RUSSIAN ECONOMY: ON THE VERGE OF GROWTH OR STAGNATION?[1]

Andrej Klepach

Senior Researcher, Institute of Economic Forecasting, Russian Academy of Sciences, Moscow

The financial crisis, followed by the deep fall of the rouble exchange rate and budget default on internal debt, brought about certain significant changes in the macro-economic situation. After meeting the acute phase of the crisis in August-September 1998, there has been industrial growth in the Russian economy combining relatively moderate inflation and widening money transactions between enterprises. In total, it is expected that this growth in industrial production will be of 8.1%, thereby bringing the economy back to its 1997 level. At the same time the financial crisis laid bare the long-term structural imbalances of the Russian economy: over-dependence of the financial system on world raw materials markets, the state debt crisis, the weakness of the banking sector and its isolated position from real production, the deficit of competitive manufacturing activities, the excessive level of imports, and the run-down state of most production facilities. The Russian economy and society found themselves not only facing the problem of simply switching over to the stable rise of production, but shaping the new model of economic development.

Economy of Overconsumption and Capital Deficit

The process of market transition in Russia has taken nine years to date and has proved to be very painful. Indeed, what has emerged is a market economy of a very specific type, characterised by its openness to the world market, by the predominance of the US dollar in financial turnover, and by a deep crisis in domestic production which features high levels of non-payment and barter. The scale of deformation and expenses incurred in the process of transformation have turned out to be so high that now it is fashionable to discuss the notion that not a market economy, but a “virtual economy” has been created in Russia. But in my opinion, the problem is not in the virtual state of economy, but in the deep structural and institutional disproportions inherited from the Soviet time as well as those acquired in the process of the rapid change towards the market and Western values in general. I now wish to analyse the main structural disequilibrium.

Overconsumption? In spite of the huge scale of poverty prevalent by August 1998, the Russian economy has been characterised by a relatively high (in comparison to the real ability of the country) consumption level.[2] As industrial production fell by about 50%, household consumption declined by only about 20%. This gap was filled mainly by imported goods, whose share in retail turnover in 1997 jumped to 48%. It is hard to find another country with an economy in transition that allowed import penetration of its home market to such an extent. Multiple rouble devaluation reduced the disbalance slightly and has recently enlivened domestic production and helped to reduce imports noticeably (now just 56% of the peak level reached in 1997). As a result the import share in retail turnover fell to 36%.

Growing incomes from raw material export and capital flight (including hard currency purchase and account opening by individuals) formed the financial basis of these lavish imports. As a result, real personal incomes fell by much less than GDP (approximately 15-18%). The share of personal incomes (money and in kind) in GDP rose from 40% in 1992 to 60% in the first half of 1998. The fall in the price of oil in 1997-1998 not only reduced exporters' incomes, but disrupted the level of personal incomes (especially of the "new middle class") and thereby the ability to import. In 1998-1999, real personal incomes reduced by nearly one-third. The volume of consumption fell by 13%. Under these circumstances, any improvement in people's welfare is focused not on the problem of rising incomes, but on the ability to expand imports and to boost the domestic production of consumer goods.

Capital deficit. The dark side of overconsumption (as well as of capital flight) has been the sharp contraction in investment. Between 1992 and 1998, investment into fixed assets fell by 75% with production capacity falling by around 25%. The average age of plant and equipment reached 16 years, thereby severely affecting the ability to produce quality competitive goods. Even in such industries as oil, it is going to be impossible in the near future to sustain the current level of production without a drastic increase (of at least two-fold) in investment. In agriculture, where investment is currently just 4% of the 1990 level, the decline in production potential has reached such a level as to threaten food security. Under these circumstances, the outlook for economic growth is actively constrained by the inability to increase investment and thus renew capital stock. The current growth potential of stimulating final demand and of utilising existing machines better is estimated as no more than 10-12%.

Devaluation has stimulated a fall in consumption, thereby increasing the rate of national savings. However, the chances of these savings being channelled into investment are not compromised by the state of the budget (since the deficit is now minimal), but by the dynamics of capital flight that now represents around 7-10% of GDP. Thus, the Russian economy is characterised by capital deficit (especially of high-quality capital) rather than by a lack of savings.

Table 1 - Main Macroeconomic Indicators and Forecasts (1997 - 2001)

	1997	1998	1999	2000	2001
GDP, bn. RBL	2 521.9	2 684.5	4 476	5 950	7 100
rate of growth					
to the previous year,%	100.9	95.4	103.2	103.5	101.5
deflator,%	116.5	111.6	161.6	128.4	117.6
Industrial production, bn					
rate of growth, %	102.0	94.8	108.1	103.5	103
deflator,%	111.0	110.8	164.8	133	121
Agricultural production					
rate of growth, %	101.3	87.7	102.4	102	103
deflator,%	109.7	111.5	188.5	148	116
Investment in Fixed assets,bn		408.8	402.4	599	810
1 000					
rate of growth, %	95.0	93.3	101.0	104	105
deflator,%	114.5	105.5	147.6	130	118
Export, bn.$	88.7	74.8	74.5	80	80
rate of growth, %	97.7	84.3	99.7	107.3	100
Import, bn.$	71.4	57.4	40.4	44	46.5
rate of growth, %	105.8	80.5	70.2	109	105.7
Retail turnover, bn. RBL	847	1 021	1723	2 250	2 880
rate of growth, %	104.7	95.6	92.3	104	103.5
deflator,%	112	126	183	126	120
Inflation					
CPI (December to December)	111.0	184.4	139	125	118
PPI(December to December)	107.5	123.5	167	130	115

Source: Ministry of Economy, Goscomstat, Development Center estimate and forecast

Reduction in savings due to capital flight. In 1998, the positive balance on both trade and current account fell. This was not compensated for by foreign capital inflow. Foreign investors turned away from Russia because of poorly developed financial markets and the budget crisis. In 1999, the significant positive foreign trade balance has not improved the level of hard currency reserves due to the negative balance on capital transactions.

As a result of devaluation, the rate of state external debt to GDP went up from 32% in 1992 to 121% in 1998. The foreign trade surplus creates more preferable terms for Russia with regard to its foreign liabilities than is the case for most countries in Latin America or South East Asia. Even under the condition of fulfilling all obligations on debt repayments in 1999, these should be only about 23-25% of expected export volume against 35-40% on average in Latin America and 20-30% in South East Asia. That is why the main problem of currency devaluation is on the one hand related to low private capital inflow and high capital flight out of Russia, and on the other hand, the inability of the budget to mobilise adequate resources to service the debt. Although the debt burden related to exports is not large by international standards, it does exceed all bearable limits regarding the federal budget and hard currency reserves. Annual payments on external Russian and Soviet debts in 1999-2001 will reach 30% of federal budget income (without restructuring, this would be 70%) and exceed gold and hard currency reserves by 1.7 to 1.8 fold. It is clear enough that the Russian financial system is not able to service payments on such a scale.

Table 2 - Capital Flows in US$bn (1994-1999)

	1994	1995	1996	1997	1998	1999*
Changes in indebtedness resulting from the non-supply of export revenue and import debt services	-3.9	-4.9	-9.8	-11,5	-8,4	-6.8
Purchase of currency, cash	-5.5	0.21	-8.8	-13,4	1	0.3
Net errors and omissions	-0.3	-7.9	-8.6	-7,6	-7,9	-8.4
Capital flight, total	-9.7	-12.6	-27.2	-32,4	-15,3	-14.9
Trade balance	17.8	20.8	23.1	17,4	17,4	34.2
Total: hard currency offers from foreign trade operations	8.1	8.2	-4.1	-15	2.1	19.3

* *Evaluation*

The likely balance of hard currency inflows and capital flight in 1999 has the potential to pay the Russian part of the debt burden (US$7.5bn) even without international financial credits. However, the failure of the tax system as well as the low level of hard currency reserves make it difficult if not impossible to sustain debt service payments. In this case, the burden of debt servicing falls not just on the budget but on the Central Bank as well. And with all this going on, the Central Bank also needs to increase gold and hard currency reserves to at least US$25-30bn from the current level of US$13bn. Reaching this level of reserves would be possible under the condition of capital flight reduction (including buying hard currency cash by individuals) as well as under the reconstruction of the net capital inflow in shape of credits, net and portfolio investments.

In the medium-term, the trade balance is likely to be reduced due to import growth and an expected fall in prices on oil and raw materials markets, caused in turn by a fall in demand in advanced market economy countries. Under these circumstances, even with a coordinated budget and Central Bank help, servicing the Soviet debt burden will constrain Russian economic growth potential since payments on debt combined with capital flight will be equal to investments.

Russia will be forced to reduce imports yet again, thereby reducing levels of individual consumption.

Rouble Devaluation and Perspectives on the Renovation of Russian Industry

Since August 1998, rouble depreciation has exceeded the limits dictated by liquidity supply, price rises or relative losses of raw materials and oil exporters. The relative equilibrium rate corresponding to the stabilisation of the balance of payments would demand a devaluation of not more than 30-50% (e.g. up to 8-9 roubles a dollar). However, the excessive depreciation of the rouble (to 26 to the dollar by the end of 1999) was determined not only by market psychology and the political crisis, but also by the structural problems inherent within the Russian economy, such as the low competitiveness of most industry and agriculture.

The large rouble devaluation has created significant opportunities to boost competitiveness both for exporters and for domestic producers via import substitution. Once again, Russia (as in 1992-1994) has become a relatively cheap state in dollar terms. In 1996-1997 the correlation between the nominal rouble rate and the purchasing-power parity of the rouble (for GDP deflator) was 1.7-1.8. As a result of the rouble's fall, by the end of the first quarter 1999 this gap jumped to 3.6.

Table 3 - Dynamics of Purchasing Power Parity (PPP)

	1996 Average	**1997** Average	**1998** June	**1998** December	**1999***	**2000****
PPP-consumer products	2.11	2.60	3.04	5.38	7.3	9.18
PPP-investment products	3.92	4.32	5.34	6.57	11	14.3
PPP of GDP	2.88	3.35	4.03	5.94	9.00	11.45
Exchange Rate (R to $)	5.12	5.78	6.18	20.65	27	31
Ratio of Exchange Rate to PPP of GDP	1.78	1.73	1.53	3.47	3.01	2.71

** Evaluation; ** Prediction*

Source: Center of Development

Usually after a drastic devaluation, exchange rate dynamics start to fall behind the change in prices. In Russia, in spite of a PPP fall of 28-30% from the exchange rate, filling this gap is proving to be a very slow process. Rouble devaluation against the dollar stimulates a rise in prices (especially for exported goods: oil, metals, timber), while inflation and import price rises stimulate a flight from the rouble thus pushing its exchange rate down. Ergo, devaluation causes an inflationary spiral. Significant inflationary potential was stored in the real sector of the economy and in the consumer market in spite of the income deficit. The release of this potential is just a matter of time.

Higher inflation is contradicted not only by tight demand constraints from both households and the budget, but also from depressive factors such as the low level of machine utilisation. Perspectives for the gradual reduction between market and PPP rates are real enough, because the weak rouble implies significant costs for society. The first loser is the population whose real incomes decline, forcing them to consume less. Producers of consumer goods of course also suffer from this. If, however, devaluation has cleared the field of imported substitutes, the further progress of the inflationary spiral simply negates this effect. The speed of rouble recovery (not more than 8-10% a year) should be in proportion to the quantitative improvement in market competitiveness of Russian industry. In any other case, a strong rouble would not be of help to Russian entrepreneurs.

Such a strong relationship between Russian industry and devaluation/world market activities is a result of the domination within its structure of export-oriented oil and raw materials industries. The export oriented sector of the economy is responsible for between 1.2 and 1.8 times more basic assets, gross and disposable income, and taxes, than import substitute industries, while having less than one-half the number employed. The level of value added per person in the export-oriented sector was 2.7 times higher than in industries oriented towards the domestic market and import substitution. The high level of employment relative to market competitiveness within import substitute industries determined the low level of gross receipts and wages. Gross receipts brought by one person employed in the export-oriented sector were 3.3 times higher than in import substitution industries, whilst wages were 1.6 times higher.

Table 4 - Structure of Industrial Potential in 1998 (%)

Industries / Indicators	**Export-oriented industries***	**Import substitution industries****	**Others**
Productive potential			
Basic assets (book value - end 1997)	44.6	34.6	20.8
Number of employed (average for 1998)	30.7	57.1	12.2
Output and income			
Output	44.4	34.8	20.8
Additional value (output minus direct material costs)	47.3	32.8	19.9
Wages	40.2	45.3	14.5
Taxes	43.6	35.4	21.0

* *Fuel industry, metallurgy, chemistry and petrochemistry and timber/woodworking/ cellulose/paper industries*

** *Heavy engineering, lubricating, light and food industries.*

Source: Development Center

The leading position within export industries belongs to the fuel complex, which accounts for 40% of Russian exports and 20% of tax proceeds from enterprises (excluding export duty). The fuel complex also credits customers by means of delaying payment, which accounts for about 40% of inter-enterprise arrears. The financial difficulties of the fuel and indeed the whole export complex due to the fall in world prices (prior to their recent rise) and the stable rouble exchange rate (prior to recent devaluation) disrupted the balance between budget and debtors' crediting.

However, the recent devaluation has restored the financial position of exporters. The export efficiency of primary fuel and raw materials goods jumped from 10% in the first half of 1998 up to 60-80% at the beginning of 1999. On the whole, the expected gain of the export sector from devaluation and the rise in world prices in 1999 is estimated at about US$15-20bn. For all that, about 80% of this sum accrues to the trusts themselves and intermediate sellers (including offshore accounts).

Enterprises sell their goods to different intermediate trade and trust structures at prices that are significantly lower (c.60%) than domestic market prices (on average and adjusted for purchase taxation), and lower still than export prices. For example, Russian official statistics place oil trusts like Lukoil, Ukos, and others not in the industry sector, but in an "others" category of the economy. At the same time, export as well as sales proceeds in accordance with world prices are concentrated in their hands. Extractive and oil refining divisions of these trusts ship the products at prices that differ from world prices. This leads to substantial under-reporting of the real cost relationships in industry. Under these circumstances, the total potential benefit from the devaluation and from the increase in the gap between domestic and world prices lands "in the pockets" of the vertically integrated trusts and some trade and financial structures tied to them.

One could say that the above state of affairs is an original way of payment for these trusts in that they are the real agents of economy rather than individual enterprises. Therefore, the declared profit of six trusts (Lukoil, TNK, VNK, Surgutneftegaz, Ukos, Komi-TEK) exceeded US$1.75bn in 1998 (according to the data published by "Kommersant-Den'gi" magazine) whilst at the same time the total profit of the oil industry in 1998 was just US$0.3bn (according to Goskomstat). According to my evaluation, the difference between real (adjusted to the complete income from exports) and the officially recorded volume of output from these industries reached 50-60% by the middle of 1999. The main part of total export income is concentrated (on our evaluation) in the oil and gas industries (64%), with metallurgy accounting for 24%.

As a result of the recent financial crisis, the Russian economy and society find themselves at the crossroads. One opportunity for their development is tied up with the attempt to extend the role and extent of exports by raising efficiency. However, this does not have any stable middle term outlook because export incomes are not able to compensate for the curtailment of production focused on the home market, nor are they sufficient to provide a decent level of national savings.

The alternative model of economic development is tied up with the reconstruction of the home market on the basis of import substitution and remonetarisation of the economy which, in turn, would strengthening the budget, help to reconstruct the banking and internal financing systems, and redirect bank credit and public debt to fund domestic production. So far, the revival of production in import substituting sectors has been gathering strength. Heavy engineering and light industry increased production by 9% between January and August 1999, a higher rate than the average for all industry. The number of enterprises (mainly in processing industries) that have become centres of growth and have achieved a relatively safe financial position reached 45-47 % according to REB[3] estimation, the highest level since 1992 and almost twice the proportion evident in early 1998.

The quantitative expansion of the number of developing enterprises and the fact that their number now exceeds the number of bankrupt enterprises (still about 30% of the total) allows us to declare that for the first time in Russia, an economic revival has been of a mass character at both the industrial and entrepreneurial levels. A specific "middle class of industry" is being formed. Prior to that, a bipolar structure dominated which featured a wide spectrum of bankrupt enterprises alongside a handful of large profitable enterprises concentrated mainly in the fuel, non-ferrous metallurgy and (some) consumer good industries.

However, further prospects for development are restrained by the weakness of both consumer and investment demand, not to mention the low overall levels of goods quality, working efficiency, marketing and financial activity. In this case, a micro-economic revolution is necessary, but one that would use the effects of rouble devaluation to boost the domestic market rather than inflation.

Debt Economy or Remonetarisation?

The policy of a stable rouble and unitary pricing for exported goods was undermined by a culture of barter and non-payment in the domestic market. The fuel and raw materials sectors failed to increase supply to the home market in spite of its higher economic efficiency in comparison with the world market in 1997 and early 1998, again due to the low level of money payments. In Russia, non-payment and barter are features of what is in effect a *debt economy* that is based not on banking, but on the outrageous development of commercial credit in the real or non-financial sector of the economy. Commercial credit performs firstly as a commodity credit due to the delay in payment to suppliers for goods and services delivered, and secondly as a financial credit in that payment obligations to workers and the budget are delayed. It therefore alters the distribution of value added and the income of enterprises. The peculiarity of the Russian economy is to a significant extent not one of commodity credit but of financial credit, that by the end of 1999 reached 27% of GDP.

Table 5 - Dynamics of Indebtedness in the Russian economy*
(Relative to GDP in % to the end of year)

	1993	1994	1995	1996	1997	Sept-98	1998
Account payable	27.4	28.5	29.6	43.6	50.3	69.0	66.9
Indebtedness to budget	4.0	5.2	5.7	7.5	9.2	11.7	10.9
Indebtedness to off-budget funds	2.5	3.3	3.6	6.2	8.0	10.8	10.8
To suppliers	16.9	17.1	16.3	22.1	24.3	32.4	31.8
Accounts receivable	25.6	24.6	22.2	30.1	33.0	44.9	44.5
Indebtedness on credits and loans	6.6	7.4	5.6	5.6	6.4	13.5	14.5
Money assets	4.4	2.1	1.3	1.2	1.5	2.0	2.9
Net account payable **	1.8	3.9	7.4	13.5	17.3	24.1	22.4
Commodity credit	8.6	7.5	5.9	8.0	8.7	12.5	12.7
Financial credit	10.5	11.4	14.4	22	26.4	36.6	35.1
Relation between banking and financial credit	101.2	86.3	60.0	41.1	37.4	60.1	67
Level of financial responsibility***	40.91	14.87	8.15	5.28	4.77	3.93	5.72
Money assets to debts to banks	52.3	22.6	18.9	17.9	17.6	10.9	14.6

* *Productive industry: industry, construction, transportation and communication, agriculture.*

** *Net account payable = account payable - accounts receivable, commodity credit = accounts receivable - indebtedness to suppliers, financial credit = account payable - indebtedness to suppliers.*

*** *Relation of money assets to net accounts payable and debts to banking credits and loans.*

In Russia, commercial credit has turned from a subsidiary financial instrument into the central column of the debt economy and it differs greatly from financial systems based on self-finance or a debt economy dominated by bank credit. In the Russian debt economy, non-payment - or, to be exact, commercial credit - has the main and multiple functions of being an instrument of payment, a source of credit to a producer, and as a quasi capital market. Non-payment and barter are thus the reverse sides of the same coin. Non-payment and barter, as substitutes for money in circulation, are unable to become independent quasi money instruments. They speed money circulation (by three- or four-fold) but do not move by themselves because they are not tradable, except in small-scale agreements on debt and accounts receivable.

Russia's specific model of a debt economy should not be viewed as a virtual phantom, where neither prices nor financial markets nor bankruptcy mechanisms work, as suggested by Barry W. Ickes.[4] The non-equilibrium position induced by barter and non-payment does not destroy value but merely changes the operation of the price mechanism. Price distortion from the equilibrium level on non-money transactions (estimated on average to be plus or minus 20 to

30% or more) is determined not only by specific monopoly-corporate characteristics of the Russian economy, but also serves as a form of correction whereby markets adapt to the low level of monetisation within the economy and the imbalance between money assets and enterprise liabilities (especially to workers and the budget). Moreover, prices also serve as a reference point to barter deals. Significant discounts on Gazprom or RAO UES bills do not falsify payments so much as approximate real payments to their normal level corresponding to energy cost and energy use in the economy. This balances out excessive appreciation during a period of high inflation.

Table 6 - Structure of Payments in Industry (%)*

	1993	1994	1995	1996	1997	Sept-98	mid-1999
Total outgoings	100	100	100	100	100	100	100
Commodity credits	22	17	8.8	14.1	10.6	14.5	12.6
Barter	11.4	21.6	33.4	44.4	53.5	59.5	40
Money accounts	63.9	56.3	55.3	32.4	32.4	25.0	46.4
Others	2.7	5.1	2.5	9.1	3.5	1	1

* *Evaluation based returns on cash receipt on goods and services, growth of accounts receivable and data survey (REB, CEC) on barter deals share.*

In Russian conditions, we may speak not of low, but of the excessive tightness of budget constraints on enterprises. This is reflected in the appearance of a stable gap between potential demand and output. This excessive tightness is indicated by the additional reduction of output, which on average is estimated to be 11-15 percentage points below what would be potentially possible given the level of demand in 1996-1998. On the other hand, much of existing output is supported by the growth of debt and non-payment which changes the financial situation of enterprises. This is manifested by the growth in the gap between the level of potential demand and the situation within enterprises, reflecting their inability to meet demand on their own (in 1997-1998 this gap was estimated at around 40-50%). We may suppose that this gap reflects the lack of equity within enterprises and corresponds to the need for debt financing. The excess of accounts receivable is not able to compensate for the lack of money assets, and this in turn leads to the under-utilisation of production capacity.

Under circumstances whereby there is a close correlation between liquidity and supply of currency (this is up to 60-70% in exporting industries), the recent rouble devaluation has helped to re-monetise the real sector. The real money deposits of non-financial organisations and enterprises in bank accounts have in 1999 risen by more than 20% whilst their share in the structure of money supply (M2) has increased to 30%. Simultaneously, the liquidity of industrial enterprises (also trade firms and holding companies) has been directly strengthened, as has the structure of settlements between enterprises. The share of money in payments for finished goods jumped from 25% in the autumn of 1998 up to 45-50% today. At the same time (REB evaluation), the share of barter decreased from 54 to 38%, the level of two years ago.

Table 7 - Monetary Dynamics (%)

	1997	1998	1999	2000	2001
Velocity of M2	6.7	6.0	6.4	6	5.3
M2 as % of GDP	14.8	16.7	15.7	16.8	18.9
Velocity of M2X	5.5	4.2	4.5	4.5	4.2
M2X as % of GDP	18.2	23.7	22.2	22	23.8
Monetary Multiplier	1.9	1.9	1.79	1.8	1.7
Monetary Exchange Rate (MER)					
- reserves to MBII	11.4	19.3	31.4	37	48.2
- reserves to Reserve Money	11.6	25.7	43.2	51.5	67.8
- MER to Exchange Rate	191.5	93.3	116.4	119.3	142.2

Table 8 - Structure of Monetary Aggregates

	1997	1998	1999	2000	2001
M2	100.0	100.0	100.0	100.0	100.0
M0	34.9	41.9	39.2	36.1	35.5
Enterprises Deposits	27.2	25.0	30.9	33.3	32.7
Household Deposits	37.9	33.1	29.9	30.7	31.8

Source: Bank of Russia, Development Center.

This phenomena of re-monetarisation (a result of rouble devaluation) begins to wane once domestic prices start to rise towards global prices. The increase in money deals between enterprises is blocked by the inability of the budget to make payments in money which leads to an increase both in bank credit and in commercial credit between enterprises.

State Debt Crisis

As was shown by the 1998 crisis, the Russian budget system has exhausted all its chances of survival using borrowed current assets, as it has effectively done for the past four years. The attempt to solve all current budget problems by changing the main source of borrowing (from Central Bank to IMF, then to state bonds, then Eurobonds and finally the World Bank) led to a fast accumulation of state debt and related interest payments. This burden proved to be unbearable for the budget under the extant conditions of weak tax collection.

The problem for Russia became not only the volume of state debt (66% of GDP by summer 1998) and not only the related service payments (c.5.3% of GDP) but the massive gap between these payments and the volume of federal revenue collection. In the first half of 1998, service payments and debt repayment on state debt reached 120-150% of federal budget current income. The government's inability to solve the problem of low revenue receipts led to over-borrowing from both domestic and foreign creditors, most of whom lost their money when Russia effectively declared itself bankrupt on August 17, 1998.

At the moment, the increase in the tax burden on exporters combined with the decrease in payments on the external debt (achieved through rescheduling and the receipt of IMF credits) has allowed the budget situation to stabilise. Federal budget income increased by up to 13% of GDP in the middle of 1999 and the primary deficit reached its target level of 2% of GDP. At the same time, talk about getting over the crisis is premature. According to government projections, consolidated budget expenditures are to be not less than 33-37% of GDP. This target includes both the service of external debt which accounts for 4-5% of GDP, and increases in state defence expenditure (in order to stop the degradation of national security) and the safety net (necessary to maintain and improve human capital). It is clear that these demands cannot be met by the existing levels of tax collection, especially given the current balance of power between the state and other interest groups. Discussions on state spending should not be limited to concepts of "liberalism", but be centred on the very survival of the Federation itself and the social development of its people.

It is impossible to escape these contradictions by further reducing non-interest expenditure. On the contrary, to stimulate industrial growth and renew human capital it is necessary to increase spending by borrowing more money both from domestic and foreign sources.

Bank Crisis and Reconstruction of Banking System

The most vivid manifestation of the banking crisis was the real bankruptcy, meaning the non-fulfilment of obligations, by the largest banks, such as SBS-Agro, Imperial and Inkombank. This started long before August 17, so the GKO-OFZ freeze did not hurt them a great deal because they had invested only a small part of their assets into state rouble bonds. Each defaulting bank had its own particular problems relating to indebtedness and bad management. However, the crisis of individual banks and the crisis of the banking system in general (the first one transformed into the second after August 17) have common patterns.

The banking crisis did not start during the high inflationary period of 1992-1994, but at the period of transition to limited investments into state bonds, an increase in bank loans to the economy (both in operational significance and in the share in assets) and a growth of the number of individual depositors. However, these positive trends led to a conflict between the higher level of reliability and efficiency within the banking system and the poor level of management and excessive indebtedness of individual banks. So the appearance of new risks connected to the devaluation of the rouble resulted in additional losses.

The retail banks with a well-developed branch system were not able to adjust to the high expense of working with individuals. This resulted in the closing of branch offices. The debt crisis of a number of banks - especially those involved in financial/industrial groups - resulted from the debt crisis of enterprises or (to be exact) their holding companies (such as Ukos and Lukoil). A specific "industrialisation of bankers", i.e. changing the leading positions in the banks to the heads of manufacturing holding companies (Hodorkovski, Potanin), led to the situation whereby the banks were crucified by the crisis. The wildcat credits of many banks (SBS-Agro, Inkom) to the regional authorities (who refused to pay them back) reflected the political ambitions of the oligarchs as well as the unprejudiced necessity to redistribute resources from Moscow to the regions. Without this, it is impossible neither to transform Moscow banks into nationwide structures nor to enhance the economic and territorial integrity of Russia.

Thus, the bank crisis (especially during the first mainly hidden phase) acted as an incubator for the more recent and complicated reality of economic crisis in general. The state debt crisis followed by the hard currency crisis transformed the crisis of individual banks into a systemic crisis of the entire bank sector.

The 1998 crisis was a result of financial shocks (state bankruptcy, sharp devaluation of the rouble and financial market collapse) outside the bank system as well as being a result of the structural weakness of the Russian bank system itself (bad management, low level of capitalisation, unequal risks evaluation, weak development of banking business itself). Russian banks losses in the second half of 1998 are estimated to have been about 50-60% of the banking system's capital (equal to around 2-3% of GDP, or double this if one includes the banks whose licenses were withdrawn).

At present, the most acute problems related to the crisis (the troubles with clearing and the depositors flight out of the banks) are over. However, this does not mean that the crisis is over too. The Russian bank system is in the process of transition from stagnation to recovery. It has to solve not only the problem of quantitative recovery of the lost capital, but also the problem of qualitative replacement of management and the relationship between lenders and borrowers.

In the short-term, the main "painful points" for the bank system will be the problems of foreign liabilities, the deficit of own capital and the limits on working assets. Russian banks have to solve these problems under conditions of low foreign financing and the limited growth of individual deposits (limited by distrust in the banking system as well as the fall in real incomes). The main difficulty for the banks is not only the lack of own capital and debt capital, but the limited areas in which profits can now be made. Under the circumstances of stagnation and the lack of public borrowing, it may take four to five years to restore the pre-crisis level of banking system capitalisation.

The Russian bank system is at the turning point between two choices of development:

- The first would be to go back to the currency-issuing type of development by which banks actively credit the budget and thereby restore their asset base. The main source of income would be hard currency operations, because when currency assets exceed liabilities, the fall in interest rates (corresponding to the fall in inflation) brings net excess profit. Under this scenario of high dollar dependence (about 60% of deposits) and capital flight, the further devaluation of the rouble would allow the banking system to maintain its general level of assets.
- The second would be an industry-oriented type of development, characterised by a more energetic crediting of the real sector under conditions of moderate inflation. Banking sector income would depend on the success or otherwise of the industries it lent to, and thus in all probability be lower than under the first option above. Thus this scenario would require a significant reduction in costs and expenses, and the sale of non-performing assets. In spite of the expected stagnation in banking liabilities in 1999, the reduction of investment into state bonds would release credit into the real economy to the tune of 14-18% of GDP. The prospects for this scenario depend upon the achievement of real industrial growth based on import substitution and the development of new corporate financial entities, and also upon the development of mature markets for both debt and equity.

Table 9 - Dynamics of the Banking System: 1996-2000 (% of GDP)

End of Period	1996	1997	1998	1999	2000
Total Assets	28.4	30.3	39.0	35.1	35.8
Liquidity	5.0	4.1	6.4	7.6	7.7
Credit to the economy*	8.2	9.6	12.5	10.4	11.8
Claims on government	6.0	6.5	6.7	4.9	4.3
Deposits	12.1	12.6	15.8	16	16.1
- household	6.9	6.8	7.8	6.8	7.2
- firms	5.2	5.8	8.0	9.3	8.8
Equity	6.37	5.59	5.55	4.13	4.16

* *Net of arrears.*

Source: Bank of Russia, Development Center

Where is the Russian Economy Going?

The devaluation and the collapse of domestic public debt market have given time for either the Russian economy to be reconstructed or for inertia to continue. Even if the government and elite do nothing, the existing stock of competitive prices along with the temporary easing of the debt burden will stimulate an increase in production of about 1.5 to 2% over the next two years. In contrast to 1999 when export growth and import decline have been the leading factors of nascent growth, one might expect the slow recovery of real incomes and investment to contribute thereafter.

However, growth in the production of resources has its limits, whilst the reduction of production capacity as well as the overall fall in social welfare may set off an explosion of economic and social contradictions around 2002-2003 that may be followed by stagnation or even a new fall in production. The enterprise survey (REB - Russian Economic Barometer) shows that managers do not expect the economic crisis to end for another eight years, e. g. by 2007-2008. By the end of the crisis, they clearly mean not only a switch over to GDP growth, but the formation of a new institutional system and closer links entrepreneurs, society and state. One indicator of current mutual alienation may be the degree of managers' aversion to the current macroeconomic policy. The number of those who do not understand or do not approve of the current economic policy rose once again up to 51% and 61% (respectively) of those surveyed. In the first half of 1999, the corresponding figures were 45% and 49%.

It is not possible to solve the problems relating to the deficit of resources, capital, trust and cooperation of and between all the main economic actors in Russia simply by allowing time to pass - "Laisser faire, laisser passer". At the same time, projects to mobilise economic restoration have neither mass assistance nor corresponding financial support. Now Russia is looking for - in a relaxed manner - its new place in the world and its own original mix between state and private methods of economic development. This will allow Russia to combine its history and its Soviet heritage with the demands of the new era.

Russia has built up a large but mainly useless growth potential based upon the mobilisation of internal resources and the deepening of institutional restructuring. But the likely limits for this type of development are in the order of 2-3% GDP growth per annum. To achieve intensive industrial and social modernisation - with a sustainable growth rate of 5-7% per annum - Russia needs massive foreign investment and institutions that are merged into Western society.

Notes

1 We used in our report analytical materials of Macroeconomics analysis and short term forecasting Center (headed by A. Belousov) of IEF RAS and Development Center (Headed by S. Alexashenko).
2 For the analysis of the structural disproportions of Russian economy, see A. Belousove. Unsustainable stabilization. What further? Problems of Forecasting, 1996, N° 1.
3 REB - Russian Economic Barometer
4 Clifford G. Gaddy and Barry W. Ickes. Russia's Virtual Economy. Foreign Affairs. September/October 1998.