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Research for Action 29

## **A Russian Puzzle**

What Makes the Russian Economic  
Transformation a Special Case

**Vladimir Popov**

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UNU World Institute for  
Development Economics Research  
(UNU/WIDER)

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**Vladimir Popov**

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A research and training centre of the United Nations University

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## FOREWORD

This interesting study of the Russian transition is part of UNU/WIDER's research on the economics of transition which started in the early 1990s and was expanded substantially in 1996. UNU/WIDER is currently implementing three major projects in this area.

The first – 'Economic Shocks, Social Stress and the Demographic Impact of Sudden Impoverishment' – seeks to explain the recent unfavourable mortality changes observed in the former socialist economies hit by sudden economic shocks and mounting uncertainty. The second – 'Poverty, Income Distribution and Well-Being in Asia During Transition' – focuses on social consequences of reforms in Asian transition economies. The principal research objectives are to identify the linkages between growth performance and welfare performance and to evaluate the long-term sustainability of different Asian patterns of transition. The third project – 'Transition Strategies: Alternatives and Outcomes' – compares different models of transition observed so far in both European and Asian countries in transition. The emphasis of this project is not only on the strategies of transition but also on the outcomes of this process: we try to establish what archetypes of economies are emerging in the post-socialist world and what patterns of long-term development will prevail in these countries in the future.

This project has three main *raison d'être*. First of all, an **integrated comparative analysis of all transition models** will allow an exhaustive comparison of the various strategies and alternative roads to the transition. Secondly, the project should provide a consistent **assessment of the state of the art on transition policy**, and in particular of 'what works' and 'what does not work' in the main policy fields. Outside a limited number of Central European (CE) countries and international institutions, there is still no agreement on key issues concerning macroeconomic stabilization, industrial policy, approaches to privatization and trade specialization. Thirdly, the project discusses **archetypes of economies emerging in the region**. Their main features and the sustainability of their long term development will largely depend on changes in a number of key areas such as asset and income distribution; the type and evolution of the new regulatory frameworks (for an efficient functioning of the market, the provision of indivisible public goods, and the creation of an adequate and fiscally sustainable 'social safety net'); and the new international specialization and domestic industrial structure evolving in these new market economies.

This interesting paper on Russian transition analyses both the objective and policy factors that contributed to the larger than expected decline in the Russian economy. The author shows that economic policy during transition was far from the best feasible choice and is largely responsible for the extreme length, if not for the depth, of the recession. Only in two areas (instant deregulation of prices in January 1992 and privatization) the actual policies seem to have been more or less consistent with the first best feasible scenario. In

other areas the government seems to have missed a number of opportunities, In particular, the government failed:

- to proceed with slow, but steady and consistent money-based macrostabilization while keeping the exchange rate at a level which could promote exports;
- to sustain the government commitments for the provision of public goods and social transfers, while concurrently downsizing the government;
- to replace price subsidies for fuel, energy and raw materials by direct subsidies to producers linked to restructuring and to use these subsidies for supporting a few potentially competitive high-tech industries instead of supporting inefficient and non-competitive agriculture and machine production;
- to introduce sound social and labour market policies of the type implemented in Central Europe.

The author suggests that past policy failures and the current state of the Russian economy do not allow for too much optimism in the future of the Russian economy. The most probable scenario outlined in the paper bears several similarities with the pattern of development observed in Latin America in the 1970s: large income inequalities and social tension, lack of consensus on major economic policy issues and outbursts of high inflation, permanent conflict between export-oriented and inward looking industries, continuous subsidization of the latter, low savings and investment, and continuation of capital flight.

The paper argues, however, that this scenario can be modified by the introduction of radical reforms. In particular, it is suggested to adopt a reasonable strategy for downsizing the government, to initiate a sound industrial policy favouring export-oriented industries, to contribute to consensus-building through strong social policy, and to stimulate savings, investment and growth. This original and provocative paper contains the detailed programme for action needed to make the Russian economic transition a success story, and constitutes an important contribution to the literature in this area.

Giovanni Andrea Cornia  
Director, UNU/WIDER  
September 1996

## ABSTRACT

This paper seeks to explain, why Russian (and CIS) economic transformation was neither a shock therapy nor a gradual transition case, but instead followed a sort of middle-ground inconsistent shock therapy path. It is argued that there were some objective constraints, mostly of a social and cultural nature, that prevented the policy makers from successfully implementing the classical shock therapy approach. Nevertheless, actual Russian policy during transition was far from first best feasible choice in such areas as macro-stabilization, exchange rate management, cuts in budgetary expenditure, industrial restructuring, social and labour market programmes.

If current trends continue, emerging Russian capitalism is not likely to duplicate European or East Asian patterns of development, but instead may resemble somewhat the Latin American model. Poor traditions to comply with laws and regulations and low tax revenues; highly uneven distribution of wealth and income and strong social tensions; government failure in providing public goods and social transfers and in restructuring the economy through supporting the winners rather than the losers; poor investment climate, capital flight, growing foreign debt, low savings, investment, and growth - this bleak picture is the most probable option provided that the government will not proceed with major reforms.

The brighter scenario implies that the government would adopt a growth strategy based on:

- downsizing part of the government, while making the remaining part more efficient;
- sound industrial policy favouring export-oriented industries;
- efforts to build consensus through strong social policy;
- measures to stimulate savings and investment (through a low exchange rate, pension system reform, increased government and foreign investment).



## I INTRODUCTION

The Russian (and CIS<sup>1</sup>) experience with economic transition from the centrally planned economy (CPE) to the market-oriented economy is a special case at least in two major respects.

First, Russia has followed a sort of middle path, which fits neither into the classical shock therapy approach, nor into Chinese style gradualism. The Russian reform path may be best described as inconsistent shock therapy – this implies that Russian reformers tried to introduce a Polish-type shock therapy treatment by deregulating prices instantly in January 1992, but failed to achieve macroeconomic stabilization, to phase out subsidies, and to shut down loss-making enterprises.

Second, the Russian transition was associated with greater costs than in East European countries, and even than in the Baltic states. Only economies affected by wars experienced a greater reduction of output and living standards during transformational recession, whereas in China and Vietnam reforms led to immediate increase in output.

Both shock therapists and advocates of gradual approach claim that these two basic facts are interrelated. While the former link the exceptional magnitude of Russian recession to the inconsistency of the shock therapy (mostly to the inability of the Russian authorities to bring down inflation in 1992-5), the latter blame the initial shock (instant liberalization of prices) and 'too rapid and poorly designed' deregulation in other areas for the vast reduction of output.

This study deals with this crucial and somewhat traditional issue of the debate by analysing factors that contributed to the extreme magnitude of the Russian recession.

The other crucial issue of the Russian transition, also addressed here, is a relatively less discussed question of why Russia failed to introduce one of the two sets of clear-cut policies (either shock therapy or gradual approach), but instead followed a middle-ground inconsistent shock therapy. Obviously, it was not a conscious choice of policy makers, but an undesired final outcome, which makes it no less puzzling provided that this 'neither-nor' approach is not advocated by anyone, but on the contrary is criticised by proponents of both mainstream schools of thought.

Finally, we intend to examine the trends that shape the contours of the future Russian economic system, to speculate in what directions it is going to develop, and to discuss

---

<sup>1</sup> In a sense the transition experience of all CIS states and some Balkan countries is very similar to the 'Russian model'. The Russian case, however, is important not only because of the size of the country, but also – as discussed later in detail – because it seems to be the most pure and typical example of inconsistent shock therapy.

possible options for long-term growth. To be more precise, this study seeks to answer three sets of questions:

1. What is the explanation of the two crucial stylised facts about Russian economic transition – greater magnitude of Russian transformational recession and high inflation? Was deep reduction of output largely inevitable? Should it be attributed mostly to poor initial conditions, greater imbalances inherited from the CPE, and unfavourable external environment or to the inability to achieve macroeconomic stabilization? What were the origins of the Russian inflation ('cost-push' versus 'demand-pull')? Was high inflation a policy-induced phenomenon that contributed to the depth of the recession (shock therapist approach) or did it result from structural rigidities of the Russian economy and mitigated the reduction of output (gradualist approach)?
2. Why did road maps of Russian transition turn out to be different from those in East European countries and from the 'Chinese way'? To what extent were these differences predetermined by objective circumstances and to what extent should they be attributed to the choice of policy makers?
3. Finally, what kind of economic system is emerging out of the transition? In which respects would it be different from the existing and emerging market economies? What are the feasible options for the policy makers to change unfavourable patterns of development?

In the first part, we focus on the greater magnitude of the reduction of output, arguing that it should be attributed mostly to factors lying beyond the control of policy makers, such as greater disproportions at the macro and micro levels inherited from the CPE; the collapse of interrepublican trade (which was a largely inevitable result of the same disproportions); poor initial conditions for reforms (i.e. a larger monetary overhang) and not a very favourable external environment. In fact, immediately before the reforms, Russia had only one significant advantage as compared to other economies in transition – an abundance of natural resources, which was more than counterweighted by the numerous disadvantages. It is argued that the exceptional *depth* of Russian recession was largely inevitable rather than policy-induced and it is doubtful that such a deep reduction of output could have been avoided even with different policies. High inflation, however, is regarded in the study as policy-induced, not cost-push, and it is argued that inappropriate macroeconomic policy (as well as wrong policies in other areas) contributed considerably to the *length*, if not to the depth, of the Russian recession.

In the second part, we examine the factors that predetermined the deviations of actual policies carried out in particular areas from both classical shock therapy and classical gradualist approach (the greater magnitude of the Russian recession was one of these factors). We argue that, though Russian inflation was predominantly demand-pull (i.e. monetary in nature), there were greater obstacles there than in East Europe and China for bringing it down. We also suggest that because of the huge and unique disparities in competitiveness between major sectors of the Russian economy, the option of eliminating all subsidies at once was not really feasible, but the form in which those

subsidies were provided (price subsidies, not direct income subsidies) was extremely inefficient. We take the view that in the social area, though the increase in income inequalities was inevitable, the government missed a chance to neutralise opposition to reforms by supporting the poor – in particular the pensioners. Finally, with respect to privatization we believe that the government generally managed to find a reasonable compromise between economic efficiency and social acceptability by taking into account the interests of managers and work collectives and, thus, making the whole programme feasible.

The last part of this study deals with outcomes of the transition. By analysing current trends we try to separate the temporary developments from the fundamental ones and to foresee what type of economy is emerging in Russia, in what respects, and why it will be different from the variety of existing and developing market models. We argue that, on the whole, Russian capitalism is going to be 'wilder' than that in East European countries. Inequalities in asset and income distribution – which are already higher than in other economies in transition – are going to approach Latin American levels; the role of the government in providing the regulatory framework and social transfers would remain relatively weak, the shadow economy, on the contrary, relatively large. There is going to be a permanent conflict between, on the one hand, export-oriented and competitive resource industries and, on the other hand, non-competitive agriculture and machinery and equipment industries (which fail to substitute for growing imports): this conflict is likely to undermine prospects for long-term growth. While assuming that this path of development is the most likely outcome if current trends continue, we explore the conditions for adopting a 'high growth model' similar to that of South-East Asian countries.

Finally, we draw some conclusions and discuss the alternative paths of transformation, making distinctions between economically optimal policy (first best option), feasible policy (first best given local conditions), and actual policy followed.

## II PECULIARITIES OF THE RUSSIAN TRANSITION

### 2.1 Why the reduction of output was so large

Economic transformation in Russia proved to be associated with greater costs than elsewhere. The recession has already continued for over six years (1990-6) and caused a reduction of gross domestic product (GDP) by more than 40 per cent (Figure 1). Worse indicators were observed only in some former Soviet Union (FSU) states and in countries affected by wars (Table 1). In East European countries the recession lasted 3-4 years causing a reduction in output of 20-30 per cent, whereas in China and Vietnam reforms led to the immediate increase in output.

True, real incomes and real consumption, after plummeting in January 1992 when prices were deregulated, recovered afterwards. Though there is considerable uncertainty over the measurement problems, it appears that in 1995 real incomes of the Russian population were *on average* comparable with the level of the mid 1980s. However, because income inequalities increased tremendously (and much faster than in East European countries) for the absolute majority of the Russians, living standards deteriorated substantially.

This factor, together with the rise in crime rates, the increase in mortality, the reduction of life expectancy and other unfavourable developments (which, again, were more pronounced in Russia than in other economies in transition) has caused widespread feelings of social discontent. According to public opinion polls, most Russians feel that they are now worse off than before the reforms. Strong support for the pro-communist and pro-nationalist candidates during the December 1995 parliamentary elections (42 and 12 per cent of seats in the Duma, respectively) and in summer 1996 presidential elections (over 40 per cent of the votes for the communist candidate in the runoff) is another indicator of the high cost of Russian transition.

Whereas the progress in creating a market-oriented economy in recent years was indeed remarkable and in many cases no less substantial than in East European countries, Russia had to pay a greater price for economic transition. Why? The answer depends, of course, on the theory adopted. Shock therapists argue that much of the cost of Russian reforms should be attributed to inconsistencies of policies followed, namely to the inability of the government and the Central Bank of Russia (CBR) to fight inflation. On the other hand, the supporters of gradual transition state exactly the opposite, blaming the attempt to introduce a conventional shock therapy package for all the disasters and misfortunes.

Shock therapists point to the example of East European countries and Baltic states, most of which managed to reduce inflation to below 50 per cent annually in the year following liberalization of prices (Table 2) and now enjoy economic recovery. Gradualists cite the

example of China, arguing that the lack of recession and high growth rates is the direct result of the step-by-step approach to economic transformation.

TABLE 1  
CHANGE IN REAL GDP IN ECONOMIES IN TRANSITION (1989 = 100%)

Countries/Years	1990	1991	1992	1993	1994	1995	1996*
Eastern Europe and Baltic countries**	93	83	79	79	83	87	91
Albania	90	65	58	65	69	74	78
Bulgaria	91	80	74	73	74	75	78
Croatia	91	78	71	69	70	71	74
Czech Republic	100	86	81	80	82	86	90
Estonia	92	82	70	65	64	66	70
Hungary	96	84	82	81	84	86	88
Latvia	103	95	62	52	53	54	54
Lithuania	95	83	51	39	40	41	42
FYR Macedonia	90	79	63	58	55	53	55
Poland	88	82	84	88	93	99	105
Romania	94	82	74	75	78	84	88
Slovak Republic	100	85	80	77	81	85	90
Slovenia	95	87	83	84	89	93	98
CIS states**	96	84	72	65	56	53	54
Armenia	93	83	40	34	35	38	40
Azerbaijan	88	87	67	52	41	34	32
Belarus	97	96	86	76	61	54	51
Georgia	88	76	45	28	18	17	18
Kazakhstan	100	87	76	67	50	45	46
Kyrgyzstan	103	98	73	62	45	42	43
Moldova	98	80	57	56	39	40	40
<b>Russia</b>	<b>96</b>	<b>84</b>	<b>71</b>	<b>65</b>	<b>56</b>	<b>55</b>	<b>56</b>
Tajikistan	98	91	65	58	45	40	37
Turkmenistan	102	97	92	83	66	63	63
Ukraine	97	85	71	59	45	40	39
Uzbekistan	102	101	90	88	85	83	81
China	104	112	127	145	162	178	-
Mongolia	98	88	82	81	83	88	-
Vietnam	105	111	120	130	141	155	-

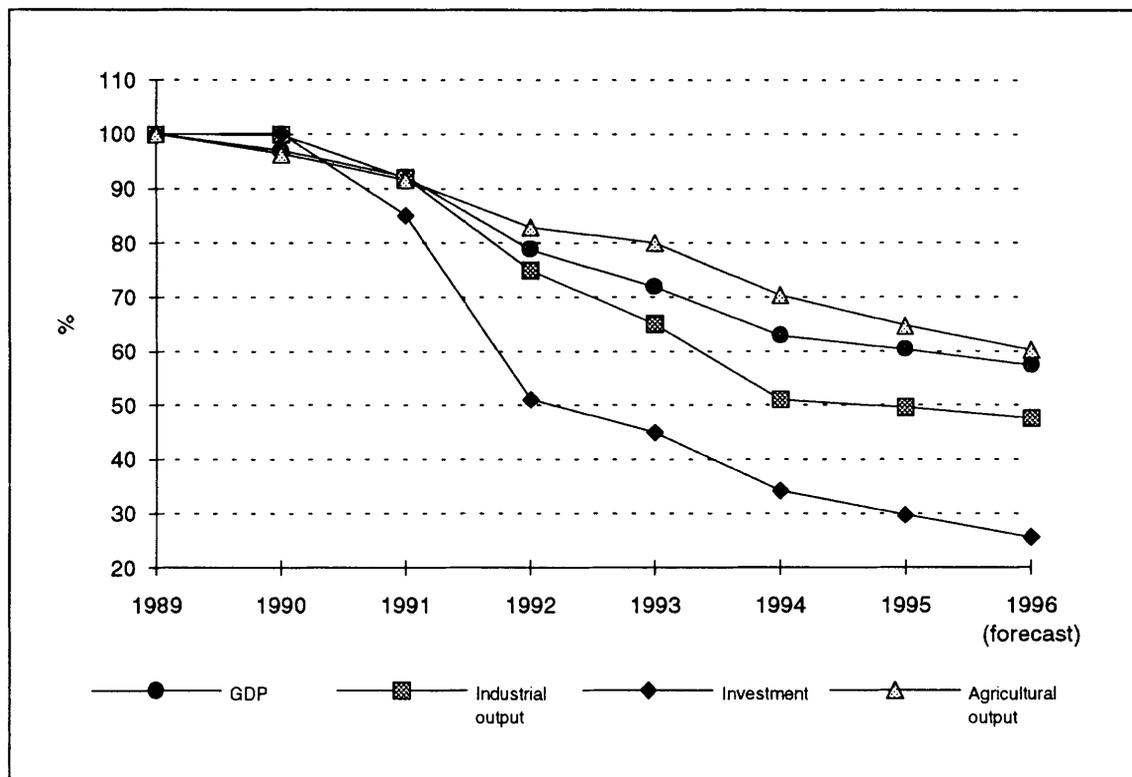
\*Forecast

\*\*Weighted average.

Source: EBRD (*Transition Report Update*, April 1996:22); for Asian non-CIS economies, World Bank, (*World Development Report From Plan to Market*, 1996:173).

Both explanations put a heavy emphasis on policy-related factors. The view taken in this study is that the impact of policy-related factors is often exaggerated, and that non-policy factors, such as unequal initial conditions may explain a greater share of differences in economic performance during transition than is usually believed.

FIGURE 1  
GDP, INDUSTRIAL AND AGRICULTURAL OUTPUT, INVESTMENT, 1989=100%



Source: Goskomstat

China largely managed to escape the restructuring problem due to 'advantages of backwardness' resulting from the low level of economic development. Its economy was mostly based on agriculture and the capital/labour ratio was low, so the centrally planned economy did not create disproportions in the stock of fixed capital (simply because there was not a lot of fixed capital around). Chinese reformers, in most cases, were not overburdened by the legacy of the CPE in a sense that they were not constrained by distorted infrastructure in industry and especially in agriculture. Chinese agricultural communes with very little fixed capital stock (except land) proved to be much more reformable than Soviet and East European collective and state farms with a huge super-centralised infrastructure poorly suited for family farms, whereas township and village enterprises (TVEs) that became the major growth sector of the Chinese economy emerged mostly from scratch.<sup>2</sup>

<sup>2</sup> Capital/labour ratios in the TVE are only 25% of those in the state sector, while their labour productivity is about 80% of the level in state enterprises. See, World Bank, World Development Report, *From Plan to Market*, New York: OUP, 1996:51.

**TABLE 2**  
**INFLATION IN THE ECONOMIES IN TRANSITION RETAIL/CONSUMER PRICE INDEX, %**

Countries/Years	1990	1991	1992	1993	1994	1995	1996*
Eastern Europe and Baltic countries**	116	148	516	223	51	26	15
Albania	0	36	226	85	28	8	6
Bulgaria	22	334	82	73	89	62	30
Croatia	136	250	938	1516	98	4	5
Czech Republic	11	57	11	21	10	9	7
Estonia	23	211	1069	89	48	29	22
Hungary	29	34	23	22	19	28	22
Latvia	10	124	951	109	36	25	20
Lithuania	8	225	1020	290	72	35	30
FYR Macedonia	120	230	1925	248	65	50	6
Poland	586	70	43	35	32	28	19
Romania	5	174	211	256	131	32	20
Slovak Republic	11	61	10	23	14	10	7
Slovenia	550	118	201	32	20	13	6
CIS states**	5	94	994	2008	2874	397	114
Armenia	10	100	825	3732	5458	175	20
Azerbaijan	8	106	616	833	1500	412	30
Belarus	4	84	969	1188	2200	800	80
Georgia	3	78	913	3126	18000	160	20
Kazakhstan	4	91	1610	1760	1980	180	30
Kyrgyzstan	3	85	855	1209	280	45	25
Moldova	4	98	1276	789	327	30	16
<b>Russia</b>	<b>6</b>	<b>93</b>	<b>1353</b>	<b>896</b>	<b>303</b>	<b>190</b>	<b>45</b>
Tajikistan	4	112	1157	2195	452	635	500
Turkmenistan	5	102	493	3102	2400	1800	500
Ukraine	4	91	1210	4735	842	375	60
Uzbekistan	3	82	645	534	746	315	40
China	2	3	5	13	22	17	-
Mongolia	0	209	321	183	145	75	-
Vietnam	68	68	18	5	8	17	-

\*Forecast

\*\*Non-weighed average

Source: For 1990-5 World Bank (*World Development Report From Plan to Market*, 1996:174), annual inflation. For 1996 EBRD (*Transition Report Update*, April 1996:23), December to December inflation.

According to this working hypothesis, the Chinese economy would have done probably no worse or even better than it actually did, if shock therapy (immediate deregulation of prices and withdrawal of subsidies) instead of gradual reforms had been introduced in the late 1970s.

This argument is supported by the example of Vietnam, which followed a different reform path (overnight deregulation of most prices and unification of multiple and black market exchange rate in March 1989), but also managed to avoid transformational recession. And by the example of Mongolia, which enjoyed some 'advantages of backwardness', and where the reduction of output after deregulation of prices was relatively mild and short-lived despite high inflation (Table 1). It is also partially supported by the example of two former Soviet Central Asia republics – Uzbekistan and Turkmenistan – which did not enjoy the advantages of backwardness and, thus, failed to avoid transformational recession under the more gradual reforms carried out by authoritarian regimes.

On the other hand, it is well known that in China large state enterprises in heavy industry proved to be the bottleneck of the whole reform process. There is a correlation between the share of state enterprises in total output and the rates of economic growth by province – the larger the share of state enterprises in total provincial output, the lower are the rates of growth. In contrast to China and Vietnam (Albania and Mongolia, to some extent), East European countries and Baltic states, and even more so Russia and CIS states where the CPE existed longer than elsewhere, entered the transition period with huge distortions in industrial structure caused by decades of central planning.

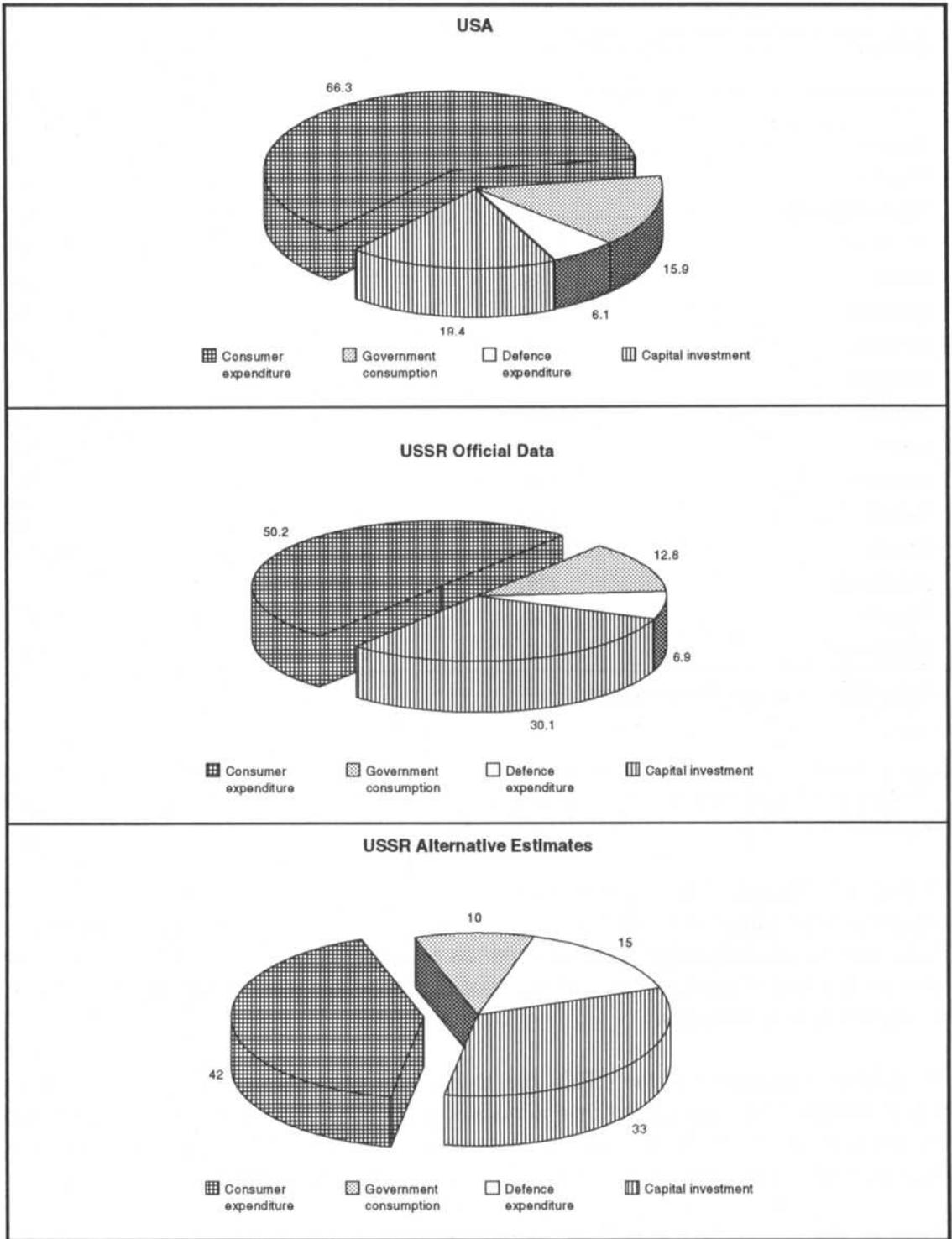
In all CPEs the share of investment in GDP was higher than in market economies: due to low capacity utilization rate and high inventories capital productivity was poor, so to maintain reasonable growth rates a larger proportion of GDP had to be devoted to investment. Soviet economy was extremely capital intensive – the share of investment in GDP in the 1980s was in the range of 30-35 per cent, as compared to about 20 per cent in the USA and 25 per cent in Western Europe. In addition, a much higher share of GDP was absorbed by defence expenditure – about 15 per cent in the USSR in the 1980s as compared to 1-5 per cent in major Western countries (Figure 2).

All CPEs were overindustrialized at the expense of the service sector, especially at the expense of trade and financial services that were relatively underdeveloped. The Soviet economy, however, was more defence and investment oriented than other CPEs, and the Russian industrial structure was 'heavier' than that of other Soviet republics. While the share of industry in GDP in Russia before the transition was not that different from other countries, the share of resource industries (fuel, energy, metals) and engineering (machine production) in total industrial output was markedly higher. Data in Table 3 show that even in 1993, after unfavourable price and output shifts, the share of engineering was still 20 per cent. In 1990, however, engineering accounted for 46 per cent of employment and 31 per cent of output of the industrial sector – more than even in the most industrialised country of the Eastern bloc, Czechoslovakia (40 and 30 per cent respectively), and much more than in Poland (32 and 28 per cent respectively)<sup>3</sup>.

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<sup>3</sup> Comparison is based on national statistics. The share of machinery and equipment industries in total value added in manufacturing in 1992 was higher than 1/3 only in Malaysia, Thailand, Singapore, and Japan (World Bank, World Development Report, *Workers in an Integrating World*, New York: OUP, 1995:172-3).

**FIGURE 2**  
**GROSS NATIONAL EXPENDITURE BY COMPONENT, 1990, % OF TOTAL**



Source: Goskomstat; Economic Report of the President.

**TABLE 3**  
**SHARE OF INDUSTRIAL SECTOR IN GDP AND SHARE OF RESOURCE INDUSTRIES AND**  
**ENGINEERING IN TOTAL INDUSTRIAL OUTPUT, %**

Country	Share of industry in GDP, 1991	Share of particular industries in total industrial output, 1993	
		Resource industries*	Engineering
Bulgaria	36	23	16
Croatia		**18	**12
Czech Republic	47	30	18
Hungary	29	25	16
Poland	36	29	21
Romania	40	24	19
Slovakia	53	36	16
Slovenia	40		
Estonia	35 (22)	20	9 (8)
Latvia	38	25	16
Lithuania	45	21	12
Belarus	(40)	(25)	(22)
<b>Russia</b>	<b>39 (38)</b>	<b>46 (41)</b>	<b>20 (17)</b>
Kazakhstan	(29)	(54)	(10)
Ukraine	(31)	48 (36)	16 (20)
Uzbekistan	(26)	(33)	(10)

\*Fuel, energy, steel, non-ferrous metals.

\*\*1995.

Source: *Economic Survey of Europe in 1995-1996*. Economic Commission for Europe, Geneva, 1996:61-2. Data in brackets are taken from: *Statistical Handbook 1995: States of the Former USSR*. World Bank, Washington DC.

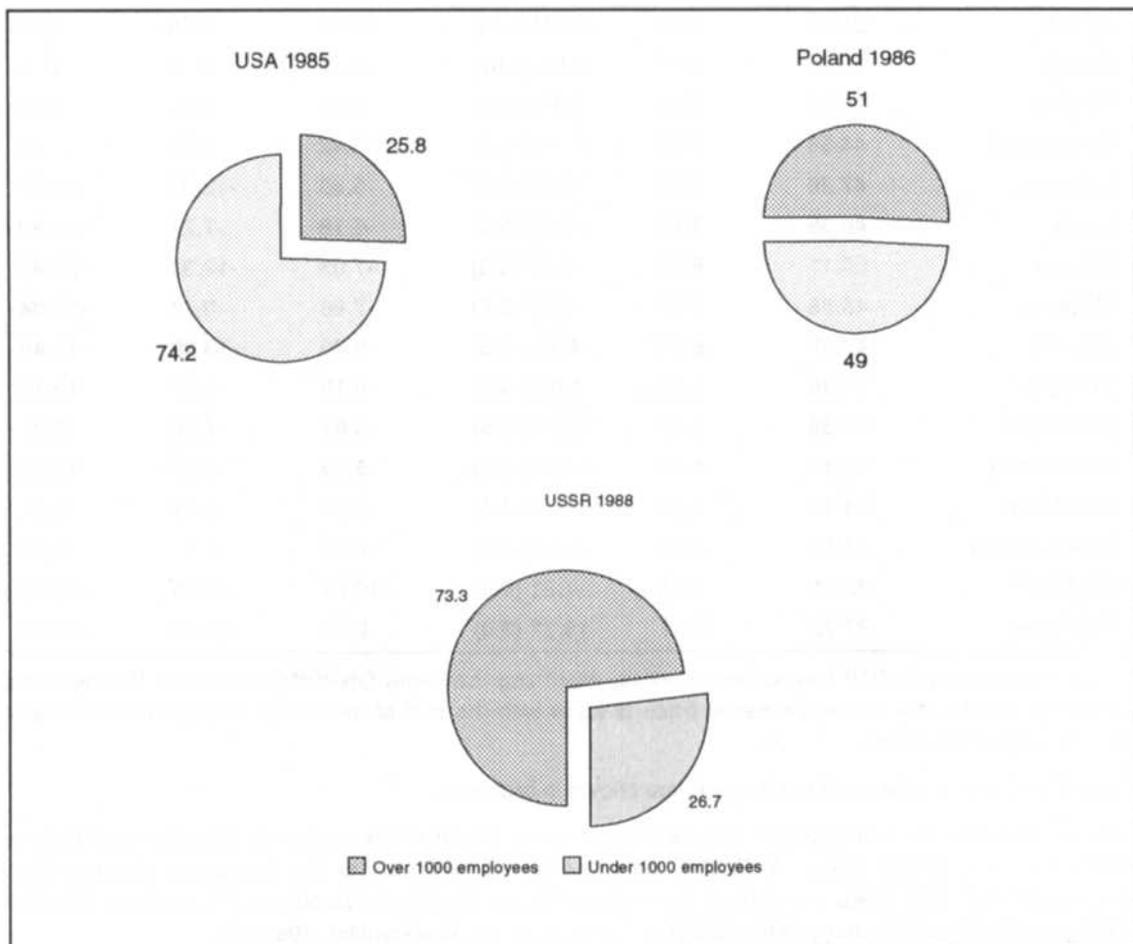
In contrast, in other republics the share of machinery and equipment industries in total industrial employment in 1990 was only 38 per cent (less than 30 per cent, if Ukraine and Belarus are excluded); Russia's position versus all other republics except for Ukraine and Belarus was that of a net exporter of resources and machinery and a net importer of food and light industry products.

In addition, enterprises in the CPEs due to decades of central planning became much larger and much less specialised than in market economies. Here again, the Soviet Union led the way: for example, the share of enterprises with over 1000 employees in Soviet industry was nearly 75 per cent, while only 50 per cent in Poland (Figure 3).

Another disproportion created by central planning – the productivity gap between resource based industries and secondary manufacturing – is unique to the former Soviet republics, as it (virtually) does not exist in other CPEs. Due to obvious natural environment factors the Soviet, and especially the Russian economy, was more resource-oriented than other CPEs, and resource industries developed into the most efficient part of the Soviet industrial potential. Their productivity (as compared to the world level) was

several times higher than that in secondary manufacturing. While the productivity gap between industry and agriculture is common for many countries (not only for the CPEs, but also for most emerging market economies), it is only countries with the abundance of natural resources that may develop a highly efficient and competitive resource sector.<sup>4</sup>

FIGURE 3  
SHARE OF ENTERPRISES WITH OVER 1000 EMPLOYEES IN TOTAL INDUSTRIAL OUTPUT, %



Source: Financial Times - *Izvestiya*, April 1992.

The explanation of high efficiency of resource industries may be trivial enough in those industries productivity depended mostly on natural comparative advantages, not on the ability of the central planners to organize production, which never was their strongest point and which ruined efficiency in areas where it was the crucial factor. To make things worse, Soviet planners chose to extract rent and extra profits of the highly efficient resource industries through underpricing raw materials and overpricing finished goods (as compared to world prices), thus contributing to the higher material and especially energy intensity, which became the highest in the world (twice as high as in the USA, and three-to-four times higher than in West European countries and Japan, according to the most modest estimates).

<sup>4</sup> The issue is discussed also in the section on industrial strategy.

**TABLE 4**  
**TRADE FLOWS AND TRADE BALANCES OF SOVIET REPUBLICS, 1988**  
**AS A % OF GNP**

Republics	Trade flows*		Trade balance			
	Domestic	Foreign	Domestic**	Foreign	Total, in domestic prices	Total, in world prices
USSR	21.11	8.27	-0.01(-0.14)	-5.76	-5.78	0.21
Russia	12.92	9.37	0.05 (0.02)	-6.28	-6.23	5.76
Ukraine	26.90	7.14	2.55 (-0.3)	-4.61	-2.05	-2.04
Byelorussia	44.56	7.39	11.14 (-1.6)	-5.42	-5.72	-5.78
Lithuania	47.26	7.21	-6.56 (4.0)	-5.83	-12.39	-29.97
Latvia	46.85	7.21	-1.03 (5.2)	-6.18	-7.21	-13.39
Estonia	50.11	8.79	-5.27 (5.3)	-7.03	-12.31	-22.86
Moldova	45.88	6.37	-1.87 (5.6)	-7.86	-9.74	-24.34
Armenia	47.85	5.84	-4.23 (-2.5)	-9.70	-13.92	-17.40
Georgia	37.88	5.90	1.98 (-4.9)	-6.15	-4.17	-13.43
Azerbaijan	35.38	5.95	13.89 (-2.6)	-6.61	-7.28	-3.31
Kazakhstan	29.48	4.69	-14.47(-1.3)	-5.09	-19.56	-17.69
Uzbekistan	34.10	5.62	-5.78 (-1.4)	-0.59	-6.37	-8.71
Turkmenistan	37.58	4.60	-1.53 (-3.0)	-3.07	-4.60	0.00
Kirghizia	39.65	5.98	-7.21 (0.4)	-10.24	-17.45	-15.86
Tajikistan	37.70	6.01	-15.32 (3.0)	-2.10	-17.42	-16.52

\*(Exports+Imports):(2xGNP) at domestic prices, assuming the same GNP/NMP ratios for the republics as for the USSR as a whole. Domestic trade is trade with the rest of the Union. Foreign trade is trade with the rest of the world.

\*\* Estimates of the balance of tourist trade are shown in brackets.

Source: *Stabilization, Liberalization and Devolution: Assessment of the Economic Situation and Reform Process in the Soviet Union*. A Report, prepared by Commission of the European Communities. December 1990:173. (Data are derived from official Soviet statistics); *Narodnoye Khozyaistvo SSSR v 1989 godu* (National Economy of the USSR in 1989). Moscow, Goskomstat, 1990:638.

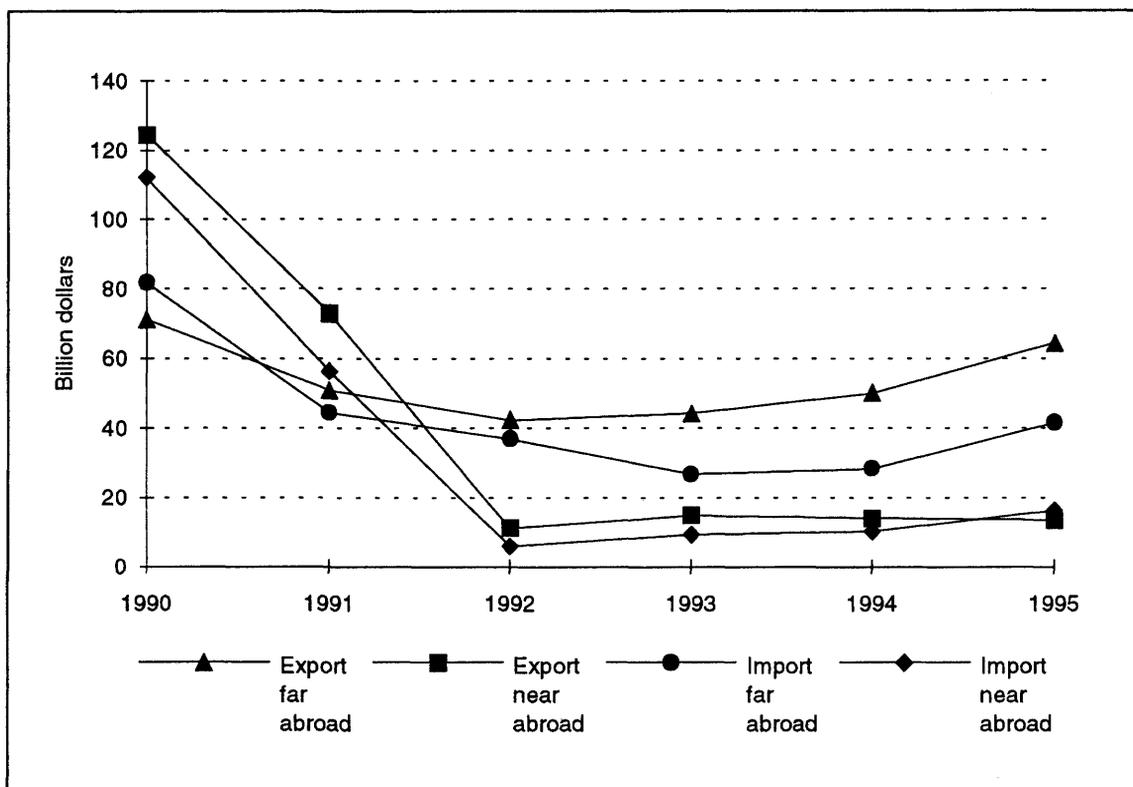
Whatever the origins of this productivity gap were, it contributed greatly to the depth of Russian transformational recession. Changes in price structure during transition – bringing domestic prices in line with the world prices – caused much greater adjustment problems in the former Soviet Union than in East European countries, in which domestic resource prices were kept roughly at the world level.

Also, the collapse of the interrepublican trade that contributed considerably to the depth of the recession in former Soviet republics should be attributed not to the breakdown of the Union itself, but to changes in relative prices, which made it impossible for the fuel importing republics to finance their trade deficits with Russia.

As the data in Table 4 shows, when trade flows among former Soviet republics are recalculated in world prices, Russia had a surplus of about six per cent of gross national

produce (GNP), whereas 10 out of the remaining 14 former Soviet republics ran absolutely unsustainable trade deficits in the range of 9-30 per cent of GDP. It is no surprise that changes in relative prices resulted in a tremendous reduction of Russian exports from 13 per cent of GNP in 1988 to about only four per cent in 1995 (Figure 4). While resource export to republics was partly reoriented to other countries (Figure 5), the sharp reduction of finished goods exports (mostly machinery and equipment) led to the decrease in output. To summarise, the legacy of central planning in former Soviet republics proved to be much worse than in East European countries: restructuring and adjustment were supposed to proceed on a much greater scale and hence were associated with the larger reduction of output. With the multiplier of 2, the reduction of defence expenditure (by 10 per cent of GDP) and interrepublican trade (another 10 per cent of GDP) alone should have caused a 40 per cent decrease in GDP, i.e. supply shocks may explain the bulk of the Russian recession. In a sense, Russia was doomed to undergo through a *deeper* recession than other countries, whereas policy related factors (high inflation included – see next section) may have accounted mostly for the *greater length* of the recession.

FIGURE 4  
RUSSIAN TRADE WITH FAR AND NEAR ABROAD, BILLION DOLLARS

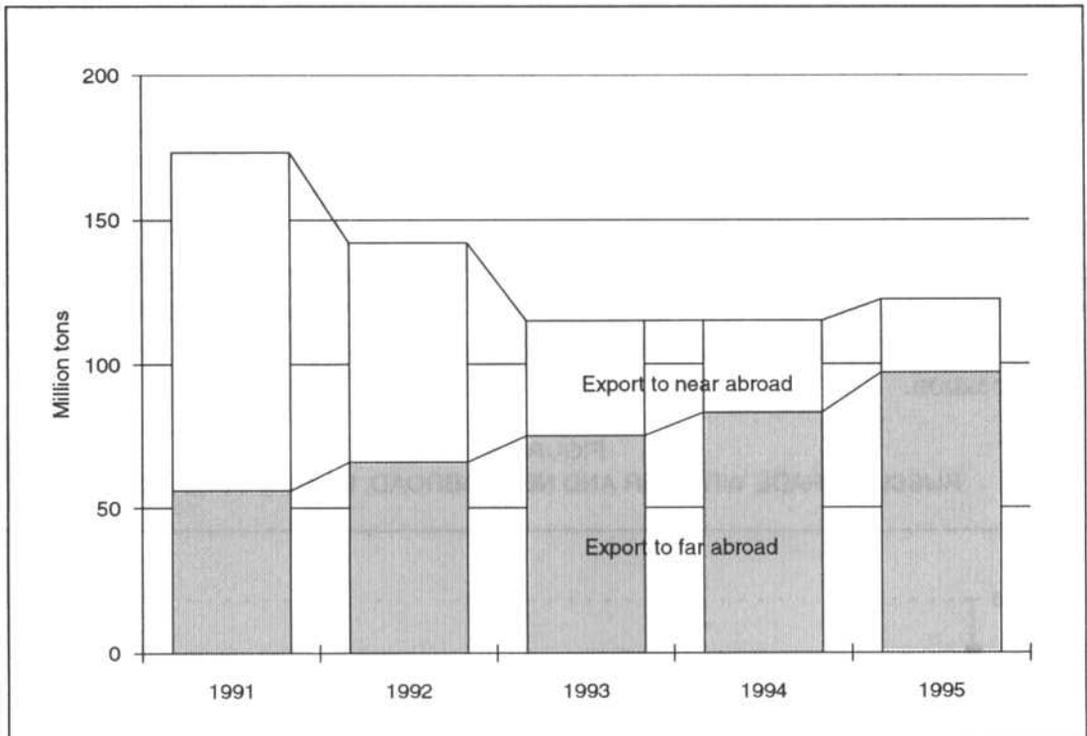


Source: Goskomstat

This interpretation is once again only a working hypothesis, which should be accurately tested. Partial support may be provided by the experience of the Baltic states, which had broadly similar disproportions (except for a high share of defence and machinery output and the productivity gap between resource industries and machine production), but

followed different policy (consistent shock therapy): their reduction of output was no less significant than in Russia, but their recovery started at least two years earlier.

FIGURE 5  
RUSSIA'S OIL EXPORT TO NEAR AND FAR ABROAD IN 1991-5, MILLION TONS



Source: Goskomstat.

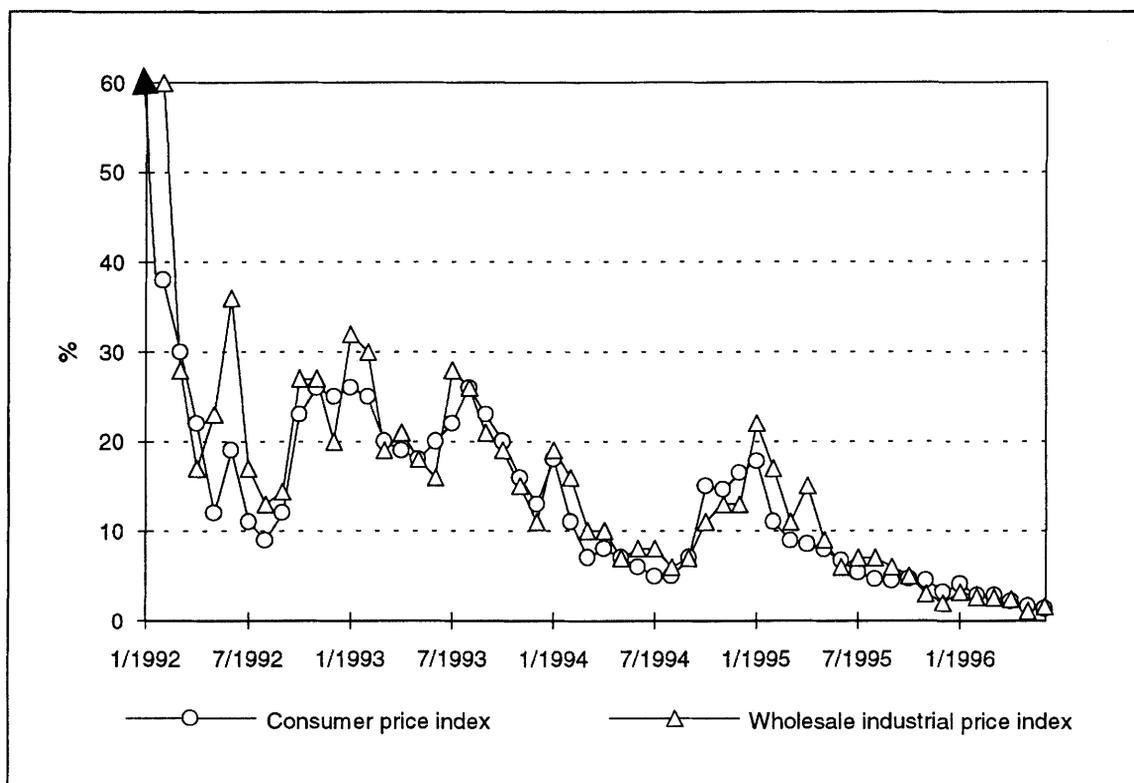
Such a line of reasoning is not necessarily in conflict with recent studies (see, for instance, De Melo et al., 1995) suggesting that even after allowing for different initial conditions in transition economies, 'good policies' (mostly consistent with shock therapy approach) finally payoff. However, it may well be that the role of policy-related factors in recent debates has been somewhat exaggerated. Naturally, the greater magnitude of the Russian recession weakened the social support for reforms and made it more difficult to work out a consensus about financing the costs of transition.

## 2.2 Why inflation was so high in 1992-5

Since the start of radical reforms in Russia in 1992 there have been three major attempts to ensure macroeconomic stabilization. The first one was made in early 1992 by Mr. Gaidar's government, and was in fact part of the major shock therapy reform package similar to the one implemented in Poland in early 1990. The government budget deficit in the first half of 1992 was drastically reduced, the growth of money supply lagged considerably behind price increases, and, as a result, inflation slowed down from 245 per cent in January (immediately after deregulation of prices) to 38 per cent in February and 9 per cent in August 1992 (Figure 6).

By that time, however, enterprises were so short of liquidity that they accumulated huge trade debts and the first non-payment crisis broke out. Faced with a difficult choice of pursuing fiscal and monetary restrictions designed to bring inflation down further or saving the national payment system from collapse, the government and the CBR chose the latter. Naturally inflation accelerated – by late 1992 it was running at over 20 per cent a month and remained at this level until late 1993.

FIGURE 6  
MONTHLY INFLATION RATES, %



Source: Goskomstat.

The second attempt to ensure macroeconomic stability was made in late 1993 and lasted until mid 1994. It was initiated by the radical reform-minded ministers in the government (Mr. Fyodorov, the Finance Minister, and Mr. Gaidar, the Minister of the Economy), but continued even after those ministers left the government in January 1994 protesting against inflationary policy and stating that they did not see any chance for macroeconomic stabilization. Nevertheless, the centrist Chernomyrdin government and the Central Bank of Russia (CBR) headed by the gradualist-minded Mr. Geraschenko managed to bring down inflation to five per cent a month in July-August 1994 – the best record since the beginning of reforms (Figure 6).

Unfortunately the 1992 scenario was then reproduced almost entirely in 1994: enterprises only partially responded to the monetary restrictions by cutting the rates of price increases, whereas the bulk of the adjustment again took the form of the accumulation of trade arrears. Once again the authorities decided to sacrifice

macroeconomic stability for the sake of preserving the payment system, which, they thought, was on the verge of breaking down: the growth of money supply accelerated, the exchange rate of the rouble collapsed in October 1994 (depreciating by nearly 25 per cent in just one day), and inflation increased to 18 per cent in January 1995 (Figure 6).

Finally, in 1995 the government and the CBR, working in close contact, undertook the third attempt to bring down inflation through combining the restrictive monetary policy with introducing a sort of crawling peg for the rouble from mid 1995. While this third attempt is discussed later (and at the time of writing it looks like it has a good chance of succeeding) the question of why it took so long to bring Russian inflation to a halt still persists. Russia's (and CIS's) macroeconomic situation was thus very different from both that of East European countries and the Baltic states, pursuing shock therapy policy, on the one hand, and that of China, pursuing gradual transition strategy, on the other. Unlike Russia and CIS countries, other economies in transition generally managed to keep inflation under control.

Poland, the first country that introduced a shock therapy package by deregulating prices, making the national currency convertible, and adopting fiscal and monetary restraints in 1990, the next year, in 1991, managed to bring down inflation to 70 per cent and further down to about 20 per cent in 1995. Most other East European countries introduced shock therapy packages in 1991 and reduced inflation to 10-30 per cent annually in subsequent years. The Baltic states were the last ones to adopt shock therapy treatment in 1992-3 after becoming independent and introducing their own currencies; in 1994-5 their inflation rates dropped to 25-45 per cent a year (Table 2).

In contrast, CIS and some Balkan countries followed a less consistent macroeconomic strategy with the result that their inflation rates remained high during transition. It was not until 1995 that Kyrgyzstan, Moldova and Romania managed to bring down inflation to below 50 per cent a year, whereas other CIS states and Bulgaria were only approaching this threshold in 1996.

There are two competing explanations for high inflation in Russia.<sup>5</sup> One is offered by shock therapists and is based on viewing inflation as a predominantly monetary phenomena, which should be dealt with accordingly, i.e. through cutting the rates of growth of money supply (Illarionov 1995a). Former Western advisers to the Russian government – Jeffrey Sachs and Anders Aslund – have long been suggesting to peg the exchange rate of the rouble to use it as a nominal anchor that would force the CBR to restrict the growth rates of monetary aggregates and would force the government to cut the deficit (Sachs 1994; Aslund 1994a). This monetarist approach is generally supported by IMF, while in Russia it is held by radical democrats, such as Yegor Gaidar and Boris Fyodorov (Gaidar 1995; Fyodorov 1994).

The advocates of such an approach believe that there is a negative relationship between inflation and economic growth. According to the Moscow-based Institute of the Economic Analysis, macroeconomic stabilization implies that inflation should be brought

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<sup>5</sup> For more details see Popov (1994).

down to below 40 per cent a year (2.8 per cent a month): this is an empirically determined threshold; if inflation is higher, it leads to the reduction of output and thus deepens the recession (Illarionov 1995b).

The other (structuralist) approach is taken by some Western scholars, by most Russian academic economists and many politicians – from 'soft' democratic opposition to communists. They state that Russian inflation is mostly cost-push, not demand-pull, that it is not yet in economic textbooks, but soon will be, that it is caused by structural factors of imperfect competition; such as monopoly pricing, barriers to competition and to flow of resources between industries and regions. They feel that the efficacy of the conventional anti-inflationary policy is quite limited because enterprises in economies in transition are not capable of responding in the desired manner to monetary policies, that monetary restrictions may only cause output to fall short of potential supply and thus lead to a new non-payment crisis (accumulation of trade arrears by enterprises), while having only marginal impact on inflation (Amsden, Kochanowicz, and Taylor 1994; McKinnon 1994; Sapir 1994; Sato 1995).

The joint report of the Economic Department of the Russian Academy of Sciences and the International Reform Foundation (the so-called 'Report of Three Academicians') argued that 'the failure of attempts to fight inflation should be explained by the inability to understand its origins in the Russian economy (understatement of monopolistic structures, cost-push factors, etc.) and by the choice of inadequate, purely monetary means to bring it down through demand restrictions' (Shatalin et al. 1994).<sup>6</sup>

An econometric study of the Institute of Economic Forecasting claimed that cost-push factors may explain about 70-80 percent of total wholesale price increases in 1993, while monetary factors account for only 10-15 percent, and inflationary expectations only for 10-20 percent (Belousov et al, 1993, 1994, 1995).<sup>7</sup> Grigory Yavlinsky, the leader of the democratic opposition *Yabloko* group, argued recently that 8-9 per cent monthly inflation (150-180 per cent a year) is predetermined by structural and institutional factors, and that monetary restrictions pushing inflation below this threshold become inefficient in the sense that they lead mostly to an increase in non-payments and to a reduction of output (Yavlinsky 1995).<sup>8</sup>

Overall, it seems that the monetarist arguments are far more persuasive in the debates on the nature of Russian inflation (demand-pull or cost-push). *First*, the experience of East European countries and the Baltic states, most of which managed to reduce inflation to

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<sup>6</sup> Another academic economist suggests that 'for each percent of inflation fall the national economy pays 3-5 percent of production slumps' and that by raising inflation to 15% monthly it would be possible to reach the production level of 70% of 1991, i.e. to increase output as compared to current levels (Lvov 1995).

<sup>7</sup> By mid 1995 the role of monetary factors, according to these estimates, declined to zero, the role of cost factors fell to about 30-40%, whereas the role of factors associated with inertia (expectations) increased to over 50%.

<sup>8</sup> In the *Yabloko* Economic Programme the 'rigid' threshold inflation level is defined as 8-10% a month and the 'real' threshold level as 15-20% a month (Economic Programme, Materials for the II Congress, *Yabloko*. September 1995:87-9).

20-30 per cent a year and now enjoy economic recovery, is quite meaningful: it suggests that Russia and other CIS countries could do this as well. There is nothing special in terms of inflexibility of prices and wages that makes Russia different from East European and Baltic countries. On the contrary, though Russian enterprises are larger on average than in other countries, monopolization of the Russian market may be in fact less pronounced due to its larger size. Anyway, foreign trade deregulation and convertibility of national currencies proved to be efficient instruments of fighting monopolistic pressure on prices in all economies in transition. As far as the trade unions are concerned, they are currently pretty weak in Russia as compared to their counterparts in Eastern Europe, and do not seem to be in a position to generate wage driven inflation (the strike rate in Russia is also rather low).

*Second*, while there is an obvious correlation between the rates of growth of money supply and the rates of inflation (with a lag of three-to-four months), rates of change in output do not seem to be correlated with the fluctuations of money supply (Figure 7). Numerous regressions that were run to check the links between money supply, prices, output, and interest rates have in all cases yielded the same results: prices did, but output did not, follow changes in money supply (Koen and Marrese 1995; Granville 1995). In the second half of 1995 Russian inflation was brought down to 4-5 per cent a month and by summer 1996 to 1 per cent a month without any significant decrease of industrial output, to mention the most recent obvious example.

Empirical evidence from other countries suggests that bringing inflation down to a level of about 40 per cent is unambiguously good for growth, while the effects of reducing it further are less clear.<sup>9</sup> The debate on whether the monetary restrictions are excessive or not is thus understandable in East European countries, where inflation is running at a rate of 10-30 per cent a year and may be close to the lower limit of cost-push inflation fuelled by imperfect competition in emerging markets. Not so in Russia, where inflation until recently was running at a rate of over 100 per cent a year.

No doubt, the high inflation of 1992-5 had the most devastating effect on output. The highly inflationary environment suppressed savings and investment, including foreign investment, held back the development of capital markets, and, more generally, created an atmosphere of economic uncertainty which contributed greatly if not to the depth then to the length of Russian recession. Having been caused by the inability of the government to control the deficit and by the expansionary monetary policy of the central bank, Russian inflation was indeed monetary in nature and hence should be viewed as the major policy failure.

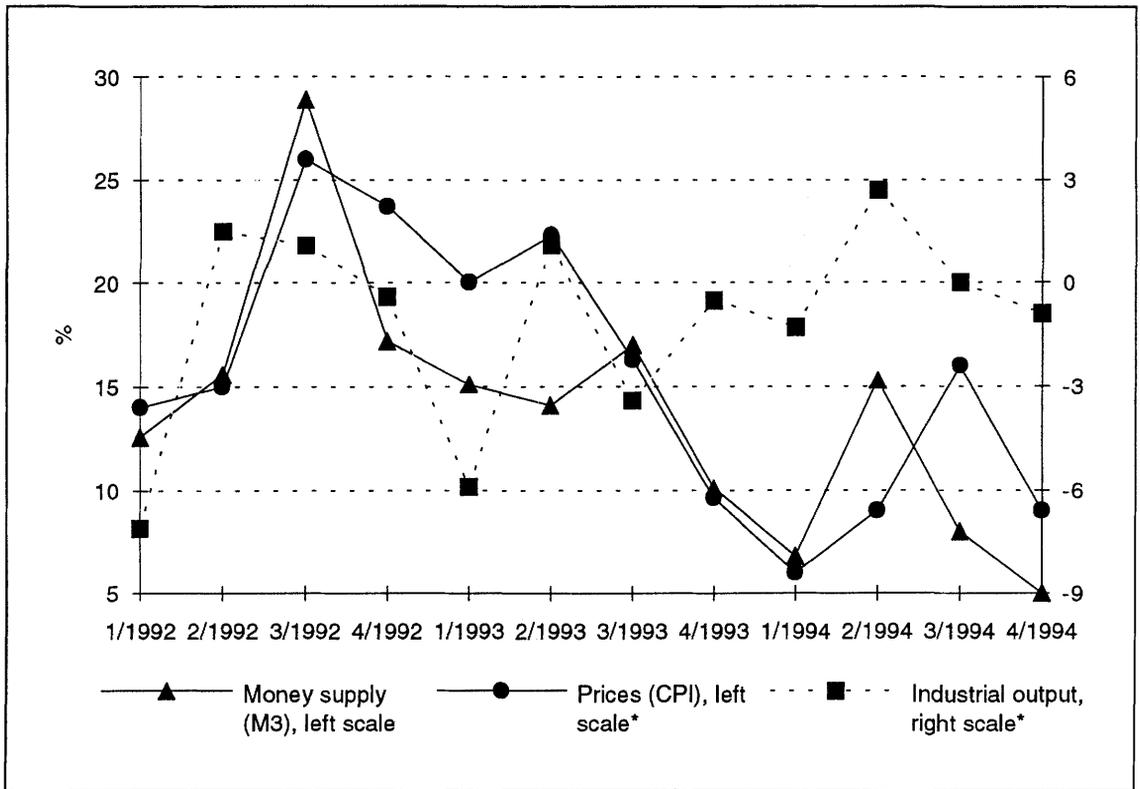
At the same time the conventional monetarist explanation of the high Russian inflation – pure mismanagement and irresponsibility of the government and the central bank (and wrong perceptions of the electorate that failed to elect a better government) – is not completely persuasive provided that high inflation continued for years in quite a number of countries. If there is an alternative explanation, it should be related to specifically

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<sup>9</sup> World Bank, World Development Report, *From Plan to Market*, New York: OUP, 1996:37.

Russian factors, to differences between the Russian (CIS) and East European model of transformation.

FIGURE 7  
 AVERAGE MONTHLY GROWTH RATES OF MONEY SUPPLY, PRICES, AND INDUSTRIAL OUTPUT, BY QUARTERS, %



\*Lagged 4 months.

Source: Computed from Goskomstat data.

### III THE SPECIAL RUSSIAN PATH TO THE MARKET

#### 3.1 Macroeconomic stabilization

There seem to be at least three obstacles at macro and micro levels for bringing down high Russian inflation that do not exist in East European countries and China.

The first one is the lack of consensus in the Russian society on the issue of financing the costs of economic reforms. The Chinese government was able to impose such a consensus 'from above' using authoritarian methods, and in East European countries this consensus was built 'from below' leading to the emergence of relatively strong democratic governments.

However, Russian society seems to be more divided than in East European countries and the Baltic states, where a greater consensus on how to proceed with economic reforms exists. Not only are communists (which are different from social democrats in Eastern Europe) and nationalists stronger in Russia, but also there are clear and deep contradictions between major industrial groups (namely, agriculture, defence and machine production, and the fuel and resource sector) on the issue of financing economic reforms. In Russia, the weak democratic government was not able to withstand the pressure of these interest groups ('complexes', as they are called in Russia – fuel and energy complex, military-industrial complex, and agro-industrial complex), of regions, and of political parties; it did not have the power to bring its expenditure in line with the revenues. The lack of political consensus at three levels – between the central government and the regions, between the parliament and the government, and within the government itself – may have been the crux for the failure of shock therapy attempts to fight inflation in 1992-2 (Desai 1994).

Inflationary financing under these circumstances was a sort of safety valve; a device allowing to the financing of the reforms (with the inflation tax) without forcing the conflicting parties to come to an explicit agreement. The alternative would have been open conflict between the confronting sides, which could have resulted in even greater costs than the highly inflationary environment.

Simplifying things, there was always a feeling that if the Central Bank were to peg the exchange rate, depriving the government of credits to finance its deficit, either the government or the exchange rate would fall the following day. In this sense, the rate of inflation may be a pretty accurate measure of the degree of social consensus on financing the burden of reforms.

The other macroeconomic reason is the unique magnitude of the second (shadow) economy in Russia and the resulting inability of the government to raise tax revenues.<sup>10</sup> Usually economists believe that there is a choice between high inflation and high taxes (with higher taxes it is possible to reduce the deficit and the financial requirements of the government). In Russia it may not be the case. While Russian tax rates are high as compared to other countries, its tax revenues are very low (Figure 8) because the shadow economy has expanded dramatically in recent years. Estimates, based on the share of cash in total operations of Russian businesses, put the size of the shadow economy as high as one third of total GDP (whereas in the late 1980s only two per cent of total cash was held by enterprises, in 1994 it was about 40 per cent, and cash operations are mostly not reported for tax purposes). Estimates based on electricity consumption suggest that in East European countries the share of the shadow economy in 1989-94 increased on average from 18 to 22 per cent, whereas in the former Soviet republics it increased from 12 to 37 per cent.<sup>11</sup>

As the data in Table 5 suggest, tax revenues as a proportion of GDP decreased markedly in most transition economies. However, Central European countries and Estonia managed to arrest the decline, while Russia (together with Lithuania, Latvia, and several South-East European and Central Asian states) experienced the greatest reduction. Chinese government revenues as a percentage of GDP has fallen by over half since the late 1970s, but it looks more like a conscious policy choice rather than a spontaneous process (authoritarian regimes always have better powers to collect tax revenues if they choose to do so, as did all governments in the CPEs before the transition).

Given the limited ability of the government to arrest the reduction of budget revenues, progress in reducing the deficit naturally depended to a large extent on the ability to cut expenditure, which in turn required a minimum consensus on how to do that and turned out to be a painfully slow process.

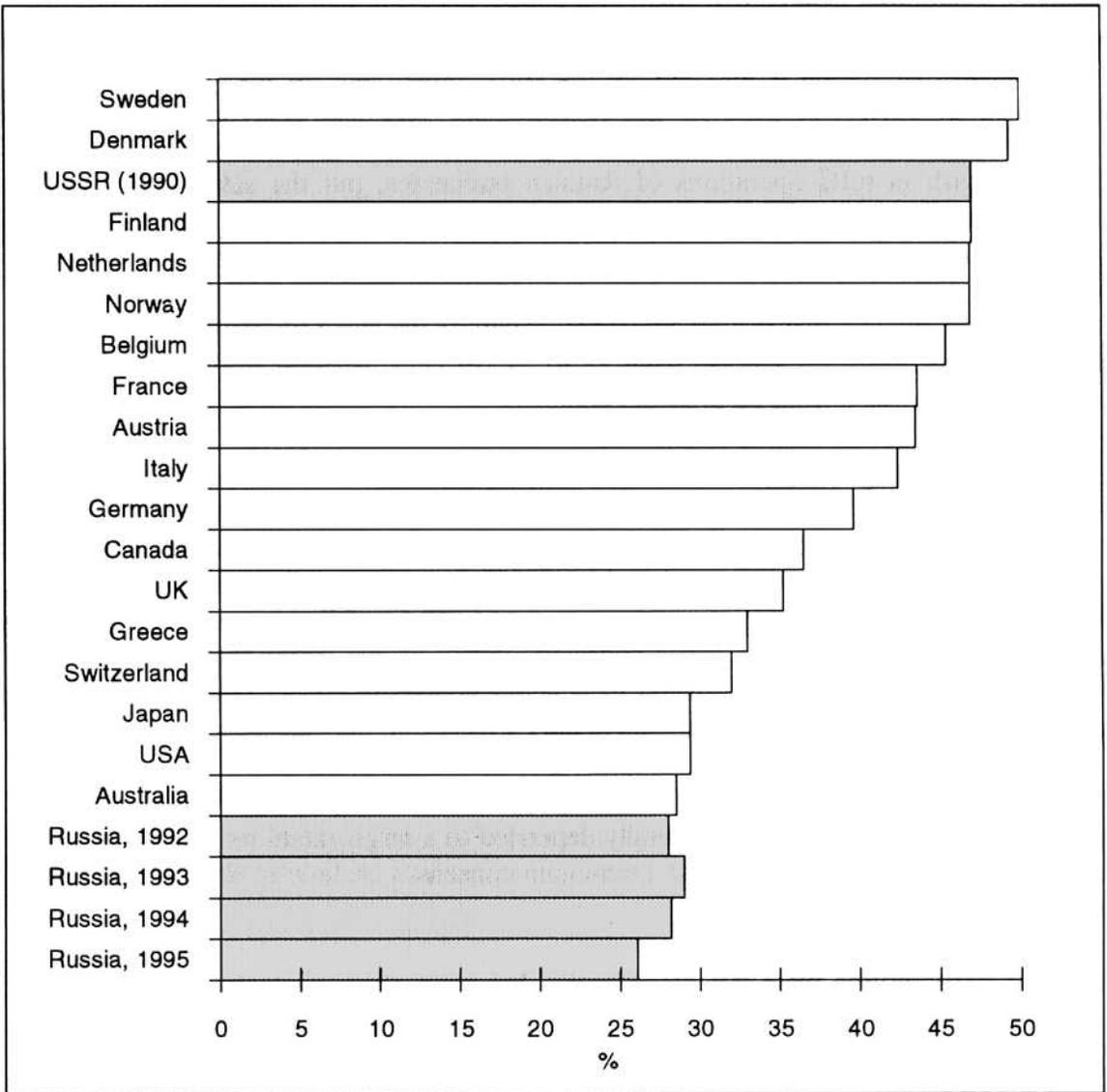
Defence expenditures were cut dramatically, but even after substantial cuts were still very high (4.4 per cent of GDP in 1994, according to official estimates – much higher than in East European countries). The same happened with social expenditure; the financing of health care and education (which were still provided mostly free of charge) declined markedly as a proportion of GDP, the share of social transfers in GDP also fell, though less markedly. Finally, by 1995 the deficit was reduced to about 3 per cent of GDP and a market for government treasury bills was created, so that the major part of the deficit was financed in a non-inflationary way.

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<sup>10</sup> The whole system of public finance has undergone the profound change during transition. While on the expenditure side there was a dramatic decrease in price subsidies, government financed investment and defence expenditure, on the revenue side there occurred an even more dramatic decrease associated with the complete elimination of turnover taxes and special foreign trade earnings (only partly compensated by newly introduced in 1992 value added and export taxes). As shown in (Tabata, 1995), the present economic flow is characterized by the weak role of state in income redistribution and by the concentration of profits, previously appropriated by the state in the form of foreign trade earnings, in specific industries (fuel, other mining industries, and *chelnok*).

<sup>11</sup> World Bank, World Development Report, *From Plan to Market*, New York: OUP, 1996:27. Goskomstat disagrees with this estimate, putting the size of the shadow economy at 20-25% of GDP.

FIGURE 8  
GOVERNMENT BUDGET REVENUES, AS A % OF GDP, 1992\*



Source: OECD, Goskomstat.

\*USSR and Russia - without social security contributions (in 1993 and 1994 such contributions amounted to 7.5% of GDP).

**TABLE 5**  
**TOTAL REVENUES OF CONSOLIDATED GOVERNMENT BUDGETS (INCLUDING OFF-BUDGET FUNDS) AS A % OF GDP IN SOME ECONOMIES IN TRANSITION**

Year/Country	1989	1990	1991	1992	1993	1994	1995*
Central European countries***	51.8	51.5	47.8	48.9	49.5	49.6	49.3
Czech Republic	61.7	60.2	52.2	49.5	49.0	50.3	-
Slovak Republic					48.1	51.4	53
Hungary	59.1	53.9	52.1	56.1	55.4	53.8	49.3
Poland	44.1	42.5	43.0	43.5	47.9	45.6	-
Slovenia	42.4	49.3	43.7	46.5	47.1	47.1	45.7
Baltic states***	47.2	42.1	39.1	32.4	32.5	30.9	32.7
Estonia	39.5	35.7	36.4	31.5	32.5	34.0	40.3
Latvia	52.0	46.0	37	27.4	34.8	33.8	35.5
Lithuania	50.0	44.7	43.9	38.3	30.1	25.0	22.4
European CIS countries***							
Belarus	-	56.8	47.5	44.0	43.6	36.5	37
Ukraine	58.2	-	-	-	42.3	-	-
<b>USSR (1988-90)</b>	<b>43.5</b>	<b>47.2</b>	<b>-</b>	<b>28.0</b>	<b>29.0</b>	<b>28.2</b>	<b>26.1</b>
<b>Russia (1992-95)**</b>							
South East Europe countries	52.3	47.0	36.6	33.5	35.4	38.6	42.7
Albania	47.8	47.1	30.9	25.6	28.6	28	-
Bulgaria	58.0	53.3	42.3	32.4	40.2	38.9	38.6
Croatia	-	-	34	34	33.6	43.8	50.6
FYR Macedonia	-	-	-	38.0	41.0	51.0	48
Romania	51.1	40.5	39.3	37.6	33.6	31.4	33.5
Central Asian countries***	32.7	34.7	31.1	26.6	26.6	24.2	25.7
Kazakhstan	35.4	32.8	25.0	24.6	23.5	17.5	16.0
Kyrgyzstan	28.0	26.3	17.1	14.5	13.5	15.5	16
Tajikistan	-	-	33.2	35.8	27.0	27.8	-
Turkmenistan	32.4	-	-	-	13.4	-	-
Uzbekistan	35.0	44.9	49.1	31.4	42.6	36.0	45
Asian non-CIS countries***	32.2				26.4		
China****	35.1	34.0	33.9	33.3	20.8	18.8	-
Mongolia	48.6	-	-	-	36.2	-	-
Vietnam	14.8	-	-	-	22.3	-	-

\* Estimate.

\*\* Excluding revenues of the off-budget social insurance funds. If these revenues are included, total government revenues amounted to about 36% in 1993 and 1994.

\*\*\* Unweighted average.

\*\*\*\* Data is from the Chinese national statistics and include off-budget funds, which constitute about half of all revenues and are not taken into account in World Bank publications (16.5% and 11.7% in 1989 and in 1993 respectively).

Source: *Transition Report Update*. April 1996. EBRD 1996:24-48; Economic Systems, Vol.19, No.2, June 1995:103; Goskomstat; De Melo et al. (1995), Table 8; China Statistical Yearbook 1995. State Statistical Bureau, 1995:223.

However, the reduction of government expenditures occurred in the worst possible way. It proceeded without any coherent plan and did not involve the reassessment of government commitments. Instead of shutting down completely some government programmes and concentrating limited resources on others with an aim to raising their efficiency, the government kept all programmes half-alive, half-financed, and barely working.

This led to the slow decay of public education, health care, infrastructure, law and order institutions, fundamental research and development, etc. Virtually all services provided by the government – from collecting custom duties to regulating street traffic – are currently the symbol of notorious economic inefficiency. There were numerous cases of government failure which further undermined the credibility of the state.

The microeconomic obstacle for getting inflation under control was associated with the specific reaction of Russian enterprises to demand restrictions. Unlike their East European counterparts that responded to tightening of the monetary policy by holding down prices and cutting employment in an attempt to reduce costs, Russian enterprises were reluctant to slow down price increases and to fire employees. Instead, they accumulated arrears through stopping payments to their suppliers, payments of wages and salaries to workers, payments of taxes to the government, and repayments of bank credits.

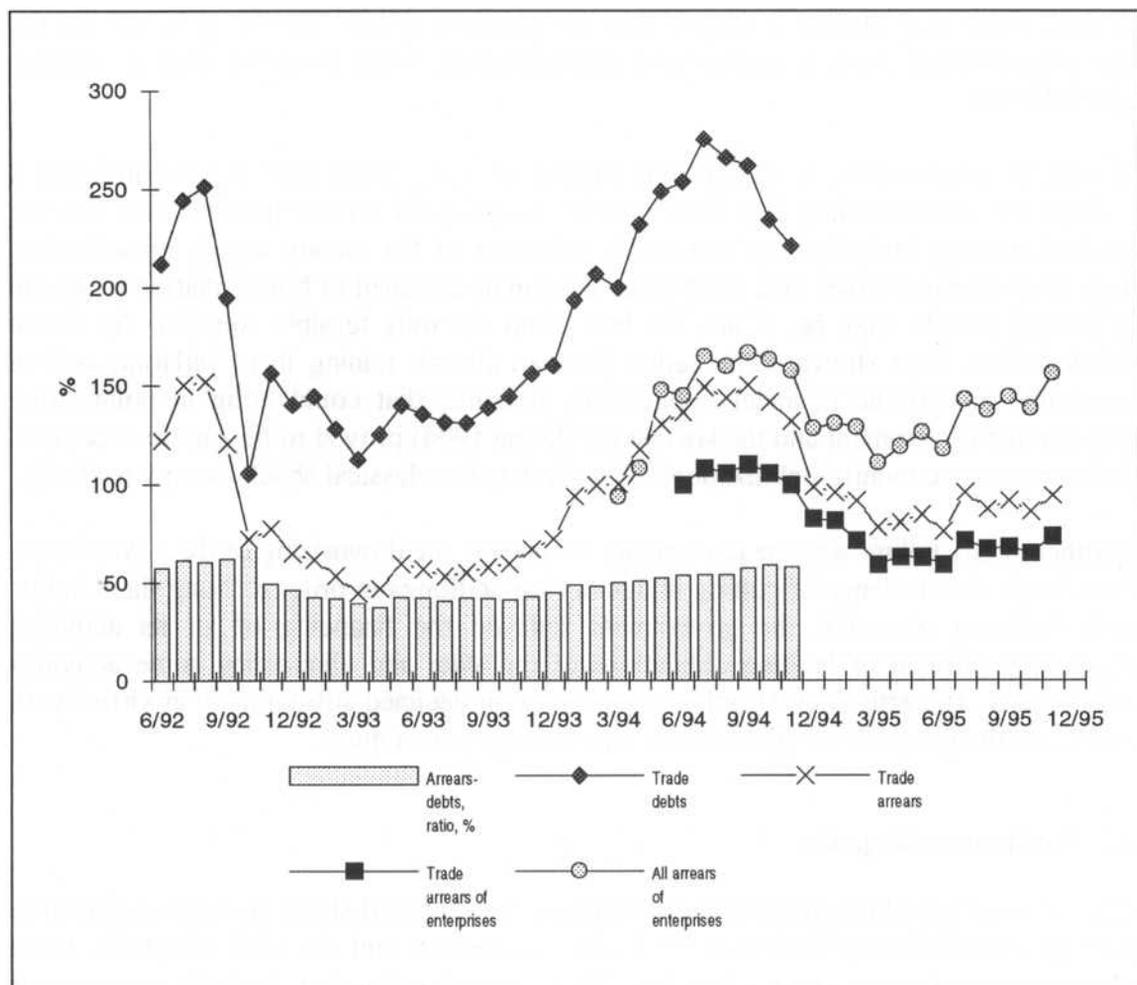
While there was no correlation between changes in money supply and the dynamics of output, the accumulation of the trade arrears definitely depended on monetary policy – two non-payment crises in the Russian economy (the summers of 1992 and 1994) were caused by the tightening of money supply and the slowdown of inflation, and there was an increase in non-payments in 1995-6, when restrictionary monetary policy was pursued. Unlike the non-payments crises in the summers of 1992 and 1994, when trade arrears of enterprises to each other increased greatly, by mid 1996 trade arrears in relative terms increased only marginally (though still reaching the highest level in 2.5 years), but arrears in paying taxes to the government grew substantially (Figure 9), causing a true budgetary crisis in mid 1996.

The monetarist explanation of this non-payment crisis is straight forward: trade arrears, they say, are not the problem of the government or the CBR. If the latter were more consistent, avoiding giving signs that enterprises may be bailed out, trade arrears would have been sorted out by entrepreneurs themselves through courts, pre-payments schemes for unreliable customers, etc. This was the general approach adopted by Poland, Czechoslovakia, and the Baltic states, which so far appears to be successful (Lahiri and Citrin 1995).

There is also an argument that if bankruptcies were common in Russia, the non-payment crisis would never have become as severe as it did. However, in East European countries bankruptcies were by no means common during the transition period, but the non-payment crisis was never as acute as in Russia (Rostowski, 1993). The ratio of interenterprise arrears in industry to broad money supply (over 50 per cent during the peaks of non-payment crises in mid 1992 and mid 1994) was over 2 times higher than in

the Czech Republic in 1991; Poland's ratio in 1990-1 was about the same as in Russia, but it did not increase as rapidly as it did in Russia after deregulation of prices.<sup>12</sup>

FIGURE 9  
TRADE DEBTS AND TRADE ARREARS TO INDUSTRIAL ENTERPRISES,  
AS A % OF MONTHLY INDUSTRIAL OUTPUT



Source: Calculated from Goskomstat data.

It is more likely that the trade arrears are associated with bribery and specific Russian entrepreneurial culture: managers often 'close their eyes' on bad debts of their partners due to bribes or special favours that were received in the past or may be received in the future (this was the conclusion of the report on non-payments prepared by the special task force of the Federal Agency on Bankruptcies in 1994).

Arrears may also be associated with the insider (workers and management) control established after privatization at most large Russian enterprises (see section on

<sup>12</sup> See (Rostowski 1993; Lahiri and Citrin 1995) for the comparison of interenterprise arrears in economies in transition. Comparing arrears as a % of GDP may be misleading in periods of high inflation, since arrears are a stock indicator, whereas GDP is a flow indicator.

privatization). While we are not aware of the direct evidence for Russia, in China for collective loss-making rural enterprises the incidence of accumulating trade, wage and tax arrears seems to be much greater than for non-collective (Sjoberg and Zhang 1996).

The impact of pervasive non-payments is that they do not allow the government and the CBR to press enterprises heavily through the demand restrictions.<sup>13</sup> Whether illusory or real, there was always a danger that the payment system would collapse and the economy would degrade to a primitive barter exchange, which would be even worse than high inflation.

In sum, the practical implication of this analysis of obstacles to fight Russian inflation is perhaps the understanding that there may be no quick fix for the problem and that the gradual strategy (step-by-step consistent reduction of the money supply growth rates over several years) rather than short-term campaigns designed to bring inflation to an end in several months may be, if not the best, then the only feasible solution. As recent developments have shown, firm, rather than an abrupt, reining in of inflation and an avoidance of extreme financial stabilization measures that could bring in polarisation between the government and the lawmakers (Desai 1994) proved to be a more successful path for macroeconomic stabilization in Russia than the classical shock therapy package.

Another policy failure was the poor ability to manage the downsizing of the government. Faced with the challenge of cutting budgetary expenditures in order to bring them in line with declining revenues, the government reduced the financing of all its activities chaotically (instead of limiting obligations of the state and eliminating some activities completely). The efficiency of public administration declined substantially in virtually all areas, and the image of the government was damaged even more.

### 3.2 Exchange rate policy

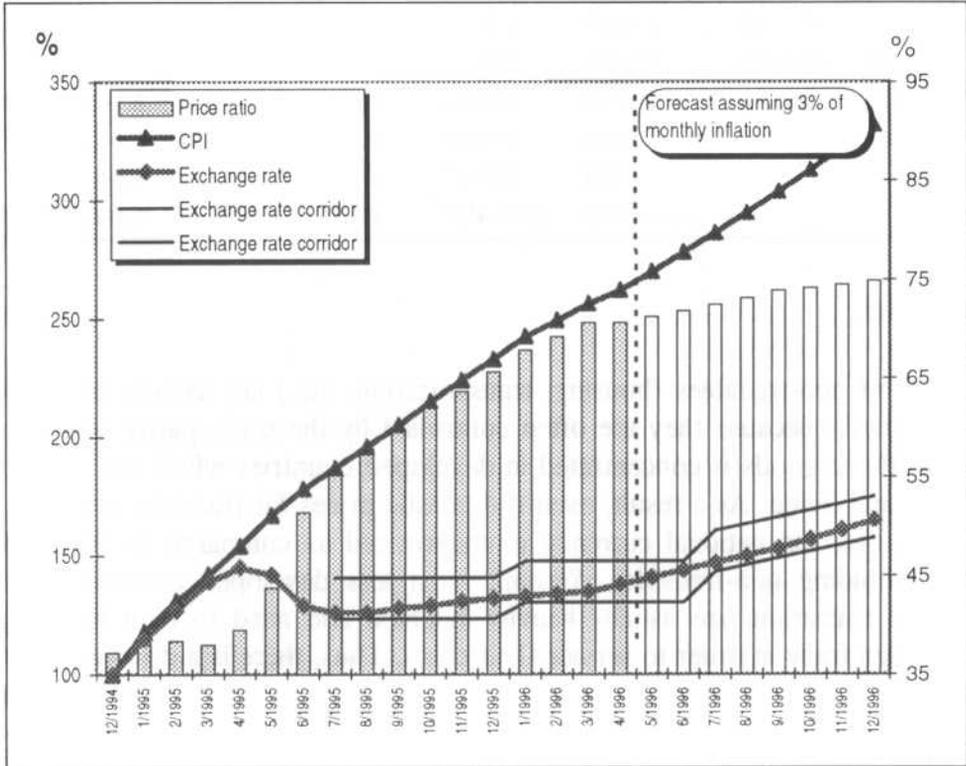
After two unsuccessful attempts to introduce a conventional shock therapy stabilization package (first halves of 1992 and 1994) the government and the CBR adopted a more promising step-by-step approach in late 1994. From that time on, both the government budget deficit and the rates of monetary expansion were reduced rather steadily, which resulted in the constant decrease of monthly inflation rate from 18 per cent in January 1995 to 3 per cent in December 1995, to and 1 per cent in the summer of 1996 (Figure 6). From 1 July 1995, the government and the CBR introduced the crawling peg – a corridor for the exchange rate of 4300-4900 roubles per US\$ for the second half of 1995, which was then changed to 4550-5150R per US\$1 for the first half of 1996, and

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<sup>13</sup> Monetary restrictions were inefficient not only because of non-payments, but also due to the widespread practice of emission of money substitutes. The Department of Finance during 1994-6 has been issuing its own peculiar type of 'treasury bill' (*Kaznacheyskiye Obyazatel'stva*) to pay for government purchases of goods and services (with yields well below the market levels), and an odd type of 'tax concession' (*Kaznacheyskiye Nalogoviye Osvobozhdeniya*) commercial paper for the same purposes. Besides, even some regional authorities and other federal government departments were issuing their own bills, which effectively acted as money substitutes and thus softened the impact of monetary restrictions.

replaced by a sliding scale for the second half of 1996 (from 5000 to 5600R in mid year to 5500 to 6100R by the end of the year).

FIGURE 10  
 CONSUMER PRICES, EXCHANGE RATE OF THE DOLLAR (DECEMBER 1994=100%, LEFT SCALE), AND THE RATIO OF RUSSIAN TO USA PRICES (% , BARS, RIGHT SCALE)



Source: Goskomstat.

There is a danger, however, that a stable Russian rouble may hurt exporters and undermine the economic recovery. By the beginning of 1996, Russian domestic prices had increased to a level of about 70 per cent of the USA prices, whereas a year before they were just about 40 per cent of those in the USA (Figure 10). To put it differently, the purchasing power parity (PPP) exchange rate of the rouble last year was rapidly approaching the actual exchange rate because the latter was rather stable, while Russian prices grew much more rapidly than the USA prices. In 1996 among economies in transition Russia (together with Slovenia – by far the richest country experiencing recovery from 1993) had the smallest gap between domestic and international prices (Table 6).

An appropriate exchange rate of the rouble becomes now the crucial issue of macroeconomic growth strategy. In all economies in transition (in fact, in most less developed economies) the national currency is usually undervalued as compared to PPP (Table 6) due to several reasons.<sup>14</sup>

<sup>14</sup> See Popov (1996) for a more detailed discussion.

TABLE 6  
RATIO OF THE ACTUAL EXCHANGE RATE TO THE PPP RATE OF THE DOLLAR FOR  
SELECTED ECONOMIES IN TRANSITION (RANGE OF MONTHLY AVERAGES)

Country /Year	1990	1991	1992	1993	1994	1995	1996*
Slovenia	0.9-1.4	1.0-1.7	1.4-1.6	1.4-1.6	1.3-1.6	1.1-1.3	1.3-1.3
Hungary	1.9-2.4	1.9-2.0	1.7-1.8	1.6-1.8	1.6-1.8	1.5-1.7	1.6-1.6
Poland	2.1-3.9	1.6-1.9	1.8-2.0	1.8-2.0	1.7-1.9	1.5-1.7	1.5-1.5
Czech Republic	2.5-3.8	3.5-3.1	2.7-3.1	2.5-2.6	2.2-2.5	2.0-2.2	1.8-2.0
Slovak Republic	2.9-3.9	3.0-3.6	2.9-3.0	2.6-2.8	2.4-2.7	2.1-2.3	2.0-2.2
Romania	1.8-2.6	1.6-5.0	2.8-4.2	2.2-3.1	2.1-2.6	2.1-2.5	2.6-2.8
Bulgaria	3.3-5.1	2.9-10.9	3.0-4.7	2.3-2.8	2.3-3.1	1.8-2.2	1.7-1.8
<b>Russia</b>	-	<b>33.0-131.0</b>	<b>10.2-45.7</b>	<b>2.5-8.0</b>	<b>2.4-2.8</b>	<b>1.4-2.4</b>	<b>1.4-1.4</b>

\*Forecast.

Source: PlanEcon.

*First*, prices of non-tradables (housing, transportation, etc.) are usually lower in these countries – partly because they are often controlled by the state, partly because world demand for those goods is concentrated in developed countries which are better places for business and living. As a result, even if domestic prices for tradables are in line with the world prices, the national currency is underpriced as compared to PPP, which is calculated including non-tradables. *Second*, most less developed countries, including economies in transition, are usually heavily indebted and need to earn hard currency through foreign trade in order to service their debts. Thus, there is a downward pressure on the exchange rate which has to be low to stimulate exports and limit imports, so that there is a trade surplus that may be used to finance debt service payments. And *third*, there is capital flight from most of these countries (especially important in the case of Russia), which should also be financed through a positive trade balance, which pushes the actual exchange rate even lower.

Besides, it is also important to create stimulus for export-oriented industries which, in these countries (definitely in the case of Russia), become locomotives of economic growth. If the exchange rate policy is not favourable for these industries, the whole growth strategy may be put into question. Russian export-oriented industries managed to increase their sales abroad in 1993-6, but are still unable to increase investment. In 1996 total investment declined again to a record low of 26 per cent of the maximum 1989 level (Figure 1). That is to say, Russian economic recovery, which is expected to materialise in 1997, is still based on a shaky foundation.

Economists and policy makers tend to disagree on what kind of exchange rate policy is best for economies in transition. While some stress the importance of maintaining the stable *nominal* exchange rate by fixing it and using it as a nominal anchor to fight inflation, others claim that *real* exchange rates are supposed to be kept stable (which implies constant devaluations if inflation is higher than elsewhere) so as to ensure that the actual rate is substantially below PPP rate in order to stimulate export and growth.<sup>15</sup>

<sup>15</sup> See Hosino et al. (1995) for details.

Czech Republic, Estonia, Latvia, Mongolia in 1991-4, and more recently Russia, tried to keep stable the nominal exchange rate despite the continuation of rather high inflation, thus allowing the real exchange rate to appreciate. In contrast, in Poland, Romania, Slovakia, Slovenia, Croatia, Ukraine and Belarus the real exchange rate was more or less stable in 1991-94 while the nominal exchange rate depreciated considerably.

Each approach has its own advantages: while the first one may prove to be useful for fighting high inflation quickly (wherever it is possible) at the initial stages of macroeconomic stabilization, the second one may be better suited for overcoming transformational recession and promoting economic recovery by facilitating the transfer of resources from domestic demand to exports – which is the pressing need in all economies in transition (Sato 1995).

The conventional shock therapy approach to macroeconomic stabilization recommends using the pegged exchange rate as a nominal anchor while pursuing an anti-inflationary policy. There is certainly reason in such an argument: a high rouble by increasing import competition helps to hold down inflation – in fact this was the case in Russia in the second half of 1995. However, the desirability of the continuation of the strong rouble policy is highly questionable because it puts pressure on the export sector and increases foreign debt forcing Russia to maintain high interest rates to slow down the capital flight at a time when exactly the opposite is needed.

There is a difference between stable and strong currency: whereas the former is highly desirable for all countries, the latter may prove to be an unaffordable luxury for economies in transition, like Russia, trying to overcome the transformational recession. It may well be therefore that the CBR and the government were right to establish its crawling peg for the rouble, but were wrong in choosing to peg it at a pretty high level.

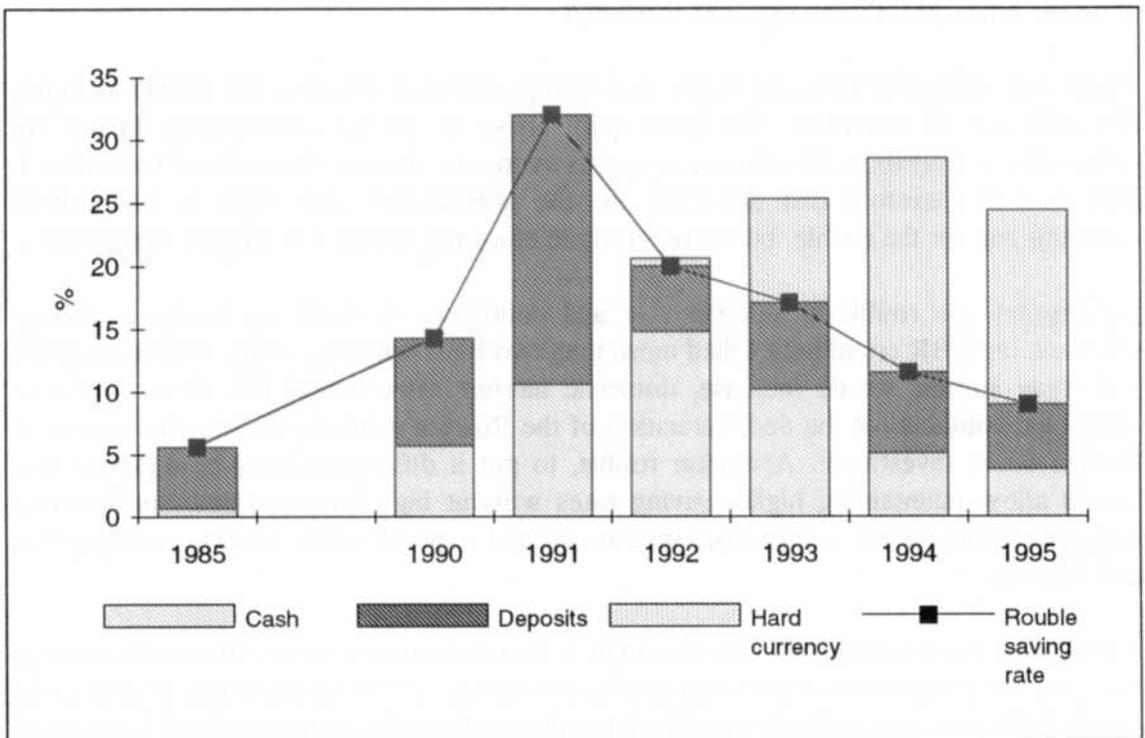
By pegging the rouble at a lower rate and continuing to build up foreign exchange reserves, the CBR could have killed more than two birds with one stone: Russian exports and trade surplus would increase, domestic interest rates would fall, there would be additional stimulus for the dedollarization of the Russian economy and for the inflow of foreign direct investment. A weaker rouble, to put it differently, may be a device that would allow maintaining higher saving rates without high interest rates, and creating additional stimulus for production, investment and exports, while limiting consumption and imports.

Though the personal savings rate was high in Russia in recent years, the rouble savings rate (i.e. the proportion of personal disposable income (PDI) invested into rouble cash, rouble bank accounts and other rouble denominated financial assets) declined from about 20 per cent in 1992 to 9 per cent in 1995, while investment in hard currency (capital flight) as a percentage of PDI increased from 1 to 10 per cent (Figure 11). In late 1995, Russian citizens and businesses, according to EBRD estimates, were holding some US\$43 billion in foreign currency, mostly US dollars (US\$10 billion in domestic bank accounts, US\$15 billion in cash, and another US\$18 billion in accounts outside

Russia)<sup>16</sup>, which was equivalent to over 10 per cent of the Russian US\$364 billion 1995 GDP at actual exchange rate. Despite the stability of the rouble in 1995 and much higher rouble interest rates (as compared to dollar interest rates), there was no noticeable decrease in purchases of hard currency (Figure 11). While a low rouble policy may not immediately cause the reduction of purchases of hard currency, it may at least make it easier for CBR to limit the growth of rouble money supply through making the capital flight more expensive (as more roubles will be needed to buy hard currency).

Another good reason for keeping the exchange rate low and building up foreign exchange reserves is the new vulnerability of the rouble with respect to short-term capital flows. Foreign investment in rouble denominated government treasury bills were recently allowed by authorities and quickly increased to some US\$2 billion legally and an estimated US\$3 billion illegally (through Russian intermediaries) by mid 1996 – over 15 per cent of all government treasury bills outstanding.<sup>17</sup> Foreign investment in those securities is definitely desirable to lower abnormally high domestic interest rates that hinder investment, but it requires high foreign exchange reserves as a protection against a balance of payments crisis.

FIGURE 11  
PERSONAL SAVINGS, AS A % OF PERSONAL DISPOSABLE INCOME



Source: Goskomstat.

<sup>16</sup> Business MN, 1995, N.43.

<sup>17</sup> Segodnya, July 26, 1996.

With an appropriate monetary policy (at least partial sterilization of increases in the money supply caused by foreign exchange reserves build-up) the inflationary pressure may be dealt with, as proven by the example of many emerging market economies. Money-based stabilization (as opposed to exchange rate-based stabilization) has proved to be successful in quite a number of countries (Albania, Slovenia, Croatia, FYR Macedonia) and there is no evidence that it is an inferior strategy to pegging the exchange rate for fighting inflation (Zettermeyer and Citrin 1995). The exchange rate is far too important to use it only for fighting inflation. Even more so, that Russia currently seems to be pretty close to achieving macroeconomic stability and looks forward to economic growth.

### 3.3 Industrial strategy

In addition to some common patterns of structural change in the economies in transition (rapid growth of the service sector, especially of trade, banking, and financial services; reduction of the share of investment in GDP and greater emphasis on consumer goods; conversion of defence production, etc.) Russian restructuring is associated with the reallocation of resources from secondary manufacturing into raw materials industries, which is fairly unusual for the economies in transition, at least on the scale it is currently happening in Russia.

The need to reallocate resources results from the huge gap in efficiency and competitiveness between different sectors of the Russian economy. While the fuel and energy sector, steel and non-ferrous metal industries are most efficient and competitive, agriculture, machinery and equipment (with some minor exceptions) and light industry are least efficient and competitive.<sup>18</sup>

The Russian resource sector (fuel and electric energy, steel and non-ferrous metals) employed in 1995 only 3 million workers, but produced nearly as much output as machine production, light industry and agriculture together with the total employment of 17 million workers. Labour productivity in the resource sector was over 5 times higher than in machinery and equipment and in agriculture and, surprisingly, even capital productivity was slightly higher (Table 7). The actual productivity gap should be even greater than suggested by the data in current prices presented in Table 7, because domestic fuel and energy prices in 1995 were still only about 70 per cent of world prices.

Before radical reforms, inefficient sectors of the Russian/Soviet economy were subsidised directly and indirectly (through perverse price structure). Because of the magnitude of the problem, it was unrealistic to eliminate subsidies at once; agriculture, machine production and light industry employed over 20 million workers, nearly 30 per cent of the total. The actual policy of gradual removal of subsidies to inefficient

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<sup>18</sup> These industries are just extreme examples. Differences in efficiency and competitiveness of other industries seem to follow this same general pattern: high in primary manufacturing and low in secondary manufacturing. For instance, with regard to chemicals, fertiliser production seems to be efficient and competitive, whereas pharmaceutical is not. The only major exception (discussed later) is the relatively efficient aerospace industry.

industries was thus, if not optimal, then the best feasible option. However, the form in which these subsidies were provided (price subsidies, not direct subsidies to producers for restructuring) was anything but optimal.<sup>19</sup>

First, by maintaining domestic fuel and energy prices at below world levels, the Russian government failed to give a boost to resource industries and to attract investment; not only output, but also investment in those industries in real terms has been falling in the last 5 years (though not so rapidly as in other industries).<sup>20</sup> Failure to carry major foreign investment projects in resource industries beyond the discussion stage should also in part be attributed to the uncertainty about domestic resource prices and export taxes. It is mostly the Russian resource sector that attracts foreign direct investments, but their total inflow remains minuscule; just about US\$1 billion in 1994 as compared to US\$5 billion in four Visegrad countries.

TABLE 7  
EMPLOYMENT, CAPITAL STOCK, AND OUTPUT IN MAJOR INDUSTRIAL SECTORS, 1995

Industries	Employment, annual average, million	Fixed capital stock, trillion rubles*	Gross output, trillion rubles	Labour productivity	Capital productivity
				% of national average	
Resources (fuel, energy, metals)	3.0	2319	418	326	72
Machinery & Equipment + Light Industry	6.7	1265	175	61	56
Agriculture	9.9	1805	276	65	60
Total economy	67.1	11504	2870**	100	100

\*After revaluation of January 1, 1996. Breakdown by branches of industry (energy, fuel, etc.) is estimated from 1994 data.

\*\* Estimate derived from the ratio of gross output to GDP in 1994 (1.73) and GDP for 1995 (1659 trillion roubles).

Source: Goskomstat.

Second, low domestic fuel prices did not promote restructuring to introduce energy saving technologies; the adjustment process was complicated by the fact that enterprises lacked the appropriate price signals and that the bulk of subsidies went to the most

<sup>19</sup> After the deregulation of prices in January 1992, fuel and energy prices were controlled directly and later indirectly (though export quotas and export taxes), but nevertheless were allowed to increase from 3-5% of the world price level in January 1992 to 30-40% of the world level in 1994 and to about 70% in late 1995. Export taxes on resource goods were gradually lowered and finally abolished on April 1, 1996 (export tariffs for oil were eliminated from July 1, 1996), whereas prices for fuel exports to near abroad increased to 75% of the world price for gas (40% - for oil and coal) in 1994, and to about 70-80% in 1995.

<sup>20</sup> In 1995 total investment in the fuel and energy sector appears to have stabilised, and several major oil companies (Lukoil, Yukos, Surgutneftegas, Tatneft, Rosneft, Slavneft, Bashneft) even managed to increase investment (Finansoviye Izvestiya 20 June 1996).

inefficient energy users. The preferable way of keeping secondary manufacturing industries afloat would have been to issue direct subsidies linked to restructuring performance of enterprises, not to maintain energy price subsidies that preserved inefficiencies.

Third, by choosing not to increase fuel prices up to world levels the government in fact provided support for all enterprises consuming energy (including those that were doomed to fail, and did fail), instead of concentrating this support on a few priority industries (for instance, aerospace), which had obvious chances to become internationally competitive.

And fourth, the preservation of price subsidies in 1992-6 complicated the debates on economic policies, since price subsidies were not transparent, and it was not really clear to what extent inefficient industries live at the expense of efficient ones.

The directions of the Russian industrial policy largely reflected the fundamental conflict between competitive (fuel and energy sector and other resource industries) and non-competitive sectors (defence and machine production, agro-industrial sector and light industry) and, more broadly, the conflict between shock therapists and gradualists, between those who favour export-led growth and those who put an emphasis on import substitution. This, in fact, is the Russian version of the old debate on whether the government industrial policy should be pro-market oriented, favouring strong and competitive sectors already identified by the market, or it should move against the grain, giving support to the losers (weak and poorly competitive industries).

Advocates of gradual transition wanted to keep domestic and energy prices at a level well below that of the world market. They argued that once these prices were brought up (through the elimination of export quotas and taxes), the whole Russian secondary manufacturing industry would go bankrupt and the deindustrialization of the country already under way would reach its climax. Sergei Glazyev – the head of the former State Duma Committee on Economic Policy – became known as one of the major proponents of such views (Glazyev 1994), but they were also widely held by Russian academic research institutes and politicians.<sup>21</sup>

In contrast, shock-therapists considered the 'resourcialization' of the Russian economy as a natural process of bringing the national industrial structure in line with Russia's comparative advantages. They argued that domestic fuel prices should be increased up to the world level immediately so that there would be stimulus to reduce energy intensity. It was also claimed that by replacing price subsidies by income subsidies industrial policy may be made more transparent and may contribute to the restructuring of inefficient enterprises.<sup>22</sup>

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<sup>21</sup> See Yevstigneyev and Voinov (1994) for details.

<sup>22</sup> See Popov (1995); Mr. Gaidar used to refer to the failure of his government to deregulate fuel prices in 1992 as to one of the major mistakes.

One way or the other, now Russian domestic prices seem to be approaching world price proportions and the first part of the restructuring, associated with the reduction of inefficient production, has already largely occurred. Due to changes in relative prices favouring resource industries, their output was falling in recent years more slowly and their exports increased in a number of cases. As a result of price and output shifts, the share of resource industries (fuel and energy, steel and non-ferrous metals) in total industrial output increased from 24 per cent in 1991 to 48 per cent in 1995 at the expense of the reduction of the share of secondary manufacturing, mostly machinery and equipment and light industries (Table 8).

The resource sector in fact has already become the backbone and the most important staple of the Russian economy. It accounts for 75 per cent of total exports to far abroad (fuel and energy, 50 per cent; metals and diamonds, 25 per cent) and for an even greater share of exports to near abroad. The share of the fuel and energy sector alone in total capital investment in goods-producing industries increased from 20 per cent in 1991 to about 40 per cent in 1995 (Table 9). Gas and oil industry workers enjoy the highest wages in the country: about US\$400 a month as compared to about US\$200 in banking and insurance, US\$100 on average, US\$80 in machine production, US\$55 in light industry, and below US\$50 in agriculture in 1995.

*Gazprom* (Russia's largest company, producing about 600 billion cubic meters of gas worth around US\$50 billion at world prices) has been heavily criticised for not paying enough taxes, in fact contributed in 1995 US\$4 billion in taxes to the government budget, or about 4 per cent of consolidated budget revenues, whereas the share of the company in total employment is less than 0.5 per cent. Taxes in oil and gas production and in oil refining already amount to over 50 per cent of gross output, whereas in the USA the comparable figure is 25-30 per cent.<sup>23</sup>

On the other hand, machinery and equipment and light industries are rapidly losing their share of domestic market to foreign competitors. The share of machinery and equipment in total Russian exports decreased from 17.6 per cent in 1990 to 3.7 per cent in 1995. In 1994 alone, output in machine production and light industry fell nearly by a good half and now they produce only less than 40 per cent and less than 20 per cent respectively of what they used to produce in better times before the recession (Table 8). Whereas employment in resource industries increased by nearly half a million (15 per cent), employment in machine production and light industry declined by over 5 million (almost half) in 1990-1995.

Russian restructuring, however, is far from being complete. As Russian domestic fuel prices are finally catching up with the world level in 1996, the previous industrial policy by default (together with the most odd fuel price subsidies) is coming to an end. The agenda for the new sound industrial policy for 1996 and beyond is twofold: (1) to redirect subsidies from inefficient to efficient industries; (2) to replace remaining price subsidies by direct income subsidies (or, in hopeless cases, by labour force and welfare programmes).

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<sup>23</sup> *Finansoviye Izvestiya*, June 20, 1996; *Segodnya*, August 31, 1996.

**TABLE 8**  
**REDUCTION OF OUTPUT BY INDUSTRY AND THE STRUCTURE OF INDUSTRIAL OUTPUT IN**  
**CURRENT PRICES**

Industries	Volume of output (1990=100%)				Share of particular industries in total output, %			Price index '94 ('90=1)
	1991	1992	1994	1995	1990	1992	1995	
Fuel	94	87	69	68	8.0	19.4	17.6	5434
Electric Energy	100	96	83	81	4.2	6.8	13.4	6071
Steel	93	77	54	59	12.0	8.6	10.1	3292
Non-ferrous Metals	91	68	54	55		9.1	7.0	2088
Construction Materials	98	78	47	43	3.1	2.4	3.6	2032
Food	91	76	57	52	11.7	9.4	11.3	1975
Chemicals	94	73	44	48	7.6	8.8	8.2	2889
Petro-chemicals								2344
Wood	91	78	44	41	5.3	4.4	4.9	1752
Machinery & Equipment	90	77	45	40	30.8	20.4	17.7	2017
Light	91	64	26	18	12.1	7.1	2.4	875
Other	-	-		-	5.2	3.6	3.8	-
<b>All industry</b>	<b>92</b>	<b>75</b>	<b>51</b>	<b>48</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>2484</b>
<b>Agriculture</b>	<b>95</b>	<b>86</b>	<b>73</b>	<b>67</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>365</b>

Source: Goskomstat.

**TABLE 9**  
**CAPITAL INVESTMENT BY INDUSTRY, % OF TOTAL (EXCLUDING INVESTMENT INTO**  
**RESIDENTIAL CONSTRUCTION AND SOCIAL SECTOR)**

Industrial complexes	USSR		Russia		
	1989	1991	1993	1994	1995
Fuel & energy	22	20	38	32	38
Steel & non-ferrous metals	4	5	7	7	8
Machine-building	12	10	5	6	6
Chemical & wood industries	5	5	4	4	4
Construction and construction materials industry	9	9	6	8	5
Agro-industrial sector (agriculture, food & light industry)	29	32	19	18	8
Transportation & communication	13	14	14	21	26
Other	6	5	7	4	5

Source: Goskomstat.

The most heavily subsidised sector is agriculture: in 1995 it received about US\$2 billion from the federal budget and another US\$3 billion from regional budgets – an amount equivalent to monthly wages of agricultural employees (about US\$50 per employee per month). If tax concessions, and government and CBR credits (which are never paid back and periodically written off) are taken into account, the total amount of transfers to

agriculture increases to over US\$14 billion, or nearly a quarter of gross revenues of the whole sector.<sup>24</sup> Because the bulk of all transfers goes to former collective and state farms – which in 1995 produced just slightly over half of total agricultural output (peasant households accounted for another 43 per cent of output, and independent farms for 2 per cent) – it turns out that value added in large agricultural enterprises is close to zero, if not negative.

At the other pole, there are only a few fairly competitive, or potentially competitive, secondary manufacturing industries (i.e. those which could quickly become competitive with reasonable investment) which account only for a tiny part of government subsidies. The aerospace industry, especially the production of defence aircraft, is, perhaps, the most notable example. In 1995-6, Russian exports of armaments after plummeting to below US\$2 billion in 1994 have increased to over US\$3 billion a year according to Russian official statistics (US\$4 billion, according to Stockholm International Peace Research Institute, and US\$6 billion according to the USA Congressional Research Service) and it is estimated that half of this export consists of aircraft and parts. The leading fighter models, MIG and Sukhoy, account for nearly a third of all defence aeroplanes used in the world (USA, CIS, and China excluded); several dozen of these fighters are exported annually. Russia also exported, in 1995, 70 out of 76 produced helicopters (the production capacity is estimated at around 300).

Civil aircraft producers seem to be less competitive. Export in 1994 amounted to US\$200 million only and production here nearly came to an end after Russian air companies stopped buying planes because of the shortage of funds. Hopes for a breakthrough are now linked to several joint projects with major Western aviation companies.

In the area of space technology, Russian producers have so far managed to penetrate the market for commercial satellite launchers (about 10 launches are expected in 1997) with the most reliable 'Proton' carrier, and to ensure some financing from the USA for the joint 'Alfa' project which allows Russia to continue its development of the spacelab.

Unfortunately, the Russian aerospace industry is not really getting any kind of special treatment from the government. Programmes to support conversion are coming to an end, whereas other budgetary sources of financing for restructuring are simply not available. Direct subsidies to both defence and non-defence aircraft producers seemed to be in the range of US\$100 million in 1995 and could not make a substantial difference. Instead, the State Committee on Machine Production (*Roskommash*) is working hard to organise domestic production of goods that used to be imported from former Soviet republics and from far abroad: production capacities for 46 such items, including commuter trains, buses, mini-tractors, pulp and paper machinery, magnetic tomographs, has recently been created, and the special programme with a meaningful name, 'importsubstitution', calls for establishing the capacities for another 57 items not currently produced in Russia.<sup>25</sup>

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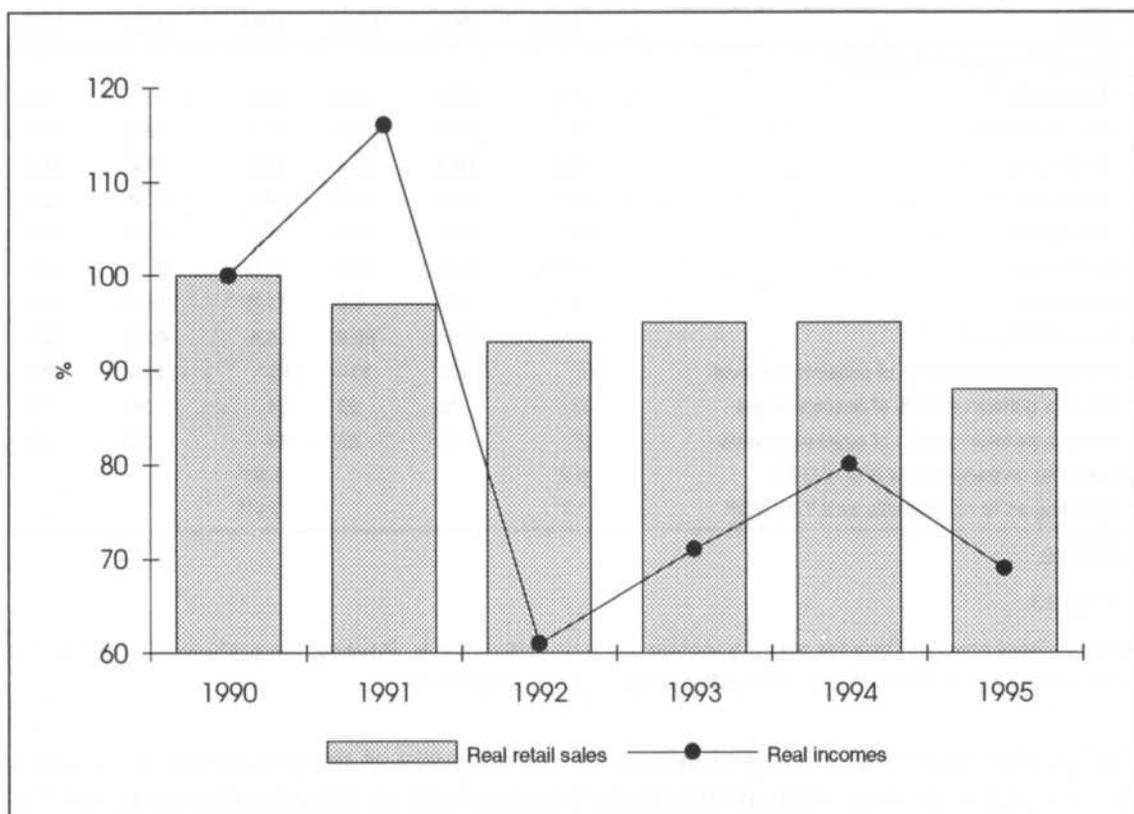
<sup>24</sup> *Segodnya*, July 31, 1996.

<sup>25</sup> *Finansoviye Izvestiya*, July 5, 1996

### 3.4 Social and employment policies

There was, and is, a considerable controversy about the magnitude of the fall of real incomes and living standards in Russia during the transition. For sure, this fall was less pronounced than the reduction of output, and even less pronounced than the comparison of real incomes with the period of the late 1980s and early 1990s suggests (Figure 12). In the second half of the 1980s incomes grew much faster than prices (which were controlled), contributing to the huge increase in monetary overhang – forced savings that may be better described as paper incomes and that were not leading to any increases in living standards. This explains why the reduction of real incomes in 1992 was much sharper than the decrease in retail sales (Figure 12): price hikes after deregulation have 'eaten up' the monetary overhang, while real consumption remained pretty much stable. Nevertheless, the decrease in real retail sales per capita, which may be a more accurate indicator of material living standards, was by no means unnoticeable – 12 per cent in 1995 as compared to 1990, and for the absolute majority of the population it was much greater because of skyrocketing income inequalities.

FIGURE 12  
REAL INCOMES AND REAL RETAIL SALES PER CAPITA, 1990=100%



Source: Goskomstat.

The Gini coefficient grew by a good half in just four years, while decile and pentile ratios increased more than 3 times (Table 10), which is an exceptional record for economies in transition. As available evidence suggests (Cornia 1996), increases in inequalities in East European countries were significantly smaller than in Russia: Gini coefficient grew from

a level 19-27 per cent in 1989-90, to about 23-35 per cent in 1993-4, while decile ratio grew from 2.0–3.4 times, to 2.7–4.3 times only. Partial analogues of the rapid growth in income inequalities in Russia may be found only in Bulgaria, the Baltics, and some other former Soviet republics: these countries are already surpassing OECD levels of Gini coefficient and are catching up with the Latin American levels.

Because the share of the top 20 per cent high income families in total income increased from 31 per cent in 1991, to 47 per cent in 1995 (Table 10), the assumed reduction of average income of total population by 12 per cent (Figure 12) was very unevenly distributed. Whereas for the top 20 per cent of the population average income increased by over a third, for the remaining 80 per cent real average income declined by a good third. Besides, due to higher price increases for food than for other commodities, the ratio of average income to subsistence level (which consists mostly of the cost of 'the basket of food' items) declined from 3.5 in 1990 to 2 in 1995 (Table 10), and nutrition standards, according to the statistics of the consumption of food products, deteriorated considerably.

TABLE 10  
INCOME DISTRIBUTION AND SOME SOCIAL INDICATORS, 1990-5

Years	1990	1991	1992	1993	1994	1995
Income shares of the population:						
-first pentile	9.8	11.9	6.0	5.8	5.3	5.5
-second pentile	14.9	15.8	11.6	11.1	10.2	10.2
-third pentile	18.8	18.8	17.6	16.7	15.2	15.0
-fourth pentile	23.8	22.8	26.5	24.8	23.0	22.4
-fifth pentile	32.7	30.7	38.3	41.6	46.3	46.9
Pentile ratio	3.34	2.58	6.38	7.17	8.73	8.53
Decile ratio	4.4	4.5	8.0	11.2	15.0	13.5
Gini coefficient, %		26.0	28.9	39.8	40.9	38.1
Average income as a % of subsistence level	352	303	210	219	238	202
Average pension as a % of average wage	33	33	26	34	34	38
Average pension as a % of average income	47	40	38	44	37	34
Spending on pensions as a % of GDP	6.2*			6.3**		
Spending on family benefits as a % of GDP	1.7*			0.4**		

\* 1987-88.

\*\* 1992-93.

Source: Goskomstat; Data for social transfers are from: Milanovic B. Poverty, Inequality and Social Policy in Transition Economies. World Bank, Washington, D.C., 1995:32-41.

The greater reduction of living standards for the majority of the population was caused by a variety of reasons, such as the greater magnitude of the Russian recession, and the larger productivity gap between industries, which contributed to higher wage differentials among industries, etc. But, whatever the reasons for this impoverishment were, the government was supposed to intervene in order to at least neutralise the outcomes of these unfavourable developments if the roots of the problem were beyond its reach.

While for the younger people such deep temporary decreases in real incomes are, perhaps, manageable, senior citizens and especially pensioners consider them absolutely unacceptable. When faced with an option of losing a third of real income in the most recent 5 to 10 years, but regaining this income later, they reject this option on the basis of absolutely rational considerations and resist reforms by all possible means. The only way to ensure the support of the elderly for reforms would have been to guarantee that their real income is not going to fall; such a policy could have contributed greatly to building consensus for reforms, not to speak about moral considerations.

Unfortunately, the Russian government failed to meet this challenge; it did much less than the East European countries that pursued shock therapy policy, despite the obviously greater magnitude of the problem. Poland was the only country that succeeded in increasing the real income of pensioners during transition, but in other Central European countries the ratio of average pension to average wage either increased (Hungary, Slovenia) or did not fall considerably (Czech and Slovak Republics).<sup>26</sup> In Russia this ratio fell markedly in 1992; its increase in subsequent years is misleading because it occurred under conditions of rapid decline of the share of wages in total income<sup>27</sup>; if compared to average per capita incomes, average pensions declined by nearly 30 per cent in 1990-5 (Table 10).

Spending on pensions stayed at a level of about 6 per cent of GDP during transition (Table 10), whereas in East European countries on average it increased in the same period from 7 to 10 per cent, not to speak about spending for family allowances, which decreased greatly in Russia, but remained constant (2.5 per cent of GDP) in East European countries (Milanovic 1995). The share of income transfers in total income increased in Russia only slightly, from 12.8 per cent in 1989 to 15.6 per cent in 1993-4, whereas in Central European countries it either stayed constant at a much higher level (Hungary, 26-28 per cent) or increased considerably (Slovenia, from 11 per cent to 20 per cent; in Poland, from 21 per cent in 1989 to 34 per cent in 1991-2).<sup>28</sup>

All in all, it looks like the Russian government in the field of social policies followed a more shock-oriented path than most East European countries, though the need for income redistribution in favour of the disadvantaged groups of the population was greater than elsewhere. By allowing the previously strong system of social guarantees to

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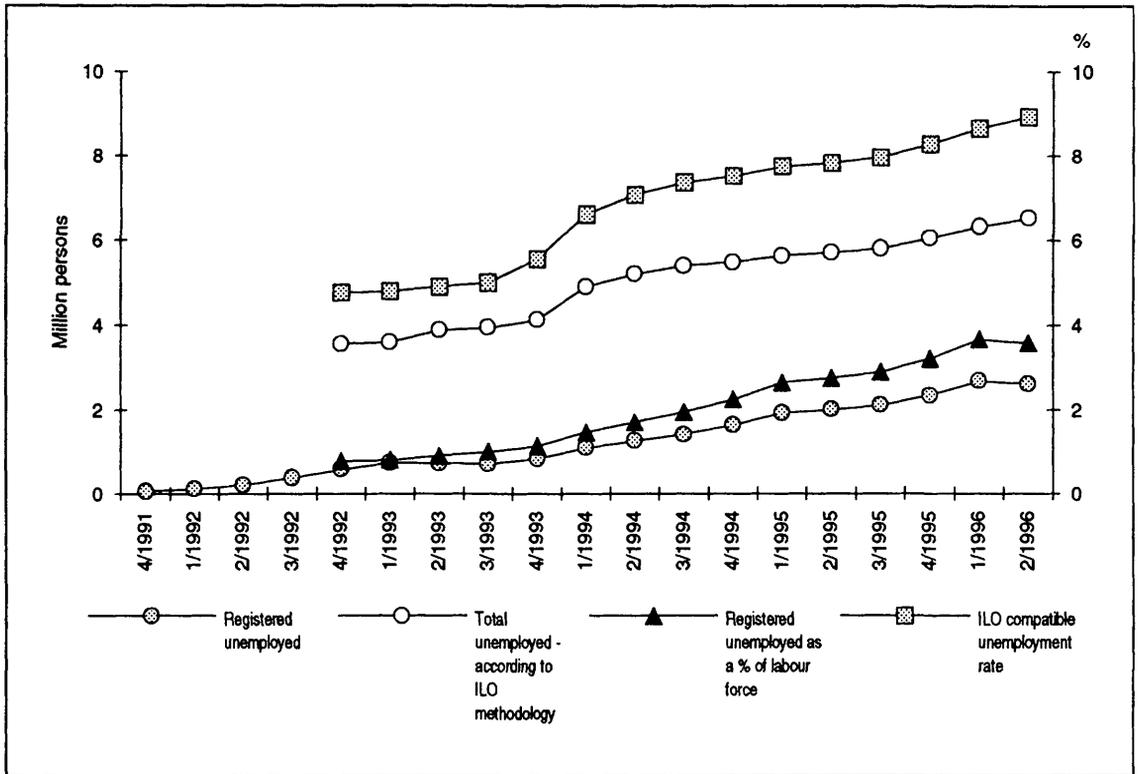
<sup>26</sup> See Milanovic (1995).

<sup>27</sup> The share of compensation of employees in total monetary income decreased from 74% in 1990 to 40% in 1995, while the share of property, entrepreneurial and other incomes grew from 13% to 44% in the same period (the rest is accounted for by social transfers). This shift may be only partly explained by the changing social structure of the Russian society, since in most mature and emerging market economies the share of labour income is much higher than the 40% registered in Russia. The major reason for the dramatic increase in business and other incomes at the expense of labour compensation is the ability of employers to hide a good part of wages from taxation through showing it as entrepreneurial and other incomes in bookkeeping in order to avoid high social insurance payments (calculated as a % of wage fund) and high excess wage tax (effective in 1992-5). The ratio of average wage to per capita GDP in 1994 in Russia was only 60% as compared to about 100% in most East European economies, and about 120% in the USA.

<sup>28</sup> See Cornia (1996).

weaken and disintegrate, the Russian authorities missed a chance to build up support for reforms and to weaken social tensions.

FIGURE 13  
UNEMPLOYMENT, MILLION PERSONS (LEFT SCALE), AND UNEMPLOYMENT RATES; % (RIGHT SCALE), END OF THE PERIOD



Source: Goskomstat.

At the same time, Russian employment policies seem to be less radical than they could be. The government largely failed to introduce retraining and other employment adjustment programmes to facilitate industrial restructuring. Instead it has adopted an income-based tax policy by introducing a tax on excess wages for the period of 1992–5. While some observers regard this tax as a useful instrument of limiting open unemployment (Layard and Richter 1995), others pointed out that it contributed to the decline in productivity and exceptionally low employment elasticity on output (ratio of the change in employment to the change in output), which in 1993 in Russia was only 33 per cent versus 46-86 per cent in East European countries (Roxburgh and Shapiro 1996).

By mid 1996, the unemployment rate in Russia (computed according to ILO methodology) increased to 9 per cent of the labour force (Figure 13), which was still below the peaks achieved in most East European countries in 1992-4 at levels of over 15 per cent. Even taking into account another 4 million employees (nearly 6 per cent of the labour force) working only part-time or on forced temporary leaves, Russian unemployment rates still look pretty low given the larger magnitude of the reduction of output.

Low unemployment rates in Russia as compared to other transitional economies seem to be associated with a number of factors (employee ownership, indirect and direct subsidies, business culture and traditions, etc.), which may be more important than excess wage tax. It has also been suggested that low unemployment has more to do with sustaining wages through lower profits, losses, and even capital consumption than with wage flexibility (Nuti 1996).

Besides, when the tax on excess wages was introduced, it was seen not so much as an instrument of fighting unemployment and holding down wage increases, but as a device that would prevent employee-controlled enterprises from eating up profits and as a means of generating budget revenues. If evaluated on these grounds, it failed: enterprises found ways to avoid paying excess wage tax by hiring 'dead souls' and paying workers through non-wage expenditure items (insurance premiums being the most notorious example).

### **3.5 Privatization and capital markets**

By the beginning of 1996, only three years after mass privatization started, Russia managed to privatize fully or partially over 120,000 enterprises (including over 20,000 large enterprises with more than 200 employees). Together with hundreds of thousands of private businesses emerging from scratch, they accounted in 1995 for 62 per cent of total employment (over 80 per cent in industry, agriculture, construction, trade and public services) according to official estimates. In terms of speed of privatization at least, Russia therefore became one of the leaders among transitional economies.

Russia's privatization scheme, however, was different from that of East European countries in that the workers were entitled to get a huge share of the total assets practically buckshee. About half of all small enterprises (mostly in trade, public and personal services) were leased to work collectives with the option to buy them out later at discount prices (the other half was mostly sold at auctions and investment competitions at market prices), whereas in most large enterprises work collectives received considerable blocks of shares (up to 51 per cent) at prices well below the market level (the rest of the shares were sold at market prices for vouchers and money). The World Bank estimates that 55 per cent of large and medium sized enterprises in Russia were privatized through management-employment buyouts, whereas the comparable ratios for other economies in transition were typically below 14 per cent (except for Estonia [30 per cent] where such buyouts were part of competitive, open tenders).<sup>29</sup>

*Post factum*, it looks like this was the best feasible way to privatize state property, though the Russian model was certainly a compromise between economic and social goals. The demand for assets was extremely low in Russia; partly because of the lack of domestic savings, partly because of the poor investment climate which suppressed

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<sup>29</sup> World Bank, World Development Report, *From Plan to Market*, New York: OUP, 1996:53.

foreign investment. As a result, the book to market ratio for companies subject to privatization was somewhere in the range of 50:1 to 100:1; i.e. the actual value of assets in current prices was about 50-100 times higher than the market price of companies shares (Table 11). In the first two years of the reforms the Russian stock prices remained mostly unchanged in nominal terms, which meant their real value decreased about a hundred times (Figure 14).

TABLE 11  
1994 MARKET CAPITALISATION PER UNIT OF PRODUCTION/PRODUCTION CAPACITIES,  
US\$

Industries/countries, regions	North America	Western Europe	Eastern Europe	Russia	
				March 1994	December 1994
Telecommunications (unit: access line)	1637	848	2083	69.97	105
Electricity (unit: MW)	372,000	650,000	448,000	2,260	21,000
Oil (unit: barrel of proven reserves)	7.06	3.58	n/a	0.17	0.08
Tobacco (unit: '000 cigarettes)	5.61	4.07	7.35	2.42	4.18
Cement (unit: tons)	144	162	40	1.92	8

Source: Economist, May 14, 1994; Russian Capital Markets. December 1994:63, CS First Boston.

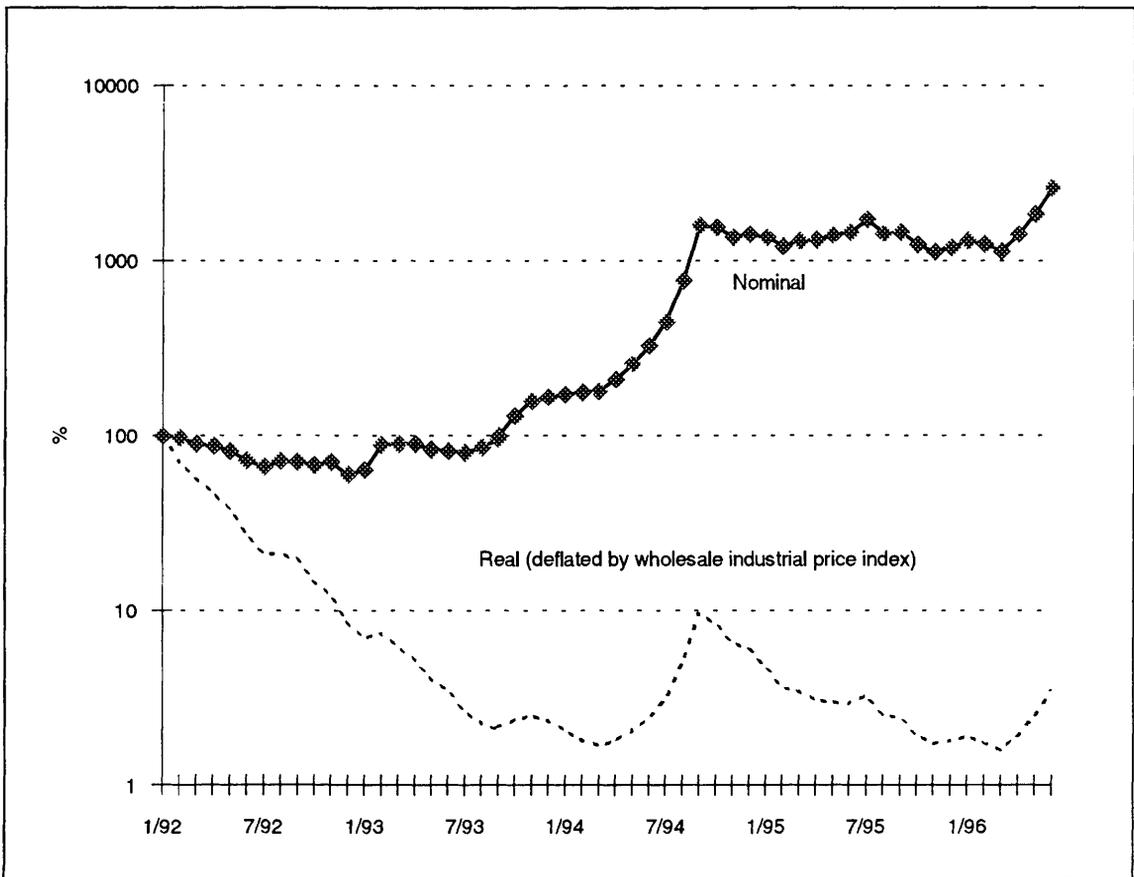
Consequently, there was no chance to sell enterprises at prices more or less close to their book value. The actual choice was between selling assets to whoever was willing to pay the highest price, but still at a great discount (most likely, to the Russian *nouveau riche* and foreign investors), and giving them away in a more or less fair way to citizens, workers, and/or managers.

Choosing among different ways of privatization (marketing assets to the highest bidder; distributing vouchers and selling property for vouchers; giving away assets to work collectives/managers) the government finally suggested a plan involving considerable concessions to the opposition and managed to pass it through parliament.

The first way of privatization (auctioning property for money) was preferable on economic grounds: it gave control over enterprises to efficient owners (strategic investors, either domestic or foreign, willing to proceed with restructuring) and it allowed the state to get some proceeds into the budget. The second way of privatization (auctioning property for vouchers) was virtually as good as the first in economic terms (except that the government did not get any additional revenues) and was even better on social grounds, allowing a fair distribution of property among citizens free of charge. The third way of privatization (giving away property to work collectives) was inferior to the first in economic terms (because work collectives, normally, were not efficient owners) and inferior to the second way in social terms (because assets per worker and profitability of particular enterprises varied enormously; whereas teachers, doctors, and such ilk, did not receive any property at all).

However, it is exactly this third way of privatization that was largely supported by existing managers ('the red directors'), by workers in profitable industries for obvious reasons, and even by the workers of unprofitable enterprises (partly due to misunderstanding, partly because work collectives through getting a large stake in their enterprises were able to control, or at least to influence, managers). Democrats, or those who advocated shock therapy treatment, supported the first and the second way of privatization; opposition forces, or proponents of the gradual transition, the third way.

FIGURE 14  
 NOMINAL AND REAL STOCK PRICE INDICES, JANUARY 1992=100%, LOG SCALE



Source: Before September 1993, Graduate School of International Business; afterwards, AK&M (*Finansoviye Izvestiya*).

By accepting the idea of giving away up to one half of total assets to the workers nearly free of charge, the government managed to increase prices for another half and, more important, to avoid accusations of 'selling off the motherland to the new millionaires and to foreigners'. The major issue of privatization, who gains control over the enterprises – outsiders (new rich or foreigners), or insiders (management and work collectives) – was resolved in favour of the insiders. They established their control over nearly all large enterprises and about over a half of small enterprises. A random survey of 439 enterprises conducted by the World Bank in 1994 revealed that workers and managers

were dominant owners in 70 per cent of all non-state enterprises, or in 84 per cent of all non-state privatized enterprises (excluding new firms that emerged from scratch).<sup>30</sup>

The costs of insider control are well known. Slow restructuring, reluctance to fire employees, and to pay back debts in due time are often blamed on insider control. As compared to their East European counterparts, Russian enterprises proved to be extremely reluctant to restructure through firing employees: the unemployment rate grew slowly in Russia and still remains relatively low.

However, the benefits of the chosen privatization model are obvious as well: privatization was carried out in record time and there are good reasons to believe that, in several years, strategic investors will emerge at least in the more attractive enterprises. This process in fact has already started: in summer and fall 1994 the demand for shares of major Russian companies increased greatly (mostly due to the inflow of foreign capital), so that their stock prices rocketed (increasing about 10 times, Figure 14). Later the stock market remained sluggish due to the Chechen war and political uncertainty, but the market value of shares (capitalization) was nevertheless more in line with the book value of enterprises, though still several times lower.

'Shares for loans' auctions carried out by the Russian government in late 1995 were, in fact, sales of the most lucrative pieces of government property to the highest bidder without any concessions to the work collectives. Several major banks received – as collateral for credits issued to the government – large blocks of shares of non-financial companies (Menatep Bank won 78 per cent of shares of Yukos, the second largest oil producer; Oneximbank got 38 per cent of the shares of Norilsk Nickel, etc.). Banks cannot yet be considered as strategic investors (since they lack the needed funds and most probably expect to sell acquired shares at a higher price after 'investmentless' restructuring), but the next buyers will most certainly be true strategic investors.

In April-June 1996 stock prices increased about 3 times in real and dollar terms anticipating, and then welcoming, Yeltsin's victory in the presidential elections (Figure 14). With respect to the capital markets, the outcomes of the Russian transition, perhaps surprisingly, seem to be more in line with the liberal (shock therapy) approach than in East European countries. The crucial choice here for the reforming economies is between the American type and the Japanese type system of banking and corporate financing (the European system is in between the two) – or to use a different expression, between market-based and bank-based financial systems.

In the American model, the banking sector is not concentrated and banks do not enjoy the position of strength vis-à-vis non-financial corporations. The latter rely mostly on internal sources of financing (undistributed profits + depreciation), whereas external sources are less important and include mostly sales of securities, not bank credits. Hostile take-overs and leveraged buy-outs reflect the absence of insider control on management and are common in the USA (Pohl, Jedrzejczak and Anderson 1995).

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<sup>30</sup> Transition Report 1995. EBRD, 1995:132.

In contrast, the Japanese (European) model implies that several major banks ('the big three', 'the big five', whatever) control the major part of total credits and are in a position to influence investment decisions of non-financial companies. In addition to being large shareholders (stakeholders) of non-financial corporations, large banks provide them with the cash needed to finance investment. External sources of financing are by no means negligible as compared to internal funds, and bank credits account for a good portion of external financing. Both models have their advantages and limitations: the American model is usually perceived as a more competitive one; whereas the Japanese model is seen as the one that allows the reduction of risk, bankruptcies and instability.

In the transitional economies with poorly developed capital markets most industrial companies are not really able to sell their shares and bonds, which is an argument in favour of the Japanese model ('only large banks can mobilise resources for capital investment'). Indeed, so far capital markets in most ex-socialist countries have been developing in the direction of the Japanese (European) model. In most of these countries market capitalization is normally at a level of several percent of GDP, whereas bank credits amount to several dozen percent of GDP (Table 12). In the Czech Republic, for instance, nearly 80 per cent of total capital investment in 1993-4 was financed by bank credit to enterprises, whereas several investment funds managed about one half of the shares of individual investors.

The notable exception, however, is Russia, which currently has more banks than any other economy in transition (2,600 in early 1996) and one of the lowest indicators of concentration of bank assets (Table 12). Ten of the largest banks (including large state-owned ones which survived the transition) account for only 40 per cent of total outstanding bank credits.

No less important, long-term credits (over 1 year term) amount to only 5 per cent of total bank credits and do not play any significant role in the financing of capital investment. Total bank credits outstanding in relation to GDP declined steadily during the transition from 31 per cent at the end of 1991 to 8 per cent at the end of 1995. In 1992 they ensured the financing of only 10 per cent of total capital investment and in 1993 even less, 6 per cent. Markets for corporate securities are only emerging, and it is only the larger companies that can resort to equity and bond financing: market capitalization to GDP ratio in 1995 was only about 7 per cent. Nevertheless, it seems that these sources of investment financing for large companies are already more important than bank credits. The total volume of trade in shares in 1995 (mostly OTC) was estimated at about US\$5 billion; 1-2 per cent of GDP or 25 per cent of market capitalization.<sup>31</sup> And market capitalization itself increased threefold in the second quarter of 1996 after stock prices soared on the eve of the presidential elections (Figure 14).

This pattern of financial development is more consistent with emerging market economies, where the share of equity financing of investment is typically very high (in Jordan, Korea, Mexico, Thailand, Turkey – in the range of 40 to 70 per cent), whereas

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<sup>31</sup> Finansoviye Izvestiya, February 2, 1996; World Bank, World Development Report, *From Plan to Market*, New York: OUP, 1996:108.

internal sources account for less than half of total financing.<sup>32</sup> This pattern also prevailed at the end of the past century and the beginning of this century in Western countries in the period of rapid industrialisation and creation of joint stock companies.

TABLE 12  
RELATIVE SIZE OF BANK CREDITS AND CONCENTRATION OF BANKING ASSETS IN SOME ECONOMIES IN TRANSITION

Country	Outstanding bank claims as a % of GDP, 1994	Share of top 5 banks in total banking assets, %	Share of largest* banks in total assets, %
Belarus		75	88
Czech Republic	95	65	71
Estonia	30**	75	
Hungary	63	63	68
Latvia	44**	57	
Lithuania	29**	71	
Poland	33	66	71
Romania	21	74	79
Russia	13	33	43
Slovak Republic	63	79	79
Slovenia	32	70	89
Ukraine	18	70	82

\*Banks with individual asset share of over 3%

\*\*Total bank assets at mid-year 1995

Source: Transition Report 1995. EBRD, 1995, p.161-2; Data for Baltic states are from: Hansson A.H. and Tombak T. Banking Crises States: Causes, Solutions and Lessons. Paper prepared for the 'Second Dubrovnik Conference on Transition Economies', June 1996, Dubrovnik, Croatia.

Why does Russia, in this crucial area of corporate financing and control, seem to be leaning towards a liberal American model, whereas most other economies in transition, including radical reformers, adopted a more conservative Japanese-European model? The immediate reasons are well known and are associated with the fight between Russian and all-union government (between Yeltsin and Gorbachev) for the distribution of power in 1991: banking was chosen to be one of the battlegrounds, when the Russian government declared all branches of all-union banks at Russian territory independent from *Gosbank*, resulting in the emergence of over a thousand new banks overnight.

Nevertheless, it is difficult to say whether these immediate reasons represent a particular fundamental pattern or should be viewed as a mere coincidence of events. Other former Soviet republics were also waging 'banking wars' against the Union, but seem to have adopted a more European type financial system afterwards. The distinct character of Russian privatization – large concessions to workers and managers coupled with the high speed of the process – definitely contributed to the dispersion of shares among millions of individual shareholders and did not allow financial institutions to become major

<sup>32</sup> Transition report 1995. EBRD, 1995:97.

stakeholders of non-financial companies. On the other hand, more liberal financial markets may be a sign of the 'wilder' nature of emerging Russian capitalism: as in other areas, it may turn out that, though Russian transition was not so radical, its outcome will be more radical than elsewhere leading to the creation of a quite liberal economic system.

## **IV TRANSITION OUTCOMES AND POLICY AGENDA**

### **4.1 Emerging Russian style capitalism**

It seems natural, at least on the intuitive level, to believe that East European countries and the Baltic states are heading in the direction of market models that currently exist in Western Europe. Even more so, that they are aiming at becoming members of the European Union (EU), which requires them to harmonise their policies and institutions with those of the EU. It is also natural to assume that China and Vietnam are developing a type of market economy that is broadly consistent with the existing regional patterns: Association of South East Asian Nations (ASEAN) countries and South Korea may show China and Vietnam their immediate future, while Japan the more distant future.

With regard to Russia (and CIS) the future patterns of development are much less clear. Factors that have to do with economic culture may prove to be crucial in shaping the contours of emerging Russian capitalism. Like fixed capital, human capital, traditions, and stereotypes of economic behaviour are inherited by the new system from the old one and thus link the future economic development to the past. The comparisons of economic culture in Russia, other former Soviet republics, East European countries, and China, lie evidently beyond the scope of our analysis. However, it may be appropriate to mention some widely accepted conclusions about cultural differences, which emerged not only from the Soviet, but also from pre-Soviet history.

Overall Russian public opinion seems to be more polarised than in East European countries and the Baltic states, where a wider agreement on major economic reform issues exists. Communist ideals are deeply rooted in Russian history; geographical, ethnic and economic diversity contributes to contradictions between major regional and industrial elite groups. Besides, law and order traditions seem to be relatively weak in Russian society, which results in a higher crime rate, a larger shadow economy, widely spread corruption, etc. Finally, egalitarian and collectivist feelings are more pronounced in Russia; there is a less tolerant attitude towards income inequalities and a much stronger emphasis on preservation of employment in times of recession.

On the other hand, Russia does not have the same traditions of business and work ethics as East Asian countries. Individuals' links to the community are weaker than in East Asia: Russian labour mobility, for instance, even in the Soviet era was much higher than in Japan (and even higher than in Europe), while social services provided by enterprises (health care, housing, recreation, etc.), though substantial, were never as extensive as in China.

Pessimists claim that the Russian tragedy is that Asian-type responsibility of the individual to the community has already been destroyed (partly before and partly after

1917 revolution), whereas the new European type responsibility to the society (state) has not yet emerged. Optimists see this as a source of Russian strength, claiming that it allows the combination of the best of both worlds. More than a century old debates between Westerners and Slavophiles are now revitalised as Russia is struggling to define its new identity and to find a new role in the world economy and politics. The contours of the future Russian economic model are now being shaped within the framework of these debates: the most frequently used 'yardsticks' for comparison are the USA and Germany in the West, and also Japan, China, Korea and ASEAN economies in the East. Below we focus on some likely options for the development of basic features of a 'Russian style' market.

### *Asset and income distribution*

Though data on the distribution of wealth in Russia in recent years is lacking, there are reasons to believe that this distribution changed dramatically in recent years and is now extremely uneven. The initial accumulation of capital in the late 1980s/early 1990s proceeded under conditions of unbelievable opportunities for enrichment. The first fortunes of the new Russians were built in external trade, in commodity exchange business and in banking and finance; in virtually all cases, it was the difference in state regulated prices and free market (domestic or foreign) prices that laid the foundation of these fortunes.

According to some very rough estimates (Aslund 1996), in 1992 alone benefits from cheap state credits issued to enterprises at 10-25 per cent interest rate (at times when inflation was 2500 per cent) amounted to 30 per cent of GDP, whereas revenues derived from export operations (due to the difference between government regulated domestic prices and world market prices for resources) and import operations (due to subsidised exchange rate used by importers of food) amounted to 30 per cent and 15 per cent respectively – overall a staggering 75 per cent of 1992 GDP. Even if these estimates are upward biased several times, the magnitude of the redistribution process is still quite impressive. Even more so, considering that the subsidization of credit and import operations did not come to an end until 1993, whereas export licenses and quotas (which allowed government bureaucrats to ask for bribes) continued well into 1994.

The redistributed revenues were more than enough to purchase all shares traded at the market at that time; market capitalization in 1992-3 stood at just a few percent of GDP. While part of these new fortunes left the country (capital flight), another part was used for establishing new businesses and acquiring existing companies in the course of privatization. The share of managers in total shareholders equity is said to have increased from 8 per cent right after the end of the voucher privatization (mid 1994) to about 20 per cent currently, whereas in newly established companies managers already in 1994 controlled over 50 per cent of the shares.

In the largest and most attractive Russian companies with high market liquidity, outsiders and managers by now own probably more shares than workers, and this pattern is likely to emerge in other companies, whose shares are not yet traded in the market and that are still controlled by work collectives. The future role of institutional investors is still an

open issue. As was already mentioned, until recently banks were not the major owners of shares of non-financial companies; and mutual, pension and insurance funds are just starting to emerge.<sup>33</sup> Even in the largest Russian banks, investments in non-government securities amounted at the beginning of 1995 to only 1 per cent of total assets – less than in the largest American banks (3 per cent), not to speak of other Western countries (Dmitriyev et al. 1996).

While it is plausible that (as a result of the 'shares for loans' auctions) several bank-centered groups of companies with financially linked affiliates would be created, it is doubtful that the Euro-Japanese model of corporate financing and control (which is favoured by the CBR and commercial banks) will represent the general pattern. As was already mentioned (see section on privatization), banks that recently acquired shares of several large non-financial companies are likely to be only transitional investors. Besides, the Federal Commission on Securities and Exchanges, which currently has the powers to regulate the securities markets, seems to favour the British-American more open and competitive capital market model with limited role of financial institutions vis-à-vis other (individual) shareholder.

An additional argument to support this view is that there are greater income inequalities than in other economies in transition (see section on social policies) which contribute to the widening of disparities in wealth distribution. It is reasonable to predict that high income inequalities will persist in the foreseeable future: even if the government is to adopt a strong social policy, it has only limited abilities to fight illegal incomes – a major source of income differentiation, to collect taxes (especially personal income taxes), and to increase expenditure on welfare.

Hence, uneven income distribution (flow) will continue to contribute to the inequalities in the distribution of assets (stock) with the result that the rich will get richer and will have more opportunities to become major shareholders. With large disproportions in wealth distribution, Russia is unlikely to develop a system of corporate financing and control based on institutional rather than on individual investors. In short, Russian capitalism with regard to wealth and income inequalities and market for corporate control may resemble more that of the 'robber barons' days in the USA, rather than a consensus-based Asian model or state-regulated European one. As one Russian parliamentarian put it: 'this is not the wild West, this is the wild East'.

Given the famous Russian (and Soviet) intolerance towards social inequalities, strong social policy is a must for consensus building, especially in view of much needed unpopular measures, such as withdrawal of subsidies to inefficient industries, promoting savings and investment at the expense of consumption, etc. But, unfortunately, the ability of the government to raise funds for such a policy is in question.

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<sup>33</sup> During voucher privatisation there emerged over 650 'voucher investment funds'; close-ended mutual funds which accumulated vouchers of about 25 million persons. Their investment are mostly in shares of loss-making and low-profit companies whose shares are not traded in the market, so dividends that these funds pay on their own shares do not even compensate inflationary losses (in 1995, when inflation stood at 130%, dividends amounted to only 70%). As a rule, these funds did not emerge as powerful institutional investors

## *The role of the state*

In European countries the role of the government is extensive in all areas: in creating institutions and regulatory framework, in providing public goods (education, health care, infrastructure, etc.), and in carrying out social transfers. In contrast, in East Asian economies, while government regulatory functions are sometimes even stronger than in European countries, the size of the government, as measured by its revenues and expenditure in relation to GDP, is considerably (1.5-3 times) smaller than in Europe, which means that the state involvement in providing public goods and especially social transfers is quite limited.

The model that emerges in Russia seems to be based on minimal government involvement in all areas of economic life. In the former Soviet Union not only were government regulations pervasive, but also the financial power of the state was roughly the same as in European countries (government expenditure amounted to about 50 per cent of GDP). This allowed the state to provide the bulk of public goods and extensive social transfers.

In post-transitional Russia (and other CIS countries) the state found itself deprived of its former vast resources and powers. On the one hand, it turned out that government regulatory activities have only limited efficiency due to difficulties in enforcing regulations since the authoritarian regime was replaced by a weak democratic one (in contrast to Central Europe, where strong democratic regimes emerged). On the other hand, government revenues plummeted after the CPE was dismantled, approaching some 30 per cent of GDP (including off-budget funds) in 1996. This is still more than in East Asian countries on average, but much less than needed to finance government commitments – a still very large defence expenditure, mostly free education and health care, and a universal pay-as-you-go system of social insurance.

Cuts in government expenditure thus became the only way of bringing down the deficit and were gradually carried out in 1992-6. However, because a consensus on major reform issues was lacking and the state was not really prepared to re-evaluate its commitments, cuts in budgetary expenditure were carried out chaotically – mostly without any coherent strategy. Poor administration of shrinking public funds turned into a major problem. As a result, excessively wide social responsibilities are currently financially unsustainable, and there is a gap between the obligations of the state and its ability to deliver what it promises.

Unless the government is prepared to reassess radically its commitments, so as to make them financially sustainable, it is safe to predict that many government activities in providing public goods and social transfers will slowly die. Since they can only partly be replaced by private and semi-private businesses, this would probably be the worst option and a clear-cut case of government failure.

In the late 1920s, when the New Economic Policy (NEP) that allowed the existence of a market economy was about to be rolled back, there were debates between two schools of planners – genetics and teleologists. The former suggested that planning should be indicative rather than directive, that it should be market conforming, following trends identified by the market itself, that industrialisation should start from light industry and proceed gradually, as savings generated in a natural way would become available. The latter argued that planners should not feel constraint by the objective laws and potentials of the economy, that they should not rely on the slow and obsolete market, but should speed up the development by mobilising savings through price controls and directive planning in order to create quickly the non-existent heavy industry that would allow the industrialization of the country.

It is this latter view that became the official policy with the result that industrialisation of the 1930s and beyond became a major isolationist import substitution experiment. From that time on, the share of export in Soviet GDP did not increase until large scale fuel sales abroad started in the 1970s. The huge 'perverted' industrial structure created without any regard to costs and prices of the world market proved to be stillborn and non-viable in 1992, when it finally faced foreign competition after half a century of artificial isolation.

Today, Russia is choosing once again between export-oriented growth and protection autarchy. On the one hand, there is an example of East Asian countries which managed to rely on export as a locomotive of economic growth: in China, for instance, the share of export in GDP increased from 5 per cent in 1978 to 23 per cent in 1994, while the GDP itself was growing at an average rate of about 10 per cent. On the other hand, there are much less appealing examples of 'the champion of isolationism', North Korea, and other socialist countries, of many developing countries of socialist orientation, which were creating their own heavy industries following the advice and using the assistance of the Soviet Union, of India (where the share of export in GDP remained frozen at a level of 6 per cent from the 1950s to the 1980s) and many Latin American countries.

The option of promoting export-oriented growth would require massive and rapid industrial restructuring; mostly in favour of resource-based industries, but also in favour of some competitive high-tech sectors (aerospace) and, perhaps, particular capital and labour-intensive industries at the expense of agriculture and most secondary manufacturing industries. Similar to the restructuring of government services, it is more efficient to make the needed cuts at once (and to support people through social and manpower programmes instead of subsidising non-competitive companies) rather than to stretch them in time forcing inefficient industries to die gradually. Rapid growth of resource sector may provide rent (partly appropriated by the resource sector itself, partly by the government) for much needed investment to restructure a few still promising secondary manufacturing industries and enterprises (*Gazprom* and major oil companies are already trying to diversify through buying fuel mining equipment producing companies).

This radical option, however, may prove to be not completely politically feasible since the inefficient sectors suffering from the competition of imported goods (agriculture and machine production) account for a much larger share of total employment than efficient sectors and exercise a good deal of influence in the corridors of power.

The other option – continuing support to major non-competitive industries – is a slower and more costly way of restructuring, implying the preservation of subsidies to and protection of weak producers. Paradoxically, this option, despite the intentions of those who propagate it to stop the deindustrialization of the country, may lead to exactly the opposite: a poor performance of the resource sector will not generate enough revenues to support all non-competitive industries with the result that the few still competitive or potentially competitive secondary manufacturing industries will fail to get necessary support and will slowly disintegrate.

## **4.2 Capital accumulation and long-term growth**

If the Russian economy starts to grow in 1997 at a average rate of 5 per cent a year, it would take 11 years (up to 2007) to achieve the pre-recession 1989 level of GDP. Five per cent annual growth may be quite an optimistic scenario, however, since most economies recovering from transformational recession did worse than that. The crucial prerequisite for steady long-term economic growth – the solid flow of investment – is nearly completely missing from the current Russian economic scene.

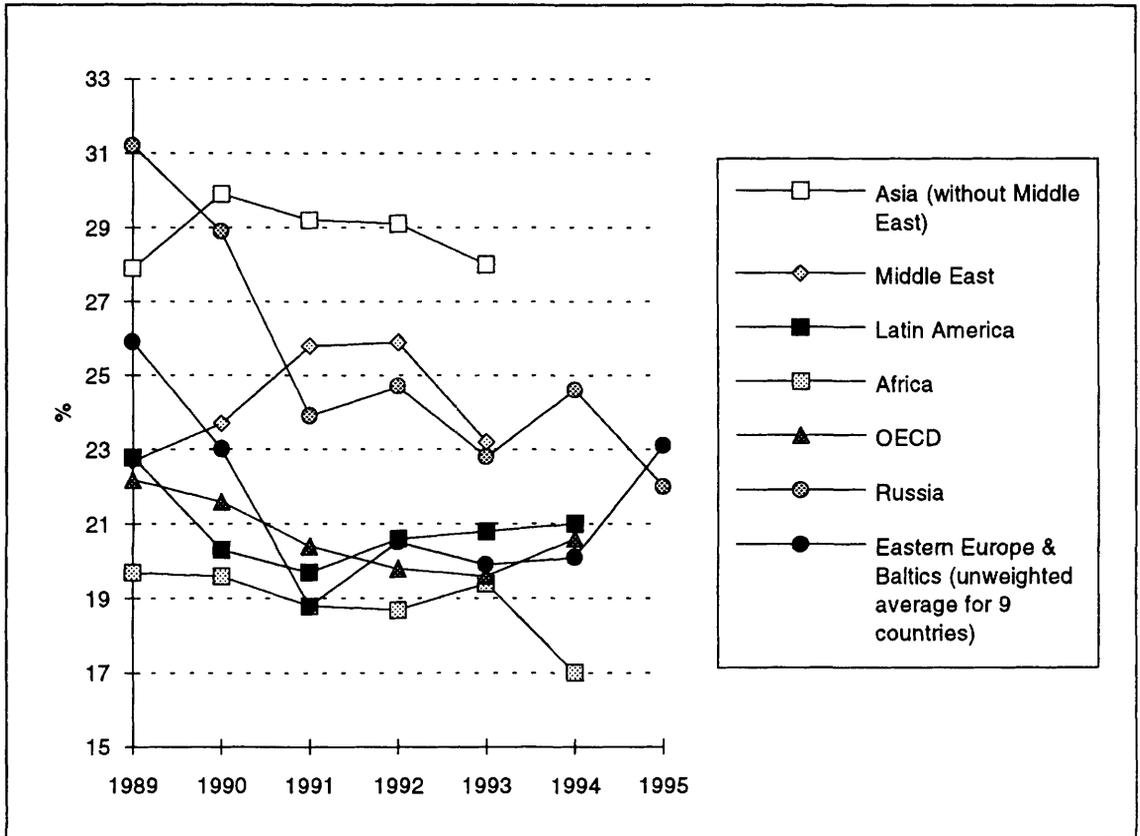
Whereas previously, investment/GDP ratios in the CPEs were among the highest in the world and comparable with East Asian economies, they declined substantially during transition and are now more in line with Latin American countries (Figure 15). The brighter part of the story is associated with the inevitable increases in capital productivity (which was extremely poor in CPEs – see section 1), but these increases can materialise mostly through the restructuring of the existing capital stock, which also requires new investment.

Meanwhile, Russian investment in 1995-6 was nearly 4 times lower than in pre-recession 1989 and did not even compensate for the retirement of capital stock. In 1995, the Russian investment/GDP ratio even fell below that of many East European countries and Baltic states (Figure 15) where it increased markedly during recovery and where the magnitude of the needed restructuring is somewhat less dramatic than in Russia.

With regard to the availability of savings for financing investment, the future does not look encouraging either. Business profits and depreciation funds are low; personal savings, though high, are made mostly through accumulating hard currency (financing capital flight, not investment), whereas rouble savings are falling (Figure 11); the government runs a sizeable budget deficit, no less than half of which is financed through domestic borrowing (the bulk of the rest through international borrowing); the inflow of foreign direct investment is weak, so that a substantial trade surplus and international borrowing are barely enough to cover debt service payments and capital flight. The prospects for increasing savings and investment and for achieving high growth rates thus

seem to be pretty bleak, unless something is done to revert existing trends. Several measures seem to be especially promising in this respect. As in other areas, the feasibility of these measures depends largely on the ability to build consensus and confidence to carry out politically difficult decisions.

FIGURE 15  
SHARE OF INVESTMENT IN GDP\*, %



\*For economies in transition - share of investment in fixed capital, since change in inventories is affected by high inflation.

Source: OECD for Eastern Europe & Baltics; Goskomstat for Russia; IMF for the rest.

First, the necessary component of the growth strategy is the low exchange rate of the rouble. As was suggested in section 3.2, this is sort of a must policy for all developing countries since they usually need to earn a trade surplus to finance debt service payments and capital flight. Unlike mature market economies, most poorer countries keep the exchange rates of their currencies low as compared to PPP (Table 13), which allows them to limit consumption and imports and to stimulate exports, investment, and growth. This used to be the strategy of Japan, Korea, Taiwan and Singapore some time ago, when they were still poor countries and were catching up with high income states.

For resource rich countries, however, there is a danger of 'Dutch disease', which arises because resource export is so profitable that it allows earning a trade surplus even under the overpriced exchange rate. Thus, Middle East countries (mostly oil exporters) are the

only major group of states in the developing world with the exchange rate close to PPP (Table 13).

TABLE 13  
RATIO OF ACTUAL EXCHANGE RATE OF NATIONAL CURRENCIES IN US\$ TO PPP FOR  
SELECTED COUNTRIES IN 1993, %

Countries/regions	Ratio, %	Countries/regions	Ratio, %
OECD*	116	Transition economies*	81
- Germany	126	- Central Europe*	54
- Japan	165	- Slovenia	69
- USA	100	- Croatia	65
- Portugal	73	- Hungary	62
Developing countries*	44	- Poland	48
- Asia*	36	- Slovak Republic	37
- China	22	- Czech Republic	36
- India	24	- Romania	31
- Korea	72	- Bulgaria	30
- Turkey	54	- USSR*	91
- Africa*	37	- <b>Russia</b>	<b>26</b>
- Latin America*	46	- Ukraine	18
- Mexico	58	- Moldova	13
- Middle East*	83	- Belarus	9

\* 1990.

Source: UN International Comparison Programme (Russian Statistical Yearbook 1995. Moscow, Goskomstat, 1995:474, *Finansoviy Izvestiya*, November 10, 1995).

The threat of 'Dutch disease' is real for Russia, since by 1996 the exchange rate of the rouble approached some 70 per cent of the PPP. The previously high export growth rates slowed down substantially (from 15 per cent in 1995 to 6 per cent in the first half of 1996 as compared to the first half of 1995 for total exports, and from 25 per cent to 1 per cent respectively for exports to non-CIS states). Needless to say, it was Russia's already weak export of manufactured goods that was most affected by the appreciation of the real exchange rate.

While the technicalities of managing a low exchange rate were discussed in section 3.2, it may be appropriate to add here that such a policy has one important practical advantage. Unlike other measures to promote growth, it may be implemented relatively easily since it favours the interests of all powerful industrial groups (creating stimulus for an export-oriented resource sector, as well as providing protection from import competition to secondary manufacturing and agriculture), whereas costs of such a policy (limits on consumption) are to be paid by unorganised and politically non-influential consumers.

*Second*, a promising way to increase domestic savings is to reform the current pension system. The debate whether the transition from the current pay-as-you-go system to the mandatory/voluntary fully funded pension plans can raise domestic savings or not, cannot

be dealt with in this study – even more so that the evidence on the issue seems to be somewhat mixed (Schmidt-Hebbel, Serven and Solimano 1996). Irrespective of the debate, however, it is pretty obvious that the current Russian pay-as-you-go system is extremely inefficient and should be reformed.

The existing system is based on mandatory contributions to the off-budget Pension Fund by employers (28 per cent payroll tax) and employees (1 per cent). The share of pensioners in the total population is only 16 per cent, while the share of employees is 45 per cent, which means that the average pension should approach 80 per cent of the average wage ( $45:16 \times 29$  minus administrative costs), whereas in reality it amounted only to 38 per cent in 1995 (Table 10). Though the share of wages in GDP in 1995 fell to a record low of 30 per cent, if payroll taxes were fully collected, the share of pensions in GDP was supposed to be at a level of at least 9 per cent ( $30 \times 0.29$  plus pension taxes paid on non-wage incomes), whereas in reality it was only 6 per cent. Even so, the Pension Fund is unable to make ends meet, still fails to pay pensions on time, accumulates pension arrears, and is lobbying for increased rates of pension contributions.

In other words, the pension system is apparently not working properly, the major reason being the unwillingness of employers to pay very high social security contributions (altogether over 40 per cent of the wage fund; 28 per cent for pensions and the rest for medical, disability and unemployment insurance) and the extreme inefficiency of the authorities in collecting these (and other) taxes. This is the fundamental reality of the Russian economic situation: there is no short-term solution to the tax evasion problem and, hence, it is the pension system (and government spending in general) that has to be adjusted to the financial abilities of the state, not vice versa.

Steps to reform the pension system have been modest so far. In 1997 the governments plans to start transition (which would require 3 to 5 years) to the so called 'individualised pension accounts', in which all contributions made by both employers and employees will be individually recorded for each person. Though it is not exactly clear what would be the link between the amount of accumulated contributions and pension levels, such a system (provided there are at least some links) is likely to make employees interested in checking how accurately their employers make payments to the Pension Fund. More radical plans – a transition to the Singapore-type mandatory fully funded pension systems – seem to find supporters among academics and in the government.<sup>34</sup> Provided that the ability of the government to gather taxes will remain weak in the foreseeable future, it may well be that the pay-as-you-go system is an unaffordable luxury for Russia.

*Third*, Russia should attract foreign direct investment into resource projects. Overall in 1989-95 Russia received some US\$4 billion of foreign direct investment, which is equivalent to about 1 per cent of its annual GDP, as compared to 30 per cent of GDP in Hungary and China, and 5-15 per cent in Albania, the Czech Republic, Estonia, Latvia,

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<sup>34</sup> The plan of such a new pension system was recently outlined by experts of the Moscow Carnegie Centre and the idea was supported by the Deputy Minister of the Economy (Segodnya 17 July, 14 August 1996).

and Poland.<sup>35</sup> The reasons for poor Russian performance in this area are well known: political instability, high inflation and an unstable currency (until recently), incomplete and frequently modified legislation, poor infrastructure, etc. Nevertheless, the fact is that Russia failed to use its 'resource advantages' to bring in foreign capital: huge rent in resource industries provides compensation for political and economic risks, so foreign investors are less sensitive to economic, political and legal uncertainty. Oil rich Azerbaijan, for instance, managed to attract foreign investment equivalent to over 2 per cent of GDP even under conditions of the ongoing war, not to speak about resource rich Kazakhstan (over 3 per cent of GDP).

In contrast, Russia in recent years failed to prevent the reduction of investment and output even in competitive resource industries (oil and gas included), which should be viewed as a major failure of the government policy. Some major resource projects have been already debated for nearly a decade with little practical progress. The major reason is probably the old-type mentality – better not to use the resources at all, than to sell them at a 'low' price, the belief that the policy makers know better than the international market the 'real' price of resource projects and joint-ventures, and the unwillingness 'to allow the foreigners to get rich on Russian resources'. However, investments were needed yesterday and are needed now – every day of delay with major resource projects slows down Russia's economic recovery.

Finally, *fourth*, to stimulate investment, it makes a lot of sense to increase government investment in infrastructure, even at the expense of financing it through government borrowing. As available evidence suggests, public savings do not crowd out private savings one to one, but rather the private sector offsets each dollar of public savings by dissaving only US\$0.25 to US\$0.50 (Schmidt-Hebbel, Serven, and Solimano 1996). The rapidly growing economies of East Asia normally keep government investment high, despite relatively low ratios of total government expenditure to GDP, so that the share of capital expenditure in total government outlays is much higher than in other countries (Sachs, Warner, 1996). To put it differently, even debt-financed government investments pay off by increasing the national saving and investment rates.

Unfortunately, Russia was not able to increase government investment in recent years – in fact, it was falling at the same rate as private investment. According to Goskomstat, the share of state supported investment (excluding investment of state enterprises, but including that financed through off-budget funds and cheap state credits) in total investment stood at a level of just over 30 per cent in 1992-5, whereas the share of investment directly financed from federal and regional budgets decreased from 26-33 per cent in 1992-3 to 21-24 per cent in 1994-5. As a proportion of GDP, budgetary financed investment declined from 4.5 per cent in 1992 to 3.8 per cent in 1994.<sup>36</sup> In 1995, the Ministry of the Economy developed a mechanism for selecting and supporting promising investment projects (20 per cent of total investment financing is to be provided by the government, 80 per cent by the private investor), but the mechanism is not working because of the lack of funds.

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<sup>35</sup> World Bank, World Development Report, *From Plan to Market*, New York: OUP, 1996:64.

<sup>36</sup> Transition Report 1995. EBRD, 1995:72.

*In sum*, it would be tempting to characterise the emerging Russian (and CIS) market structure as the one that combines the features of both the European and the Asian model. A closer look, however, reveals that this kind of description may be no more than a general negative statement: evolving Russian capitalism is going to be compatible neither with the European, nor with East Asian patterns.

The closest analogue may probably be found in some of the most common Latin American archetypes of the 1970s – very high wealth and income inequalities, strong social tensions and poor consensus in the society about reforms, large unreformed latifundias in agriculture, non-competitive sectors in industry supported by government subsidies, an economically and politically weak government whose commitments stretch beyond its financial abilities, resulting in numerous cases of government failure, outbursts of inflation and capital flight, discouraging savings, investment and growth.

This is a rather pessimistic, but yet the most probable scenario based on extrapolation of the existing trends. To change this scenario into a more favourable one, non-cosmetic reforms are required: restructuring of government services (public goods and social transfers) so as to make them smaller, but more efficient and financially sustainable; sound industrial policy supporting competitive export-oriented industries rather than non-competitive inward looking; a strategy to promote savings and investment (maintaining a low exchange rate of the rouble, reforming the pension system, increasing government investment and attracting foreign direct investment into resource projects); strong social policy which may be the only chance to build consensus under the conditions of high wealth and income inequalities. The political feasibility of such a scenario does not seem to be high, though some moves in this direction are likely.

### **4.3 Concluding remarks**

As was mentioned at the beginning, the aim of this study was not to discuss the advantages and disadvantages of shock therapy versus gradual transition strategy, but rather to examine the objective factors which prevented Russia from following the classical shock therapy model.<sup>37</sup> It was argued that in some economies, that of Russia and CIS states included, classical shock therapy package (even if it is a superior approach as compared to gradualism) may not be a practically feasible policy and the attempts to introduce it at any cost may do more harm than good.

The approach taken in this study is somewhat similar to the approach of Friedman and Johnson (1995), which shows that in the presence of complementarities between

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<sup>37</sup> Shock therapy package in this paper is defined in a traditional way (see Brada (1993) and Murrell (1993) for more discussion): immediate deregulation of prices, liberalisation of external trade, and introduction of convertibility; quick macroeconomic stabilisation through fiscal and monetary restraint and, possibly, through pegging the exchange rate of the national currency; drastic cuts in subsidies; rapid privatisation and institutional reforms; limits on social expenditure, if this is needed to cut the budget deficit. The shock therapy package for Russia in 1992 (deregulation of prices and macro stabilisation) is discussed in detail in Sachs (1995).

government policies and enterprise attributes and convex adjustment costs for enterprises (i.e. costs increasing with the speed of reforms) radical 'big bang' reforms may not necessarily be optimal.<sup>38</sup>

For the sake of the argument, we assumed, though, that adjustment costs for enterprises are concave, i.e. that one or a few large reform steps are less costly than many small ones, which is the crucial fundamental assumption for those who advocate shock therapy<sup>39</sup> and we made no particular assumptions about complementarities with the result that shock therapy became the optimal choice in all instances. Nevertheless, it was argued that this optimal scenario was not feasible in Russia because of objective local circumstances – mostly of a social and cultural nature.

The conclusions are summarised in Table 14, where the distinction is made between a consistent shock therapy approach and first best feasible policies in major areas as compared to policies that were *de facto* carried out. Only in one area (deregulation of prices and foreign trade [(introduction of convertibility)]) did the three types of policies largely coincide with each other. In another case (privatization) actual policy was carried out more or less in line with the feasible option. In other areas feasible policy was different from both shock therapy treatment and actual policy.

If one accepts this somewhat controversial distinction, two conclusions follow. First, the orthodox shock therapy package should have been adjusted for Russian conditions in such a way as to make it practically implementable. Second, in quite a number of areas, Russian policy makers failed to follow not only shock therapy, but also first best feasible policy choice. The deviation of actual policies from the first best feasible option should be attributed to the peculiarities of the Russian political process and is likely to persist in the future. Here are some specifics.

- Given the magnitude of structural disproportions inherited from the CPE, the extreme depth of Russian supply shock recession was largely inevitable, though the exceptional length of this recession seem to be associated mostly with policy related factors, which are discussed below.
- Given the structural macro and micro rigidities of the Russian economy, it was counterproductive to try to fight inflation in several months: two such attempts created unnecessary political and social tensions and resulted in two non-payment

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<sup>38</sup> They conclude that gradual reforms may be the best choice under some initial conditions (China - stable pre-reform economy, the absence of market institutions, strong government), whereas radical reforms - under other initial conditions (Poland - poor pre-reform economic situation, weaker potential for creating new firms, and low credibility of reformers). Other authors have also pointed out that Chinese initial conditions were fundamentally different from those in the USSR, that China was still reformable, but the USSR had long since passed that point (Aslund 1995), and that what is good for Poland should not necessarily be good for China (Sachs and Woo 1994); the view that Russia is special and standard shock therapy package is not for Russia is widely held by Russian academics and politicians -see Yevstigneyev & Voinov (1994) for details.

<sup>39</sup> See, for instance, Aslund (1994b).

crises, which finally forced the authorities to relax the restrictions thus undermining trust in the idea of macroeconomic stabilization itself.

Despite the predominantly monetary origin of Russian inflation, there are, nevertheless, some objective factors that explain why it was more difficult to bring it down in Russia and other CIS countries than in East European and Baltic states. The Russian economy seems to be different at least in several respects: it is more difficult to work out a consensus on how to cut the budget deficit (partly because of the stronger position of communists and nationalists, partly due to disagreement between powerful industrial lobbies); it is also more difficult to ensure a solid inflow of revenues to the government budget (because of the larger size of the shadow economy); and, finally, it is more difficult to overcome the 'non-conventional' reaction of enterprises to demand restrictions (accumulation of arrears instead of holding down prices and wages).

Though 'surprise strategy' – sudden introduction of the shock therapy package – worked in other countries, in Russia it resulted in sort of 'stop and go' policies: tightening of fiscal and monetary restraints resulted in greater tensions among conflicting parties, in the fall in budget revenues, and in non-payments, which led to another period of monetary ease. The best policy to fight inflation in Russia seems to be not the conventional stabilization package (relying on the pegged exchange rate as the nominal anchor and designed to cut inflation drastically in several months), but rather consistent, though gradual, efforts to bring down the budget deficit and slow down the rates of growth of money supply.

Taking into account objective difficulties in bringing down inflation, recent Russian experience with macroeconomic stabilization (massive reduction of the deficit and tightening of monetary policy) should be viewed as moderately successful. However, the inability to properly handle the downsizing of the government (poorly designed cuts in expenditure without the reassessment of commitments in providing public goods and social transfers) remains an obvious policy failure case.

- Provided that quick exchange rate-based stabilization was not a feasible option for Russia anyway, it probably made sense to keep the exchange rate considerably undervalued to encourage exports, restructuring, and growth, while fighting inflation through tight fiscal and monetary policy (sterilization of increases in money supply caused by the growth of foreign exchange reserves), not through highly priced national currency. The sort of crawling peg established for the rouble from mid 1995 proved to be an important device in fighting inflation in the second half of 1995, but Russian domestic prices were rapidly approaching world levels and there is now a danger that strong rouble will undermine exports and economic recovery.
- It was unrealistic to proceed with the elimination of all subsidies because inefficient machine production and agriculture were so large and so much behind efficient resource industries in terms of productivity. However, the actual Russian policy in the field was largely a failure; partly because it took a highly inefficient form of price subsidies (instead of direct subsidies), partly because it did not succeed either in supporting investment in competitive resource industries, or in allocating funds to

those few high-tech industries (aerospace) that had good prospects for becoming competitive.

- While the greater magnitude of the Russian recession and greater increases in income inequalities led to a considerable reduction of living standards for the majority of Russians, the government did less to mitigate these unfavourable developments (and thus to strengthen the support for reforms) than in Eastern Europe. In a sense, in the area of social policy, Russia was more shock-oriented than East European countries though the need for sound social policies in Russia was greater than elsewhere.

On the other hand, tax-based income policy in 1992-95 supported employment, but contributed to the enormous decline in productivity and hindered restructuring. The government also failed to launch major labour retraining and adjustment programmes.

- In carrying out privatization – the most important institutional reform – the Russian government gave work collectives larger concessions than governments in East European countries did. By doing this, it emphasized political feasibility over equity and economic efficiency. It seems, however, that the game was worth the candle: massive and quick privatization became socially acceptable and politically feasible at a cost of establishing the control of insiders (former managers and work collectives) over most privatized enterprises. As shares are traded, strategic investors from the outside gain control over enterprises and start restructuring.
- Decentralisation of the banking system and emergence of millions of individual shareholders due to the extremely 'worker's friendly' nature of Russian privatization facilitated the development of the American type (market-based) system of corporate financing and control: banks and other financial institutions are not normally stakeholders in non-financial companies, nor do bank credits account for a substantial portion of investment financing. Nevertheless, the usual advantages of such a system are not really visible in Russia: shareholders do not seem to exercise an efficient control over management, whereas thin markets for corporate securities cannot compensate for the lack of bank credits.
- If current trends continue, emerging Russian capitalism is not likely to duplicate European or East Asian patterns of development, but instead may resemble somewhat the Latin American model. Poor traditions of complying with laws and regulations and low tax revenues; highly uneven distribution of wealth and income and strong social tensions; government failure in providing public goods and social transfers and in restructuring the economy through supporting the winners rather than the losers; poor investment climate, capital flight, growing foreign debt, low savings, investment, and growth – this bleak picture is the most probable option provided that the government does not proceed with major reforms.

The brighter scenario implies that the government will adopt a growth strategy based on:

- downsizing part of the government, while making the remaining part more efficient;

- sound industrial policy favouring export-oriented industries;
- efforts to build consensus through strong social policy;
- measures to stimulate savings and investment (through low exchange rates, pension system reform, increased government and foreign investment).

While quick progress in adopting such a growth strategy does not seem to be politically feasible, some steps in this directions are more or less inevitable, especially in the longer term.

**TABLE 14**  
**SHOCK THERAPY VERSUS FEASIBLE AND VERSUS ACTUAL POLICIES**

POLICY AREAS	SHOCK-THERAPY	FIRST BEST FEASIBLE POLICY	ACTUAL POLICY
Price liberalization and currency convertibility	Immediate	Immediate	Immediate, except for fuel, energy and some other prices
Macroeconomic stabilization	Quick macrostabilization (bringing down inflation to below 50% annually in several months after price liberalization) through pegging nominal exchange rate	Gradual monetary-based stabilization – slow but steady progress in cutting the budget deficit and rates of monetary expansion	'Stop and go' policies – unsuccessful attempts to bring down inflation quickly followed by periods of monetary ease and rising inflation
Fiscal policy	Active policy of downsizing the government – massive cuts in taxes, government commitments, and budgetary expenditure	Cuts in government commitments and budgetary expenditure, when and if they become financially unsustainable due to decline in tax revenues	Chaotic cuts in budgetary expenditure forced by the undesirable decline of tax revenues without reassessment of government responsibilities
Exchange rate policy	Exchange rate-based stabilization –pegging nominal exchange rate at a low initial level (overshooting), allowing prices and PPP to catch up later; using the exchange rate for fighting inflation, not for promoting export and growth	Monetary based stabilization with constant devaluation of nominal exchange rate in line with inflation (maintaining real exchange rate, i.e. the ratio of domestic to world prices, at a stable level) to stimulate export and production	Absence of the particular exchange rate policy in 1992-94 (not using the exchange rate either for suppressing inflation, or for promoting growth); attempts to use it for both purposes in 1995-96 (crawling peg with rising real exchange rate)
Industrial policy	Withdrawal of all kinds of support to particular industries or redirecting this support to competitive industries	Substitution of price subsidies for direct (income) conditional subsidies for restructuring	Preservation of price subsidies to mostly non-competitive industries (agriculture and secondary manufacturing)
Employment and social policies	Promoting the reduction of employment at inefficient enterprises; elimination of 'excessive' social guarantees and transfers in order to cut government budget deficit and increase stimulus to work	Dealing with unemployment through retraining and other adjustment programmes; social transfers to poor and pensioners to allow them to maintain their living standards during transition and to ensure their support for reform	Holding down increases in unemployment caused by restructuring through subsidies and taxation of excess wages; failure to launch major employment adjustment programmes; failure to support real incomes of poor and pensioners
Privatization	Selling small enterprises and shares of large companies at auctions at market prices (with or without vouchers)	Auctioning of state property for money and vouchers with some concessions to work collectives	Auctioning of state property for money and vouchers with large concessions to work collectives and managers
Capital markets	Decentralisation of the banking system; dispersion of shares among individual shareholders preventing financial institutions from becoming stakeholders in non-financial corporations; rapid development of securities markets with an aim to make them an important source of investment financing	Decentralisation of the banking system; dispersion of shares and importance of securities markets in investment financing depends on privatization model (high, in case of large concessions to work collectives; low, if assets are sold to the highest bidder)	Decentralisation of the banking system; high initial dispersion of shares, growing role of strategic non-institutional investors; managers are still not accountable to shareholders; banks do not provide long-term credits for financing of capital investment, whereas securities markets are still too weak to compensate for the lack of bank financing

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