

# The Russian Economy

## Concern about reform delays

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In 1997 a number of developments occurred in the Russian Federation that can be interpreted as the seeds of an economic recovery. Through no fault of its own, Russia was then badly affected by the Asian currency crises. Just as it appeared that Russia would prove able to successfully face up to this challenge, the financial consequences of the fall in the price of oil on world markets began to exert a serious effect on Russian export receipts and the central government budget. In such a situation the replacement of the Russian government threatened to postpone economic policy reforms to a worrying extent. The hope is that the time lost will be made good by all the more decisive action by the new government.<sup>1</sup>

## Macroeconomic developments

After the many years in which hopes of recovery had repeatedly been dashed, Russia's economic decline finally came to an end in 1997 (cf. table 1); GDP stabilised (+0.4%). This overall figure includes unofficial economic activity as estimated by the State Committee for Statistics (Goskomstat).<sup>2</sup> However, the overall picture of stabilising output conceals extremely divergent developments.

The decisive factor preventing a further decline in GDP was the trend of private consumption. Evidence of this comes in the form of a marked increase in retail trade turnover (+2.5%) and market services for final consumers (+3.7%). Service growth was reported for the first time since 1990. Within the context of general service growth, that in the automobile-related areas was particularly striking; in real terms automobile workshop turnover rose by 19%.<sup>3</sup> Spending on local government

services (e.g. private electricity consumption) declined in real terms (-2.8%); this seems likely to be linked to price trends (see below).

Retail trade turnover expanded very strongly, particularly during the second half of 1997, with a trend towards a further acceleration in the fourth quarter (+6.6% on the fourth quarter of the previous year). Real turnover of food expanded fairly constantly in the course of the year (at a rate of around +3%); last year it contracted in all four quarters. The accelerating trend in retail trade turnover as a whole was due primarily to non-food trends, which declined in real terms during the first half of the year, but then recovered, expanding by as much as 9.1% in the last quarter of 1997. This impressive trend is in need of some explanation, however. First of all, it needs to be borne in mind that a large volume of overdue wage, pension and transfer payments was made in the fourth quarter of 1997, and this seems to have had a direct effect on the consumer-good market.<sup>4</sup> And on top of this, it seems that to some extent purchases were brought forward in the run-up to the redenomination of the rouble (at the rate of 1 000 to one) due to fears of hidden price rises, and possibly also due to renewed expectations of depreciation and inflation in the wake of the Asian crises.<sup>5</sup>

Looking beyond these rather short-term aspects, there are some indications that the scope for a lasting expansion of domestic output is widening. A number of factors, including foreign direct investment in consumer-good production, are evidently reducing the market shares of imported goods on the consumer-good market, which had risen sharply in recent years: the share of the market filled by imported goods rose rapidly from 23% in 1992 to 52% in 1995; it remained at this level in 1996, but then fell for the first time in 1997 to 49%.

The real volume of gross fixed capital formation declined once again in 1997 (-5.0%), the contraction was markedly slower than during the 1990s to date, in which two-digit annual rates of decline had been typical. One indication of a changing trend towards economic growth can be seen in the fact that so-called productive investment contracted only slightly last year (-1.1%). Investment for social purposes ("non-productive" investment), on the other hand, again fell sharply (-11.5%), although

<sup>1</sup> Unless otherwise indicated, all the statistical data are from Goskomstat (the State Committee for Statistics). Precise sources are given in the full-length German version of the report; cf. *Wochenbericht des DIW*, no. 18/98.

<sup>2</sup> See, for example, Goskomstat: *Rossiia v tsifrakh 1997*, Moscow 1998, p. 127; it seems likely that GDP would have continued to decline in the absence of the rapid growth posited for the unofficial economy.

<sup>3</sup> Strong growth was also recorded in telecommunications (13%), private medical services (20%) and education (40%).

<sup>4</sup> This had a particularly strong effect on sales of alcoholic beverages, which expanded by 12%. It should be noted that the decisive figures for the second half of 1997 consist primarily of estimates by the statistical authorities. The figures were "adjusted".

<sup>5</sup> Further evidence comes in the form of the decline in the savings-to-income ratio in the last quarter of 1997.

Table 1

**Selected Economic Indicators**

Change on previous year or shares in %

	1990	1991	1992	1993	1994	1995	1996	1997
GDP <sup>1)</sup>	-3.0	-5.0	-14.5	-8.7	-12.7	-4.2	-4.9	0.4
Industrial output <sup>1)</sup>	-0.1	-8.0	-18.0	-14.1	-20.9	-3.3	-4.0	1.9
Agricultural output <sup>1)</sup>	-3.6	-5.0	-9.0	-4.0	-12.0	-8.0	-5.1	0.1
Fixed capital formation <sup>1)</sup>	0.1	-15.0	-40.0	-12.0	-24.0	-10.0	-18.1	-5.0
Volume of goods transport, in tonnes	.	-7.4	-23.6	5.0	-24.3	-10.2	-17.7	-9.8
Volume of goods transport, in tonne-kilometres	.	-7.4	-13.9	-11.5	-14.2	-1.0	-4.6	-3.6
Retail trade turnover <sup>1)</sup>	12.0	-3.2	-3.0	1.9	0.1	-7.0	-4.1	2.5
Market services for final consumers	10.2	-17.0	-18.0	-30.0	-38.0	-18.0	-5.8	3.7
Nominal monetary income of private households <sup>1)</sup>	18.0	120	750	1 030	360	158	46.1	18.2
Real monetary income of private households <sup>2)</sup>	.	7.5	-50.5	11.2	13.0	-13.0	-0.9	3.5
Nominal wages and salaries	15.0	81	994	878	276	114	57.3	19.7
Real wages	.	-3.0	-33.0	0.4	-8.0	-28.0	6.4	4.3
Consumer prices <sup>3)</sup>	6.0	160	2 510	840	215	131	21.8	11.0
Industrial producer prices <sup>3)</sup>	4.0	240	3 280	895	233	175	25.6	7.4
Unemployment rate <sup>4)</sup>	.	.	4.7	5.5	7.4	8.8	9.3	9.0

1) Real. — 2) 1990 to 1993: December to December of the previous year; 1994 to 1997: annual averages. — 3) 1990: Annual average; 1991 to 1997: December to December of the previous year. — 4) At the end of the period; on ILO definitions.  
Source: Goskomstat.

also significantly more slowly than in 1996. The evidence for a possible turnaround becomes even clearer if the analysis is conducted on a quarterly basis: while in the first two quarters of 1997 productive investment continued to decline in real terms, real growth was recorded in the last two quarters (of 2.8% and 2.2%). If the available data on investment activity are disaggregated by economic sector, they suggest a further decline in housing construction (real expenditure: -23.4%, completed living space: -5.0%), whereby housing construction has focused on high equality housing units and has been concentrated in the Moscow region. Given that a number of economic sectors have been less seriously affected by the general decline in investment – for instance, the oil and gas, and electricity industries, transport and communication, and trade – a further concentration of investment spending appears likely. Particularly striking is the extreme contraction of investment activity in agriculture.

The available statistics on government expenditures, even if they are not comparable within the framework of the GDP expenditure calculations, do not suggest that it has exerted a stimulatory effect on demand. The same is true of foreign trade and inventories, whereby in the latter case the data are fragmentary.

## Output by sector

The origin side of GDP also reveals a heterogeneous picture, one reflecting diverse structural shifts. For the first

time there was a slight increase in industrial output (+1.9%).<sup>6</sup> On the other hand, agricultural output stagnated (+0.1%) and there was a sharp decline in freight transport.<sup>7</sup> There has been a further shift in the composition of GDP away from goods towards services, the latter now accounting for 49.4% of GDP. Goods production declined in terms of its share of GDP and in volume terms.

Disaggregating total industrial output into investment, intermediary and consumer goods shed further light on the nature and the dimensions of a possible turnaround. The output of investment goods stagnated completely in 1997, following a sharp contraction in the previous year (-14.5%). The output of consumer goods, on the other hand, increased (2.1% compared with -6.6% in the previous year), as did the output of intermediary products (+2.4% after -4.3% in 1996). 1997 saw a further acceleration in the decline in electricity output on the previous year.<sup>8</sup> The stagnation of the fuel industry (+0.3%) resulted from a slight increase in oil production (+1.3%) and a marked decline in natural gas production (-5.5%).<sup>9</sup>

<sup>6</sup> The figure relates to gross industrial output.

<sup>7</sup> The figures in tonne-kilometres continue to diverge markedly from those in tonnes: smaller quantities are being transported over longer distances.

<sup>8</sup> This can be assumed to reflect nascent attempts to save energy. In any case, recent developments would appear to have finally put an end to the occasionally propounded suitability of electricity consumption as an indicator for the extent of unofficial economic activity.

<sup>9</sup> According the official statement, the decline in natural gas production is due not to supply-side problems, but to reduced demand.

The iron and steel industry, non-ferrous metallurgy and the chemical and petrochemical industries were able to continue the recovery that had first begun in 1995. The strength of the expansion was far from sufficient, however, to compensate for the hiatus in 1996. Export activities seem to have been an important factor behind the recovery in these industries.

Engineering and metal-working experienced output growth in 1997 for the first time in the 1990s (+3.5%; 1996: -11%). Trends within the sector were highly heterogeneous, however. Rising output was only experienced in automobile construction (+12.6%; 1996: +0.2%), appliance construction (+5.8%; 1996: -30.0%) and in communications technology (+23.2%; 1996: -64.2%). Output continued to fall in all the other industrial branches. This was the case in metal-working machinery, electrical engineering, oil-production technologies (by -20.3%) locomotive and rolling stock construction and machine tools.

Within the automobile industry, the expansion was particularly strong in the case of cars (+13.5%; 1996: +3.9%) and also buses (+21.6%; 1996: -3.7%). The important role played by the automobile sector can be seen from at least three perspectives: the production of vehicles themselves is on a strong expansionary trend, the services provided by road-vehicle workshops have, as mentioned earlier, expanded strongly, and, last but not least, there has been strong growth of tyre production (+11.6%; for private cars: +25.7%).

Within the appliance industry, the output of personal computers continued to expand (+29.8%). An important indicator of the increasing orientation towards domestically produced consumer goods is the increase in the output of colour televisions (plus 140%; 1996: -71%), although this must not be allowed to obscure the fact that the market continues to be dominated by imported goods. With a view to the decline in the real consumption of local government services (especially electricity), mentioned above, it is interesting to note the strong growth in the output of electricity meters (+54%).

In a number of other industrial branches (wood and wood processing, building materials, light industry and the food industry) the freefall of output appears to have come to an end, or at least to have slowed markedly.

The stagnation in agricultural output must not be allowed to obscure the highly divergent underlying trends. Although the grain harvest proved significantly better than last year (+27.6%), a very poor harvest was recorded for a number of other products (sugar beet: -14.4%, flax: -60.7%). The decline in animal production continued.<sup>10</sup> The output of grain, sunflower and sugar beet was produced almost exclusively by state and cooperative enterprises; the production of vegetables

and potatoes by private part-time cultivators. Independent farmers are still almost insignificant, accounting for just 2.1% of agricultural output.

Freight transport trends, too, were heterogeneous. Remarkable was the slowdown in the decline in the volume of rail transport (-2.7%; 1996: -11.4%), due largely to an increase in the transport of exports (+30.3%; 1996: -3.0%).<sup>11</sup> In air transport, international freight movements grew extremely strongly (+25.2%), whereas domestic air freight transport contracted (-6.1%). Postal and telecommunications services expanded strongly (+8.9%); specifically, the number of main telephone connections rose by 5.1%, that of long distance calls by 14.7% and of e-mails by 352.3% and of fax messages by 9.0%.

## Prices

Inflation has now subsided to such an extent that it can no longer be considered a decisive barrier to economic recovery.<sup>12</sup> In 1997 the consumer price level was 11.0% higher than in the same period the previous year (December to December, cf. table 1). Remarkably, the currency crises in Asia has so far not caused a perceptible reaction in the Russian price level.

The prices of alcoholic beverages (+18.0%) and of their required inputs (sugar: +22.8%) rose far more than average consumer prices. This is in accordance with the government's social and fiscal intentions. The prices for services to private households, most of which are set administratively, rose sharply (+22.5%). As far as one can tell, this is part of the attempt, which is to be welcomed, to bring prices to a level at which costs are covered. This is true of public transport (+18.5%), local telephone calls (+40.1%), electricity prices (+36.0%), housing rents for local authority-owned housing (+35.0%), whereby in each case extreme regional divergence can be observed.<sup>13</sup>

Given that there can be no doubt that the increases in administrative prices are necessary in order to cover costs, attempts to reduce the average rate of inflation make little sense where this would require an absolute decline in the level of those prices determined freely on the market. This would amount to the dubious attempt

<sup>10</sup> The output of meat, for example, fell by 10% (1996: -0.8%).

<sup>11</sup> These figures are only given in terms of tonnes, not tonne-kilometres.

<sup>12</sup> It should be recalled that in Poland the economic recovery from the transition crisis began while inflation was running at 30%.

<sup>13</sup> This is particularly true of rents, which in Moscow are up to fifty times the level prevailing in other cities.

to counter that proportion of inflation which is caused by administrative price increases by means of a restrictive monetary policy. For as long as major shifts in relative prices are necessary, a reduced pace of inflation reduction would appear more sensible.

Industrial producer prices increased by 7% in 1997, for the first time in the 1990s more slowly than consumer prices. A way above average increase was recorded for fuel prices (+19%). This must be seen in the light of the attempts to bring Russian energy prices into line with the world market level. Price increases were below-average in the iron and steel industry, in non-ferrous metallurgy and the chemical industry. This is partly due to the competitive pressure to which these branches are subjected on world markets. A remarkable decline in inflation could be observed in a number of areas important for corporate customers. The prices for investment goods, for example, rose by just 5.0% (1996: 37.2%); within this category the price rise for machinery and equipment reached 8.0% (23.3%) and in construction and assembly the increase was 4.0% (41.4%). The prices for freight transport services (all means of transport) increased by just 0.9% (1996: 22.1%), telecom rates for corporate customers by just 4.2% (1996: 44.7%).

In spite of considerable progress made in liberalisation, price determination in Russia at the current stage in transition can be said to be based on market principles only to a limited degree. Although for consumer goods prices are generally presumed to have been determined freely on the market,<sup>14</sup> price determination for transactions between companies cannot generally be considered to be market-based. The volume of overdue payments is enormous, and there has been a further increase in the proportion of companies making repeated losses (in industry, for example, to 48%, compared with 46% last year and just 16% in 1993).<sup>15</sup> Quite clearly, a firm's financial position is of only very limited relevance to its activities. This is suggested by the rather paradoxical fact that companies in those industries making above-average losses are more optimistic than the average concerning their business prospects, whereas those in the industries where losses are less pronounced tend to look more pessimistically into the future.

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<sup>14</sup> This is true even though it is well known that, in the wake of the failure to pay wages, pensions and transfers on time, retail traders frequently allow credit purchases, with the debts subsequently being paid directly out of the company wage payment. This is part of the explanation for the ability of the population to subsist despite the failure to pay wages and other sources of income.

<sup>15</sup> Contradictory results on the basis of surveys are provided by *Russian Economic Trends*, no. 1/1998, p. 110.

## Private household income

In 1997 the real money income of private households increased on the previous year by 3.5% (1996: -0.9%). Real wages grew by 4.3% (1996: +6.4%), whereas the real value of the average monthly pension fell by 3.4% (1996: +8.7%). Real income from property, entrepreneurial activity and other sources stagnated. Because wages grew faster than other forms of income, there was an increase of one percentage point in the share of total money income of private households derived from wages (42.9%). The relative importance of social transfers rose by 0.6 percentage points to 14.8%. Accordingly, income from property, entrepreneurial activity and other sources declined in importance from 43.9% to 42.3%. The actual level of earned income remains unknown, however: firstly it is uncertain to what extent income earned in second jobs is recorded in the income and wage statistics, and, secondly, it is impossible to quantify the widespread use of payment in kind.

Moreover, overdue wage payments are recorded as wage income in the Russian statistics. Expressed relative to monthly wages, outstanding wage payments have declined from 130% in December 1996 to 113% in December 1997. Central government accounted for 10.1% of the total volume of unpaid wages in December 1997 (fourth quarter of 1996: 19.7%). In recent months there has been a renewed sharp increase in overdue wage payments.

As a proportion of total money expenditure, consumer spending remained unchanged in 1997 compared with the previous year at 68.9%. Taxes and contributions fell from 6% to 5.5%. There was scarcely any change in the relative importance of savings (25.6% compared with 25.2%). This conceals a shift within savings, however, with a decline in the proportion of money income invested in savings accounts and securities from 4.9% to 2.3% and an increase in foreign currency saving from 18.9% to 21.6%. The high savings-to-income ratio and the relative importance of foreign currency saving can be explained by the fact that all foreign currency acquisitions are defined as savings in the statistics, although clearly they are to some extent also used for direct imports or are spent abroad. On the other hand, unpaid wages must also be understood as forced saving. The true savings-to-income ratio is estimated to have fallen from 10% in 1996 to 8% last year.<sup>16</sup>

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<sup>16</sup> Cf. *Russian Economic Trends*: Quarterly Update, First Quarter of 1998.

## Government budgets

The budgetary crisis continues. According to IMF figures, the deficit on the federal budget exceeded 9% of GDP during the first three quarters of 1997 (cf. table 2); an estimated figure of 8% of GDP is given for the year as a whole. This would imply an increase in the deficit not only on the previous year, but also compared with the first half of 1997. These figures exclude the substantial quasi-fiscal activities and the credit guarantees given by various ministries at all federal levels. There is still a wide gap between the deficit calculations of the Russian finance ministry and those of the IMF. According to finance ministry figures, the deficit on the Federation budget amounted to 3.6% of GDP between January and September. The difference between these results is apparently to be explained by the fact that the calculation methods used by the finance ministry take account of non-cash payments on the revenue side, while only actual payments from the budget are recorded on the spending side.

Overdue tax payments to the consolidated budget for the first seven months of the year amounted to 11.3%; by the end of November 1997 they had been reduced to 8.4%. It seems that it is primarily government pressure that determines whether and when firms pay their taxes. The extent of tax dues and the circumstances under which firms are willing to pay taxes indicate that firms only act under the threat of severe sanctions for failing to comply. Thus the persistently high level of overdue tax payments reflects the still limited power of the state to enforce its will. However, in April 1998 a new legal provision enabled tax dues and fines, among other things, to be paid back over the longer-term, offering tax debtors an incentive to recognise their tax dues and to bring their monetary transactions out of the unofficial economy.

As in previous years, the 1997 deficit was run up primarily at Federation level. The deficit was financed by borrowing on the domestic and international financial markets and by IMF credit facilities. Definitional problems in the statistics make it difficult to determine the relative importance of the various sources of finance with any precision. It seems, for example, that GKO<sup>17</sup> purchases by foreigners and loans from the IMF are classified partly as financing on the domestic financial market and partly as financing from abroad.<sup>18</sup>

The Federation budget plan for 1998 posits revenues totalling 13.1% of GDP and expenditure of 17.8%.<sup>19</sup> The federal budget deficit is to remain under the 5%-mark

<sup>17</sup> GKO is the Russian abbreviation for government bonds ("state cash obligations").

<sup>18</sup> Cf. *Russian Economic Trends: First Quarter of 1998* (draft).

Table 2  
Federal Budget  
as a percentage of GDP

	IMF	Finance ministry
1995		
Revenue	10.6	13.6
Expenditure	15.4	16.6
Deficit	4.8	3.0
1996		
Revenue	9.5	12.4
Expenditure	15.8	15.6
Deficit	6.3	3.3
1997 <sup>1)</sup>		
Revenue	9.7	10.6
Expenditure	19.3	14.2
Deficit	9.6	3.6

1) January to September.

Source: Goskomstat.

(4.7%). The savings efforts are to ensure that the primary deficit is limited to 0.6% of GDP. If revenues lag behind planned levels, spending is once again automatically to be reduced to a corresponding extent. In past years this has meant that failure by large firms to pay their tax dues has led to non-payment of public sector wages. This approach fails to punish those responsible for the loss of revenue. Contrary to IMF conditionality, the practice of offsetting tax dues against claims on the budget has not been definitively abolished. Taxation reform has been announced, but has been postponed.

## Monetary and exchange rate policy

In recent months Russian monetary policy has been dominated by the repercussions of the currency crisis in Asia and by the aim of stabilising the US-dollar/rouble exchange rate. Although a devaluation of the rouble was successfully averted, between June 1997 and February 1998 the central bank was obliged to commit more than one third of its currency reserves to defending the parity. Moreover, in two steps the official refinancing rate was raised in November 1997 from 21% to 28% and at the start of February 1998 to 42%. Thus the central bank was prepared to accept a marked increase in inter-

<sup>19</sup> In drawing up the budget an annual inflation rate of 5.7% was assumed.

est rates in order to defend the exchange rate. A slight inflow of foreign exchange has been one factor subsequently enabling the central bank to reduce the official refinancing rates and the Lombard rate, which is of central importance for bank refinancing, from 42% to 30% in stages since mid-February.<sup>20</sup> Even so, at an annual inflation rate of around 10%, real interest rates are once again at a high level, having reached their lowest point since the start of stabilisation in 1995 in autumn 1997 (cf. figure 1).

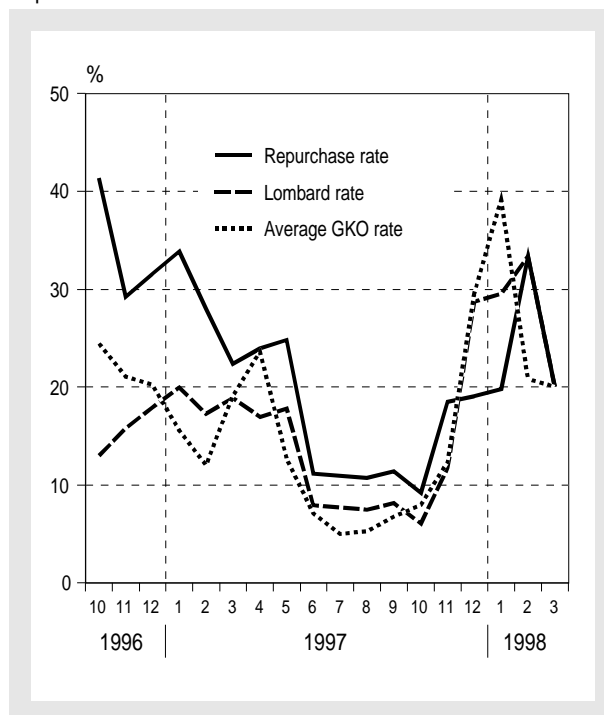
The decline in currency reserves was offset almost completely by a rise in the domestic components of the central bank money stock, so that the monetary base declined only slightly in the fourth quarter of 1997. Purchases of GKO government bonds by the central bank in November constituted the driving force behind this increase in domestic lending. Yet lending to the commercial banks also increased for the first time in more than two years, albeit from a very low initial level. On balance, the growth in the money base in 1997 was approximately equal to last year's figure, at 25% (cf. table 3). The growth of the broader monetary aggregates was successfully limited to around 30%, slightly less than last year.

The re-denomination of the rouble at the start of January 1998 proceeded without major friction. There was some restructuring out of rouble and into foreign exchange accounts, however, so that on a broader definition (i.e. including foreign exchange accounts) M2 grew faster than the rouble money supply in the second half of 1997. To some extent such portfolio restructuring also reflected the currency crises in Asia. Moreover, in expectation of the re-denomination of the rouble in the last quarter of 1997, private households reduced their bank deposits by around 5%. This is in accordance with the increase in private consumption observed in this period.

As regards its responsibility for bank supervision, in mid-January 1998 the central bank reacted to the tensions on the international capital markets by limiting the maximum amount that Russian banks could borrow abroad to four times their equity capital or 28% of bank assets. In their Autumn Report 1997 the Institutes had pointed to the possibility of mutually reinforcing effects between a banking and balance-of-payments crisis resulting from banks borrowing abroad. However, in the third quarter of 1997 the banking system recorded net capital inflows, whereas the other sectors exported capital on balance. It remains unclear to what extent Rus-

<sup>20</sup> Since the start of December 1997 there has been a single Lombard rate for loans of differing maturities; since the start of February 1998 this has been set at the same rate as the official refinancing rate. The most recent interest rate cut, from 36% to 30%, occurred in mid-March.

Figure 1  
Real Interest Rates, 1996 to 1998  
% per annum<sup>1</sup>



<sup>1</sup>) Real exchange rate, Index: January 1995 = 100. For January, February and March 1998 an annual inflation rate of 10% was posited. Sources: Russian Economic Trends; calculations by the Institutes.

sian banks have open foreign currency positions and would therefore be negatively affected by a devaluation of the rouble. Many banks have sought to insure themselves against exchange rate fluctuations by means of hedging transactions, and more than 40% of domestic borrowing is denominated in foreign currencies. Yet this exposes the banks to a substantial risk of their customers defaulting on repayment. It is, however, virtually impossible to quantify the risk of debt default given the failure so far to implement the insolvency law and the interlocking ownership linkages between banks and companies.

So far, the crisis in Asia has not exerted any significant destabilising effects on the Russian banking and financial sector. Indeed, towards the end of 1997 bank lending to the business sector recovered (cf. table 3). On the other hand, the – temporary – increase in real interest rates in response to the currency crisis will at the very least delay economic recovery.<sup>21</sup> Alongside the

<sup>21</sup> According to the official statistics, the increase in the GKO and financing rates has not yet had a direct effect on lending rates. It must be assumed, though, that the officially reported rates do not reflect those actually relevant to companies, but rather that they are forced to pay risk premiums.

Table 3

## Growth of Money Supply and Credit Aggregates

Change on the end of the previous period in %

	1993	1994	1995	1996	1997 <sup>1)</sup>		
					1st half	2nd half	Total
Cash	691	169	126	29	32	-5	25
Monetary base	648	186	118	26	28	-2	25
M2 (rouble)	409	200	126	34	23	2	28
M2 <sup>2)</sup>	.	217	108	36	19	9	32
Bank lending <sup>3)</sup>	448	241	61	21	15	16	33
Net foreign currency reserves (in US-\$)	112	-64	238	-78	547	-62	147
Domestic assets of the central bank	787	412	71	61	-14	32	14
memo item:							
Producer prices	895	233	175	26	6	1	7
Consumer prices	840	215	131	22	8	2	11

1) M2 and bank lending: rate of change to October (rouble M2: November) at a six-month or annual rate. — 2) Including accounts in foreign currency. — 3) Lending by the banking system to firms and private households.

Sources: Russian Economic Trends; working documents and calculations by the Institutes.

negative effects of this interest rate hike on the budget, the conditions prevailing on the financial markets are of central importance for corporate financing. While it is frequently argued that the situation on the financial markets has only a limited influence on economic growth in Russia, because of the very small size of the banking and financial sector relative to GDP,<sup>22</sup> this argument is potentially misleading. Although it is correct that the direct effects of financial crisis in a small financial sector are initially quantitatively minor, the small size of the financial sector constitutes a barrier to investment, due to the difficulty of obtaining external financing.<sup>23</sup> In the prevailing situation investment by Russian companies depends primarily on their current profitability.

The Russian central bank plans to continue to orient its monetary policy to the intermediate target of the exchange rate in 1998 (cf. figure 2), with monetary growth being used merely as an indicator.<sup>24</sup> Although since the start of 1998 the central bank has permitted the exchange rate to fluctuate around a central parity within a broader band (+/-15%), the central parity is to remain constant in 1998 at 6.1 rouble to the US-dollar, and in the

<sup>22</sup> Although the volume of M2 increased last year relative to GDP, it is still significantly below 20%. Similarly, bank lending to the business sector represents less than 10% of GDP.

<sup>23</sup> Empirical studies indicate that the development of the financial system has an influence on the quality and quantity of investment; cf. Ross Levine: Financial Development and Economic Growth: Views and Agenda, in: *Journal of Economic Literature*, no. 35/1997, pp. 688-726.

<sup>24</sup> Growth of M2 of between 20% and 30% is planned.

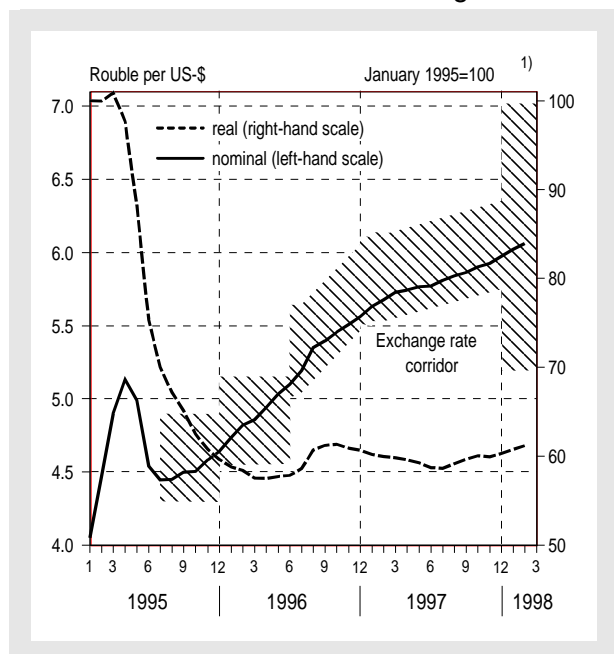
next two years is to rise only marginally to 6.2 rouble. The Institutes welcomed the broadening of the exchange rate corridor in their last report. A critical view was taken, however, of the replacement of the crawling band by a virtually fixed parity for a period of three years. Although the maximum possible devaluation of the rouble in 1998 is likely to be greater than the inflation rate, enabling a real appreciation of the currency to be avoided in principle, given a rate of inflation for tradable goods in excess of 6% per annum, in the coming years at the latest this exchange rate target virtually guarantees a real appreciation, with all its negative consequences for foreign trade. Last year the rouble appreciated only marginally against the US-dollar (by around 1%), but even this was accompanied by a decline in Russia's current account surplus (see next section).

## Balance of payments

Following on positive developments in the first half of 1997, particularly on the capital account, Russia's balance of payments situation began to deteriorate seriously in the third quarter of 1997. This was due primarily to an outflow of foreign capital. The surplus on the balance of trade also declined. Although balance of payments figures are not yet available for 1997 as a whole, provisional data on the external position pointed to a slight improvement in the fourth quarter.<sup>25</sup> The outflow

<sup>25</sup> *Russian Economic Trends*, First quarter of 1998, p. 82.

Figure 2  
Russian Rouble/US-dollar Exchange Rate



1) Real exchange rate, index: January 1995 = 100. Following the currency conversion of 1.1.1998, 1000 old rouble are worth 1 new rouble.

Sources: Russian Economic Trends; calculations by the Institutes.

of capital continued, however, leading to a marked fall in the foreign exchange reserves of the central bank.

1997 saw the first actual fall in exports (-2%), following a marked decline in the rate of overall export growth in 1996. Exports continued to be dominated by energy and primary goods. Thus in value terms the sharp fall in the price of oil was the major factor behind the export trend.<sup>26</sup> Receipts from oil exports fell by 8%, although the quantity exported remained virtually constant. At 8.5%, import growth in 1997 was markedly higher than that of exports for the first time.<sup>27</sup> The rate of growth of imports includes estimations by Goskomstat of the volume of unofficial border trade (so-called shuttle trade).<sup>28</sup> Analysis of the commodity structure of imports is hampered by the fact that almost 40% of goods flows are classified under a residual category. The fact that engineering products increased in 1997 from one quarter to one third of imports could be interpreted as a positive sign. However, a look at Germany's bilateral foreign trade statistics with Russia suggests

<sup>26</sup> *Russian Economic Trends*, First quarter of 1998.

<sup>27</sup> Whereas in the fourth quarter of 1996 imports had contracted by 15%, they grew by 26% in the fourth quarter of 1997 (in both cases with respect to the same quarter of the previous year).

<sup>28</sup> Goskomstat puts the volume of shuttle trade at 22% of total imports for 1997.

that the strong growth of "engineering products" largely reflects an increase in Russian car imports.

The fact that negotiations on accession to the WTO are slowly making progress is likely to have a positive effect on Russia's integration into the international division of labour. At the end of February 1998 the government submitted a long-awaited application to the WTO. The EU, too, has declared that it is in principle willing to consider Russia (along with China) to be an economic system functioning according to market principles. So far, however, this has only led to a partial change in a relevant EU Regulation, making it more difficult to initiate anti-dumping proceedings against Russia.

In the first half of 1997 Russia recorded a surplus on the capital account for the first time. The public sector was the main beneficiary of capital inflows, but an increase in direct investment was also recorded. However, in the wake of the Asian crisis, capital inflows were reversed in the second half of the year. The central bank reacted to the outflow of capital by raising its base rates. This, together with short-term borrowing from western banks by the government towards the end of the year,<sup>29</sup> averted a balance of payments crisis. Initially these loans were not officially announced, presumably to avoid undermining the confidence of international investors. Yet once they become public, such transactions are more likely to worry than to calm investors. Tensions eased in February 1998, leading to a renewed inflow of portfolio capital. In March 1998 Russia announced two new issues on the Eurobond market for the first time since the outbreak of the Asian crisis. The two issues, with a volume of DM 1.25 billion and ITL 750 billion, have since both been successfully placed.<sup>30</sup>

## Privatisation and market liberalisation

1997 saw increased sales of shares in large companies belonging to strategic sectors (such as the energy sector), the privatisation of which had previously been illegal. One aim of this was to generate additional privatisation receipts. Shares were sold in, amongst other companies, the telecommunications company Svjaz'invest and the energy utility EES. Compared with previous years, sales were conducted more or less under competitive conditions; foreign investors were allowed to participate in the auctions. In 1997 privatisation receipts amounted to rouble 23.6 trillion (cf. table 4); this was around 3.5

<sup>29</sup> *Financial Times*, 18 February 1998 and 9 March 1998.

<sup>30</sup> The rate of interest on the DM-bonds are between 450 and 500 base points above those on German government bonds. The premiums on the lira-bonds are of a similar order of magnitude.



times the planned volume of privatisation receipts. 1997 was the first year in which privatisation receipts made a significant contribution to financing government budgets, accounting for 3.5% of consolidated budget revenues. A total of around 3 100 companies were sold in 1997, less than half the previous year's figure. In terms of the number of employees, there has been only a marginal decline in the (partially) state-owned sector. Around 60% of the employment is still concentrated in the state and the so-called mixed-economy sector.

For 1998 the government has proposed to parliament a number of large-scale companies, some from the energy sector, for partial privatisation. Under the privatisation law parliamentary approval is required in such cases. In February 1998 a parliamentary investigating committee called for privatisation proceedings that had already begun to be suspended, pointing out that such approval had not yet been given and that earlier sales had been illegal. It was also unclear to what extent foreigners would be able to participate in auctions. Back in November 1997, however, a presidential decree had removed the statutory ceiling of 15% of shares in oil companies that could be held by foreigners.

In the past the aim had been to privatise companies as quickly as possible. In doing so too little attention had been paid to efficient enterprise control and incentives for corporate restructuring. Both during the first phase, so-called voucher privatisation, and in the subsequent privatisation by auction, external actors have played only a limited role as strategic investors. In most cases the workforce and management have together acquired the majority of shares in partially privatised companies.<sup>31</sup> As empirical studies have shown, the former managers were frequently not replaced, and were even able to strengthen their position.<sup>32</sup> The fact that corporate control is dominated by internal actors, and the rights of other shareholders remain precarious,<sup>33</sup> alongside other factors such as the lack of competition, have meant that restructuring efforts have been inadequate even in privatised companies. An attempt has recently been made to correct these deficiencies by way of a government action programme, introduced in January 1998, in which privatisation plays a subordinate role, while at the same time the improvement of enterprise management is emphasised as an important meas-

<sup>31</sup> *Russian Economic Trends*, no. 4/1997, p. 92.

<sup>32</sup> Alexander Bim: Ownership, control over the enterprises and strategies of stockholders, International Institute for Applied Systems Analysis, Working Paper WP-96-050, Laxenburg, 1996.

<sup>33</sup> Joseph Blasi, Maya Kroumova and Douglas Kruse: *Kremlin Capitalism – Privatizing the Russian Economy*, Cornell University Press 1997; Dirk Willer: *Corporate Governance and Shareholder Rights in Russia*, London School of Economics, Centre for Economic Performance, Working Paper no. 343/1997.

Table 4  
Number of Privatised Companies  
and Privatisation Receipts

	Number of privatised companies (or objects)	Privatisation receipts in trillion rouble
1994	21 905	1.1
1995	10 152	3.8
1996	6 720	3.2
1997	3 100	23.6

\* At current prices.  
Source: Goskomstat.

ure. On the other hand, steps to protect domestic producers, the implementation of which is currently under discussion, would have the effect of retarding corporate restructuring.<sup>34</sup>

The unequivocal ascription and implementation of liability rights are a precondition for both restructuring and improving the financial discipline of Russian companies. With these aims in mind, a new legal base was created in the form of the insolvency law that came into force on 1 March 1998.<sup>35</sup> In contrast to its predecessor and to the proposed amendments, the new law explicitly requires the debtor to file for bankruptcy. This establishes an important prerequisite for overcoming the passiveness of creditors in initiating insolvency proceedings that is characteristic of the transformation countries. The new law explicitly calls on owners to take measures to avert the danger of bankruptcy in good time and to put the company's finances on a healthy footing; in this context mention is even made of financing such restructuring out of government budgets. Another new provision is that after filing for bankruptcy the company is provisionally placed under supervision. The aim here is clearly to avoid the company's assets being misappropriated before a decision is taken on whether to go through with bankruptcy proceedings or go opt for "external management" proceedings with

<sup>34</sup> In the automobile industry Russian firms are already benefiting indirectly from a law passed at the start of 1998, the declared aim of which is to promote foreign investment. According to the law foreign investors are to receive concessions subject to the condition, among others, that within five years Russian production accounts for more than 50% of output. Only investment projects larger than US-\$ 250 million are entitled to support. (Report in *Izvestija*, 7 February 1998, p. 1).

<sup>35</sup> The following description is limited to the central features of the new insolvency law. Special provisions apply in the case of small private enterprises, for example. A special insolvency procedure applies to financial institutions.

the aim of refloating the company.<sup>36</sup> As under the previous legislation, the "external management" has a maximum of 18 months in which to successfully conclude reorganisation measures; in most cases this deadline has not been met. An additional new feature is that bankruptcy proceedings should not last more than 18 months. At any time during the proceedings it is possible to make an application for debt composition and thus to avoid liquidation. Like its predecessor, the new law provides opportunities for preventing bankruptcy and for postponing liquidation.

The new law on limited companies also came into force on 1 March 1998, although this legal form had been envisaged as early as 1994 in the Civil Code. The new limited company law is particularly relevant for small and medium-sized private enterprises. It is expected that a large number of joint stock companies will be converted into limited companies.

## Summary and outlook

In 1997 economic decline finally came to a halt in Russia. There was no further decline in GDP (+0.4%); the figure includes an official estimate of the size of unofficial economic activity. Two factors played a decisive role in bringing the economic contraction to an end. There was a marked increase in private consumption, and investment activity declined far more slowly than in the previous year. Government spending, net exports and inventories did not exert a determining influence.

The marked increase in nominal household income, including wage income, did not prevent a further decline in inflation to just over 10%. The rate of inflation can no longer be seen as a decisive barrier to economic recovery. The slight decline in the unemployment rate to around 9% should not be interpreted as a sign of improvement, however, as Russia still has to accomplish structural change. Labour market trends differ markedly in sectoral and regional terms; there is a labour shortage in Moscow, for instance.

Government budgets are characterised above all else by difficulties on the revenue side. The prevailing taxation system and the failure to recoup tax dues undermine allocative efficiency and are blocking Russia's economic recovery.

Monetary and exchange rate policy remain primarily oriented towards achieving the exchange rate targets set. For this reason, Russia experienced a sharp decline

in foreign exchange reserves in the wake of the Asian currency crisis, a trend that was only stopped by a substantial rise in interest rates. Strong capital imports were recorded in the first half of 1997. Although real interest rates have been falling once again since mid-February 1998, they are still significantly higher than before the crisis. Maintenance of a pre-announced, fixed exchange rate corridor for a period of three years brings with it the danger of a real appreciation of the rouble. The central bank has recently declared its intention to counter such a trend. The deterioration in the balance of trade in the course of 1997 is not, however, due to a real depreciation in the wake of an inconsistent monetary and exchange rate policy, but rather can be explained largely in terms of the decline in primary energy prices on world markets.

As far as privatisation and market liberalisation are concerned, two developments are particularly noteworthy. Firstly, privatisation of companies in strategic areas increased in importance in the course of 1997, partly as a means of raising additional government revenue. Secondly, the new insolvency law marks a significant improvement in the legal framework for market processes. What will be decisive, however, is the political will to enforce the statutory provisions.

For 1998, the Institutes retain in principle the cautious optimism they expressed for the first time in their Autumn Report of last year. It seems that the influence of the currency crises in Asia will remain temporary. Private consumption is expected to continue to expand moderately. Provided the trend towards lower real interest rates is maintained once the recent political uncertainties have been overcome, this, along with further steps to improve the framework for market economic activity, leads to the expectations that, of all the demand aggregates, investment will experience the most pronounced turn for the better. In such a case, the Institutes stick by their forecast for economic growth of the order of 2% to 3%. If the political uncertainties drag on, however, the stagnation period could also be prolonged.<sup>37</sup> There is no prospect of an improvement in the labour market situation given the structural changes that still need to be implemented. The economic situation will remain precarious, largely due to the numerous problems, primarily in the fiscal area, that still exist because their resolution has been repeatedly postponed. Given that the existing monetary and exchange rate policy stance will be maintained, the Institutes consider an inflation rate in the region of the current figure of around 10%, or even slightly lower, to be realistic.

<sup>36</sup> The new law makes no mention of "refloating", which under the former law constituted an alternative reorganisation procedure alongside "external management".

<sup>37</sup> The provisional results for the first quarter (GDP: 0.0%; industrial output: +1.3%) give an impression of the risk involved; press reports based on Goskomstat.