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Prospects of the Russian Economy: Problems and Factors of Growth

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Summary

1. Russia is at the start to economic growth, the main driving factor being market reforms which enabled to exploit the results of rouble devaluation and growing oil prices.

2. The world economy is experiencing a recession. There are rumours of a crisis although optimists expect forthcoming changes for the better. Russia is largely in a favourable situation. Its economy is expected to grow, albeit at a slower pace, over the next one or two years, even if there is a global economic crisis and a dramatic decline in oil prices. We will look to advantage compared to most other countries.

3. The budget is stable. Should oil prices drop to USD 15 a barrel, we shall lose only our financial reserves and shall have to resort to borrowing in 2003 for external debt service.

4. Nevertheless, Russia's dependence on energy exports brings about long-term instability which manifests itself in sequestration as oil prices decline or sterilization of excess liquidity when they grow.

5. In order to ensure sustainable growth and positive structural changes we need large-scale modernization which will essentially mean a new stage of transformation for the Russian economy. The question is what methods will be used to achieve it. This will shape the image of Russia for 20 or even 50 years to come.

6. A need for modernization, including structural changes, towards an economy relying more on high added value finished goods and less dependent on exports of raw materials and energy is further underlined by a long-term forecast of the global economic development. It is expected that markets for current Russian exports and food will relatively shrink which means that the influence of countries depending on these goods will diminish.

7. Studies conducted at the Higher School of Economics suggest that at the current relative prices in our industry the share of non-market sector is practically zero but approximately 2/3 of enterprises still continue to waste their assets. This is another argument in favour of urgent modernization and large-scale investments to upgrade fixed capital.

8. Meanwhile, transformation of saving into investments, despite any changes, is practically at a standstill in Russia. With gross saving of more than 30 percent of GDP, investments account for approximately 17 percent. Flight of capital is declining in relative terms but external debt payments are growing. As a result, there is a deficit of investments capable of boosting productivity.

9. Absence of any movement of capital between economic sectors results in inefficiency of even available investments. This makes impossible to implement much-needed structural changes.

10. The stock market is the most efficient arrangement to transform saving into investments. However, it is only emerging in Russia, its development being largely obstructed by the lack of protection of minority shareholders, weakness and dependence of courts, and weaknesses of the banking sector as the cornerstone of the stock market. There are countries with a weak stock market and strong banks but there is no single country with a developed stock market and a weak banking system.

11. Accelerated development of the banking sector and primarily its higher capitalization would allow to increase monetization of the economy and in some way repeat the breakthrough achieved in 2000. This would also result in economic growth

to absorb growing money supply and create conditions for stock market development. Long-term targets for the banking system are:

- *assets of GDP – 100 to 120 percent (currently 35 percent);*
- *lending to economy – 50 to 70 percent (currently 15 percent);*
- *capital of the banking system – 6 to 8 percent of assets, minimum USD 35 to 40 billion by 2004.*

12. Distortions in the system of relative prices and a sizeable non-market sector are another major problem. Although the share of the latter in the Russian industry dramatically declined in 1999-2001, this happened at the existing prices of gas and energy, and railway tariffs. In addition, the non-market sector includes housing, utilities and natural monopolists where prices are regulated by the government, and to some extent households which enjoy numerous privileges at the expense of low wages.

13. Prices and tariffs of natural monopolists are considerably lower than in the world market and other countries. Costs are not transparent but prices are not high enough to encourage energy saving. Essentially, this does not really mean saving consumers' costs but simply losses. This confirms that natural monopolists provide large-scale subsidies to the economy and households, something which finally slows down any efforts to achieve modernization and economic efficiency.

14. Reform of natural monopolists for the purpose of reducing costs and changing prices on the basis of competition will not be as effective as expected despite the focus that the government and the public have on it. It is unlikely to create a competitive environment in the gas industry and railway transport. Competition is only possible in the electricity sector.

15. In order to solve the above problem which essentially means manoeuvering to expand the cash trade and market sector, we need to increase prices of gas threefold and electricity by 2-2.5 times over the acceptable period provided that housing and utilities subsidies will also be terminated while pensions and wages in the public sector will increase to compensate for growing costs of the people and encourage growth of earning across the economy in general. Moreover, demand for goods and investments will also grow while there will be more choice for both consumers and producers.

16. At this stage of modernization of the Russian economy the main reliance is on private initiative, something which will require further deregulation and liberalization. At the same time we need more aggressive structural policies implementable within bounds imposed by a modernization policy. The government cannot assume the role to ensure economic growth but it should encourage positive changes in the structure of manufacturing and exports which cannot be implemented by market forces alone.

17. A choice of the way that the Russian economy and society will follow in their development will largely depend on the role played by the country's two main social forces: bureaucracy and business. Modernization relying on broad public support and therefore support of private initiative and democratic institutions is only possible with the business assuming a dominating role, hence the need for its consolidation.

Table of Contents

1. Russia: A Start to Economic Growth

After the crisis of 1999-2001 Russia is demonstrating relatively high growth, with GDP growing 20 percent in 2001 to account for approximately 72 percent of the level achieved in 1990 as compared with the lowest point of 60 percent in 1998.

The main driving force of these positive changes is the market reform implemented since 1988 and especially in 1992-93. Theoretically, it was clear from the very onset that the reform was supposed to lead the country out of the deadlock of the planned economy and ensure an economic growth on totally new principles. This finally proved true despite multiple disruptions and considerable losses.

During these years the growth was normally explained in other terms: devaluation of the rouble, high prices of oil and other Russian exports, and growing domestic demand which was especially manifested in 2001. This is also true.

However, for these factors to play their role, the country needed an economy capable of responding to market signals. It is worth noting that oil prices peaked in 1983 but they could not induce a growth of the Soviet economy.

Studies conducted by professor V. Popov (National Economic Academy) suggested that liberalization was the second to transformation important growth factor but its positive effects were not instantly manifested, depended on the extent of structural distortions and required institutional changes. For this reason East European countries experienced economic growth 2-3 years after liberalization while Russia with distortions at their worst, institutions requiring a radical change and aggravated weakness of government, could not make it for 8 years.

The key factor was emergence in Russia by 1998 of an aggressive market sector and reasonably manageable companies which could exploit the available opportunities.

During these years the problem of arrears and barter trade was practically solved while the economy became increasingly monetized and based on cash payments. It enabled to increase tax collection and ensure a balanced budget. Higher foreign exchange revenues, and growing base money and foreign exchange reserves largely contributed to this process. Moreover, inflation rate was contained at 20.2 percent while money supply grew 62 percent in 2000.

A growing domestic demand, once it is made sustainable, will mean that the Russian economy has finally started working.

However, growth rates have slowed down in the recent months while expectations of the business deteriorated. The global economic crisis which has been gaining momentum since mid-2001 may have considerable implications. However, it is worth noting that while the main economic indicators of industrial economies deteriorate, Russia is showing itself to advantage as compared to most of these countries.

The economy was much influenced by positive expectations of business circles and the public at large due to political stabilization following the election of V.V. Putin as the president and continuation of liberal reforms. They provide brickwork for emergence of a free market economy and future prosperity of the country.

2. The Current Situation: Stuck Between Sequestration and Sterilization

The Global Crisis and Oil Prices

While Russia was thrown into a dramatic crisis of transformation, the global economy showed an unprecedented growth relying on Internet and revolution in the area of information and telecommunications, with U.S. economy averagely growing 3.5-4 percent a year during 10 years and Europe lagging behind by only a fraction. Japan was experiencing a development crisis of pulling up with others but before 1997 the "Asian cubs" and also China and Vietnam achieved a record development in their own right. China's GDP grew twofold while other developing countries grew generally 5 percent a year. It seemed that we were at the age of post-industrial prosperity. There were complaints of low labour discipline in the U.S. due to an extremely low unemployment rate.

The crisis of 1997-98 ravaged developing countries, with flight capital heading towards calm harbours of Europe and North America, something which resulted in the markets being overheated.

This boom should have ended up with at least an adjustment. The disaster of September 11 boosted the developments, and the global economic crisis (or at best a recession) finally came around.

In November the IMF published a pessimistic forecast to adjust its previous assessment of the global economic growth (see Table 1). Further negative changes followed in December. In particular, the forecast of Russia's GDP growth rate in 2002 was reduced from 4.2 to 3.6 percent.

Table 1. **Comparative indicators of global economic growth**

	Forecast as of October 2001		Adjusted forecast	
	2001	2001	2001	2002
Global production	2,6	3,5	2,4	2,4
USA	1,3	2,2	1,1	0,7
EU	1,8	2,2	1,7	1,4
Japan	-0,5	0,2	-0,9	-1,0
Developing countries	4,3	5,3	4	4,4
Asia	5,8	6,2	5,6	5,6

The main idea of this forecast was to change trend from upward to downward for the forthcoming year.

Meanwhile, hardcore optimists from governments of some countries came forward with their arguments. Despite that Americans expected the situation to improve from mid-2002, the prospects of a deepening recession will have to be reckoned with.

For the last two decades the economic growth was much attributed to increased openness and lower transaction costs, especially in international trade and capital flows. It remains to be seen whether the anti-terrorist coalition is successful in reversing the consequences of September 11 and maintaining this positive trend. If the answer is yes, the crisis is likely to be overcome relatively soon. Otherwise, we will have to confront a steady growth of mistrust, nationalism and xenophobia. With new barriers, slower growth rates and probably economic decline in the world will be ever more likely. But the outcome of these developments will only become clear in one or two years.

For us the global economic crisis is primarily fraught with shrinking demand for Russian exports and, correspondingly, lower prices and revenues. Of course, it can disrupt the pace of the beginning economic growth. The pivotal point is oil prices.

In early November the Economic Expertise Group (EEG) under the Ministry of Finance made a forecast of Russia's economic prospects and position of the budget, its three scenarios depending on oil prices (see Table 2 for the main indicators). Other forecasts, despite differences in assumptions, provide similar results.

Table 2. **Three macroeconomic scenarios of the Russian economy in 2002-2003 Depending on oil prices (Economic Expertise Group, November of 2001)**

Indicators	2001	2002			2003		
		Scenarios					
		Optimistic	Realistic	Pessimistic	Optimistic	Realistic	Pessimistic
Assumptions							
- average price of «Urals» grade oil, USD a barrel	23,3	35,5	18,5	15,0	19,3	18,5	15,0
- Capital outflow, USD bln	25,1	28,0	26,3	22,8	29,1	27,2	22,1
Forecast							
- GDP growth rate (% of previous year)	5,5	4,3	3,3	2,2	4,0	2,5	1,7
- Inflation (CPI, % Dec to Dec)	18	13,5	14,6	17,4	12,0	12,4	14,0
- Money supply growth (%, Dec to Dec)	35	25	21	17,0	18	19	14,0
- Balance of trade (USD bln)	52	50	41	35,0	43	42	36,0
- Current account (USD bln	36	33	24	19,0	25	25	21,0
- Average nominal exchange rate (rouble to USD)	29,2	31,4	32,4	34,8	34,2	36,4	43,0
- Real exchange rate, % of 1997	63	65	64	60	64	62	54
- End of year international reserves (USD bln)	37,8	42,8	38,1	31,9	39,0	37,0	27,8

As follows from Table 2, it is expected that the price of Urals grade oil could be as low as USD 15 a barrel. Moreover, it will be paralleled by a dramatic decline of GDP growth rate (1.7-2.5 percent) which practically means a stop to any economic growth and deepening gap from industrial economies while developing countries will continue to catch up. Under other scenarios GDP growth rates will also shrink as compared to 2001 although not so considerably. Scenarios with the price of USD 18 a barrel are not satisfying either. The authors did not dare to use lower assumptions (for instance, USD 12) although oil prices in 1998 were as low as USD 8. The IMF forecast assumes oil prices at the level of USD 18.5.

The pessimistic scenario also shows that inflation rate is compensated by the growing money supply. It means a stop to monetization of the economy at today's absolutely inadequate level (16 percent of GDP). The third scenario outlines the utmost limit before which a new crisis will not develop. A relative decline of the rouble exchange rate allows strengthening to some extent the competitive position of Russian producers although in other scenarios the rate remains noticeably undervalued. Under another forecast (Centre of Economic Competition) with similar assumptions, the growth of real income of households will practically freeze (101.5 percent in 2002 as compared to 105 percent in 2001) which also means a stop to the growth of consumer demand.

Nevertheless, the average scenario is more likely to occur.

I believe that the above forecast was close to economic realities in March of 2002 which did not happen too often before. In addition, as a result of efforts by oil producing countries and economic improvements in the U.S., oil prices stabilized at USD 19-21 a barrel. As a matter of conclusion, traditional concerns over the likelihood of a new crisis in the Russian economy could be relaxed despite poor performance of the production sector during the first few months of the year.

The Budget and External Debt

Table 3 shows forecasted indicators of the federal budget constructed by EEG under the same scenarios and, therefore, reflecting the influence of oil prices on the budget. A pessimistic scenario envisaged sequestration of expenditures in 2002 (5 percent) in order to maintain the budget surplus of 0.5 percent of GDP. Without this sequestration, expenditures in 2002 will amount to Rb 1668.7 billion (15.9 percent of GDP), with a deficit of 0.1 percent of GDP to be compensated by further borrowings.

Additional revenues (which are small compared to the huge amount of Rb 341 billion in 2001) are assumed only under an optimistic scenario for 2002. The financial reserves which would have amounted to USD 4.9 billion in the optimistic scenario, are zero in the pessimistic one. Thus, the idea of accumulating reserves for servicing the external debt which peaks in 2003 becomes unrealistic, and the government will have to borrow at least USD 4 billion from the IMF and eurobond markets, and take a foreign currency loan worth approximately USD 4 billion from the Central Bank of Russia.

Таблица 3**. Forecasted Indicators of the federal budget in 2002-2003 (EEG)**

	2001 forecast	2002				2003		
			Forecast scenarios			Forecast scenarios		
	2001 forecast	draft budget	Optimistic	Realistic	Pessimistic	Optimistic	Realistic	Pessimistic
Revenues (Rb billion)	1535,3	1844,5	1871,7	1734,4	1669,1	2008,7	2009,9	2022,6
% GDP	16.8	16,8	17,0	16,3	15,3	16,1	16,2	16,0
Expenditures	1303,5	1666,3	1680,6	1651,8	1620,8*	1848,1	1835,4	1848,4
% GDP	14,2	15,2	15,3	15,5	15,3	14,8	14,8	14,6
-debt service	267,1	289,8	288,9	296,4	314,7	290,5	312,4	357,6
% GDP	2,9	2,6	2,6	2,8	3,0	2-3	2-5	2-8
-non-interest expenditures	1036,3	1376,5	1391,7	1355,4	1306,1	1557,6	1523,0	1490,8
% GDP	11,3	12,6	12,7	12,7	12,4	12,5	12,3	11,8
Surplus	231,9	170,2	191,1	82,7	48,2	160,6	174,5	17,3
% GDP	2,5	1,6	1,7	0,8	0,5	1,3	1,4	1,4
For reference:								
– Additional expenditures	341,8	–	27,2	–	–	–	–	–
– End of year financial provisions	81,9	109,8	156,7	105,6	0,0	6,3	7,2	0,0
External debt service and repayment, USD billion	13,7	14,2	14,2	14,2	14,2	18,8	19,0	18,8
- repayment	6,3	6,8	6,8	6,8	6,8	12,0	12,0	12,0
- service	7,4	7,4	7,4	7,4	7,4	6,8	7,0	6,8
External borrowing (incl. IMF, eurobonds and other financial projects)	0.4	2,9	0,9	2,9	0,9*	1,6	3,2	3,1*

*) Conditional on 5% sequestration.

In this case the IMF will probably refer to the agreement with Russia that the Fund will resume emergency lending while refusing to support the restructuring of Russia's debt to the Paris club. However, it remains to be seen whether the decline of oil prices to USD 15 a barrel will be considered an emergency in a situation where the country does not intend to either increase taxes or reduce expenditures.

According to the calculations performed by FBK, the breakeven point of the federal budget is less than USD 15 and equals USD 11.5 a barrel. The sequestration mechanism is not worth launching unless the prices fall to USD 11.5 a barrel.[1] Meanwhile, in early 2002 oil prices went up again, something which could potentially create a problem of sterilization. Under these circumstances the government would hardly revisit the problem of debt, even if the U.S. wanted to compensate Russia for its active support of the struggle against international terrorism by writing off Russian debts. We owe primarily to Germany.

By the way, calculations performed by EEG suggested that the tax burden (revenues of the broad government as percentage of GDP) would be reduced from 37 percent in 2001 to 35.3 percent in 2002 (1.7 percentage points) under the optimistic scenario and to 33.9 percent (3.1 percentage points) under the pessimistic one, and by approximately one percentage point more in 2003 under any scenario. If it is true, the economy will continue to be on the rise on the basis of private initiative, albeit to a minor extent. However, the optimal tax burden in view of the country's circumstances should not exceed 30-32 percent of GDP.

But let us go back to the problem of debt. Russia embarked on repayment of the external debt under the original schedule and terminated both restructuring negotiations and borrowing from the IMF. One has to admit that the government has made some progress in this area. The data provided by the Ministry of Finance suggested that as of July 1, 2001 Russia's external debt amounted to USD 137.8 billion as compared to USD 158 billion in the peak year of 1998. This reduction was achieved by repayment without any new borrowing and, according to rumours, through debt purchase transactions of government banks (Vedomosti, 20.02.02). This amounted to nearly 44 percent of Russia's GDP in 2001 calculated in U.S. dollars at the market exchange rate which is quite adequate for determining the country's credit rating. New payments which would peak in 2003 were reduced from USD 19.5 billion to USD 17 billion. Financial reserves accumulated by the government in late 2001 amounted to nearly USD 2.7 billion. On this basis M.M. Kasianov announced in February that the problem of external debt had been solved.

But what if oil prices fall? Was the need for modernization properly accounted for? Is it worth going back to the problem of debt restructuring? The administration of the U.S. President is willing to compensate Russia for support after September 11. Indications suggest that the problem of restructuring of the Russian debt was discussed in the U.S.

My position is this. Russia should not have terminated negotiations for a comprehensive settlement of external debt including its partial write-off. We could at least maintain periodic consultations irrespective of whether or not they were successful. Then we could wait until the position of counterparts changed. But, once the occasion had been wasted, it is not worth going back to this problem, unless in emergency. The reasons are as follows:

First, as we have seen, the changes that declining oil prices cause to the budget are not at all catastrophic. With some pressure on the budget (minimum sequestration,

[1] FBK. The Oil Prices and the Budget Safety Margin in 2002. The Analytical Note, M., December of 2001.

some increase in the budget revenues or borrowing including in the domestic market), we probably can come through the peak in 2003.

Second, we are anyway late for negotiations on restructuring of the debt by 2003. They will not be completed in time, even with the good will of all parties.

Third, it should be borne in mind that negotiations will only deal with the Paris club debt which is approximately USD 40 billion while outstanding eurobonds of the Russian Federation are issued to a comparable amount and not subject to restructuring under any pretext.

Fourth, the interest to debt restructuring after 2003 is considerably declining. Apart from the peak in 2005, payable amounts will not exceed USD 12-13 billion a year while the total debt will fall to approximately USD 110 billion in 2004. It is also quite likely that Russia will enjoy better borrowing terms in international markets (one could not even think of it back in 1999). It is therefore likely that the debt could be refinanced at more acceptable terms.

Nevertheless, it is worth looking into the external debt problem and borrowing policies but at a different angle, particularly, in the context of objectives to modernize the Russian economy.

3. Capital for Modernization

Objectives of Modernization

Before moving forward, let us sum up what has been said so far. A decline of oil prices is visibly the worst threat for the Russian economy. Under the most likely scenario it will result in slower rates of economic growth by 1.5-2.0 percentage points and a fairly moderate pressure on the budget. In short, over the next two or three years a new crisis is unlikely to occur. It appears that Russia will even have a better image than others against the background of the weakening global economy.

"The Economic Strategies of Russia for the First Decade of the XXI Century" (March of 2000), a report[2] presented at the round table discussions at the "Liberal Mission" Foundation and Ist International Conference "Investment Climate in Russia" at the Higher School of Economics, proposed a three-stage programme implementable over ten years:

I stage (2002-2003) – **overcoming a crisis of confidence and improving investment climate**; annual growth of 2-3 percent, inflation of 10-12 percent. Federal budget revenues are up to 14.5-15 percent of GDP. Forthcoming intensification of the structural adjustment.

II stage (2004-2007) – **growing investments** as a consequence of improved investment climate, accelerating structural adjustment of the economy, monetization of the economy – problems of barter trade and arrears solved. GDP growth of 2-2.5 percentage points. Inflation rate of 5-6 percent, growth of real income of households by at least 2-3 percent.

III stage (2008-2010) – achieving **high growth rate** of the economy and completing the structural adjustment. Annual growth rate of 7-8 percent, growth of real income of households of 4-5 percent, considerable increase of productivity.

[2] Yasin Y.G., Alexashenko S.V., Gavrilenkov Y.Y., Dvorkovich A.V. The Economic Strategies and Investment Climate. SU-HSE. The Investment Climate and Prospects of Economic Growth of Russia, book 1, p. 33.

I revisited this programme for three reasons. First, I believe that it is logical even today because institutional changes favourable for investment are followed by investments which then provide a basis for increase of productivity.

Second, it is worth seeing what has and what has not been done in line with this logic. It is now certain that developments largely followed the above outlined logical pattern. The current institutional changes seriously improved confidence and business climate although many things are yet to be done.

Interestingly, the advanced growth of investments was observed already at the I stage as GDP growth rates were noticeably higher than expected, and collection of federal budget revenues increased to 16 percent of GDP but this was essentially **luck rather than logic**. We had luck with oil prices just as we did not have it back in 1998. It was due to this fact that we basically solved the problem of barter trade and arrears already at the Ist stage.

But since it was sheer luck we should be happy when we have it and not be disappointed when we have not. Life is not all beer and skittles, we still have to seek solutions to strategically important problems.

Third, the above concepts are built around structural adjustment at every stage. Later this notion was replaced with “modernization” in the Gref programme, simply because at that time it was only logical to undertake serious modernization. This is a strategic objective of enormous importance, unlike those which result from oil price movements: sterilization of excess liquidity or sequestration is a routine procedure similar to taking meals or following one’s physiological needs.

The meaning of structural adjustment or modernization is clear:

1) restructure Soviet enterprises into market-oriented companies, upgrade equipment, introduce advanced technologies in every sector, manufacture products competitive both domestically and internationally, and, therefore, achieve a dramatic increase of productivity and efficiency, reduce costs and ensure supply of workforce capable of achieving these objectives. This should be done at the company level.

In addition, outside individual companies we have to determine the future structure of the Russian economy in the XXI century:

2) will it continue to be oriented towards production of energy and raw materials or will it be able to assume strong positions in the manufacturing and high technologies sector?

3) will there be prevalence of large manufacturing financial groups (conglomerates) which will each time absorb new sectors and enterprises or will small and medium-sized companies take a high share of the economy? Will competitive environment be confined to international markets or also develop domestically?

4) will modernization be enforced by authoritarian methods, with direct and aggressive economic intervention of the government, or based on private initiative with the government playing only a restricted role and strengthening democratic institutions?

The country’s image in 20, 30 or 50 years to come really depends on solution to these problems. Moreover, it is the matter of using a historic opportunity to reverse a centuries long tradition of backwardness, poverty and oppression of the vast majority of people by the powerful and omnipotent bureaucracy, and to transform Russia into a country of free and prosperous people.

It may seem to an outside observer that we have just started to solve the problems of this sort by creating prerequisites and hesitating before the main objectives.

Here are three short comments to these objectives.

1. Table 4 shows a forecast of the structure of global exports performed by the Institute of World Economy and International relations under the Russian Academy of Sciences (IWEIR RAS). The conclusion is this: exports of finished goods will show advanced growth rates in the international trade. They will also account for a growing share of revenues. Moreover, demand for textile and clothing, the backbone of Chinese exports, will diminish. Naturally, the share of the Russian exports market will shrink by more than twofold. The specific weight and influence of suppliers of fuel and raw materials will generally diminish, and their revenues will relatively fall. The main reason is introduction of energy-saving technologies in industrial economies. The role of the agricultural sector which many people expect to revive and which was prevailing in post-revolutionary Russia will diminish even more.

Table 4. **Commodity Structure of Global Exports (% of total)**

Commodity groups	Actual		Forecast		
	1990	2000	2005	2010	2015
Finished goods	70,4	77,5	80,8	83,2	85,3
- plant and equipment	35,8	41,9	44,8	47,4	49,5
- chemical products	8,5	9,6	9,9	10,2	10,3
- investment goods for intermediate consumption	7,8	7,6	7,3	6,5	6,5
- textile and clothing	6,3	6,1	5,9	5,9	5,4
- other consumer goods	11,9	12,3	12,9	13,4	13,6
Minerals and semi-finished goods	17,4	12,5	10,4	8,9	7,6
- fuel	10,5	7,3	6,1	5,3	4,4
- ferrous metals	3,1	2,3	1,9	1,6	1,4
- non-ferrous metals	2,1	1,8	1,6	1,5	1,3
- ore and other minerals	1,7	1,1	0,8	0,6	0,5
Agricultural products	12,2	10,0	8,8	7,9	7,1
- food	9,3	8,0	7,2	6,6	6,0
- agricultural inputs	2,9	2,0	1,6	1,3	1,1

Source: IWEIR RAS. The World at the Turn of the Millenium. A Forecast of Global Economic Development until 2015., M., 2001, p. 169.

Thus, in order to maintain and strengthen its position in the world including in terms of revenues, reserves and well-being, Russia will have to win a share of the international markets for finished products and services which will grow faster than global commodity trade.

No breakthrough has been observed in this area so far. Moreover, there is no coherent policy on this vitally important issue.

2. Table 5 shows individual results of the studies which have just been completed at the Higher School of Economics (I stage). They suggest that the non-market sector of the country's industry (defined by the added value criterion as it was in the well-known McKinsey report[3]) ceased to have any sizeable importance by the end of 2000. The number of companies incurring debts above the critical level

[3] McKinsey Global Institute. The Economy of Russia: Growth Is Possible. 1999.

declined dramatically. However, nearly 2/3 of enterprises continued to waste their assets, their share declining only insignificantly since 1997.

Table 5. **Individual Structural Indicators of the Russian Industry (data of a random survey of approximately 1000 enterprises, % of total)**

	1997	1998	1999	2000
Share of enterprises with negative added value (plus barter trade)	22,0	16,1	4,8	2,5
Share of enterprises with overdue accounts payable (including wage arrears) of over 18 months of added value production	34,3	32,7	29,8	12,9
Share of enterprises with negative net capital growth	83,5	82,9	72,7	65,4

As a matter of conclusion, transition to the market economy, at least in the industry, has been completed if one understands it as a process of adjustments of enterprises to market conditions. But the process of modernization as related to fixed capital upgrade and increase is only at its inception.

Russia witnessed two attempts of forced modernization: at the time of Peter the Great and at the time of Stalin. In both cases the result was strengthening of the bureaucracy, impoverishment of people, and finally an aggravated slump in social economic development and formation of a civil society based on laws without which any development on the basis of private initiative was impossible.

It appears that now there is a hope for relatively liberal policies and modernization with reliance on broad public support. This is the only reasonable and promising guidance for this country. However, it should be borne in mind that the above objectives, including structural changes, will have to be achieved within limits imposed by this guidance.

Saving and Investments

Whatever form of the economic modernization, it needs sizeable investments. Estimates differ. According to the McKinsey Institute, USD 15-20 billion is enough to double productivity in Russia in five years.

These estimates were derived on the basis of assumption of implementing new important technologies in ten key sectors, including continuous steel moulding in metallurgy, and retail super- and hypermarkets instead of small wholesale markets. It was also assumed that implementation of such projects was representative for the entire Russian economy. It is worth noting that fixed capital investments amounted to more than USD 40 billion including one half into the fuel and energy sector in 2000.

Other estimates made by the Ministry of Economy in 1997 are based on the assumption that the entire pool of equipment will have to be upgraded in 20-25 years. These estimates suggest that the country will need USD 1.5-1.8 trillion of investments during this period. These needs may be exaggerated if one accounts for a change in investment efficiency in the process of modernization. But still…

What estimates better reflect the reality?

It is worth noting that the most popular topic for discussion among Russian economists was recently excess of foreign exchange revenues generated by high oil prices which created an upward trend for the rouble dangerous for competitive advantages of manufacturing sectors. It was then proposed to give up the external debt restructuring and welcome outflow of capital that the country was unable to absorb efficiently. But the requirement of efficiency does not deny the need for investments.

Speaking of excess of inefficient investments, it should be borne in mind that the change of investment principles largely occurred in 1991-98 as Soviet-style investments (high amounts, low return) were replaced with market-oriented ones (low amounts, high return) although there is still a lot of room for improvement. The fact that the amount of private investments was negligible would mean that the attitude to investment totally changed.

In 1998 fixed capital investments reached their peak which amounted to 24.8 percent of the 1991 level. In 2000 42.4 percent of operating assets were worn out, the upgrade factor (commissioned facilities to those available as of the end of year) was 1.2 percent as compared to 5.8 percent in 1990 and 8.2 percent in 1980. Despite that these indicators are quite notional, the waste of fixed capital during ten years is a universally recognized fact.

It is arguable what amount of annual investments we need. These arguments are harmless because investment decisions are largely made outside the government. But it seems obvious that potential for maintaining growth on the basis of available facilities without any sizeable increase of fixed capital investments is practically exhausted. Even the most optimistic assessments do not exceed 8-12 percent.

Reflecting an appreciation of new problems of the Russian economy (he was familiar with old ones), Stanley Fischer, a renowned international economist, said on June 19, 2001 at his public presentation at the Higher School of Economics: "The dilemma that you are facing will persist while Russia has a strong balance of payments. Moreover, this dilemma will probably aggravate as investors' confidence in the Russian economy improves. **To the extent that it would increase the currently low growth of capital investments in Russia, this phenomenon will contribute to long-term economic growth without imminent pressures on real exchange rate (highlighted by the author, Y.Y.)** However, to the extent that the corresponding resources are used to purchase existing assets, this factor will cause further appreciation of the exchange rate. Structural reforms are called to play a vitally important role to ensure that real exchange rate appreciates on the basis of improved productivity, larger investments and more efficient business organization" (S. Fischer. The Russian Economy. SU-HSE, 2001, p.p. 9-10).

I share this opinion (see Voprosi Ekonomiki, No. 9, 2001). The problem is exactly to depart from urgent sequestrations of the budget or sterilizations of excess liquidity. The objective is to allocate all available resources to modernization, so that economic growth would bring about a demand for money by allowing increasing money supply which would generate a new round of growth.

Russia shows a relatively high saving rate (more than 30 percent of GDP) but low rate of fixed capital investments. Given below are the data and estimates (Tables 6, 7, 8) borrowed from the work done by the Centre for Macroeconomic Analysis and Short-Term Forecasting (CMASF headed by A.R. Belousov)[4] which confirms this suggestion and helps to understand the underlying reasons.

[4] CMASF. Will Russia Grow? April 2001. The data shown in the tables have been updated as of the end of 2001 thanks to prompt cooperation with Belousov who receives our sincere thanks.

Table 6. **Consumption and saving across economic sectors (% of generated GDP)**

	1997	1998	1999	2000	2001
Economy in general					
produced GDP	100	100	100	100	100
available gross national income	97,9	95,7	96,3	97,4	97,1
end consumption	76,3	76,6	69,5	63,8	64,6
gross saving	21,6	19,0	26,9	33,6	32,5
- gross formation	22,8	16,2	15,3	17,6	20,3
- financial transactions	- 1,2	2,9	11,5	16,0	12,2
Households					
available income	59,2	56,6	52,7	48,4	48,8
end consumption	51,1	54,7	52,5	47,1	47,6
gross saving	8,2	1,9	0,2	1,3	1,2
Public institutions					
available income	23,0	19,2	19,5	24,1	24,8
end consumption	21,8	18,7	14,7	14,6	14,8
gross saving	1,2	0,5	4,8	9,4	9,9
Non-financial enterprises etc.*					
available income	16,1	20,2	24,4	24,9	23,5
end consumption **	3,5	3,3	2,3	2,1	2,2
gross saving	12,6	16,9	22,1	22,8	21,4

*including financial organizations and no-profit organizations providing services to households.
**consumption of no-profit organizations providing services to households.

It follows from Table 6 that gross saving grew by jumps as a result of the crisis of 1998 and growing oil prices. In 1999 and 2000 it amounted to 27.0 percent and 33.6 percent respectively as compared to 21.2 percent in 1997. It is noteworthy that saving was relatively high before (27.9 percent in 1995 and 26.75 percent in 1996). This jump owes itself to the declining share of end consumption. Households (i.e. individuals) suffered the worst damage: consumption fell and saving was practically nonexistent in 1999. Moreover, gross saving in the sector of non-financial companies experienced a dramatic growth of 5.2 percentage points. This fact helps to explain much of the economic revival that followed. The next few years may bring gross saving down to 26-27 percent of GDP but it will still remain substantial.

Table 7. **Gross saving for capital formation and financial transactions of Residents with the rest of the world (% of GDP)**

	1997	1998	1999	2000	2001
Resources					
Gross saving	21,6	19,0	26,9	33,6	32,5
Utilization					
Gross formation	22,8	16,2	15,3	17,6	20,3
- fixed capital and valuables	19,5	17,7	16,1	18,3	19,5
- reserves	3,3	-1,5	-0,8	-0,7	0,8
capital flight	5,8	9,4	8,9	7,7	6,4
net public debt repayment*	-4,8	-5,7	2,0	2,4	1,9
accumulation of foreign exchange reserves	0,4	-1,9	0,9	6,3	3,5
other (balance)	-2,7	1,0	-0,3	-0,4	0,3
Fixed capital investments	16,5	15,1	14,7	16,7	17,4

* according to the data of the consolidated budget execution report i.e. excluding CBR transactions and including lending by commercial banks and firms

Table 7 shows where the difference between capital saving, capital formation and fixed capital investments comes from: in 1997 this difference was 5.2 percentage points of GDP, in 1999 – 12.2 points and in 2000 – 16.9 points. The main factor is flight of capital which increased from 5.8 to 9.4 percent of GDP in 1997-1998. After that it started to shrink in relative terms. Before the crisis of 1998 less capital was in flight, growing public debt allowed investments at lower saving, and international reserves did not grow. After the crisis borrowing opportunities were undermined, and since 2000 there was only room for repayment. From 1999 foreign exchange reserves started to increase as accompanied by growing rouble liquidity due to increased hard currency revenues from exports. A combination of these factors, in the words of A. Belousov, resulted in growing “non-investment pressures” on gross saving. (CMASF, p. 22).

The main conclusion: **saving is not easily transformed into investment; the result is slower economic growth which should be based on upgrade and increase of fixed capital, and growth of productivity**. It means that, though growth has been relying on broader domestic demand since 2001, **it will soon stop because there will be no revenue increase from higher productivity**. The alternative is to dramatically increase the efficiency of transforming saving into investments, and of investments themselves.

This conclusion does not pretend to be new but it has specific importance and urgency under the existing circumstances. There was time to wait before. We cannot wait any more now.

No Intersectoral Movement of Capital

Let us look at the problem from another side. In 2000 enterprises financed 46.1 percent of investments from their capital, the share of this source falling below 50 percent (as compared to 53.1 percent in 1993) for the first time. Other funds were raised primarily from budgets (21.2 percent), especially regional, and in the form of loans by other organizations (7.2 percent). Bank lending accounted for 2.9 percent, underwriting – 0.5 percent and undisclosed sources – 17.9 percent[5]. Enterprises received capital for investments in the form of revenues (23.4 percent) and depreciation (18.1 percent) as the share of total fixed capital investments.

As a result of the crisis of 1998 and the revival that followed, investment resources were overconcentrated in export-oriented sectors while being extremely scarce in domestically oriented sectors.

Table 8. **Distribution of gross revenues and investments across industries in 1999-2000 (%%)**

	Gross revenues			Fixed capital investments			Investment quantum index	
	1999	2000	2001**	1999	2000*	2001	2000\1999	2001\2000**
Industries	100,0	100,0	100,0	100,0	100,0	100,0	112,8	110,9
Exports-oriented industries	68,3	74,4	72,4	54,0	68,8	71,0	139,2	118,2
oil	28,0	38,1	42,4	25,1	36,3	39,5	165,1	121,4***
gas	2,5	2,8	1,0	9,0	11,8	11,5	122,9	
ferrous metals	9,3	9,3	6,6	5,4	5,5	5,6	114,7	131,3
non-ferrous metals	17,9	17,0	14,4	6,5	7,2	7,4	122,4	113,3
chemical/petrochemical	6,4	4,5	5,0	4,2	4,1	4,2	113,1	110,9

[5] CEC, Russia 2001, vol. 1, p. 97.

timber and paper pulp	4,2	2,6	3,0	3,9	3,8	2,7	109,0	74,1
Domestically oriente industries	31,7	25,6	27,6	46,0	31,2	28,4	80,1	92,0
Manufacturing and meta processing	9,4	9,5	11,2	9,8	7,3	7,2	88,4	84,5
light	0,7	0,5	0,5	0,9	0,3	0,3	66,9	169,6
food	8,9	5,3	5,3	15,7	7,9	7,4	61,4	91,8

* without small companies and informal sector
** data for the first six months
*** fuel industry
Source: CMASF, p.26.

Table 8 shows the extent of the observed disproportion. In 2000 fixed capital investments in export-oriented sectors grew 39.2 percent as compared to 1999, roughly in line with an increase of gross revenues. Investments were visibly below revenues only in metallurgy where resources were allocated to other sectors including for purchase of automobile plants. On the contrary, investments fell 20% in domestically oriented sectors. Only the food industry showed a noticeable excess of investments over revenues in 1999 when the food market demonstrated an active process of import substitution.

This suggests that there is no intersectoral movement of capital. The observed developments could be attributed only to acquisition of control over operating assets in other sectors, and no signals had been received from the market whether these acquisitions were profitable or risky.

Thus, the mechanism of transforming saving into investments does not work in practical terms. This is aggravated by the lack of intersectoral movement of capital. **Under this situation we cannot even dream of structural changes in the economy which are vitally important for the country, nor of taking a share of markets for finished goods and services.** So far Russia is following a traditional way of a raw material country with the prospects that its role in international markets will decline. This is really a problem of strategy.

Financial Markets

In theory there are three mechanisms of transforming saving into investments capable of operating independently or in a combination:

1. Public investments with the respective level of taxation (Soviet experience).
2. Distribution of capital through large financial industrial groups like Korea's "chaebols". The Korean experience is the most remarkable, hence the name of this option – "chaebolization".
3. Financial markets: primarily American experience[6].

Public investments offer the advantage of following the priorities of structural policies if there are any. But they are not efficient: the larger the investments, the less efficient they are. In addition, priorities set on the basis other than market principles are seldom correct. Therefore, public investments should never dominate as a method of transforming saving into investments.

It might seem that the "chaebol" option should be discarded a priori. However, the Korean "economic miracle" could be viewed as one of the most remarkable

[6] See Bulletin of Information and Analysis No. 28, June 2001, Bureau of Economic Analysis for more detail of these mechanisms as they relate to scenarios of economic development of Russia.

success stories in the II half of the XX century. In 1954 the country had USD 150 of per capita GDP which is the level of Nigeria. In 1995 this indicator amounted to USD 11 thousand (close to the best achievements) while Korea's economy became the world's 13th by the size of GDP. This result was achieved primarily due to "chaebols" such as Hyundai, Samsung, LG, Daewoo etc. Most importantly, the country won a share of high technology markets and implemented structural adjustments of the same type that Russia would like to achieve. This was the most remarkable success story since Hong Kong, Taiwan and Malaysia performed less effectively in the electronics and information technology markets. True, "chaebols" operated on the basis of active support of the government, especially at the first stage. There were reports of corruption and lobbying of group interests, especially at the second stage, which made Korea and other countries of the South East Asia more prone to devastating effects of the Asian crisis of 1997-98. In 1950-60 Korea existed in an environment which was significantly different from that of Russia today but favourable for the model of "followup development" already tested in Japan. To an objective observer, advantages brought by "chaebols" before 1997 would in many respects overbalance any shortcomings.

The trends of intersectoral movement of capital which could be observed in operations of large Russian companies in the wake of the crisis should be supported rather than condemned. In any event, the Russian economy would have gained a lot more if Interros could perform well in the markets for energy generation equipment and aircraft engines, and Sibal and Severstal in the markets for automobiles. But risks are high, too. Meanwhile, it should be clear that this mechanism cannot and should not dominate in transforming saving into investments. There are dangers associated with the union of large conglomerates and authorities, as well as with the restricted mobility of people's savings and capital held by small and medium companies.

A predominant role should be played by the mechanism capable of mobilising capital in the required amount including resources of small investors, and ensuring its optimal use. This is the mechanism of financial markets[7].

Financial markets could be classified into two main categories: 1) lending markets and banks: the latter guarantee depositors' risks; and 2) stock markets where investors themselves assume risks to some extent. Stock markets are principally the most flexible and efficient mechanism of transforming saving into investments. In spring of 2001 Vodafone of London mobilised USD 3.5 billion in one day.

Russia has today toy-sized stock markets which cannot be used to raise really significant resources which are badly needed.

In addition, while financial institutions and organizations are the product of historic development, the Russian financial system has a short history. Accelerated development of stock markets in this country is obstructed by a number of reasons.

One of them is lack of protection of minority rights, which is not an isolated problem. So far the Russian business has been fighting for control over assets rather than raising significant resources for investment. Open joint-stock companies (OAO) formally prevail but in reality most of them are not only closed but also closely owned, with control held by a restricted group of persons connected through family ties. They would normally fear transparency because **informal relation**s prevail there. Otherwise, the company would not be manageable. However, this makes it impossible to involve small shareholders though only a large number of such shareholders could

[7] In this section we use the results of specific case-by-case analysis performed by the "Liberal Mission" foundation for banks and financial markets as of May 30 and October 15, 2001.

really generate significant money. Moreover, the dividends they receive are symbolic, and the shares they hold do not practically grow.

It would have been another story, if shareholders were sure that they would not be deceived, their money would not disappear, and dividends or growth of capitalization would be beneficial for them while managers would efficiently ensure that the company operated successfully for the benefit of all shareholders who would not have to follow the details of its operations. Then we could have large public companies which could be controlled by a holder of a 5-percent share package. This requires an environment of confidence and high corporate culture of management. Creating this environment which may require minimum 5-6 years to emerge is not simple.

Second, we need independent and impartial courts capable of protecting property rights including small investors, and resist pressures of executive authorities and criminal circles. This requirement is well-known to the point of banality. However, it makes people doubt whether the required changes are real and their country could prosper. It is, though, worth noting that we have seen many things which would have been unbelievable ten years ago.

Interestingly, Russia's legal system is law abiding to the letter. It relies on the continental tradition of civil law which in the Russian situation often follows the form but totally neglects the essence. In those countries that follow the Anglo-Saxon tradition of common law where laws are not so detailed and leave much room to precedents and discretion of court, investors' rights appear to be better protected and, consequently, stock markets are more developed. It does not mean that we should give up our tradition. But as the legal reform proceeds, we should take into account international experience and our freedom of choice which would be a gross mistake not to use.

A well-known lawyer told me that the law would not become meaningful and enforceable in Russia until the current generation of judges resigned. It is perhaps not only them who should resign.

The third but not the least reason is the weak banking system. We have been discussing for a number of years whether the Russian banking system should follow the example of America where stock markets prevail, or that of Germany where banks assume the leading role. I believe that the choice appears at a level which we have not achieved yet. An adequately developed banking system is not an alternative but a prerequisite of stock market development.

There are countries with a strong banking system and relatively weak stock markets but there is no single country with a developed stock market and weak banks.

Banking Sector: A Point of Breakthrough

The existing banking system is weak and does not match the objectives of modernization and economic growth, nor requirements to development of stock markets. Lending to the real sector does not exceed 12-15 percent of GDP which is 5-6 times below the normal level while capitalization of the entire banking system in mid-2001 did not exceed USD 12-13 billion, of which Sberbank accounted for one-fourth. This capital does not allow the majority of banks to assume reasonable risks, hence low level of monetization of the economy (≈ 16.5 percent of GDP).

The development strategy of the banking sector recently proposed by the Central Bank and the Ministry of Finance proceeds from the assumption that the situation of the banking sector cannot be better than that of the economy in general and that banks currently meet the demand for their services, and no breakthrough is needed. Moreover, positive trends of the banking system development are observed as growth of capitalization, and lending to non-financial organizations is developing at a faster rate than economic growth in nominal terms.

Lower profit tax for banks (from 45 to 24 percent) encourages accelerated capitalization, to be followed by even more aggressive increase of active operations.

Table 9 shows estimated data for the banking system over 10 months of 2001.

Table 9. **Principal indicators of the Russian banking system in 2001.**

Rb mln	01.01.01	01.10.01	growth	growth rate
Banking system				
Assets	2147461	2794609	647148	30,1
Capital	302993	418918	115925	38,3
Lending to economy	788589	1087188	298599	37,9
Sberbank				
Assets	551377	765623	214246	38,9
Capital	44793	98314	53521	119,5
Lending to economy	264668	341535	76867	29,0
Vneshtorgbank				
Assets	111928	136298	24369	21,8
Capital	46896	49539	2643	5,6
Lending to economy	28240	33125	4885	17,3
Banking system w/o Sberban and Vneshtorgbank				
Assets	1484155	1892688	408533	27,5
Capital	211303	271064	59761	28,3
Lending to economy	495681	712529	216848	43,7
Share of Sberbank an Vneshtorgbank in the bankin system				
Assets	30,9	32,3	36,9	
Capital	30,3	35,3	48,4	
Lending to economy	37,1	34,5	27,4	

Source: - Development Centre.

Impressive growth, isn't it? It is worth noting that back in 2000 lending to the economy also grew 1.67 times in nominal terms and 1.55 times in real terms (as estimated by CPI) for 1 rouble of GDP. Lending to the economy grew 37.9 percent and capital of banks 38.3 percent over 10 months of 2001. However, these indicators will become 10.3 and 10.6 percent in real terms as estimated for 1 rouble of GDP which is not much if one takes into account that lending to the real sector was still 14.5 percent (as of May 1, 2001 in relation to GDP over the last 12 months).

It is also worth noting that growth of bank capitalization and lending to the economy was largely attributable to public banks. The Russian Agricultural Bank and Development Bank received large allocations from the budget. But is this the way for the banking system to follow?

In September and October lending and borrowing grew 6.8 percent as compared to 11.4 percent for the same period of 2000 which was due not only to competition but also to restrictive monetary policies after acceleration of inflation rates earlier in the year. The Central Bank would purchase less foreign exchange and issue less roubles. Correspondent account balances of banks with the Central Bank fell from Rb 130 billion to Rb 80-90 billion but deposits with the Central Bank grew due to a higher interest rate to sterilize the supply of roubles. These are considerable resources that banks do not risk to invest into the economy. Money multiplier fell to 2.2 against 2.28 in 2000 (EEG Survey, December 2001). It means that commercial banks were less active in creating liquidity which was all the same quite low. This is a situation of uncertainty.

Over the last months of 2001 economic growth rates slowed down, even to the point of stagnation. CMASF observed a reversal in the growth trend of end consumption, termination of investment boom and a decline in sales of plant and equipment (CMASF. Economic Competition in November-December, No. 33). For the third time since 1998 the economic growth is losing momentum. Where can the next growth come from?

Let us go back to the remarkably successful year of 2000. Where did success come from? Impartial studies show that increased liquidity diet of the economy that year was the key growth factor. High oil prices generated a flow of foreign exchange revenues which was translated into growth of foreign exchange reserves and rouble supply of the currency board pattern. Inflation grew 20 percent but the money was largely spent to reduce arrears, barter and mutual netting, and to ensure higher tax collection ratio. The economic growth absorbed the additional money supply.

Is it possible to repeat the manoeuvre? Not in the same form since there is no such inflow of foreign exchange revenues while barter trade and mutual netting have been largely overcome. In 2001 macroeconomic policies were altogether different: monetary authorities were afraid of growing inflation early in the year, and base money declined dramatically over 10 months (25.4 percent growth as compared to 39.3 percent a year ago). Moreover, inflation was 16.7 percent against 18.2 last year. In other words, the economy less absorbed liquidity while growing money supply increased the risk of inflation. It will be impossible to repeat the successful experiment because conditions changed.

What about changing the sector? Low lending and low monetization are undeniable facts. Bank loans are out of reach of a considerable number of companies. According to the November data of the Russian Economic Barometer (2001), 37 percent of companies never resorted to bank loans. Opportunities for economic growth by increasing working capital, let alone investments, were not exploited. Increase of investments with the same efficiency and repayment ratio could have boosted demand and encouraged growth of production and productivity. **Thus, banks would have boosted another economic growth** which is now losing momentum.

Meanwhile, there is a potential in this sector. A report by the Expert magazine No. 24, 2001, provides examples of operations by the Central Russia Sberbank. A loan allowed OAO Safonovo-khleb, an ordinary district bakery, to increase its output by 10-12 percent a year over the last 3 years. The company now operates 17 bakeries, 60 trucks and 2 joint ventures. It has customers in neighbouring regions.

Briansky Arsenal, a plant for manufacturing road construction equipment, was in decline by 1998. A loan allowed it to modernize the range of products, purchase foreign accessories, improve quality and organize exports to traditional markets in Poland, Lithuania and Iraq. The plant is making leasing arrangements which will allow to increase output even more.

The Liudinov equipment plant (hydraulic equipment) also modernized its product range by 95 percent, with shipments to the domestic market (coal mining industry) and Germany. A. Levin, a Moscow restaurant owner (the famous “Gaucho” restaurant), is building in Tula the "Bibigon", Russia's only second or third turkey factory.

These examples of successful operations are, of course, short of convincing because they could be paralleled by as many examples of failures. Unfortunately, we do not have reliable statistics of the latter. But, taking into account the accumulated experience and general economic atmosphere, there should be more success stories today. Each of these, multiplied by growth of revenues, will generate new successes. This is the way to growth.

Thus, the problem of transforming saving into investments could be solved as follows:

1. **Accelerated development of the banking system** which is now the key area. Undoubtedly, the problem is not just banks whose condition reflects the economic situation. But something should be done to begin with, and the analysis shows that it is best to start with banks.
2. **Growing capitalization** of the banking system will encourage growth of lending. It is principally important to have a few large banks capable of assuming risks. Undoubtedly, the size of banks is not a measure of their quality, and it is a bad practice to close medium and small banks altogether. But the ability of banks to assume depositors' risks, build up confidence and aggressively accumulate assets is now of primary importance. We need several banks comparable to Sberbank.
3. **Increased lending** will allow to increase economic growth rates and encourage revival.
4. **Growth will encourage demand for money** and allow to increase money supply without the risk of inflation, and enhance **monetization** of the economy.
5. Accelerated development of the banking sector will create conditions for rapid **development of the stock market** until it becomes a steady savings mobilisation mechanism. This will in turn encourage saving required for capital formation.

Our proposals have much in common with those previously made by the Russian Union of Entrepreneurs and Industrialists (RUEI) and contain the following points:

a) Setting long-term development targets for the banking system at the level compatible with requirements of a normal market economy:

- assets to GDP – 100-120 percent;
- lending to economy to GDP – 50-70 percent;
- capital of the banking system to assets – 6-8 percent, at least USD 35-50 billion in 2004.

Targets set in the Central Bank's concept paper are realistic but they have a demobilising effect because they do not outline the objectives to be achieved and, therefore, do not enable to define what measures will be needed to meet these objectives.

Simple calculations show that under the inertia scenario with optimistic assumptions of annual capital growth of 10-12 percent in real terms, it will take between 9 and 11 years to reach the above target. As of late 2001 capitalization of the banking system was USD 16.2 billion which is less than in 1997. Unless it is supported by adequate growth of lending, the economic revival will lose momentum in 1 or 2 years.

Therefore, it is necessary to implement measures capable of accelerating the movement towards the above targets.

b) A shorter schedule of transition of the banking system to international accounting standards (to be completed by January 1, 2003).

Industry experts believe that it may result in 1/3 to 2/3 reduction of formal capitalization of the banking system. This measure alone will enable to sort out non-viable banks. Those banks which will be able to restore the minimum amount of capital could be given an extension of this period (maximum one year).

At the same time it is also necessary to speed up transition of companies to international accounting standards. With time banks should lend only to those borrowers that maintain their accounting in line with these standards.

c) Increasing the minimum capital requirement to banks holding the general license:

- up to USD 5 million from January 1, 2004;
- up to USD 10 million from January 1, 2006.

In this connection it is also necessary to review the terms of issuing a general license and licenses for foreign exchange transactions, individual deposits etc., with relevant amendments being made to the legislation.

We should proceed from the assumption that banks which will not be able to comply with new requirements to capital, capital adequacy and liquidity, will maintain a status of credit or settlement institutions but their customers should be aware that these institutions do not assume risks of their depositors.

Higher capital and capital adequacy requirements are precisely needed to ensure that banks are capable of assuming risks on attracted resources and increasing active operations while building up confidence to themselves. They are also needed to encourage the process of mergers and acquisitions in the banking sectors. These banks may remain operational but not in terms of the general license.

d) Accelerating development of a deposit insurance scheme with mandatory participation of banks as the end target. As the deposit insurance scheme should not involve problem banks, it should be implemented after the transition to international accounting standards. For banks which adopted international standards the scheme could be implemented from mid-2002, once these banks provided their annual reports. Before 2004 the scheme may allow voluntary participation of banks as indication of their willingness to become involved. But participation in the scheme should be originally made available to all banks to ensure equal competition. Special privileges afforded to Sberbank, according to M. Matovnikov, accounted for Rb 2.5-3 billion (17 percent) of its revenues in 2000, this figure amounting to Rb 3-3.5 billion in 2001 (Expert, No. 24, p. 63).

Once participation becomes mandatory, the deposit insurance scheme can also play the role of a supervisory institution and a corporate liquidator interested in a healthy banking system.

In order to solve the problem of Sberbank without undermining confidence of depositors, it is useful to consider a possibility of applying government guarantees in the deposit insurance scheme as guarantees of the last resort.

e) While reducing tax burden of banks has been very important and timely to increase their capitalization, it is also necessary to exclude increase of risk insurance provisions from the taxable base for their profit tax.

f) In order to reduce risks for banks in lending to the real sector, it is necessary to make amendments to the Civil Code (Article 855) and put banks on equal footing with other creditors for collection of debts and collateral. I mean the provisions on priority collection of wage arrears and tax shortfalls, with banks being at best third in this order of priority.

Capitalization is the focal point. Apart from opportunities opened by reduced tax burden, it is necessary to keep in mind increasing operations by non-resident banks which have been so far neglected. Meanwhile, they have been largely providing loans to Russian companies in the recent time. Lending to non-banking private sector during the first six months of 2001 exceeded total lending in 2000. The Central Bank already equalized domestic and international banks in terms of the minimum statutory capital which was decreased from Euro 10 to 5 million for newly opened non-resident banks (Expert, No. 46, December of 2001). The process of transfer of international capital to the Russian banking sector should be ever more encouraged.

If this seems inadequate, other measures might be invited. Despite all the controversy, I would not discard the proposal by the Association of Russian Banks for temporary participation of the government in the capital of banks with its share to be subsequently sold, provided, however, that current public banks are not included into the number of eligible banks, to be selected on the basis of tender; nor the alternative proposal to resume the World Bank's company support and financial institution development project which envisaged lending by international finance organizations and, possibly, money markets to improve performance and capitalization of the best Russian banks.

4. Balancing Relative Prices and Natural Monopolists

Non-Market Sector

Another group of problems capable of slowing down economic modernization is related to large-scale distortions in the system of relative prices and presence of a sizeable non-market sector.

Distortions in the system of relative prices primarily deal with products and services of natural monopolists. This is a long-standing political issue which is splitting the Russian business into groups with various interests. One group largely representing the natural monopolists asserts that their products are underpriced, and, therefore, they subsidise the rest of the economy while being unable to mobilise resources for investment required for reproduction of fixed capital and business development. On the contrary, another group, consumers of their products, believes that they are overpriced or at least could not be properly priced because associated costs are overestimated. For this reason the prices should be increased, if ever, only after these monopoly sectors become transparent, and we know to what extent their costs could be reduced. Consumers should not be forced to pay for wasteful use of resources.

It is worth noting that the post-crisis programme of the Kirienko government (1998) had a target of 50 percent reduction of prices and tariffs of natural monopolists as a key measure. It was expected to improve the situation of manufacturing sectors and solve the problem of barter trade and mutual netting which, as the authors of the proposals believed, were induced by high prices used in unreliable transactions.

The approaches were obviously quite opposite. For this reason it is even more important to have an objective assessment of the situation.

Leaving aside largely public sectors (education, health care and culture), the non-market sector includes:

- inefficient enterprises in industry, agriculture and other sectors producing negative added value. As we have seen, the number of these enterprises fell dramatically over the last 3 years but on the basis of existing prices. Once subsidies available through prices of natural monopolists are removed, and rouble becomes stronger, the specific weight of this part of the non-market sector may visibly increase;
- housing and utilities, primarily budget financed;
- natural monopolists which maintain regulated prices and large-scale cross subsidies, and administrative management methods;
- households to the extent that they use free or subsidised services in exchange for respectively low wages.

Are There Subsidies?

The question is whether there are subsidies or not. One would be hard pressed to find arguments which look convincing to both parties. For example, according to EBRD data, average royalties in gas and oil industry in 1992-2000 amounted to 27% of GDP, including net exports royalties (appropriated by producers) of 9.5 percent and royalties used for domestic price subsidies of 18.5 percent.[8] In 2001 the price of gas in Europe was USD 110 for 1000 m^3 against USD 16.4 in the domestic market (IV quarter) which means a difference of 6.7 times.

It is noteworthy that subsidies observed by international experts are an important basis of refusal to acknowledge Russia as a market economy country. They demand that domestic and international oil and gas prices be equalized since they believe that the difference is attributable to export duties or other ruse of the government.

In reality the government is not in a position to eliminate this difference because current demand by Russian consumers is only possible on the basis of current prices. Price increase will undermine demand and, consequently, production. Therefore, price equalization is largely conditional on structural adjustment and modernization of the Russian economy. Thus, domestic crude oil prices could only increase on the basis of considerably improved oil processing since domestic prices of derivatives do not differ significantly from world prices.

In addition, gas subsidies, if any, are provided at the expense of royalties received from extremely rich fields. This is Russia's competitive advantage similar to competitive advantages of industrial economies in manufacturing. Finally, these subsidies have only limited implications for foreign partners since they are largely provided to households and other economic sectors operating in the domestic market rather than exports sectors.

But these estimates relate to the sector posting different prices – domestic and international – of one tradable product of one company.

As regards products which are not much tradable internationally (including electricity), the difference of markets and conditions would cast a doubt whether a comparison of domestic and international prices is valid. Nevertheless, this comparison could be meaningful since other criteria are even more arguable.

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[8] EBRD. Transition Report 2001. Energy in Transition. P. 81.

It is worth noting that we refer to the prices of products by natural monopolists which are not market-regulated. It is asserted that, once prices are regulated by the government, they could be determined only on the basis of associated costs. This would always cast a doubt whether the cost data are reliable.

I would remind that prices are determined on the basis of associated costs only in the Marxist political economy and planned economy. In the market economy, even in the case of a monopoly, there should be additional criteria related to usefulness and efficiency of products. The price should give proper signals to market agents. In the case of electricity this could be, for example, lower energy content in production of other products and GDP in general, once tariffs increase.

Given this approach, cross-country comparisons become quite meaningful. Table 10 shows data of average electricity tariffs for industrial consumers and energy content of GDP in a number of countries.

Despite individual exceptions, the principle is universally the same: the lower is the tariff, the higher energy content of GDP. Characteristically, a tariff increase in CIS countries would result, as a rule, in lower energy content of GDP. Russia is the only country where tariffs for households are (considerably) lower than for industrial consumers.

Table 10. **Average electricity tariffs for industrial consumers and GDP energy content across countries**

Country, year	Average tariff (cents/1 кWh)	GDP energy content (in terms o purchasing power parity of currencies, kWh (USD)
Japan (1998)	14,30	0,40
Great Britain (1998)	6,40	0,33
Germany (1998)	5,70	0,34
(1998)	15,90**	
USD (1998)	3,90	0,51
(1999)	8,20**	
Armenia (1999)	4,09*	0,51
Belarus (1999)	3,72*	0,77
Ukraine (1999)	2,87*	1,55
Kazakhstan (1999)	1,69*	1,13
Russia (2000)	1,36	1,47
	1,23*	

* for all consumers. Source: RAO UES

** for households

Countries rich in energy normally have lower tariffs and relatively higher energy content of GDP. This moves U.S. towards the end of the list of other industrial economies.

Is it possible to conclude on the basis of the above data whether tariffs in Russia are reasonable or could be increased? Despite that the conclusion is obvious, one should be cautious. In 1997 tariffs in Russia (U.S. cents per kWh) were almost the same as in the U.S., their later decrease being attributable to devaluation of the rouble. They never declined in rouble terms. Meanwhile, it is obvious that the current level of tariffs will not encourage neither lower consumption of electricity in industry, nor power saving.

According to international studies, an increase of electricity prices from 1 to 6 cents for 1 kWh will result in lower consumption of energy per USD 1000 of added value from nearly 3.7 tons of fuel equivalent (oil equivalent) to 0.5-0.6 tons[9]. It appears that lower energy prices do not really benefit industrial consumers in terms of growing savings and profits but largely cause a waste of resources. It is argued that high fuel and energy prices will benefit natural monopolists and oil companies. But their extra revenues could at least be taxed. It is also possible to increase taxes in order to collect royalties and lower the tax burden for other sectors. But nobody is winning from the current situation, everyone is only losing.

Under this situation it makes sense to follow U.S. indicators.

Movements of Prices and Tariffs

It has been asserted that using their monopolistic position following the price liberalization natural monopolists managed to raise prices of their products faster than the other industries and so their prices are disproportionately high as compared to those of other industries, with other industries being forced to pay extra charges. Shown in Table 11 are deflator indices of the GDP and specific industries in 1995, 1998 and 2000 as compared to 1990.[10] That data shows that one of the highest rates of price growth among the natural monopolists was registered by the power generation industry (its prices grew 23,080 times in the period of 1990-2000). It was only surpassed in that respect by oil production, the oil refining industry and trade; and in the period of 1990-1998, by trade alone. The oil producing and oil refining industries raised their prices sharply in 1998 (as a result of a price rise in the world oil market), while power generation came to lag behind the others at that time (in the period of 1998-2000, its index amounted to 1.51, while the GDP index stood at 2.26). It is to be noted that the most extensive growth in those prices was observed before 1995.

While being another natural monopolist, the gas industry registered a much more moderate growth of mere 14,210 percent (246.6 percent in the period of 1995-1998). Unlike RAO UES, Gazprom has been able to subsidize its domestic prices out of proceeds from international sales.

It is also to be noted that in trade (which is a market-based sector) the growth of prices was higher than in any other sector of the national economy, except the oil refining industry).

Table 11. **Deflator Indices of Various Economic Sectors and Industries**

	1992 to 1990	1995 to 1990	1998 to 1990	2000 to 1990	1995 to 1992	1998 to 1995	2000 to 1998
GDP, in market prices	36.3	3,852	7,394	16,691	106.0	1.920	2.257
Commodity production *	31.2	3,156	6,079	13,482	101.1	1.926	2.218
Services *	52.1	4,607	8,445	18,339	88.4	1.833	2.172
Industry**	43.3	3,767	6,381	14,323	87.1	1.694	2.245
Including by sectors:							
Power generation	54.2	7,100	15,285	23,080	130.9	2.153	1.510

[9] EBRD. Transition Report 2001, p. 94.

[10] The data (originally produced by the CEC of the Government of the Russian Federation) has been corrected especially for the purpose of this Report by E. F. Baranov, through whose courtesy the author has been able to use it.

Fuel industry	89.9	5,759	8,514	29,690	64.1	1.479	3.487
Oil production	132.4	6,339	9,854	40,360	52.4	1.420	4.096
Oil refining	100.8	7,563	13,747	56,939	75.1	1.817	4.141
Natural gas production	25.7	2,451	6,044	14,210	95.2	2.466	2.351
Coal production	55.6	4,577	6,726	10,195	82.3	1.470	1.516
Iron & steel production	61.3	5,178	7,277	17,637	84.4	1.405	2.424
Nonferrous industry	68.1	3,626	6,375	19,114	53.2	1.758	2.998
Chemical and petrochemical industries	47.8	4,029	6,093	11,953	84.3	1.512	1.962
Engineering and metal work industries	27.5	2,618	4,706	10,171	95.2	1.798	2.161
Wood, timber, pulp and paper industries	34.3	3,741	5,465	13,627	109.0	1.461	2.494
Production of construction materials	35.5	5,306	9,088	15,440	149.5	1.713	1.699
Light industry	29.3	1,992	3,104	6,331	67.9	1.558	2.040
Food industry	36.4	3,053	5,776	12,968	83.8	1.892	2.245
Agriculture	19.3	1,914	3,453	8,460	98.9	1.804	2.450
Construction	34.2	5,457	10,645	21,373	159.6	1.951	1.815
Transport	39.0	6,777	11,840	21,492	173.7	1.747	1.815
Trade and public catering	180.3	9,815	17,110	44,070	54.4	1.743	2.576

* Calculated using gross value added index
** All figures of specific industries have been calculated on the basis of output/volume of production in basic prices
Source: CEC of the Government of the Russian Federation.

Agriculture and the light industry were hit the hardest. It is to be concluded that monopolistic position was not the only factor that helped certain industries to win the ‘price race’ during the high-inflation period; also important was their ability to resist competition. The products/services of such industries as power generation, natural gas production and railway transport are vital, unlike the defense industry’s products and even agricultural produce (which can be imported). Those industries’ vital significance made the authorities in the particularly grim period of the crisis to turn a blind eye to the disproportionately fast growth of their tariffs, the more so since there were practically no special bodies in charge of supervision of those industries at that time. It is also to be noted that the price rises did reduce the volume of subsidies (which had been great indeed in the Soviet era), but by no means brought an end to the practice of subsidizing (as is evidenced by the still existing differences between the prices in the domestic market and the international markets and also by the lack of efficiency in use of fuel and energy resources).

There are also other estimates of price movements in the period of 1990-2000. A. N. Illarionov, for instance, believes that in the December 1991-December 2001 period the electric-power rates grew 23,503 times over; the natural gas prices, 35,630 times over; railway transport tariffs, 17,754 times over; the pipeline tariffs, 10,301 times over, while the prices of manufacturing industries' products, 10,301 times over and consumer prices, 8,578 times over. Those figures show that the rate of price growth was the highest with natural monopolists. However, as can be seen, the CEC data is very different from the above figures.

For their part, spokesmen for the power industry argue that the data contained in official statistics only refer to the approved rates (in the same manner as in the Soviet era all statistical data was calculated on the basis of approved price lists), and if the effective privileges and discounts were taken into consideration, power industry's tariff index would be less than that of other industries (and other sectors of the economy).

However, we are going to use the CEC data, since we believe it to be more accurate than any other estimates, and there is no evidence to the contrary.

As to the qualitative aspect of the matter, the situation developed as follows.

In 1995, when another (third) attempt was made to ensure financial stabilization and it became clear that mere introduction of monetary restrictions would not do the trick, the natural monopolists' prices/tariffs were frozen. (That is why the rates of growth of such prices/tariffs were lower than those of the prices of manufacturing industries' products that year. The same thing happened in 1998, after Kiriyenko's anti-crisis program was implemented. Generally speaking, in the 1997-1998 period, the Government kept pressurizing natural monopolists into lowering of the prices. However, by that time, natural monopolists had considerable reserves (amassed in some cases through a disproportionately high rate of growth of prices/tariffs, while in others through annuity-like proceeds from international sales). They also had such an asset as a really immense accounts receivable (large numbers of their customers failed to pay for their products/services in a timely manner or paid in kind).

However, the situation changed dramatically following the 1998 crisis.

The domestic price indices (2001 on 1998, percent) were as follows:

- Industry 302.9
- Fuel industry 458.0
- Natural gas 207.0
- Residual fuel oil 267.0
- Power 222.3
- Heat 191.6

The reserves amassed earlier became devalued, and the monopolists' price growth became the slowest instead of the fastest. The problems which remained unsolved in the happier days (when the natural monopolists still had the resources) became acute and urgent. While before, even taking into account the disproportionately fast growth of prices, natural monopolists subsidized other sectors of the economy and even sustained their growth in the 1997-2001 period, it seems that there will be no chance of that in the future. For years those industries have been wasting their capital, obviously in the hope that when need be they would be able to use the extra capacities that had stood idle since the recession in production. However, when economic growth actually began it turned out that many of those capacities were too worn to be usable, while operation of others would mean exuberant costs. Major investment and stimuli for thrifty attitudes to resources are needed if the situation is to be rectified. A rise in the prices and tariffs is needed even for investments and lending. The Government has, in fact, acknowledged that by consenting to raise natural monopolists' prices in 2002.

Reforming Natural Monopolists

It is believed that a rise in the prices of natural monopolists' products can be avoided if a reform of the natural monopolists is carried out. It is asserted that such a reform could be essentially the same with all such industries and consist in separation of the market-based operations and subsequent reduction of the costs and prices by means of competition. Analysis shows, however, that such a reform can only be carried out in power generation.

In that industry, separation of the mainlines (those operated by a system operator) would really mean isolation of the natural-monopoly segment. Generating companies would have an equitable access to networks and be able to offer their services to corporate consumers or local power distributors on a competitive basis, provided the existing local power monopolists (of the AO-Energo type) cease to exist. Even that task is by no means easy. In theory, the power rates could be stabilized or even somewhat lowered in two to three years, once restructuring of RAO UES is completed, that is, no sooner than in 2006 or 2007.

As for Gazprom, separation of its market-based operations is fraught with considerable difficulties caused by the fact that most of the natural gas produced in this country (over 90 percent) is produced on three or four gas fields in northern areas of West Siberia. Neither natural gas production on other gas fields, nor production of oil gas is capable of competing with these, either in costs or in output, except on local markets. Besides, since Gazprom is a major exporter, it is advisable to maintain it as a single company. The purpose of reforms in that sphere should be, therefore, to ensure transparency, better management and access to pipelines for independent producers, rather than introduction of intra-industry competition. Even if competition were to be introduced, there would be no material reduction in the costs.

At present, Gasprom is working gas fields with dwindling outputs. The last remaining major deposit, Zapolyarnoye, is expected to permit maintenance of gas output at over 530 billion cubic meters a year. However, even now 30 billion cubic meters of natural gas has to be imported from Turkmenistan, so that Russia's export obligations are continuously met. The price paid for natural gas thus imported is $45 to $50 per 1,000 cubic meters, which is three times the domestic price of natural gas. And it becomes ever more obvious that the natural gas prices in Europe may nose-dive (the gas directive of the EU provides for establishment of a spot market and toughening of the competition, which may result in the prices going all the way down to $45 to $50 per 1,000 cubic meters.

Free competition on the domestic natural gas market in Russia, and, therefore, reform of Gazprom in accordance with the standard scheme (separation of market-based operations) will only be possible after the major deposits become depleted and the production costs there become comparable to those on smaller and higher-cost gas fields (situated in the vicinity of Orenburg and Stavropol) and the oil gas production costs. However, in such a situation Russia will cease to be a major natural gas exporter and the domestic gas prices will grow considerably.

A similar situation is to be observed in railway transport. Analysis shows that introduction within the framework of a single infrastructure of competition between railway companies, cargo and passenger alike, is practicable in principle, but is likely to push up the costs. The historically-determined situation on the Russian railways is such that centralized management of that sector as a natural monopolist is advisable, not only in respect of maintenance of the railways proper, but also in respect of maintenance and operation of the rolling stock. At least, not a single attempt to prove the contrary has been successful, much as one may be willing to accept such proofs. Nor have there been any success stories in that sphere abroad, nor any international experience for us to draw upon.

Rather than mull over the issue of introducing competition in railway transport, the public should concentrate on another question: why did the Ministry of Railways, being in the situation of definite lack of rolling stock, decide to invest in construction of a bridge to link Sakhalin Island with the mainland and also in Transtelecom?

As can be seen, reformation of Gazprom and the Ministry of Railways would hardly bring about any reduction in costs or prices. It is also to be noted that considering this country's size and low density of the population, it seems advisable that passenger transportation by rail and by air be subsidized (for social reasons).

From the above, one can draw the conclusion that **the task of equalizing relative prices and conditions of competition cannot be achieved through reform of natural monopolists** towards reduction of the non-market sector of the economy. Except in the case of power generation, such reforms are not as topical an issue as it would seem.

Such reforms should be seen as part of the reform in public sector management rather than as a factor of lowering prices and tariffs. The principal objective of such reforms is to ensure transparency, put an end to abuse and make public control possible.

A Manoeuvre to Change Relative Prices

Having discussed the above, we can now resume discussion of the issue of reduction of the non-market sector and leveling of the relative prices and estimate the scope and implications of such a manoeuvre (which, as it would seem, needs to be implemented if healthy development of Russia's national economy is to be assured).

We can now formulate this point in the following way.

The government subsidizes the economy and the populace through a mechanism of regulation of prices of natural monopolies' products. (See Chart 1).

Exporter industries gain higher profits (from which the costs of ineffective use of fuel and energy should be deducted, though). In part, exports are supported in this way and Russian exporters, especially exporters of raw materials, gain artificial competitive advantages.

In the non-exporting sectors, subsidizing through the natural monopolists' prices and tariffs enables unprofitable enterprises to survive and pushes down the efficiency criteria. The above data on the share of the non-market sector in industries would have been very different if those prices were raised by 100 to 200 percent (it is supposed that the share of enterprises with negative value added is higher by 50 to 100 percent). As a result, modernization has been impeded and motivation for modernization slackened.

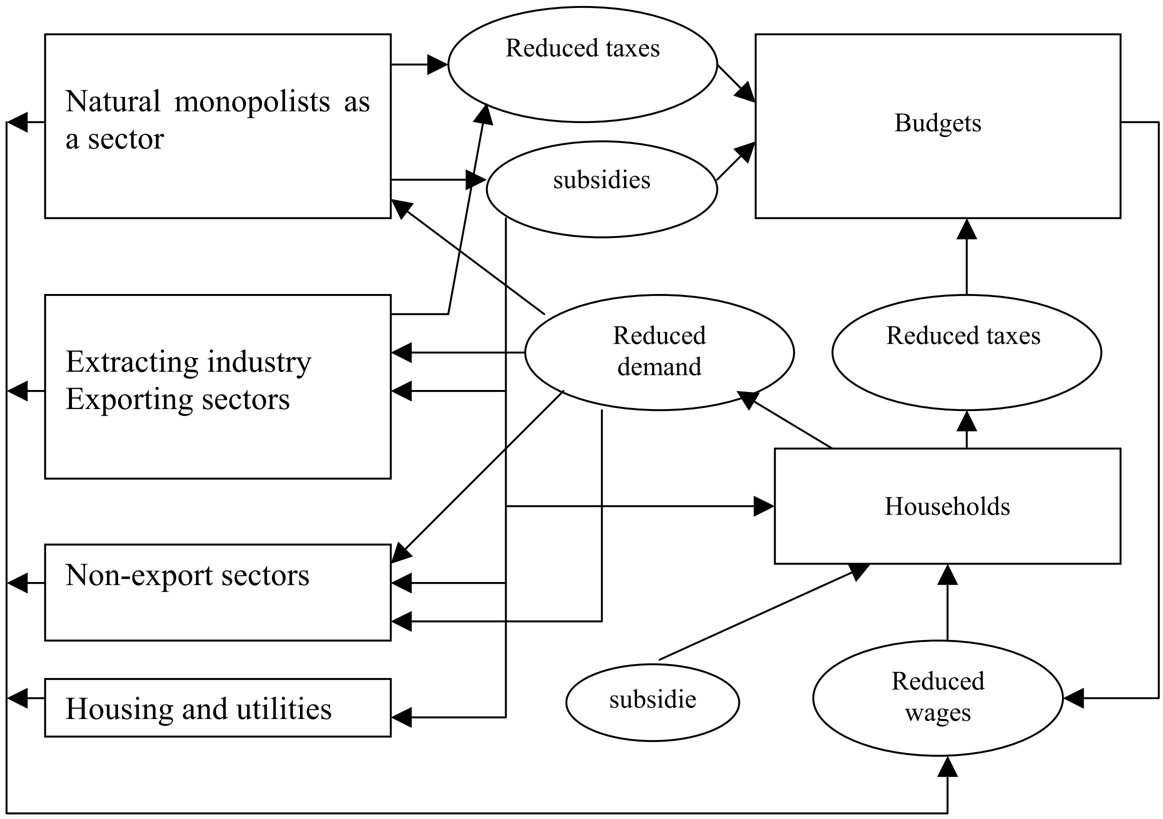

Chart 1. Non-market sector in the Russian economy

Housing and utilities are a most illustrative example of the remaining non-market sector, a pocket of the Soviet-era economy which has remained practically unaffected by change, a bulwark of inefficiency and corruption whose expenses have been reimbursed partially out of the budget, partially out of citizens' pockets and partially through subsidizing of the power rates, gas-, water- and heat-supply tariffs, sewage services and other public utilities.

The budget has benefited by public-sector institutions' reduced spending on the natural monopolists' products, but has paid subsidies and under-levied taxes.

Citizens seem to benefit from the subsidized prices of housing and public utilities, as well as numerous privileges in respect of public transport fares. However, they are underpaid at work, especially those working in the public sector. In this way, citizens have been forced to pay indirectly for the 'privileges' granted them and services supposed to be available to them free of charge or at reduced rates. People with low incomes have been hit the worst, social differentiation has been ever greater.

Natural monopolists themselves lack money for investment (apart from subsidizing the rest of the national economy, they have been seen by the authorities as an 'hidden purse', in respect of which, unlike the budget, there is no legal restraint). That natural monopolists are wealthy, is a mere illusion produced by centralization of financial resources of a vast number of poor producers (which eventually have to be given financial support) and by many years of waste of their fixed capital.

To the national economy as a whole, that means inequitable conditions of competition (which favor exporter industries and disadvantage non-power-intensive hi-tech industries) impeding all favorable structural change. That also means inefficient use of resources and reduced solvent demand in investment, consumer goods and services. That also means narrowed choice for the consumers and opportunities for manufacturers (and those factors, though their influence on the economy does not become obvious at once, constitute the principal impediment to the processes of renovation of the economy).

There is thus a dire need for further reduction of the non-market sector. The plan proposed for that purpose is a momentous structural maneuver, rather complex from the social point of view which is expected to crown the reforms launched in the late 80s and early 90s and to shape the structure of a free market economy. The task being very complex and comprehensive, thorough studies and calculations are required so that every eventuality is provided for and the reforms are carried out in conditions of economic and political stability.

Yet, some very rough preliminary estimates have already been made. Those are discussed below with indications where necessary of the need for further elaboration.

The estimates are in respect of consequences of raising of the natural gas prices and power rates. Since the international prices of Russian-produced natural gas are higher than the domestic natural gas prices by around 600 percent, and the former are most likely to drop by 30 to 40 percent, let us assume for the purpose of calculation that the domestic natural gas prices should be 33.4 to 50 percent less than those on the international markets so that Russia's competitive advantages are preserved. Proceeding from such an assumption, it is to be concluded that the domestic natural gas prices should be raised by 200 percent on the 2000 figure. When such a level should be achieved is a separate question. In respect of power rates, let us assume for the same reason that they should be by 33.4 to 50 percent lower than the power rates in the US. The minimum required rise in such prices will than be by 100 percent on the 2000 figure. The time-limits are not specified in that case, either, for any decision on that matter is of a political nature.

The calculations were done using the 2000 figures. They have shown that in this situation a reduction in the amount of subsidies or increase in consumers' costs would be as follows:

- In respect of natural gas, Rb 225,000,000,000 to 230,000,000,000, plus growth of the power industry's costs by about Rb 130,000,000,000 to 135,000,000,000;
- In respect of electric power, Rb 360,000,000,000 rubles to 370,000,000,000;
- Total, around Rb 590,000,000,000 to 600,000,000,000.

It is presumed that in exporting industries such an increase of costs may be compensated out of revenues, and also through reduction in power consumption (by means of energy saving) by at least 15 percent. There may be a certain rise in domestic prices of those industries' products, but it cannot be significant since there are limitations imposed by specifics of the demand.

In **non-exporting industries,** with the same level of energy saving (15 percent) and investment in resources-saving technologies there may be a price rise by four to five percent.

In the housing and public utilities sector, provided a minimum reorganization is carried out for the purpose of introduction of competition and consolidation of proprietors of housing and fuel and power saving of 10 percent is ensured, the cost of housing and public utilities (with reference to the 2000 conditions) will grow Rb 125,000,000,000 to 130,000,000,000, with the difference to be covered by households.

The budget will be compensated for its loss by a growth of revenues from taxation of the natural gas and power industries and through discontinuation of subsidizing of the housing and public utilities sector. It is thus to gain the resources for raising of the public sector workers' pay.

Households' spending will be increased, first, due to a growth of the housing and public utilities sector tariffs, second, due to discontinuation of the existing privileges in respect of gas prices and power rates and growth of prices of non-exporting industries' products. According to our estimates, the resulting growth in expenses is to amount to 7 to 12 percent.

Households can be compensated for those increased expenses in the following ways:

- Housing subsidies to such families as have to pay for housing and public utilities a higher proportion of their budgets than the maximum acceptable percentage specified by the law (15 to 20 percent);
- Privileges in respect of mortgage loans (subsidizing of the interest rates);
- An around 30-percent rise in pensions and benefits in combination with an increase in the funded portion in the contributions to pension funds;
- Pay rises to public-sector employees.

Spending for those purposes out of the general government's budget may amount to up to 70 percent of the amount by which households' spending will be increased, that is, between Rb 130,000,000,000 and 135,000,000,000 (with reference to conditions of 2000). It is supposed that for the remainder of that amount households will be compensated through rises in wages and salaries of workers employed in the non-public sector (which rises are expected to take place, in particular, because a new balance on the labor market is to be established).

As a result, citizens' annual solvent demand (which is a factor stimulating economic growth) is to grow by around 4% to 6% (with payment for the housing and public utilities services not counted in; with payment for the housing and public utilities services counted in, such a growth will amount to 12% to 18%). Apart from that, investment demand for energy-saving technologies and equipment is to grow, including in the housing and public utilities sector and ousting of centralized heat supply with up-to-date local boilers is to begin.

The estimates discussed above are but rough and in need of thorough elaboration. Yet, they show that the change businesses and households are to face will not be very significant or difficult to endure. The effect of that change (if spread over a period of one year) will not be so great, either. There may be a certain slowdown in the economic growth and a rise in the rate of inflation. However, in time expansion of the market sector and monetary relations (and, as a consequence, broadening of the opportunities of choice for manufacturers and consumers) are to create better conditions for ensuring greater efficiency and economic growth.

The above structural change will not be equally beneficial to different economic sectors and industries, so, there will be a vast variety of opinions in this respect among members of the business community. We believe that factors generally beneficial to Russian businesses (factors that create favorable conditions for economic growth in this country) should be distinguished from developments of a purely local significance and interests vested therein. Members of the business community should accept the inevitable change on the markets and adjust their businesses to it, especially in cases where such change benefits the national economy as a whole, even if it is not exactly favorable to certain economic sectors in a specific period of time.

5. The Role of the Government and Structural Policies

With the task of performing such a manoeuvre at hand, the issue of the role played by the government in the national economy as a whole, especially during the period of modernization, is quite topical. That issue is also known to play an important role in the dispute between the two principal groups of economists, liberals and advocates of dirigisme.

On the whole, we support the liberal approach to that matter with our principal arguments in favor of that stance being as follows:

First, the principal driving force of development of the modern post-industrial IT-based economy is creative and inventive ability and enterprise of individuals. The best results are achieved where the individual has the most personal freedom and opportunities. While the industrial era favoured Fordism, conveyor systems and monopolization for the sake of economizing through mass scale of production (all of which proved to be a breeding ground for totalitarian regimes), in the postindustrial era the preferences are exactly the opposite. Freedom is an indispensable condition of development now. Hence the tendency towards liberalization observed world-wide.

Second, Russia has already experienced modernization ‘from above’ on two occasions, in the reign of Peter the Great and in the Stalin era. On both occasions such modernization brought about long-lasting unfavourable consequences, such as hypertrophied role of authorities, suppression of the freedoms and lack of opportunities for development of the individual. As a result, the bureaucracy wielded formidable power, while a majority of the populace lived in poverty, the authorities’ rule was arbitrary and based on compulsion, while citizens were irresponsible, isolated and depressed. If that tradition of the omnipotent bureaucracy is continued, this country will remain backward forever.

At the same time, it is to be noted that even the pretty inconsistent moves undertaken in the closing decade of the XX century towards a free market economy and democracy showed that Russia does have the power and energy for fast development on the basis of private enterprise. In our belief, that policy (which has been carried on and enhanced by President Putin) is the right one.

If that is true, the main principle of the government’s economic policies should consist in further liberalization and de-bureaucratization of the economy, lowering of the administrative barriers currently faced by those willing to enter the market or start businesses of their own and enhancement of rule of law (required for ensuring of stability and transparency of business activity). The government also has other functions, in particular, in such spheres as defense, security and protection of such citizens as are unable to work, but we are not going to discuss those functions herein. Seen as social factors guaranteeing personal freedom, proprietary rights and favorable prospects for business activities should be stability on the macroeconomic level, a balanced budget, a low rate of inflation and a stable national currency. This is what Ludwig Erhardt who proposed the ‘social market economy’ scheme (upon which the post-War German ‘economic miracle’ was based) meant when he added the word ‘social’ to the name of his scheme: the government should ensure favourable conditions for realization of the potential of a free and responsible individual, but not take too much upon itself (meaning that the government should not give such guarantees as would breed parasitic attitudes).

According to that principle, the government should not assume direct responsibility for economic growth. That issue should be handled by businesses. The role of the government should be confined to encouraging private enterprise. And that is what the Government has in view today in taking measures aimed at improving the business and investment climate. This time, modernization in Russia should come from below.

At the same time, as we have seen, modernization requires change in the Russian national economy’s structure, termination of its primary reliance on fuel and raw material production, accelerated development of science-intensive high-tech industries, ensuring of a high competitive capacity of those industries and their staying power on the market. Market mechanisms alone cannot ensure structural change of this kind (in fact, they may trigger off quite the opposite tendencies), so, the government will have an important role to play in that sphere.

In this connection, the question arises of what the structural policy should be like and what methods should be used in its implementation. Advocates of an ultra-liberal approach to that matter believe that no structural policy would be the best structural policy. In our belief, however,public policies cannot be based on a single theoretical scheme. It should be primarily guided by common sense and take into account the actual situation, in particular, the specifics of the current stage in the country’s development. The specifics of the present stage consist in modernization and a need for structural change, so, an extensive structural policy is required. It is such a policy that should ensure achievement of the above-specified tasks, such as transformation of savings into investment, development of the banking system and leveling of the relative prices and conditions of competition.

At the same time, it is important that structural policy should not be at variance with the adopted strategy of development of a free-market economy and modernization through private enterprise. That does pose certain difficulty which can only be overcome through use of unconventional, flexible methods. These should preclude:

- Granting of any individual privileges, in the form of tax exemption or in any other form;
- Any such large-scale subsidies or investment by the government as would mean increased tax burden;
- Including subsidizing through regulated prices;
- Official establishment of any such priorities in respect of specific sectors of the economy as would require financing out of the government budget.

The above limitations are based on the experience amassed and on the adopted economic strategy as a whole.

Since intensification of the structural policy is a must and its objective consists in stimulation of priority development of manufacturing industries and export of manufactured goods and high technologies, it seems advisable that the following principles be adopted:

- Any support by the government is to be granted on a comparatively small scale, in the form of co-financing or in other forms presupposing businesses’ responsibility for implementation of the projects thus supported;
- Any support is to be granted only to such products and businesses that have gained a repute on the market and proved their competitive capacity; in this way, the real priorities will be determined;

- Financial support is only to be given to winners of public, transparent tenders.

It is generally known that before there was much abuse in organization of such tenders, and so they are generally distrusted. But it is to be admitted that either we manage to civilize them (just like control over budget expenditure or the functioning of the customs authorities) or kiss goodbye to the dream of this country's prosperity. We cannot go on explaining every failure by weakness of the government and omnipotence of corrupt bureaucrats. For rectification of the situation, a reform of the judicial system and an administrative reform are to be carried out, so, society is prepared to accept various innovations aimed at consolidation of public institutions.

On the basis of those principles and taking into account the positive experience amassed, the following mechanisms for implementation of the structural policy can be suggested.

1. Thorough analysis of the Russian **manufactured goods and services exports,** especially highly technological ones, for the purpose of selection of such of these as show promise as market-winners and require support, including public support, in their promotion. Export capacity is thus to be seen as one of the criteria in selection. One of the acceptable methods of support of exports may consist in the government guaranteeing loans received against export contracts.
2. Creation of as favorable conditions as possible for development of all **small businesses,** including simplified taxation procedure, privileged tax rates and support of favorable terms in borrowing, including through subsidization of interest rates. Small business has traditionally been Russian national economy's Achilles' heel, yet, it has the potential to contribute a great deal to this country's economic growth.
3. Establishment of a separate system of support of **small innovation businesses.** Its main objective is creation of favorable conditions for incubation of viable ideas and products. The methods of support to be used consist in establishment of pools of equipment or innovation technology centers (ITCs) and contribution to development of the more viable of these, subsidization of the infrastructure created within the framework of such institutions and making available of that infrastructure on a temporary basis free of charge to businesses active at the pools of equipment and ITCs, and also subsidization of the interest rates of bank loans.
4. **After-care programs** (in the meaning adopted in international practice) which consist in creation of favorable conditions for development of promising products and businesses (those capable of winning and retaining markets). The principal form of such programs could consist in temporary (five years max) participation in such businesses' capital and subsidies for development of distribution networks, training of personnel, and the like. According to our estimates, the cost of such programs at the initial stage (in 2002-2003) could amount to up to $2,000,000,000-$3,000,000,000.

To make those mechanisms work, special institutions and authorities are needed. In that connection, it seems appropriate to return to the issue of a development budget, government agencies of the export-import bank type, an investment insurance agency, a fund for support of small businesses, and the like.

The proposed measures and methods may be unsatisfactory from the point of view of liberal principles or from the point of view of structural policy's objectives. But the problems are there, and in need of dealing with.

6. Consolidation of the Russian Business Community

The two social forces that are able jointly or individually be the motive power of the reforms after completion of the revolutionary stage of the transition period in Russia are bureaucrats and the business community. With bureaucrats dominating, the role of other public forces will sooner or later be reduced to a subordinate one, while their energy, suppressed. However, bureaucrats are only able to carry out the reforms from above justifying their methods by passiveness and unpredictability of those they rule. On the other hand, modernization coming from below (which has been prescribed to Russia by international experience and its own experience in the past) is feasible only in a situation where the business community plays a leading role in that process, while the bureaucrats render them assistance in that cause. One may wonder if it is possible at all and, if so, in what circumstances?

With all the evident merits and clear breakthroughs of the policy pursued by President Putin (including speedy and almost painless resolution of problems related to the weakness of the authorities which this country experienced under Yeltsin's presidency there are facts pointing to a dangerous degree of excessive concentration of power which has considerably strengthened bureaucrats' positions. Within a brief period of time, the following has been done:

- The arbitrary rule by governors has been put to check; the reform of the Council of the Federation (the Upper House of the Russian Parliament) has been completed with the latter keeping to the executive authorities' heel since 2002. The regions have been placed under a stricter control by the President due to introduction of the institution of authorized representatives of the President in the federal regions.
- A pro-presidential majority has been formed in the Russian Parliament which has enabled the executive power have the Parliament pass practically any statutory acts it favors. Such a state of things could be considered normal, if the government were formed by the same parties as have a parliamentary majority. However, things are not done this way in this country.
- Legislation on parties has been enacted which has limited political parties' of getting into the Parliament, and also their chances of remaining independent from the executive authority (which exercises a mild control over the election process). To preserve their independence political parties will have to stay out of the Parliament. Thus, the power of the political pluralism, one of the most important institutions of any civil society has been seriously affected.
- As before, the judiciary are not entirely independent. In most cases, courts, law enforcement bodies and especially the Procurator's offices, are zealous to show loyalty to the President and guess and anticipate his every wish.
- With all legal formalities observed the freedom of speech has been restricted in practical terms. Official censorship has not even had to be introduced for that. Taking advantage of the economic situation in which the media have found themselves, the authorities used individual cases if the situation required to demonstrate their ability to punish the media (that measure alone was quite sufficient to make editors-in-chief of many newspapers and magazines to introduce the self-censorship). That and the practice of the media circulating with impunity biased materials prepared to order from interested parties, which practice became so widespread even before the above events that by now it seems almost

acceptable the ability of the mass media to perform their social and political function has become very doubtful.

- Cleverly designed measures, including enhancement of the status of the armed forces and security services have secured such loyalty of those forces to President Putin as Boris Yeltsin never had. That loyalty has in no way been affected by the obvious change in the foreign policy priorities, by appointment of a civilian Minister of Defense or by the President's serious intentions to carry out a military reform. On the contrary, the President has managed to strengthen his positions more than ever.

All those measures are of a legitimate nature and well grounded from the point of view of society's requirements. Political stability and continuity of the reforms have been secured. All the dreams of the Yeltsin Administration have come true. The hierarchy of power has been established. All the President's instructions are complied with (as well as the bureaucrats' efficiency permits). All these initiatives are supported by the majority (at least, they have not met with any open opposition).

It seems that there is no need to play up the danger of all those measures for the prospects of Russia's long-term development as a democratic country based on a market economy. It is just that the pendulum set in motion by revolutionary reforms has now swung in the opposite direction. It is to be hoped that sooner or later a balance will be achieved though, certainly, that will require some effort.

However, one threat is becoming ever more evident. With the authority relying on bureaucrats it is highly probable that the reforms will be carried out from above and thus the role of the business community, trade-unions and other institutions of the civic society will be reduced to that of a 'drive belt'. In such a situation, the business community should make its voice heard.

The revival of private enterprise in Russia (which started with enactment of the law on cooperation in 1988) has demonstrated a vast variety of different, sometimes conflicting trends:

- Emergence on the scene of new strivers for property and flows of money;
- Transformation of the old-type management (the so-called 'red directors') into managers and owners of market-oriented companies;
- Formation of the big business, including the emergence of the so-called oligarchs who during Boris Yeltsin's presidency benefited from their connections with the authorities;
- Extensive development of small businesses at the initial stage followed by their stagnation and, finally, decline, primarily due to the strengthening of the bureaucrats' positions;
- The 1998 crisis which brought about such dramatic changes in the structure of the Russian business community as a decline in the banking system and strengthening of exporters and import substitution industries.

By the time Vladimir Putin came to power, the Russian business community was very disunited. Major businesses tended, each, to establish some special relationship with the authorities on different levels from which they could benefit. In pursuing that goal they tried to oust their competitors and get their men in 'the right places'.

Managers from among former Soviet directors established two organizations: the Congress of Manufacturers of Goods which is headed by N. Ryzhkov and usually takes a conservative, procommunist stance, and the Russian Union of Industrialists and Entrepreneurs (RUIE) which is headed by A. Volsky, always takes a centrist stance and seeks to maintain constructive relations with any government. In the very beginning, the RUIE was joined by some groups of new entrepreneurs such as the Association of Joint Ventures, the Union of Co-operatives and others. In the 1991-2000 period, the RUIE was the most influential business association, however, its influence was limited.

Liberals, while still in the government, initiated establishment of an Association of Private and Privatized Industries which took quite the opposite stance to that of the Congress of Manufacturers of Goods, that is, right-wing. However, the Association never became an influential force, either.

The principles of association in entrepreneurs' organizations were mostly of a political nature with most businesses remaining unassociated and forced to face the authorities, criminals, competitors and employees on their own. However, the latter showed even less ability to associate for the purpose of protecting their own interests than their employers.

One of Putin's first remarks on the issue of relationship between the authorities and oligarchs which was of interest to the public in those days was: 'We shall ensure equidistance'. And shortly after, many well-known businessmen understood that those were not mere words: their offices, one by one, were visited by the police in camouflage which people call the 'Masky Show' after the name of a popular TV show. And it became no longer possible to kick doors open to the offices of high-ranking government officials. The more quick-minded soon realized that in future it would be impossible to strike a deal with the authorities single-handed. The business community had to unite, since only organized business could talk to the authorities if not as their equal, at least, with dignity. That was the only way to defend properly their corporate interests. As a result, the RUIE was revived and thoroughly renovated with new forces and major businesses joining its ranks and big money was brought in. Consolidation of the Russian business community became a real possibility from that time. Meetings between the President and major businesses became regular, just like meetings of the Council on Private Enterprise at the office of the Prime-Minister where businessmen could voice their views on key issues of economic policy (and their advice was often heeded). The Committee on Problem Issues set up at the RUIE Board Bureau organized work on examination of proposals prepared for the government and the Parliament and development of the required argumentation.

The Committee had an important role to play in preparation of Russia's joining of the WTO: it helped to find out the real state of things in most sectors of the economy and form the position of the Russian Government at negotiations on that matter (that position took into account recommendations put forward by businessmen).

The RUIE's proposals on the reform of the banking system and liberalization of the foreign exchange regulation were no less important. Those instances revealed another specific feature of the consolidated business: even if their recommendations on issues of the economic policy are not fully accepted, these constitute an articulate alternative in the public dialogue, which alternative is usually liberal. And that is what is really needed.

The authorities could not but be alarmed to some extent by strengthening of the positions of the Russian consolidated business. In their typical manner of the recent years, the authorities initiated establishment of new entrepreneurs' organizations such as Delovaya Rossiya (the Business Russia) to unite the medium-sized businesses and OPORA (the Support) for the small businesses, in order to make every institution of society to play its own role and mind exclusively its own business and rather than claim greater independence from the authorities. In itself, establishment of those organizations may be a sensible thing, since the interests of big businesses and the interests of the small businesses are quite different and the latter need some protection. It is important, though, where the initiative comes from, from above or from below.

At the same time, the above suggests that establishment with support of the Administration of the new organizations, just like enhancement of the role of the Chamber of Commerce and Industry can be regarded as measures aimed at prevention of further consolidation of the Russian business as an active social force which may oppose bureaucrats. And this is another proof of the important role played by the business community at the current stage of this country's development and the business community's important social duty.

It is to be noted that all authority should not be identified with bureaucrats though the former is inclined to fall under the influence of the latter. Business is in a position to play the role of a counterweight to counterbalance that influence.

Business should not go into politics. The merger of the authorities and business, such as was observed during Yeltsin' presidency, is harmful. But as a social force whose mission is not limited to the lobbying of the private interests of its individual representatives or groups, business cannot be indifferent to politics. For this reason, it should:

- Seek consolidation to resist pressure by bureaucrats and ensure reformation of the Russian national economy from below, on the basis of private enterprise;
- Be represented politically by parties which as members of the ruling majority or the opposition could protect common interests of the business community and free development of the country;
- Support such institutions and organizations of civic society as defend human rights and freedoms, as well as democratic values, since business has vested interest in those values becoming deep-rooted in Russia forever. That is its shield against the bureaucrats.

As is known from Russian history, the bourgeoisie has once failed to play that role because of its fear of the authorities and its reluctance to assume responsibility. And that led to the Revolution of 1917. The same thing may happen again.

Today, the opportunities for prevention of a repetition of the past are there. Those opportunities should be used.