The Economic Situation in Russia and Belarus[1]

by the German Institute for Economic Research, Berlin (DIW) and the Institute for the World Economy at the University of Kiel (IfW) with the collaboration of
the Institute for Economic Research Halle (IWH)

The Economic Situation in Russia

Economic policies must finally spawn growth

In 1997 some progress was made in transforming Russia's economy. The slump in gross domestic product and the massive outflow of capital seemed to have come to a halt in the fall, the inflation rate has reached its lowest level since the beginning of the transformation process, the currency is stable, and institutional reforms are being effected. Consequently, the available forecasts predict an economic recovery for 1998. The forecasts for GDP growth range between 1 and 5 per cent. In the past, however, excessively optimistic forecasts have frequently not been met. The present report discusses the conditions necessary to overcome last year's economic stagnation and to initiate a process of sustained growth.

In the first three quarters of 1997 (cf. table 1), a small increase in private consumption prevented a further decline of GDP, while investment, government consumption, and net exports by contrast, declined, investment particularly strongly. Growth has been reported for only a few branches and product groups. In engineering, the only expanding sector has been automobiles, which still enjoys a high degree of protection from import tariffs. In the raw materials and energy sector, a small increase in the production of crude oil has been accompanied by a noticeable decline in the output of natural gas. Both agricultural production and the transport volume have contracted, in some areas sharply. In view of the stagnation of GDP, the situation on the labour market failed to improve. The decline in employment merely slowed, and the rate of open unemployment has remained at a level in excess of 9 per cent.

The renewed decline in investment by more than 7 per cent is one indication of the fragility of the economic situation. While extremely high real interest rates and uncertainty about the progress of reforms could no doubt explain hesitant investment behaviour in the past, the impact of these factors has declined significantly. Apparently, however, substantial uncertainty about the institutional framework still persists. It would therefore be incorrect to expect that tapping foreign capital alone could help to overcome the weakness of investment performance. Large inflows of foreign capital in the first half of 1997 mainly took the form of portfolio capital, and were almost exclusively used to finance the budget deficit. This also applies to a certain degree to the capital inflows into the corporate sector. The fact that foreign direct investment, while it has risen somewhat, still remains at a very low level shows that investors have yet to develop the necessary confidence in the institutional framework.

The high share of short-term capital inflows brings with it the risk of a sudden withdrawal of capital and a balance of payments crisis, as recent developments have shown. In addition, capital imports tend to lead to real exchange rate appreciation, which monetary and exchange rate policies only have limited means to counter. Such an appreciation is unproblematic if it reflects increases in productivity. If this is not the case – because foreign savings are used to finance government consumption or capital flight rather than productive investment – a balance of payments crisis becomes all the more likely. So far, there are few indications that the inflows of foreign capital have been invested. In order to improve the stability of the domestic currency, it is thus even more necessary to reduce the government deficit as the economy opens up further to foreign capital.

The Central Bank of Russia reacted to the capital inflows of the first half of 1997 by intervening on the foreign exchange markets to prevent a nominal appreciation of the ruble. These interventions have partly been sterilised through sales of government securities. Further inflows of foreign capital should contribute to lowering domestic market interest rates. Continued sterilisation of intervention on the foreign exchange market would thus be counterproductive, because the scope for a lowering of interest rates could not be exploited. In addition, the Central Bank should choose a sufficiently flexible range for the exchange rate corridor of the ruble in order to reduce the risk of a speculative attack. The widening of the corridor, as has already been announced for 1998, meets this requirement. Plans to establish a corridor around a virtually unchanged central parity for the coming three years, however, must be viewed critically: this is likely to result in a real appreciation, with all its potentially negative implications for foreign trade.

The need to stimulate investment, the opening up to foreign capital and increased market access for foreign financial institutions impose tough demands on the domestic banking system. The efficiency of the Russian banking system continues to suffer from a large share of non-performing loans, opaque corporate governance

[1] This is an abridged version of the report. The previous reports have also been published in the *Economic Bulletin*.

Table 1
Selected Economic Indicators
Change on previous year or share in %

	1990	1991	1992	1993	1994	1995	1996	1997*
Gross domestic product[1)]	–3.0	–5.0	–14.5	–8.7	–12.7	–4.2	–6.0	(0.4)
Industrial output[1)]	–0.1	–8.0	–18.0	–14.1	–20.9	–3.3	–4.0	(1.9)
Agricultural output[1)]	–4	–5	–9	–4	–12	–8	–7	–0.5
Gross fixed capital formation[1)]	0	–15	–40	–12	–24	–13	–18	–7.1
Volume of goods transported[2)]	.	–7	–24	5	–24	–10	–18	–22.1[6)]
Retail trade turnover[1)]	12	–3	–3	2	0	–7	–4	0.7
Marketed services to end-user[1)]	10	–17	–18	–30	–38	–18	–7	1.9[6)]
Nominal monetary income of private households	18	120	750	1 030	360	158	46	18.2
Real monetary income of private households[3)]	.	8	–51	11	13	–13	0	2.7
Nominal wages and salaries	15	81	994	878	276	114	55	19.5
Real wages		–3	–33	0	–8	–28	5	3.2
Consumer prices[4)]	6	160	2 510	840	215	131	21.8	(11.5)
Industrial sales prices[4)]	4	240	3 280	895	233	175	25.6	11.6
Unemployment rate [5)]	.	.	4.7	5.5	7.4	8.8	9.3	9.1

*) First to third quarter, preliminary figures for the whole year in brackets.
1) Real. — 2) On the basis of tons. — 3) 1990 to 1993: December to December of previous year; 1994 to 1996: annual average; 1997: January to September to previous year's period. — 4) 1990: annual average, 1991 to 1996: December to December of previous year; 1997: September to September of previous year (12-months-rate). — 5) At end of period, on ILO definitions. — 6) January to August.
Sources: Goskomstat.

structures, and high foreign exchange risks. An opening up to foreign capital must therefore be accompanied by an improvement in banking supervision. Protecting domestic banks from increased competitive pressure, and thus preserving oligopolistic market structures, would be the wrong strategy. Although the Central Bank has made substantial progress in the field of banking supervision, deficiencies persist, particularly with respect to the classification of non-performing loans and the tax deductibility of loan loss provisions as well as the assessment of foreign exchange risks.

Improved banking supervision can only provide the basis for a more efficient financial system: incentives for increased lending to the corporate sector must be created elsewhere. Currently, banks are hesitant to grant new loans, not least because they find it difficult to secure and to enforce their claims. It is striking that bankruptcy proceedings are rarely initiated by banks; rather the banks try to secure their claims by taking up equity stakes in firms. Progress with the reform of the institutional framework has certainly been made, but questions such as the privatisation of land are still not being treated in a satisfactory manner – and banks are thus deprived of an important instrument to secure their claims.

A more detailed analysis of the insolvency law shows that the implementation of the law has only partly been obstructed by a lack of institutional arrangements. Additional factors were the lack of political will and a lack of synchronisation with the tax law. The new draft of the insolvency law aims at speeding up insolvency proceedings and strengthening the position of creditors, but the fundamental problem of creditor passivity in the process of corporate governance is not being tackled. The new draft offered the chance to promote lending by banks and other creditors to the corporate sector. Moreover, the discretionary leeway in the implementation of the law could be reduced by introducing an automatic trigger to start insolvency proceedings, thereby enhancing the financial discipline of firms.

A central factor for the economic recovery is the rehabilitation of government finances. Reducing the deficit and improving the enforcement of tax claims can provide important signals for the enhancement of the institutional framework, and also help to reduce the risk of a balance of payments crisis. Yet with respect to reducing expenditure, the government has little room to manoevre: in the first three quarters of 1997, tax revenue remained almost 50 per cent behind targeted levels, and the federal government deficit reached about 7 per cent of GDP. Furthermore, a substantial share of tax revenue has been collected in the form of promissory notes, whose true value is quite uncertain.

The government must quickly signal that it intends to get to grips with its fiscal problems. Too much time has already passed since the beginning of the transformation process without producing visible results; the time at which Russia must begin to repay it's foreign debt is approaching. As elections are scheduled for the coming years, sweeping reforms will become increasingly difficult to implement. If the government is able to quickly rectify its legacy with respect to institutional reforms, the propensity to invest will eventually be promoted. This also requires a better payments discipline on the part of the public sector, the rigorous enforcement of tax claims, and the reduction of still existing indirect subsidies. As long as enterprises, in particular those in the energy sector, perform quasi-fiscal functions, they are implicitly being granted substantial bargaining power to withhold tax payments. The erosion of payments discipline then encroaches on other sectors of the economy. Resistance to harsher sanctions against enterprises which fulfil important social functions comes from the regional level. Reforms of public finances must thus comprise the entire system of fiscal federalism. Ultimately, structural reforms of the tax code are also needed, if the incentives to invest are to improve. Yet the necessary decisions keep being postponed. In the short run, reforms of the tax code cannot be expected to yield positive revenue effects.

Long-run growth perspectives are also affected by the integration of Russia into the international division of labour. Although substantial progress has been made in liberalising of foreign trade, it is still being hampered by the relatively high level of Russian import tariffs, delays in the negotiations on Russia's accession to the WTO, and a large number of anti-dumping cases, initiated, in particular, by the EU. In contrast to the central and eastern European transition economies with which the EU has concluded Europe Agreements, trade with the EU as a share of Russia's total foreign trade has declined since 1992. Russia should make efforts to take the jurisdictional and institutional norms of the EU as a guideline for its own institutional reform and to reduce non-tariff trade barriers. This would help to improve investment conditions and Russia's prospects for integration into European trade flows. The conclusion of a free trade agreement between the EU and Russia could set an important signal for the future integration of Russia into the international division of labour.

Based on their analysis of economic developments in Russia, the three Institutes are, for the first time, cautiously optimistic for 1998, provided the impact of the Asian crises remains temporary. Moderately expansive impulses could once again come from private consumption. No positive effect can be expected from public consumption however. Expansionary impulses from foreign trade seem unlikely at present. Sufficiently positive reform signals are thus crucial in order to bring the decline of investment to a halt. The more the recent critical developments on financial markets contribute to speeding up reforms, the less likely is a further decline in GDP. For 1998, the Institutes expect GDP growth in the range of 2 to 3 per cent. If net capital inflows resume, maintaining the exchange rate target would imply an increase in the money supply. If reforms continue, the remonetisation of the Russian economy and an increase in money demand will reduce inflationary pressure. A further – albeit slight – decline in the rate of inflation below the level of 1997 would therefore seem realistic.

The Economic Situation in the Republic of Belarus

The difficulties of initiating growth by command

For several years now, the three institutes have commented extremely critically on the economic policy pursued by the Republic of Belarus. The numerous discretionary interventions in economic processes, in particular, run counter to the idea of an economic policy oriented towards the market economy. They have served to slow the implementation of reforms, if not actually reverse them. Criticism has focused on the lack of progress made in privatisation, the abuse of monetary policy instruments for the purposes of administrative steering of the economy, and the inappropriate exchange-rate policy, that has repeatedly failed to put an end to the overvaluation of the Belorussian rouble. The Institutes consider this incorrect economic policy framework to be the reason behind the persistent decline in economic output in recent years. They also criticised the almost fatalistic hope pinned on support from Russia – in the form of either cheap energy, regaining former sales markets or direct financial support – in order to arrest the economic decline.

Yet recently, the country's official statistics reported an increase in real GDP of no less than 11% during the first half of 1997. And provisional data suggest a similar growth rate for the year as a whole. Although statistical inconsistencies continue to exist, it must be supposed that a considerable recovery in the level of economic activity has in fact taken place. The decisive impulse for the astounding recovery of the economy came from a turnaround in investment activity. Whereas there was an absolute decline in 1996, investment expanded at a rate of 18% during 1997, according to the most recent figures. Yet this trend, however satisfying it may appear at first sight, at the same time reveals a number of problems associated with the supposed economic turnaround. The rise in investment consists largely of construction activity, particularly private housing construction. Behind this trend, in turn, lies the fact that credit has been made available at substantially negative real rates of interest (a credit interest rate of 5% while inflation is running at more than 50%) to private persons for this specific purpose. These cheap credits are in fact tantamount to subsidies to construction costs, financed by printing money. Such a policy amounts to a step backwards towards the financial system under socialism, and must be viewed extremely critically. In efficiency terms, attention must be drawn to the allocative distortions resulting from the specific subsidisation of any given sector of the economy. As far as macroeconomic stabilisation is concerned, the accelerating effect on inflation must be borne in mind. It might be possible to ignore both problems if it could be expected that the monetary impulse would prove to be more than a straw fire, and would lead on to a broad-based growth process. Thus it is important to ask whether the framework of conditions in Belarus is conducive to transmitting and reinforcing this initial impulse. Yet it is precisely here that virtually all the preconditions related to the market order and processes are missing. Significantly, there are no signs of induced investment within the construction industry itself, which has benefited most from the monetary impulse. On the contrary, investment activity in this area declined, as did that of industry as a whole.

A more detailed analysis reveals that the fundamental problems of the Belorussian economy remain unsolved, irrespective of the reports of economic growth. While unemployment has remained at just a little over 3%, the under-employment of people in formal employment relations remains at an extremely high level. Even so, the real monetary income of the population has risen strongly (10% according to the official statistics), whereby the rise in real wages has lagged only marginally behind that of profits. According to the official statistics the growth of private consumption was even more rapid. Although fiscal policy has not exerted an expansionary impact, as the overall government budget is practically balanced, the task of subsidisation is no longer performed by fiscal policy, but has been assumed by monetary policy, in the form of loans tied to specific projects in housing construction and also agriculture. The government apparently considers it expedient, for instance with a view to international financial institutions, to be able to point to a balanced budget. At the substantive level, however, it does not intend to abandon the old policy. The same impression is given by the course taken by privatisation. Socialism remains the role model for the economic order; only slightly more than one tenth of the labour force are employed in the private sector. Not least for this reason, it would be incorrect to suppose that Belarus was proceeding towards an economic model based on the market economy, if not on democracy: neither democracy nor the market economy plays a major role in Belarus.

For small economies such as Belarus, the external economic environment is of central importance. Developments here can, especially if they lie outside the ambit of economic policy, override the economic processes that would otherwise be expected, in some cases such that they can no longer be recognised. Belarus has so far pursued a policy that has failed to devalue the currency as appropriate, or has done so too late. In consequence, the persistent overvaluation of the currency has caused the

Table 2

Selected Economic Indicators

Change on previous year or share in %

	1990	1991	1992	1993	1994	1995	1996	1997*)
Gross domestic product1)	.	–1.2	–9.6	–10.6	–12.6	–10.4	2.6	(10.0)
Industrial output1)	2.1	–1.0	–9.4	–10.0	–17.1	–11.7	3.5	(17.6)
Agricultural output1)	–8.7	–4.9	–8.5	3.7	–14.1	–4.7	2.4	4.6
Gross fixed capital formation1)	9.0	4.0	–29.0	–15.0	–11.0	–31.0	–5.0	18.0
Volume of goods transport2)	–3.1	–5.7	–25.1	–30.1	–36.2	–25.7	–19.3	5.1
Employment	–0.9	–2.5	–2.6	–1.3	–2.6	–6.1	–1.0	0.8
Retail trade turnover1)	14.7	–8.1	–22.0	–14.4	–10.0	–23.0	31.0	19.0
Nominal private household income	17.7	94.4	755	1 390	2 008	496	79.5	72.3
Nominal wages	16.0	101.0	838	1 107	1 504	669	60.5	73.9
Consumer prices								
Annual average	4.7	94.1	971	1 190	2 221	709	52.7	(63.8)
December to December	.	.	.	1 997	1 960	244	39.3	29.4
Industrial producer prices								
Annual average	.	165	531	1 787	1 916	499	36.3	80.9
December to December	.	238	4 091	3 868	1 857	140	32.3	49.0
Unemployment rate an period’s end	.	0.1	0.5	1.4	2.1	2.7	3.9	3.3

*) First to third quarter, preliminary figures for the whole year in brackets. — 2) Real.— 3) On the basis of tons.
Sources: Belarus Ministry of Statistics; Belarus Economic Trends, June 1997, p. 21ff.; Reuters.

trade deficit to widen and has created a large black market for foreign currency. De facto split exchange rates have also resulted from the fact that significant price concessions were made in barter trade with the main creditor country, Russia. By introducing these discretionary measures the government has attempted to bring the balance of trade trend back under control. Indeed, non-registered exports to Russia, arms exports to third-world countries and debt-equity swaps with Russia appear to be functioning as the invisible lifeline of the regime.

These developments all serve to reveal the extraordinary degree of dependence of the Republic of Belarus on the Russian Federation. Consequently, any prognosis depends to a significant degree on the extent to which Russia is prepared to finance the misguided policies pursued by its neighbour. The prospects of this seem to be becoming increasingly bleak. Besides this uncertainty factor, any prognosis must also consider the reservations about the economic growth recently observed, regarding its sectoral structure, causes and its sustainability. As far as monetary stability is concerned, both the inflationary impulses emanating from monetary and credit policy, and the dampening effects (in purely statistical terms) of the administrative price controls will make themselves felt. The Institutes expect that the official rate of inflation will exceed an annual rate of 60 per cent in 1997. For 1998 it is already evident that inflationary trends will be influenced by the inevitable devaluation of the Belorussian rouble, even if this devaluation is once again postponed until the last minute. On the other hand, at least a partial monetisation of the already existing overdue payments and current spending will occur. In the light of this, the Institutes expect inflation to continue at a rate approximately equal to that in the current year. Given that there are no signs that the monetary impulse will give rise to a broad-based growth process, a renewed stagnation or even a slight decline in GDP is to be expected.