Russian Federation, *Bulletin of Banking Statistics*, no. 1(32) and no. 8(39), Moscow 1996. At the start of 1996 significant revisions were made to the statistics on the extent of non-performing loans on the banks' books. Accordingly non-performing loans fell as a proportion of total bank loans from 33% to 8% at the end of 1995. Presumably this revision reflects the writing-off of irrecoverable debts.

<sup>14</sup> A further 9 banks were restructured or liquidated during the first seven months of 1996.

activities. On the other hand, if the monetary reins are slackened too abruptly the credibility of the central bank is in danger; it will then be more difficult to resist calls to finance the budget deficit and insolvent banks and firms. One way of establishing such credibility is by making monetary policy more transparent. Discretionary monetary policy measures, such as support for insolvent banks, should be avoided. Data on the monetary policy course and movements in the leading monetary and credit aggregates should be made available at the earliest possible time and should be readily interpretable. The monetary authorities are not in a position to create the conditions for lasting economic stabilisation on their own, however. Monetary policy measures must be underpinned by structural reforms in other areas of the economy; in the current situation this is particularly true of fiscal policy.

The credibility of the central bank – which is also responsible for supervising the banking sector – can also be increased by taking steps towards a lasting reform of the banking system. A new law on the activities of the commercial banks that came into force in February 1996 and brings Russian law broadly into line with international standards, provides a basis for this.<sup>15</sup> The law stipulates the activities that banks may perform (Article 5). Although Russian commercial banks may not operate directly as universal banks, the banks do in fact function – through their subsidiaries and investment funds – as universal banks. Financial-industrial groups currently receive support, for example in that the participating banks receive special conditions in the form of loans at interest rates below the official refinancing rate. This cannot be justified in market-theoretical terms, as interest concessions of this type represent a subsidisation of the participating banks and companies.

The law also seeks to place the system of deposit insurance that has so far been implicit on a legal footing (Article 36 ff.). In addition to requiring banks to create reserves for non-performing loans (Article 24) and to join a deposit insurance scheme, the state has guaranteed the deposits of banks in majority state ownership. It is unclear to what extent the guarantee also covers banks founded by state agencies. Given that most Russian banks have their roots in the Soviet monobanking system or were founded by state institutions, an implicit deposit guarantee by the government seems likely to persist for the leading banks. The activities of foreign banks remain restricted by substantial barriers to market entry (Article 17 ff.). Foreign banks must be in possession of a licence from the central bank, the volume of

<sup>15</sup> Stefanie Seeberg and Adalbert Winkler, Lending in a New Regulatory Environment – The Monetary Situation in Russia in the Summer of 1996, *International Project Consult*, Frankfurt 1996.



Table 8

## Origin and Destination of the Increase in Central Bank Assets

in % of the absolute increase in central bank assets<sup>1)</sup>

	1994	1995	1996		
			I	II	III
			Origin		
Foreign assets	20.5	51.2	50.8	-144.5	20.3
Domestic assets	79.5	48.8	49.2	244.5	79.7
of which:					
Claims on government	71.6	47.0	45.3	235.8	75.0
Claims on commercial banks	7.7	1.8	3.9	4.5	4.0
			Destination		
Currency in circulation	25.1	40.2	20.9	334.1	69.7
Commercial bank accounts	16.6	17.9	17.2	-3.2	14.0
Government accounts	10.7	6.9	21.1	-317.5	-31.7
Other liabilities (net)	47.6	35.0	40.8	86.6	48.0

1) Absolute increase = 100; as a result the figures can take negative values and values over 100.

Sources: International Monetary Fund (IMF), International Financial Statistics, Washington D.C., October 1996; calculations by the participating Institutes.

foreign capital within the Russian banking system is limited to a maximum of 12% and differing regulations may in principle be issued for foreign as compared with domestic banks. The liquidity and solvency criteria for banks have also been revised.<sup>16</sup> Even so, a number of special conditions – although in milder form – still apply to the traditional state banks, and a transition period was introduced by the end of which – in 1999 – all banks are to have met the new standards.<sup>17</sup>

In principle the bank closures that have occurred to date, and the revision of the banking legislation, constitute steps towards a credible banking reform. What is now decisive, however, is that the new standards are enforced rigorously and – above all – uniformly for all banks. This is all the more important given the serious risks involved in the close interrelations between banks and firms which make it difficult to control the activities of the banks. Competitive pressure and the transfer of knowledge from foreign banks could play an important role in transforming the banking sector. Particularly since convertibility of the rouble for capital transactions has yet to be realised, the removal of the still prevailing barriers to market entry by foreign banks is necessary if the reform concept is to be considered comprehensive.

<sup>16</sup> The new minimum capital for commercial banks with a general licence is ECU 5.0 million; the risk-weighted equity capital share was increased from 4 to 8%, a number of regulations on large-scale credits and liquidity coefficients were adjusted and weighting criteria for risk assets introduced. Cf. Stefanie Seeborg and Adalbert Winkler, *op. cit.*

<sup>17</sup> The central bank intends to increase the degree of control over a group of larger banks regarding adherence to the new standards. These banks are to be forced to publish their financial data in more stringent fashion and are to be restructured by the central bank.

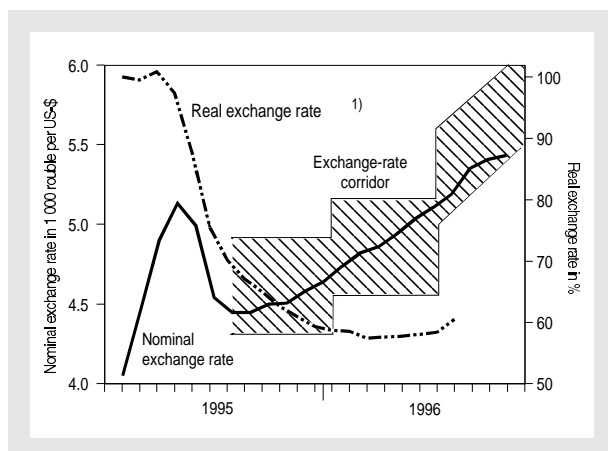
## Exchange rate policy

In 1995 a corridor for the exchange rate between the Russian rouble and the US dollar was set for the first time. In mid-1996 the central bank moved over to a crawling peg; since then, the exchange rate of the rouble against the dollar has followed a continuous devaluation path steered by the central bank within a "crawling band". The crawling band was adjusted from between 5 000 and 5 600 rouble at the start to between 5 500 and 6 100 rouble at end-1996. The crawling band announced for 1997 envisages a further devaluation to between 5 750 and 6 350 rouble per US-\$ as of 31 December 1997.

During the first half of 1996 the rouble depreciated against the dollar by an average of 1.6% per month (cf. figure 2). During the remainder of 1996 the depreciation of the rouble above and beyond the rate of inflation has meant that the real appreciation that occurred during the first half of the year was actually slightly overcompensated; the real appreciation that occurred in 1995 remained, however. In the second quarter of 1996, in particular, central bank intervention prevented a more rapid depreciation of the rouble.

At the start of June the central bank introduced full convertibility of the rouble for current account transactions, thus bringing the exchange rate regime into line with Article VIII of the statutes of the International Monetary Fund. *De facto*, however, the rouble had already been largely convertible on the current account, so that this step essentially required merely the abolition of the still existing restrictions on the use of rouble accounts for non-residents and on the repatriation of profits. Restrictions on capital transactions may remain in force. These are unlikely to be effective, however, and

Figure 2  
Exchange Rate of the  
Russian Rouble to the US Dollar



1) Real exchange rate calculated on the basis of consumer prices  
January 1996 = 100.  
Sources: Government of the Russian Federation, Russian Economic Trends,  
Monthly Update, October 1996, a.a.O.; calculations by the participating Institutes.

have – to the extent that they are evaded – the disadvantage that capital exports are not recorded in the official statistics, creating uncertainty about actual capital movements. In August 1996 cautious steps were taken to liberalise the Russian capital market for foreign investors. At the same time, however, the volume of purchases of Russian government bonds by foreign investors and the maximum yield accruing to foreigners were restricted. The overall effect of the new exchange rate policy is that the continued real appreciation of the rouble has been replaced by a slight real depreciation. This can be expected to have improved the competitive position of Russian exporters on world markets and reduced the incentive to substitute imports for domestic products. Moreover, the reduced inflow of capital has prevented the exchange rate target from exerting an expansionary effect on the money supply. Yet this decline is likely to have been primarily due to political uncertainty, as there is still a substantial interest rate differential compared with other countries, generating incentives to import capital. Moreover, the crawling band announced for 1997 amounts to a renewed real appreciation as the inflation rate in 1997 can be expected to exceed the planned nominal depreciation.

## Foreign economic relations

The available data on the most important balance of payments items for 1996 indicate that there has been no fundamental change in the balance of payments situation compared with 1995. During the first eight months

of 1996 there was a surplus on the balance of trade of US-\$ 14.4 billion (exports: US-\$ 56.6; imports: US-\$ 42.2 billion). On this basis, for 1996 as a whole, the results achieved in 1995 – a surplus of US-\$ 22.5 billion for the trade balance and of US-\$ 14.4 billion for the current account excluding factor services – are likely to have been repeated. According to German foreign trade statistics, Russian exports to Germany in the first half of 1996 were up by about 5%, and imports from Germany by about 8% on the previous year.

Trade with the CIS increased slightly as a proportion of total foreign trade. For exports the figure was 20.8% for the period January to August 1996 compared with 18.2% for the same period the previous year; the corresponding figures for imports were 30.3% and 25.9%. To some extent this trend is due to the fact that prices for intra-CIS trade were largely set in Russian roubles, and the value of these trade flows expressed in US dollar increased in the wake of the real appreciation of the rouble during the first half of 1996 to a greater extent than the prices for other exports and imports.

Apart from the surplus on the balance of trade, an inflow of foreign resources also is expected to have occurred from medium- and long-term borrowing for 1996 as a whole. The Donor Assistance Database of the G7 Support Implementation Group records disbursements of foreign aid of US-\$ 7 billion in 1996 up to the start of October. According to the same source, the figure for 1995 as a whole was US-\$ 12.9 billion: in evaluating the 1996 figure it must be taken into account that not all of the disbursements reported by the donor assistance database are reflected in the balance of payments and that reporting by donors occurs only after a time lag. Even so, it seems likely, on the basis of these figures, that the 1995 level of support will have been more or less matched in 1996. Further revenue is to be expected from direct investment; in 1995 direct investment totalled around US-\$ 2.0 billion. It seems that during 1996 revenue also entered the country in the form of portfolio investment for the first time. The vast majority of foreign portfolio investments do not enter Russian businesses, but are directed towards government bonds and investment in the banking sector. Increasingly, though, Russian firms are seeking to circumvent the restrictions of the domestic financial markets by placing equity stakes and bonds as American Depositary Receipts (ADRs) on the international financial markets.

On 29 April 1996 an agreement was reached on the long-term restructuring of Russia's foreign debts with the members of the Paris Club.<sup>18</sup> The rescheduling

<sup>18</sup> The obligations taken on by Russia since the dissolution of the Soviet Union on 28 October 1991 do not form part of the rescheduling agreement, as so far they have been serviced punctually.

agreement largely avoids the capitalisation of interest arrears, and a repayment period of 20 years was agreed for the greater part of the debt and 25 years for the smaller part. The rescheduling agreement covers debts totalling US-\$ 40.2 billion, of which around 46% are held by Germany.<sup>19</sup>

The rescheduling agreement reached with the Paris Club is tied to Russian adherence to the conditions of an IMF long-term loan from the "Extended Fund Facility". These conditions stipulate that Russia must limit the deficit of the consolidated budget to 4% of GDP, to be reduced by one percentage point in each successive year and to introduce comprehensive structural reforms in taxation and the banking and agricultural sectors. The IMF has repeatedly criticised Russia's failure to adhere to fiscal policy conditions and postponed disbursement of the tranches for July and then for October and November. More generally, though, the linking of the rescheduling agreement to IMF conditions has increased confidence in Russia's ability and willingness to pay.

Following the successful conclusion of the agreement with the Paris Club, in May 1996 the London Club, responsible for debts to the commercial banks, presented its rescheduling agreement for their approval to the commercial banks affected. By the end of September 1996 approval from the creditor banks was received for US-\$ 24 billion of the total of US-\$ 25 billion.

The rescheduling agreements and postponements of payment to the creditors organised in the Paris and London Clubs initially led to a marked fall in Russia's foreign payments obligations. Compared with original due payments in excess of US-\$ 20 billion p.a., the rescheduling agreements have reduced Russian payments obligations to around US-\$ 9.5 to 11 billion p.a. for the years 1996 to 1998. For 1999 an increase to around US-\$ 16 to 17 billion is to be expected as the IMF facilities then have to be repaid, climbing further to around US-\$ 20 billion in the year 2002. The rise in Russian payments set out in the rescheduling agreements has been perceptibly reduced by the provision of fresh credits. Within the framework of the Extended Fund Facility the IMF has made available a loan totalling US-\$ 10.1 billion to be disbursed over several years. From Germany, Russia's largest bilateral creditor, additional loans totalling DM 5.1 billion were made in 1996.<sup>20</sup> These loans are tied up closely with the conclusion of the long-term rescheduling agreement.

<sup>19</sup> *Russian Economic Trends*, Monthly Update, May 1996, p. 6; *Economist* of 4 May 1996.

<sup>20</sup> Of these loans, DM 4 billion consist of balance of payments and budgetary assistance (DM 1 billion of those funds tied to specific projects), and a further DM 1.1 billion of supplier credits secured by government-backed guarantees (Hermes and the BVS, the successor organisation to the Treuhandanstalt).

Both factors, the long-term rescheduling of foreign debt and the associated disbursement of new loans, significantly ease the short-term pressure on Russia. Equally important is that the long-term restructuring of Russia's foreign debt has served to reinforce the confidence of private investors in Russia's ability to pay. Russia's relatively favourable position in the rankings of the international rating agencies has significantly reduced the costs of obtaining finance.

The impact of the rescheduling agreements with the Paris and London Clubs is likely to be a rapid rise in Russia's outstanding foreign debt, however. Due to the partial capitalisation of interest arrears alone, Russia's foreign debt will increase, until the agreed principal repayments begin in the year 2002, to between US-\$ 145 and 180 billion, depending on the interest rate assumed.<sup>21</sup>

## Privatisation and market reforms

Since the change in the privatisation procedure from the voucher method to the direct sale of state enterprises, the pace of denationalisation has slowed markedly. Employment in the state-owned and mixed sectors<sup>22</sup> as a share of total employment fell by 10 percentage points during the voucher privatisation in 1993 (cf. table 9). In 1994 – it was in the middle of that year that the transition to privatisation by sale occurred – the decline in the employment share was just 3.5 percentage points, and in 1995 4.4 points. Since then denationalisation has virtually come to a standstill. Just 0.3% of the labour force were employed in the firms privatised in the first half of 1996. Thus employment in the mixed and state-owned sectors continues to represent around 62% of total employment. In terms of the number of enterprises due for privatisation, around 5% of those envisaged had been privatised (or at least partially so) by mid-1996.<sup>23</sup>

In the first half of 1996, 2 775 "objects" (firms, corporate divisions, land) were in the process of privatisation. Privatisation has concentrated on those enterprises that, by virtue of their activity profile and their small size, are relatively easily sold. 93% of the firms privatised between January and May employed less than 200 work-

<sup>21</sup> This scenario is based on the assumption that 60% of due interest payments are capitalised.

<sup>22</sup> The mixed sector contains partially privatised firms, including those in which the state retains a significant share. In order to describe the weight of the public sector, the mixed and the state-owned sector are considered together in the following – and not, as in other studies, the mixed and the private sectors.

<sup>23</sup> Calculated on the basis of figures from the State Committee for Property (GKI).

Table 9

## Structure of Employment by Ownership Form

	1990	1991	1992	1993	1994	1995
	in thousand					
Total employment	75 300	73 800	72 100	70 900	70 000	67 000
Public sector	62 200	55 700	49 700	37 600	32 970	25 996
Mixed sector <sup>1)</sup>	3 000	7 500	8 400	12 500	14 000	16 013
Private sector	9 400	9 800	13 200	19 900	22 120	24 120
Other sectors	700	800	800	900	910	871
	as a % of total employment					
Public sector	82.6	75.5	68.9	53.0	47.1	38.8
Mixed sector <sup>1)</sup>	4.0	10.1	11.7	17.6	20.0	23.9
Private sector	12.5	13.3	18.3	28.1	31.6	36.0
Other sectors	0.9	1.1	1.1	1.3	1.3	1.3

1) The mixed sector includes, among others, joint-stock companies in which the government holds a stake. Russian statistics do not indicate the precise distinction to the public and private sectors.

Source: Goskomstat.

ers. 35.4% of the firms belonged to the trade or hotel and catering sectors (first six months). As in the previous year, the proportion of firms in the industrial sector declined further (to just 16.8%; cf. table 10): 70% of the enterprises privatised were formerly local government owned. 582 of the objects were converted into joint-stock companies, prior to their actual privatisation. The state holds an equity share in 156 companies – in 51 cases in the form of a "golden share" that gives it a right of veto in important business decisions. The distribution of shares (cf. table 11) shows that government and workforces are the most important owners of the joint-stock companies so formed. The large proportion of shares that found no buyer indicates that external investors are largely uninterested in acquiring shares, particularly in the form of a minority holding. External investors have also been reluctant to participate in the direct purchases, auctions or tenders by means of which the remaining 2 193 objects were privatised. Around 43% of these were sold directly to former tenants, around 19% sold at auctions and commercial tenders and just 1% via investment tenders to external investors. As far as capitalisation is concerned, these results must be viewed negatively, as the primacy of sales to former tenants makes it unlikely that substantial amounts of capital will be invested. Moreover, in the past the commitments on investment made by tenderers were frequently not honoured.

By the summer of 1996 a total of 35 so-called financial-industrial groups had been set up throughout Russia. In principle a financial-industrial group represents a voluntary association of legally autonomous firms and financial institutions.<sup>24</sup> The members of the group found a so-called central company, comparable to a

holding company. In order to acquire the status of a financial-industrial group, the group must register with the authorities, providing various documents (formation contract, list of shareholders etc.). State bodies decide on registration on the basis of a report. Officially the formation of such groups aims to bring together privatisation and demonopolisation with structural change. In particular, the cooperation between banks and firms is supposed to improve investment financing. To this end the groups are entitled to a number of benefits. The central bank may reduce the minimum reserve ratios for certain banks belonging to financial-industrial groups, and the government may grant investment guarantees and grant groups the right to set their depreciation periods at their own discretion. These direct and selective concessions constitute instruments of a centrally steered structural policy. Within a registered group, property is to be concentrated within the central company. Although competition law sets certain limits on the concentration of ownership, the danger remains that the state will increase its influence on the activities of such groups through selective registration, support and concentration of its ownership shares.

As a means of regulating natural monopolies, new price guidelines were issued in the second half of 1996. For commercial consumers the prices for transport and loading of crude oil and initially also the price of natural gas were tied to the average rate of growth of industrial prices. In October natural gas and electricity prices for industry were frozen until the end of the year. Indeed, for large-scale consumers, electricity prices were actually cut as of November. Given that business consumers rarely pay their fuel and electricity bills in any case, the effect will merely be to reduce the extent to which payments arrears against the energy companies are accumulated. The incentives to save energy, and to restructure production accordingly, remain inadequate.

<sup>24</sup> In practice, however, it cannot be precluded that the formation of these groups is being promoted by central organs such as ministries.

As far as foreign trade is concerned, the export duties on crude oil and natural gas were reduced during the first half of 1996, the loss of revenue being partially offset by an increase in the indirect taxes on oil and gas and in the pipeline tax. Although with the abolition of the export duties on energy on 1 July 1996 Russia, under pressure from the International Monetary Fund, has abolished the last of its export duties, these measures were counteracted for oil companies by the imposition of differentiated export taxes on 1 August. From 1997 onwards taxes are also to be imposed on gas exports. Given that it is more difficult to collect indirect taxes than export duties, the reorientation in favour of taxes has served to reduce fiscal revenue.

## Summary and outlook

In the autumn of 1995 the international financial institutions were agreed in forecasting the onset of economic growth in Russia during 1996. The Institutes, on the other hand, expressed their concern that a further decline in output might occur. Actual developments have confirmed this worry; indeed, they proved even worse than feared. Not only has GDP contracted – probably by at least 5% – the decline was even more pronounced than the previous year. The slide in investment that has continued for several years now was maintained in the first three quarters (–17%), again an acceleration of the decline. The optimism for 1996 was based on the growth recorded in 1995 in some areas of industry. Yet output growth was restricted to basic-goods industries such as iron and steel, non-ferrous metallurgy and chemicals/petrochemicals. In 1996 nothing remained of these first signs of recovery. Not in a single industrial branch did output grow. This is partly due to the still extremely high real interest rates and the long period of real currency appreciation. The latter has gradually come to an end in the wake of the transition to a more flexible crawling peg or band since mid-year.

What remains is a real interest rate of over 50% p.a. as the core element of the counterproductive incentives characterising the Russian economy. Not only do such high interest rates make it prohibitively expensive for firms to finance investment, they have also induced firms to invest profits or other liquid assets in government securities. These assets also include financial resources that should have been used to pay taxes and wages.

Secondly, high real interest rates place a heavy burden on fiscal policy. The rapid rise in public debt has raised the government's need for refinancing and has pushed up interest rates on the market for government

Table 10  
Privatised Firms by Branch  
in %

	1994	1995	1996 I to II
Industry	26.9	20.5	16.8
Agriculture	3.0	1.8	2.3
Construction	5.4	3.0	3.5
Transport and communications	11.0	9.3	9.5
Trade	28.8	32.2	30.1
Hotel and catering	5.4	5.8	5.3
Other	19.5	27.4	32.5

Source: Goskomstat.

bonds (GKO). Because the tax authorities are failing to collect tax dues, all tiers of government have reacted to the precarious financial situation by further cuts in spending, often abandoning important public capital spending projects. Despite this, the budget deficit in the first eight months of 1996 was, at around 5.4%, again higher than in the previous year.

Thirdly, the banking sector is exploiting the high real interest rate to acquire relatively risk-free government bonds. The banks often obtain the necessary liquidity by means of credit auctions from the central bank. This has led to a sharp rise in the money supply that has bypassed the business sector.

Fourthly, the real interest rate differential compared with the rest of the world has again prevented a more pronounced real currency depreciation to the extent desirable in the current situation in order to stimulate exports. Under such conditions exports proved unable – as they had done in 1995 – to chart out a path towards real economic recovery.

In such a situation it would seem obvious to recommend a swift cut in interest rates by the central bank, all the more so given that all is quiet on the exchange rate front. Yet one must not overlook the fact that the high real interest rate is not only a cause of the negative developments mentioned, but is itself an expression of the extremely sceptical view of Russian transitional policies taken by national and international market agents. High real interest rates are an expression of substantial uncertainty and the risk premium demanded by those investing in Russia because of the inconsistencies, failures and delays in transformation policy.

Under such circumstances it cannot be precluded that a rapid cut in interest rates by the central bank might kindle expectations of inflation and currency depreciation, thus leading not to the desired fall in real interest rates, but rather to capital flight. A better policy would be to open up the capital market. Russian banks are keen to prevent foreign competitors from gaining access to the market for government bonds in order to

Table 11

## Ownership Structure of Newly Emitted Shares

	1st half 1995		1st half 1996	
	Mill.	Share in %	Mill.	Share in %
Shares emitted	304.7	100.0	132.4	100.0
of which:				
Publicly owned	70.9	23.3	34.3	25.9
Held by workforce	122.7	40.3	49.9	37.7
Transferred to holding companies	16.3	5.3	15.3	11.5
Successfully placed with the public	47.6	15.6	4.5	3.4
Sale failed	47.2	15.5	28.4	21.5

1) It must be taken into account that government retains decisive influence over many firms in the form of a "golden share".

Source: Goskomstat.

counter any trend towards lower interest rates that would bring to an end the lucrative exploitation of interest rate arbitrage. If the capital market were opened, foreign institutional investors would in all probability take a more positive view of the prospects for the Russian market, would supply more capital, initiate a move towards lower interest rates and, not least, also convince potential domestic investors that it pays to bring capital back to Russia.

Such a policy is a necessary, but not a sufficient, condition to bring about a cut in interest rates. Rather, confidence must be engendered in the consistency and reliability of Russian economic policy as a whole. An important additional condition for interest rate cuts is fiscal policy reform. Most urgently required is the credible threat of sanctions against large-scale tax debtors, particular those in the energy sector. The initiation of bankruptcy proceedings against a number of medium-sized tax debtors in October 1996 constituted a step in the right direction. This will only exert a disciplinary effect on large debtors, however, if the proceedings are brought to a conclusion and, in the final analysis, all firms are treated equally. The impenetrable jungle of exceptions (tax concessions, subsidised loans, special minimum reserve ratios for certain banks etc.) have rendered market forces ineffective or have nipped them in the bud.

Additional impulses must also come from privatisation. In spite of all the weaknesses and incentive problems associated with earlier and current privatisation procedures, it must be recognised, on a positive note, that 36% of all employees are now active in the private sector and a further 24% in the mixed sector – firms with a state shareholder – compared to just 13% and 4% respectively in 1990. These percentages bear comparison with a number of central and east European transition countries that have made greater progress

with transition than Russia. Yet the pace of privatisation has slowed since the programme of voucher privatisation was abandoned and state-owned firms have been largely privatised by direct sale. Agriculture, too, has been largely unaffected by privatisation, a fact that has contributed to the continued decline in output.

A sensible policy on wages is an indispensable component of any package of reforms. Such a policy is yet to be established. For example, although statistically real wages rose by 8%, the rapid rise in outstanding wage payments means that private household purchasing power has not increased to the same extent. This sort of practice, particularly by the public sector, is conducive to social instability and undermines confidence in the rule of law.

The slight economic recovery forecast by the Russian government for 1997 – GDP growth of 1% – can only be achieved if economic policy changes along the lines sketched in the preceding paragraphs. If this does not occur, a further decline in GDP of around 3% is to be expected. During 1996 the efforts by the central bank to significantly reduce the rate of inflation were successful. For 1997 an inflation rate of 25% (December to December) can be seen as realistic. However, given the exchange rate corridor announced for 1997, which permits a depreciation of no more than 15%, there is the danger of a renewed real appreciation of the currency, which would damage the prospect for economic recovery.

Against the macroeconomic background described above the question of further financial support for Russia by western governments needs to be addressed. On the one hand Russia's international reputation improved in 1996 (October) in the eyes of the international rating agencies. The decisive factor behind this is likely to have been the long-term rescheduling agreed with the Paris Club and the sure prospect of a similar agreement with the London Club. On top of this comes the fact that Russia has punctually serviced all the debts taken out since 1992. Problematic, on the other hand, is that the burden of debt service will rise extremely sharply in the year 2002. Russia will only be able to service its debts, including the loans granted between now and then, on schedule if, by means of appropriate economic policies, it has by this time managed to achieve a sustained and adequate rate of economic growth and an efficient utilisation of foreign resources. Moreover, Russia has ensured that the yield from credit-financed projects leads to corresponding export surpluses. In 1996 these preconditions were either not met at all, or not to a satisfactory extent.