The Economic Situation in Russia

Crisis reveals economic policy mistakes[1]

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The events of 1998 amount to a severe setback for the economy of the Russian Federation. Not only was a there a dramatic contraction of economic activity, the whole strategy of restructuring on market economic principles has been called into question. This was despite the fact that in 1997 the economic decline had finally come to an end and there were even signs of an imminent recovery.

The loss of confidence in economic policy, both at home and on the international markets, has assumed disastrous proportions. Faced with this development, it must be asked what led to the renewed turn for the worse, and what prospects there are for the economic policy course now adopted. If success is to be achieved, greater efforts will be required than in earlier attempts to stabilise the economy.

Macroeconomic trends

In the first three quarters of 1998, GDP was down 3% on the same period the previous year; for the whole year, the decline was an estimated 5%. This overall figure conceals a progressive deterioration which began to emerge in May 1998, and which reached a provisional maximum in September, with a decline of 9.9% on the same month the previous year.

Looking at GDP from the expenditure side, the most striking trend is the continued expansion of private consumption (as measured by a real growth of retail trade turnover of 2.7%). Indeed, immediately before the dramatic worsening of the crisis in August 1998, the rate of growth of retail trade turnover was particularly strong; it was at 4.6% above the level recorded in the same month the previous year. This trend is in stark contrast to the simultaneous and accelerating decline in real money income at the disposal of private households – by 12.4% in the first three quarters of 1998 compared with the same period the previous year.[2] This indicates that the loss of confidence and growing concern among the population began as early as the second quarter of 1998, leading to panic buying at this stage. Such purchases were financed by plundering savings accounts.

In the first three quarters of 1998 gross fixed capital formation was 6.8% lower in real terms than in the corresponding period the previous year; this marks a renewed acceleration of the decline in investment, following a hiatus in the second half of 1997 when 'productive investment' had increased for the first time, due not least to falling real interest rates. This put an early end to the reorientation of investors away from purely financial investment towards investment in real capital. Worse still, it led to a renewed increase in capital flight. In order to grasp the importance of these trends, it needs to be recalled that investment activity is currently only between one-quarter and one-fifth of its 1990 level. Russian estimates suggest that investment now accounts for no more than half of capital write-offs. This implies that the capital stock is contracting or becoming increasingly obsolete. Clearly the consequences of such a development can only be resolved over the longer term, even if the greatest efforts are made.

According to the available data – although they are not comparable within the framework of GDP expenditure calculations – government consumption, far from stimulating demand, has exerted a restrictive effect on the economy. The same would appear to be true of changes in stocks. Foreign trade exerted a marked contractionary effect. In the first half of 1998 the value of exports declined by 13% on the same period the previous year, a trend that continued to accelerate during the rest of the year. The decline in export earnings is, however, partly due to falling prices on international commodity markets. The value of imports measured in dollars was 7% higher in the first half of 1998 than in the first half of 1997. Import growth accelerated in the run-up to the crisis of August 1998. Imports contracted sharply in the wake of the crisis, however.

The question of the reliability of the above-mentioned data still needs to be borne in mind. It should be recalled that the official statistics attempt to take account of unofficial economic activity by means of a flat-rate supplement (most recently of 25%) on all figures. It scarcely needs to be emphasised how inevitably inaccurate such a procedure must be. Not least with regard to the dramatic decline in investment, the unoffi-

[1] This text contains the introductory and summary chapters of the full report which is available in German. In *Wochenbericht des DIW*, no. 51–52/98, Berlin.

[2] In the first seven months of 1998 the decline on the corresponding period the previous year had been 8.9%; in September the fall on September 1997 reached 29.7%.

cial economy almost certainly focuses on producing consumer goods and services, rather than on 'unofficial investment'. A further source of uncertainty results from the prevalence of barter trading, the reported prices for which are not in line with market prices.[3]

Sectoral output

The origin side of the GDP statistics also clearly reveals the onset of the crisis and the accelerating contraction of the economy in the course of 1998. Following a growth in industrial output of almost 2% in 1997, that was maintained in the first quarter of 1998, a slight decline was recorded (–1.3%) as early as the second quarter of 1998. This contraction then accelerated, reaching a provisional peak in September at a rate of 14.5% compared with the same month the previous year. Taken together, the decline in industrial output in the first three quarters of 1998 amounts to just under 4%. This was actually exceeded by the decline in agricultural output, which in the first three quarters of 1998 was 38% down on the same period the previous year. A marked contraction also occurred in goods transport: –3.6% between the same two periods.

Analysis of industrial output by branch shows that output trends were almost consistently negative. The only exception was the wood and wood processing industry (which includes the cellulose and paper industry), whose output in the first three quarters of 1998 was 1.4% above that in the first nine months of 1997. Yet even in this industry, the general diagnosis still applies that in the course of the year, and especially following the crisis in the summer of 1998, output has fallen, and in many cases the decline has gathered pace. The drop in output has been particularly precipitous in mechanical engineering and metal working. In contrast to 1997, for which strong growth of automobile output was recorded, in the first three quarters of 1998 output losses were suffered here, too. Particularly hard hit were private cars (–6%). Similar trends were registered for personal computers, output of which had increased by 30% in 1997. In the first three quarters it fell by 30.2% on the same period the previous year; the figure for September was as high as –68.9%. By contrast, the flight into real assets in the run-up to the crisis was matched by rising output of a number of consumer durables, such as refrigerators and freezers and washing machines. However, in the wake of the crisis output fell sharply, and in some cases dramatically.

The decline in agricultural output was due to a poor grain and animal-feed harvest, to which drought and flooding in certain regions made a contribution. Meat and milk output also fell, though. A significant share of the population now covers much of its food needs by cultivating small plots of land. Even so, supply shortages have occurred, particularly in those regions in which self-sufficiency is not possible for climatic reasons; northern regions are consequently particularly badly affected. The supply of these areas during the summer months seems to have been inadequate to a greater extent than in previous years. In the autumn it was decreed that rail charges for transporting potatoes, vegetables, fruit and fish to these regions were to be halved for a limited period.

Against the background of the general decline in the volume of goods transported, it deserves special mention that the volume of pipeline transport was not only maintained, but actually increased (by 2.2% in the first three quarters of 1998 compared with the same period the previous year), a growth trend that was maintained even in the wake of the crisis (September: +2.9%). This is in line with the unflagging efforts being made to at least maintain, if not increase, exports of energy.

Prices

From the start of intensified reforms in 1992, Russian economic policy initially allowed three and a half years to elapse, before (hyper)inflation was brought under something like control. With the introduction of the exchange-rate corridor in mid-1995, a process of economic stabilisation, based on a crawling exchange-rate peg, was initiated that very quickly brought inflation under control. On the other hand, the very slow pace of the pre-announced devaluations – which were stringently adhered to – exerted a tight constraint on other policy areas, and in particular on monetary policy, to pursue the goal of a rapid cut in inflation; otherwise the currency was bound to appreciate in real terms.

In July 1998, that is just before the outbreak of the crisis, the level of consumer goods prices was just 5.6% above that of 12 months earlier, and thus lower than in all the successful central European transition countries, in which a slower reduction in inflation had been accepted, and in which output had already begun to rise at a time when inflation was still at two-digit levels. In the months prior to the outbreak of the crisis, industrial producer prices remained constant or even declined in absolute terms.

[3] According to Russian estimates, GDP is overstated by between 30% and 40% as a result of excessive prices in barter trade. Such prices are agreed upon by suppliers and customers in the hope of being in a better position to obtain state aid in meeting their outstanding payments once they reach epidemic proportions.

The crisis was followed by sharp price increases, however, which left their impact on the figures for September. Consumer prices rose by more than 38% on the previous month, industrial producer prices, on the other hand, by a comparatively moderate 7.5%. The main impact came – directly and indirectly – from the increase in the price of imported goods following the devaluation of the rouble. However, according to provisional data, inflation subsided quickly in October 1998. This suggests that economic policy makers still have a chance of getting a grip on future developments. More specifically, it means above all else that the combination of exchange rate, monetary, fiscal and incomes policies must in future be such as to prevent a renewed surge in inflation.

Policy implications and outlook

At no time has Russian economic policy met, to a satisfactory extent, the requirements for a successful transition from a centrally planned to a market economy. The necessary reforms on the micro- and macroeconomic levels were either not initiated, not implemented or at best were half-hearted. In spite of these inadequacies, to which the Institutes have repeatedly drawn attention, in 1997 it appeared that market forces were already strong enough to offset the weaknesses of economic policy, leading to an economic turn for the better. However, at the same time the global economic environment deteriorated in the form of a sharp fall in energy prices and a withdrawal by investors from markets that they considered risky. Russian economic policy makers failed to respond to this challenge in an appropriate way. In the summer of 1998 the progressively dwindling confidence of market actors in the ability of economic policy makers to get the situation under control collapsed, leading to a financial and currency crisis. The Russian government was forced to abandon its exchange-rate target and to admit its inability to meet its financial obligations, revealing at a stroke the economic policy failings of recent years.

In the wake of the crisis, consumer prices exploded, rising in September 1998 by more than 38% on the previous month. In the first three quarters of 1998 GDP was 3% down on the corresponding period the previous year, whereby the decline began as early as the spring and subsequently accelerated. Investment was particularly hard hit (–7% in the first three quarters of 1998), and was not even sufficient to maintain the existing capital stock, never mind modernise it.

The decline in investment, the fall in bank lending in the wake of the financial crisis, the collapse of payments transactions and the severing of supply linkages between the regions all contributed to the decline in industrial output of almost 4% in the first three quarters of 1998. Although immediately before and during the crisis private consumption initially rose, despite the fall in real incomes at the disposal of private households (–12% in the first three quarters), this merely reflected widespread panic buying. Yet because this demand surge was met primarily out of existing stocks and imports, it failed to bolster domestic production. Government consumption also exerted a contractionary effect, as the spending components relevant for domestic demand were cut due to the financial crisis. Last but not least, net exports also declined, as export earnings fell while imports continued to rise in the run-up to the crisis. This forced the Russian current account into the red for the first time.

The decline in output led to a further rise in unemployment. The unemployment rate – calculated using the ILO method – rose from 10.9% in July 1997 to 11.5% in September 1998. Falling real money incomes at the disposal of private households, and in particular the drop in real wages and real pensions due to the crisis, have further exacerbated the problem of poverty. Even before the onset of the crisis, in July 1998, almost 22% of the population were living in poverty according to the Russian definition. The sharp fall in real wages and pensions caused the figure to leap up, probably to 30%, in September.

The widespread existence of poverty since the start of the 1990s, and in particular since price liberalisation in 1992, must be seen as partially responsible for the current crisis to the extent that it has increased the risk of social and political instability. The determining factors behind poverty are not only the persistent decline in output over the period of many years, but also the fact that money incomes, and especially wage incomes, are more highly differentiated than in other transformation countries. The extreme differentiation of wages by regions and sectors was in many cases due to political influences at central and local level, and also reflected the lack of incentives in the private sector to ensure that wage determination took account of enterprise realities. On top of this came the failure by firms and government to pay wages on time. In particular, the attempts by the government to restrain budget deficits simply by not paying wages and pensions inevitably had political consequences such as strikes and demonstrations in an economically critical situation and a heightening of the ongoing conflict between the Duma and a reform-oriented government.

One of the central factors behind the crisis is the persistent failure to implement a reform of government budgets. The chronic budget deficits reflect primarily the lack of will on the part of the government to ensure that tax dues are paid. Six years after the dissolution of the Soviet Union, a sensible division of tasks between the Federation and the various years of government, and a system of fiscal redistribution appropriate to it, have still not been put in place. As a result many regions simply refrain from transferring tax receipts to the Federation budget or permit taxpayers to pay in kind. The resultant deficit at federal level was financed by issuing short-term treasury bills. Yet the foundations of this financing concept crumbled when real interest rates began to rise once more at the end of 1997. This led to a rapid loss of confidence in the ability of the state to meet its obligations.

The crisis of government finances meant that economic stabilisation was inevitably a precarious process, all the more so given that as of mid-1995 monetary policy was obliged to pursue an ambitious exchange-rate policy target. Although the band within which the exchange rate was theoretically able to fluctuate permitted nominal depreciation of a sufficient magnitude, the central bank prevented the bandwidth being fully utilised by intervening at an early stage, so that even the increase in bandwidth at the start of 1998 proved irrelevant. This was tantamount to a system of fixed exchange rates. The price of tying monetary policy to the exchange-rate target was high interest rates, which actually began to rise further at the end of 1997. As inflation initially continued to fall, this implied extremely high real interest rates.

Real interest rates, which since the start of economic stabilisation have at times been far in excess of 15%, cannot be sustained by any economy in the longer run. At the same time they reflected the fact that the combination of exchange rate, monetary, fiscal and incomes policy, against the background of at best sluggish improvements in the institutional framework, was inconsistent. Given the failure of the government to respond appropriately to negative influences from the global economy, the markets increasingly lost faith in the credibility of this policy constellation.

This loss of confidence, which eventually resulted in the collapse of the currency, has hit the banking sector particularly hard. Given its huge liabilities in foreign currency, the fall in prices of domestic treasury bonds, and the heavy burden of non-performing loans, the majority of Russian banks are *de facto* insolvent. The state-owned Sberbank is also affected; its monopoly in the market for private deposits was actually consolidated further by transferring to it the accounts of other banks. What is decisive for a sustainable solution to the problems facing the banking sector is that in future financial support to the banks must only be provided if the risk of a renewed banking crisis can be reduced to a sufficient extent. One central measure to restore confidence in the banking system over the medium to longer term should be to remove the existing protection against foreign competitors. Even after the crisis financial-industrial groups, albeit in a rather different form, are likely to play a role in the Russian economy. Any attempt to regulate these groups should focus on the aim of ensuring efficient bank lending to production firms.

Emergency measures, such as a renewed extension of foreign exchange controls, have given the governments a short breathing space. What is needed, however, is a consistent reform policy. At the macroeconomic level this implies first and foremost an exchange-rate policy that permits adequate nominal depreciation. This would offer the other policy areas sufficient room for manoeuvre; in the case of monetary policy, for example, to cut its refinancing rates. In order to ensure that market interest rates also fall, however, an appropriate fiscal policy is also necessary. This implies both a reduction in the budget deficits and a shift in spending in favour of investment. In particular, what is urgently needed are decisions on the tasks, revenue and spending of federal and regional budgets, with the aim of deploying the available resources more efficiently.

The current crisis must not be allowed to obscure the fact that Russian economic policy makers do have a real opportunity to imitate the positive results achieved by the successful transition countries. However, the programme put forward by the government emphasises the short-run aspects of stabilisation, whereas it is seriously deficient in describing the longer-run path towards reform. This has raised doubts about continued market reforms just one year before parliamentary elections and two years before the presidential election. Confidence has been lost in the ability of economic policy, under the pressure of these imminent political changes, to take unpopular but necessary measures to overcome the crisis and to place the reform policy on a stable basis.

The Institutes do not expect a generalised economic recovery in 1999. The decline in GDP could, however, be slightly less serious than in 1998. A renewed fall in investment and also in private consumption are expected, partially offset by a slight increase in net exports. The inflation rate is likely to be of a similar order of magnitude to that in 1998. Whether in the course of the year economic activity, and particularly investment, will recover and longer-term prospects improve will depend decisively on whether it proves possible to restore confidence in the ability of the political system to implement reform. For this to occur, however, tough decisions establishing a basis for progress in this direction must be taken in the coming weeks.