COMMENTS ON THE PAPERS OF GERARD WILD, ANDREJ KLEPACH AND ROSTISLAV KAPELIOUCHNIKOV

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The papers presented in this session all point to the peculiarities of Russian transition to the market compared to other countries in transition in Central and Eastern Europe. The efforts to single out the specifics of Russia and understand better her comparative failures in macro-stabilisation and structural reforms is stimulating both Russian and foreign experts to unravel the complicated mechanisms through which the Russian economy has managed to survive, while prospects for sustainable growth remain gloomy. Several studies have been circulated and published which focus on political developments, sociological roots, economic policies and structural adjustment. Few have attempted to look at the interaction between all these factors. An interesting attempt is that of Gérard Wild, who portrays possible scenarios that link economic developments and their perceptions in Russia, security matters, and also cultural factors.

Although demand for a multi-disciplinary approach is high, supply is scarce, understandably, since science in any field proceeds along the specific paradigms of the field and through small incremental insights, until a genius eventually puts the bits and pieces together providing a reasonable and consistent theory. Waiting for a theory of Russia's involution to emerge, the bits and pieces of serious research, which is reflected also in the papers presented in this session, are useful contributions to a better understanding of Russian failures, and, hopefully, improved transition management policies. My comments will concentrate on the structural obstacles to transformation towards the market in Russia and the present policy options.

Mr. Kapeliouchnikov's paper focuses on structural issues through the prism of labour market developments and concludes that Russia compared to other European transition countries has undergone lesser structural change. The paper argues that a high degree of labour mobility and labour market flexibility has not translated into structural shifts, because of informal arrangements between employers and employees, which distort the market's rules of the game. Since, from the start of transition to date, the amount of net labour shedding has been far lower than the fall in output, it would follow that total labour productivity has decreased and is continuing to fall.[1] The problem with this type of analysis

- which gives useful insights into the working of the labour market in Russia - is that aggregate data are not very revealing. The high number of resignations over dismissals suggests that mobility also may have to do more with labour regulations, policy arrangements between employers and employees, and seasonality than with effective labour turnover. In particular, one should explore further whether, given the high share of insiders that dominate enterprises (see below), much of the labour market flexibility is only apparent.

The bottom line of Mr. Kapeliouchnikov's valid argument is that, in the absence of effective rules of the game, informal arrangements such as administrative leave, shorter worktime, multiple job-holding, wage arrears and unrecorded wage payments, cannot lead to sustainable recovery and growth.

From a different approach, after overviewing macroeconomic and structural developments, Mr. Klepach also concludes that the prospects for growth in Russia are slim. His main argument, however, is that Russian output potential and sustainable recovery are hampered by shortage of capital and very tight budget constraints for enterprises. The re-monetisation of the economy, which has been stimulated by the devaluation of the rouble and reflected in higher enterprise banking accounts and lower shares of barter deals, is slowing down due to a combination of domestic price pressures and a lack of credit. The way out of this scenario lies, according to Mr. Klepach, in the strengthening of import substitution industries and the development of a corporate equity market. He also notes that for the first time in Russian transition, the revival of industry is generalised and if conditions develop that allow for a further strengthening of domestic industry, this will provide support to the budget and to the recovery of the banking and financial markets.

While both papers raise interesting insights into how the Russian economy is working and its weak potential for recovery, some crucial links are missing. In particular, an analysis of the crucial role of public and corporate governance. While public governance has an impact on trust and credibility, corporate governance affects managerial decisions, equity raising and structural adjustment. In both areas, Russians have not fared well. On the corporate side, the structures of corporate governance that have developed in the course of transition reflect different patterns of privatisation. The trade-off between wages and job rights is peculiar not only to Russia, but also to the Czech Republic, which until end-1997 had an unemployment rate of 4.4% (ILO methodology), while in all other transition countries the unemployment rate rapidly shot up to two-digit figures. Both Russia and the Czech Republic chose (voucher based) mass privatisation methods which opened the way to insiders' control. One can discuss whether mass privatisation has led to management or employee-controlled enterprises and the relative effects of either development on the allocation of factors of production. However, there is a high likelihood that in both cases the workforce has a disproportionate voice on decision-making, particularly when this affects job rights.[2] This state is not propitious for a smooth opening of corporate structures to outsiders and strategic investors. Mr. Kapeliouchnikov argues that the combination of high labour market flexibility with low restructuring reveals the de-institutionalised character of the Russian labour market. One could argue, alternatively, that Russian enterprises, at least a large part of them,[3] have become a species apart working on their own set of rules and codes of behaviour.

While in advanced market economies labour market flexibility contributes to higher productivity and continuous restructuring in response to market demand, in Russia, the result has been the opposite. This raises the question of whether the informal arrangement so well described by Mr. Kapeliouchnikov in his paper are, indeed, vehicles of stickiness rather than flexibility in the labour market. An apparent high level of labour mobility, whose complicated mechanisms need to be carefully studied at the microeconomic level, is likely to conceal a high level of protection of job rights through implicit labour contracts at the level of the firm, and stickiness in the re-allocation of resources, including labour.

Another important explanation for such diverse outcomes is that economic incentives are also different. In fully-fledged market economies, the re-allocation of resources, including labour, is the result of profit incentives, with investment moving from loss making to profit-making enterprises. In Russia, owing to the dominance of insiders in decision-making, profit incentives have a weaker role whilst the structure of corporate governance matters in the allocation of resources. Insider controlled enterprises will preferably use any profit[4] for wage increases or re-investment, regardless of better investment opportunities in other companies or sectors. At the same time, outsiders are not attracted by these corporate structures. On the one hand, insider-controlled enterprises do not offer sufficient guarantees for the distribution of profit and minority shareholders'rights are not sufficiently protected. On the other hand, the low monetisation of the economy does not provide sufficient knowledge of comparative returns on investment in different companies and branches.[5] Excluding other types of payment (offsets, securities, barter, etc.) cash counts for 43.4% of total payment in large firms and natural monopolies, and is as low as 14% in machine building.[6]

While a different set of incentives in insider-dominated enterprises explains the low level of restructuring, explaining their survival is more complicated. A number of factors enter into play: limited competition, concealed subsidisation, tax payment practices and barter arrangements are the most important. While entry in the market is free, exit is constrained. Even after the approval of a modern bankruptcy law in March 1998 (which is well described in Keith Bush's paper), the number of bankruptcies is small compared to the number of loss-making companies. This means that creditors' claims against firms are not well protected. According to official statistics, the number of loss-making enterprises in Russia has been variable, but altogether high, between 55 and 60% across sectors.[7]

How do loss-making companies survive? Ingenuous accounting no doubt helps to conceal profits and sustain tax evasion. But years of output and productivity falls suggest that the effective number of loss-making companies is, indeed, high. The explanation lies in the continuation of subsidies. The losses accumulated by the enterprises are borne by other sectors of the economy. Contrary to what Mr. Klepach suggests in his paper, Russian enterprises are not subject to tight budget constraints but to soft ones because they pay lower than market prices for necessary inputs, energy in particular, and often they do not pay at all. Under government instruction, energy suppliers cannot interrupt their supplies to a large number of companies, either because they are strategic companies or because they have a "political" role. Defence industry, coal mines, transport, as well as other companies which can justify their social role as providers of high employment and social services have no incentives to pay for energy. Tax payment arrears are also a form of subsidy. At both the federal and local government level, tax payment arrears have continued to accumulate over the years with only occasional and localised spells of tax compliance. In spite of increased liquidity and improving performance of the industrial sector, total tax arrears to the federal budget have increased 37% (13% in real terms) since January 1999.[8]

The increasing indebtedness at all levels of the economy prompted the use of a system of clearing mutual debts (offsets) between enterprises and tax offsets between companies and the state. The amount of enterprise arrears (payables in all sectors of the economy) reached 659 trillion roubles in the second quarter of 1998 and was up to 853 trillion roubles a year later. Although lower in real terms and dollar value, this amount kept increasing in 1999 in spite of higher liquidity. Since the incentive to delay payments increases with inflationary expectations, the improvement in the payment of arrears observed in November and December of 1998 due to increased liquidity did not last. Offsets in large-scale enterprises and natural monopolies are very high, ranging in some sectors such as machine building and electricity from about 40% to 50% respectively.

The practice of payment by tax offsets raises the issue of public governance, meaning that set of institutions that govern the choice of public policy. In this area the Russian government has failed to build the necessary level of trust which is required for implementation and law enforcement. Resorting rather often to the practice of sequestration of expenditures, the Russian government (at all levels) has shown disregard for its commitments towards society and disrespect for the rule of law. The practice of payment arrears extends from central government to local governments and off-budget funds. It exacerbates people's distrust in public administration, while at the same time justifying complacent behaviour towards several categories of tax delinquents, namely those companies and sectors that are creditors to the state. While tax offsets have been eliminated by the central government in 1999 and all tax is collected in cash, this practice is still common at the local level. The share of non-cash receipts at the local level went up to more than 50% of total tax revenues in 1998.

Against this background and on a more general level, developments since August 1998 raise issues about the effective potential of the Russian economy, alternative policy choices and their future implications. The revival of industry hints that there are positive forces at work. Industrial output increased by 7% in the first three-quarters of 1999 year-on-year, led by import substitution and some export-oriented sectors, such as chemicals, wood and paper, and ferrous metallurgy. Internal demand re-oriented towards domestic products giving a boost to food-processing and light industry. Structural shifts, that, as pointed out by Mr. Kapeliouchnikov, had not been remarkable until now, were probably much more pronounced in 1999 than in any year before. Unemployment fell a couple of percentage points, down to close to 12%. In spite of frequent and overall unexplained political changes, monetary and fiscal authorities have been able to keep track of reasonable policies in their respective areas. In the context of rapid recovery, modest positive growth is expected in 1999.

So far the monetary authorities have managed keep inflation under control, while aiming at a slow disinflation. The real effective exchange rate started to appreciate in the first half of 1999. Commodity prices have contributed to positive fiscal developments. Tax collection has improved in the second quarter of 1999, and has been driven partly by higher oil prices. However, there are serious concerns about the sustainability of both trends. Although the current account surplus has rapidly improved, also due to positive oil price developments, capital outflows are still strong. Preliminary data put them at about US$11bn in the third quarter of this year. The level of reserves is low, partly because they are used to finance the public deficit. Foreign currency reserves (excluding gold) cover about two months of imports. The appreciation of the real effective exchange rate halted in August. Since then, the rouble has continued to slide. Oil prices in 2000 could be less favourable than expected. Moreover, with falling real incomes, poverty has increased, putting pressure on the local budgets that bear the bulk of social expenditure. On the structural side, the re-capitalisation of the banking system is jeopardised by a combination of wishful thinking and a lack of resources.[9] Fixed capital investment has not recovered from the tremendous fall in 1998. A further concern is the outflow from government posts of leading reformers, whose authoritative presence in the main financial agencies offered until recently the main guarantee for the continuity of reform orientated policy, even though such policies have not always been effective.

Russia is now at the crossroads. On the one hand, as discussed above, adequate market institutions, incentives and budgetary constraints are not in place. On the other hand, the factors behind rapid recovery from the 1998 financial crisis, namely the kickback from the devaluation of the rouble, are waning. This faces the authorities with a dilemma. They may choose to continue to pursue the goal of macrostabilisation, let the rouble appreciate in real terms under the positive pressure of the current account surplus, and tighten further the federal budget. This policy should provide support to re-negotiation and rescheduling of the payment of foreign debt, help to restore confidence in the currency and, in time, the confidence of foreign investors. However, to be credible, this policy should be backed by convincing structural reforms and the introduction of effective budget constraints at all levels of the economy. The positive outcomes of this policy choice will materialise in the medium-term and could, *ceteris paribus*, provide for sustainable growth.

A possible, and worrying, alternative is that the authorities will release both monetary and fiscal policy to increase domestic demand and continue to sustain industrial growth while refraining from structural reforms. There are strong pressures to move in this direction coming from industry, the military sector, and the poor and social agencies, which have found sympathy among some exuberant pro-Keynesian scholars.[10] The budget for 2000 has been approved, apparently resisting demands for increased expenditures, but is hardly sustainable without support from the IMF and the World Bank. With parliamentary and presidential elections coming closer, pressures to increase public spending will get stronger. Monetary financing of the budget will jeopardise progress in macroeconomic stabilisation and stimulate further capital outflow. A slowing down of reforms, and even reversal in some areas, could follow. There are already signs that the state grip on monopoly sectors, in particular energy where the stake of the state is high, is strengthening. In this scenario, economic growth could continue for a while at the expense of macroeconomic stabilisation. But sooner or later, all the elements for a new crisis will re-appear.

Nevertheless and in spite of frequent government changes, a catastrophic scenario - which was possible in the wake of the August crisis - has been avoided. The result of parliamentary elections on 19 December will be crucial for the fate of the Russian economy in the years to come. None of the main political blocks which are running for parliamentary elections under well-known figures wishes to reverse the course of market-oriented policies. However, none has put forward comprehensive economic programmes, which would justify confidence in deepening structural reforms and more openness to foreign investment. Contrary to the best performing emerging market economies in Europe and Asia, Russia has not managed to attract sufficient strategic investment which could have stimulated a demand for improvements in the institutional environment (as a pre-condition for their implementation). This point is well elaborated by Keith Bush's paper. While the time is ripe for considerable re-thinking of policies in this area, the risk of a retrenchment of Russia away from a challenging interaction with the outside world in all areas of private and public management is also present. While it will be up to the new Russian government, who will emerge from the elections to weight the pro and cons of alternative strategies, the support of the international community will also matter. This support should increasingly focus on the medium and long term advantages of mutually favourable policy options.

Notes

1 The MacKinsey Global institute report published on 9 October 1999 estimates that the Russian productivity has fallen from 30 % of the US level in 1991 to 17% in 1997 mostly because the falls in demand and output were not matched by the decline in workforce.
2 The recent case of the porcelain Lomonosov factory, where workers organised against foreign investors is symptomatic.
3 An interesting article by Grosfeld and al., "Dynamism and Inertia on the Russian labour Market: a Model of Segmentation", CEPR Discussion paper Series, no.2224, argues convincingly that the Russian labour market is increasingly divided into a stagnant pool of less productive enterprises, and a dynamic segment of relatively well performing companies.
4 Profits are often derived from economic distortions rather than efficient production (MacKinsey Report).
5 The last McKinsey & Co. report argues that the most productive companies are often the least profitable.
6 Official sources.
7 Goskomstat official statistics.
8 PlanEcon, Monthly Report, 22 October 1999, p.12.
9 While the number of commercial banks has been decreasing over the years, also due to a more focussed CB policy on issuing and withdrawing of bank licences, this number is still high. The criteria for selecting banks for rehabilitation are not totally clear. The funds, 10bn roubles assigned to the agency created for this purpose, ARKO, of which almost half of it has already spent, are insignificant if compared with the fall in aggregate banking capital following the August 1998 crisis.
10 The theoretical underpinning of this approach is particularly weak after the strong devaluation of the rouble that should have supported export led growth. The fact that this is not taking place in Russia suggests that problems still remain on the supply side and its related structural deficiencies.