CHAPTER ONE

Russian Economic Conditions

RUSSIAN PRODUCTIVE POTENTIAL

Since its establishment as a separate state in 1991, Russia's economic performance has been vastly below its productive potential. Per capita income stands at about $4,200 in world market prices, which is lower than the world average of $5,200 and less than one-sixth that of the United States.[1] Per capita income in Russia falls beneath that in Tunisia, Algeria, Botswana, Costa Rica, Colombia, Panama, Brazil, Mexico, and other economies, all of which, at least in the popular image, are relatively poor countries. In Russia, which is the landlord of a space station for American astronauts, something is amiss.

What separates Russia from these other third world countries is its enormous, immediate, current growth potential. Russian income is three, perhaps as much as four, times lower than it could and should be.

First, Russia has the productive capacity in place to double its

1. Updated from the World Bank, *World Development Report 1997: The State in a Changing World* (New York: Oxford University Press, 1997), Statistical Appendix, p. 7.

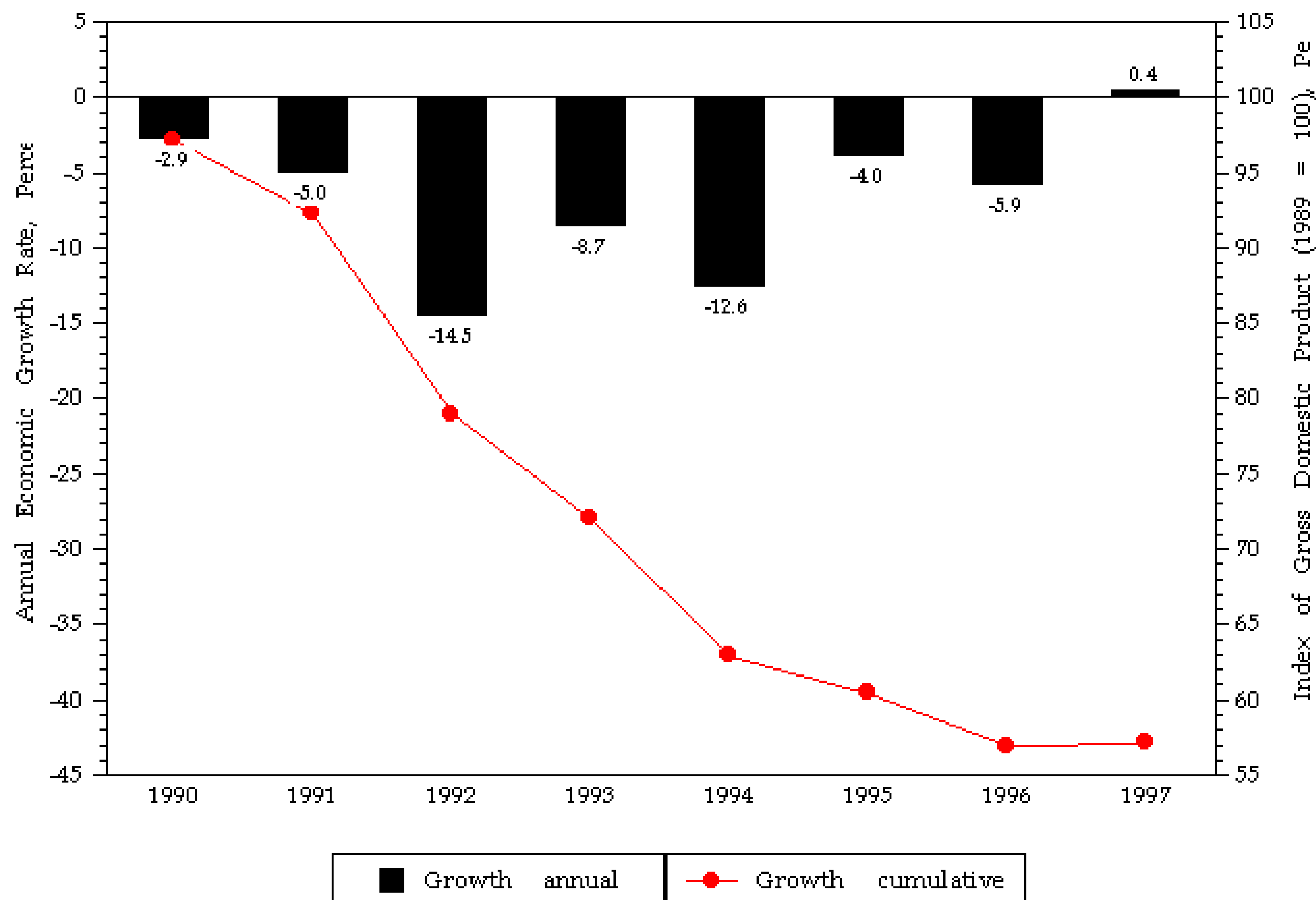
Figure 1. Economic Contraction in Russia, 1990–1997
Source: Russian State Committee on Statistics, regular releases

output of goods and services (its gross domestic product, or GDP). Indeed, just nine years ago, Russian GDP was nearly double current levels. By official and international counts, the economy contracted by 43 percent during 1990–1997 (see figure 1). This accounting may exaggerate the decline in output, as many firms underreported production to reduce their tax liabilities. Offsetting this potential undercounting, however, is the gain that accrued, equivalent to 15 percent of Russian GDP during 1992–1997, when Russia terminated $58 billion in annual energy subsidies to Eastern Europe and the former Soviet Union.[2]

Second, even before the great contraction of the 1990s, Russian industrial investment allowed for a much higher level of output than that produced under the country's faulty, inefficient,

2. The World Bank, *World Development Report 1996: From Plan to Market* (New York: Oxford University Press, 1966), p. 27.

Figure 1



Source: Russian State Committee on Statistics, regular releases.

socialist economic arrangements. Western estimates show that the Russian level of capital stock per worker should have produced some 44–52 percent more goods and services than it did.[3]

Third, Russia has a highly educated workforce. Western estimates imply that countries with the same number of years of education per employee as Russia enjoyed in the late 1980s had about 35 percent higher income per capita.[4]

Fourth, and perhaps most important, Russian industry produced, and continues to produce, a large amount of *negative value added* as a result of the application of arbitrary, artificial, distorted, subsidized, and cross-subsidized prices that determine the real cost of production inputs. In other words, a dollar's worth of raw ingredients emerges from the production process as finished merchandise worth less than a dollar. In 1994, the middle year of Russian reforms, Russian industry subtracted 34 percent from the global market value of natural resources alone, without accounting for subtracting the additional value from the intermediate goods used in their production.[5] The mere introduction of true market prices, coupled with the elimination of subsidies, cross-subsidies, cross-debts, and other distortions, would eliminate negative value added in production. The whole country would be better off if the workers in these value-subtracting enterprises were paid full wages to stay at home until sufficient reforms were put in place to add value to production.

3. Abram Bergson, "The Communist Efficiency Gap: Alternative Measures," *Comparative Economic Studies* 36, no. 1 (spring 1994): 1–12.

4. Calculated from Robert E. Hall and Chad I. Jones, "The Productivity of Nations," National Bureau of Economic Research, working paper no. 5812, Cambridge, Massachusetts, 1996, p. 45.

5. Calculated from the Russian State Committee on Statistics, *Rossiiskii Statisticheskii Ezhegodnik 1996* (Moscow, 1997), pp. 293–94; world market prices are from the U.S. Bureau of the Census, *Statistical Abstract of the United States 1996* (Washington, D.C.: U.S. Government Printing Office, 1996), pp. 694–97.

By itself, the cessation of value-subtracting economic activities would substantially increase GDP, without any additional investment or other effort.

Taking all four factors together, a three- to fourfold increase is a ballpark estimate of Russia's real productive potential under true private markets in the near term. To this can be added the potential gains from the application of recent Western technological advances to the exploitation of Russia's vast untapped natural resources, assuming that Russian politics can tolerate a much larger role for foreign enterprises.

THE INSTITUTIONAL LEGACIES OF SOCIALISM

A key factor in Russia's failure to develop real banks has been the institutional legacies of socialism. Long decades of socialist rule resulted in deep and pervasive state penetration of the economy and society. Under central planning, the Russian economy was highly centralized, monopolistic, protected from foreign competition and exposure; it was also structurally anomalous. It lacked most of the social, legal, and institutional infrastructure taken for granted even in underdeveloped market economies.

The old Soviet banking system was a monobank system, centered on the state bank, Gosbank, which covered the entire Soviet Union through its many branches and collection systems. All monetary transactions went through Gosbank or one of its affiliated banks. The primary purpose of the banking system was to support the economic system of central planning, in which government bureaucrats allocated inputs (raw materials, labor, investment), outputs (told enterprises what to produce and where to ship goods), set prices and wages, determined incomes, and rationed consumption. The banking system mirrored the real economy by recording financial flows that tracked the flow of

goods and by supplying credit to aid plan fulfillment and finance investment. It also supplied cash to enterprises for wages to employees to facilitate daily transactions.

In 1987–1988, during perestroika, a two-tiered banking system was created. The state bank split into three branch state banks for (1) industry, (2) construction and utilities, and (3) agriculture. Private, nominally commercial banks emerged in 1988–1990 and mushroomed thereafter. In 1991, Gosbank became the Central Bank of Russia (CBR), which held responsibility for monetary policy, commercial bank supervision, and facilitating interbank settlements. Other state banks were reformed into joint-stock banks owned by enterprises, government agencies, and government-connected private groups. All these commercial banks, however, remained dependent on subsidized credits from the CBR and, thus, were its de facto branches.

Moreover, in 1992 the government established a secretive body named the Credit-Monetary Commission, chaired by a senior deputy prime minister. The chairman of the Central Bank of Russia was the ranking member of this commission, but he does not exercise the influence and power that Alan Greenspan enjoys at the U.S. Federal Reserve Board. The commission sets targets of monetary expansion and credit for commercial banks, thereby replacing the Politburo of the Communist Party, which had set monetary and credit targets during Soviet times. In practical terms, the Credit-Monetary Commission made an independent central bank impossible, despite the existence of legal statutes that promise autonomy.

The reason the government could not let the CBR be independent is that the commission required individual commercial banks, which sought subsidized credit from the CBR, to allocate that credit to specific enterprises in accordance with commission directives. Once these credit allocation targets were satisfied, banks had some discretion in reselling unallocated central bank

credit. As most banks were owned by, or connected to, enterprises, the banks basically serviced their founders or subsidiaries with government money.

From their inception, commercial banks served as government check-cashing windows, similar to those used by U.S. welfare recipients. Banks were inherently insolvent because their loans were not supposed to be recoverable. The commercial banking system of Russia began its existence with inherently bad assets. When these assets were dissipated by inflation, a new stock of bad assets accumulated because of government-directed credit. As a result, banks required either a continuous flow of central bank refinancing at subsidized interest rates or, when this means was eliminated, other forms of government refinancing and recapitalization.

BACKGROUND TO ECONOMIC REFORM

Analyzing the transition economies of Central and Eastern Europe and Asia has created a new area of scholarly inquiry, producing a spate of books and journals exploring a variety of transition issues as these countries try to make the adjustment from their former socialist systems to market economies. It is not clear that the word *transition* is suitable for Russia. A more appropriate concept might take the form of asking what is required to destroy the old economic and financial systems and then, on a clean slate, how to build new systems.

In 1991, there was no broad consensus on the correct transition strategy. Between March 1985 and October 1990, varying teams of economists proposed twelve different economic reform plans to then Soviet leader Mikhail Gorbachev. All twelve were subsequently dismissed or abandoned.

The first genuine reform measure was the first privatization

law in 1991, which established the right to private property in productive assets. In 1992, the government liberalized prices and began a small-scale privatization program, followed by a voucher privatization program. A new system of ownership structure was created, but that structure was not private property in a normal sense. The reason, as explained below, is that private property was not accompanied by *private budgets*.

ERSATZ PRIVATIZATION

It is important to dispel the notion that privatization created real private property in Russia. In reality, spontaneous privatization in the former Soviet Union began in 1988 when the Law on Enterprise allowed enterprises to withhold the remittance of profits to the government and convert them into wages and managerial bonuses. Private ownership of previously government-owned enterprises was initially acquired by insiders but not in a form that could be sold or traded. In financial terms, ownership did not take the form of securities in joint-stock corporations, which would entitle holders to a share of the enterprise and a portion of its profits.

The government proceeded with a program of voucher privatization, which segregated the country's assets into two unequal parts. All highly profitable enterprises, especially in natural resources, remained government owned, with a proportion of transferable shares distributed to workers and managers of these firms. All other enterprises were converted into joint-stock corporations, or securitized, and their shares were exchangeable for broadly distributed vouchers (every Russian citizen received a voucher).

Between October 1992 and June 1995, a process of spontaneous privatization and voucher distribution and use resulted in the sale of more than fifteen thousand large state-owned enter-

prises (more than 118,000 for the whole economy). By mid-1995, 75.5 percent of all industrial firms were nominally private, producing 87.7 percent of industrial output and employing 77.7 percent of industrial workers (more than 18 million people).

Most Russian citizens placed their vouchers in largely unregulated voucher investment funds and became shareholders of those mutual funds. The investment privatization funds, IPFs as they became known in many transition economies, exchanged the vouchers they collected from individuals for shares of enterprises slated for voucher privatization. Most of the funds then vanished. Individual Russians were hard-pressed to identify what they owned and rarely received any dividends. In 1996, the government considered closing and banning the remaining voucher investment funds because of widespread fraud and the impossibility of monitoring and supervising them. Still, some funds remain. Where and with whom the actual stock of voucher-privatized enterprises ended up remains a mystery because there is no property registry. Scores of holding companies own other holding companies, which own enterprise shares. Invisible and illegitimate ownership created further incentives to run down assets rather than foster new investment.

In 1995, the government began to sell through various, largely rigged cash auctions the truly valuable assets that were spared the voucher episode of privatization. The first wave of these sales was best known as "loans for shares." To justify the subsidized transfer of highly profitable assets in natural resource firms to a small group of selected banks, the government gave the banks shares in "temporary trust" for state-owned resource firms in exchange for their loans to the budget. Banks financed those loans from government deposits they held (a bizarre circular process). When the government failed to repay the loans (as expected), the elite banks became owners of a large chunk of Russian natural

resources. (See chapter 3 for details and unforeseen consequences.)

Revenues from privatization fell from 0.28 percent of GDP in 1995 to 0.11 percent in 1996. Activity picked up in January 1997 with the sale of an 8.5 percent stake in United Energy Systems. In the third quarter, the government sold a 25 percent stake plus one share in Svyazinvest, the telecommunications holding company, which raised almost half as much revenue as all previous privatizations combined.[6] The government also sold major stakes in Tyumen Oil Company and Norilsk Nickel; each of those sales was managed and won respectively by the insider banks that had advanced the loans for those shares (financed by government deposits at these banks) in the first place.

Today, almost all production is nominally in private hands, and few industrial workers remain state employees. But this does not mean that the Russian economy is built on a foundation of private property or that private enterprises are really private. On the contrary. *What appear to be private firms are not really private because they share a common budget with the public sector.* So-called private firms and private banks in Russia have served largely as appendages to a differently constructed system of state control and financing than was the case in the former socialist system. The lines between the public and the nominally private sectors are so blurred that government financing of economic activity has been far in excess of the ostensible 30 percent ratio that defines government expenditures as a share of GDP, rendering this measure almost meaningless.

The evidence for the proposition that the size of the government exceeds 30 percent of GDP is the large share of the negative

6. The sale of a 25 percent stake in Svyazinvest was the first large-scale privatization that appeared to be conducted at a real competitive auction. In that vein, it was probably the first real market privatization, rather than a preferential giveaway of state assets.

value added in production previously mentioned. In a privately financed economy, firms cannot produce negative value added (output whose market value is less than that of its material resource inputs) for long. Such firms and industries soon go broke. Russia is different. One-third of the value of natural resources and one-half of the final value added of industrial output amounts to value subtraction, a process that survives on the basis of subsidies from the natural resource sector and the few profitable firms in other sectors. Neither income nor expenses derived from production are truly private. All flows of funds are linked to a regime of subsidies and cross-subsidies, which creates a common budget for all the ostensibly separate entities. The common budget is facilitated through the interplay of the government and the banking system. Within this system, the appearance of domestic free market prices is deceptive. All prices embody subsidies and taxes in one form or another. Prices serve a fiscal, not a market role, as is always the case under socialism.

The normal meaning of private property rights is exclusive ownership of assets and their returns. So-called private assets that do not generate real private returns are private in name only. When these so-called private assets generate income, largely on the basis of access to government subsidies, they are of little long-term value to their new owners, who face incentives (given the insecurity of their property rights in these assets) to strip them of their real economic value. The value that remains, after real assets have been stripped, is the claims that the owners make on the real resources of other enterprises and actors (by accumulating debts to other enterprises, banks, and the tax authorities they cannot pay or do not expect to pay). Such a system perversely transforms liabilities into assets.

Russian-style privatization, which has thus far amounted to continuous access to government subsidies, is the antithesis of real privatization. A famous theorem in economics, named after

Nobel laureate Ronald H. Coase, states that, regardless of initial ownership, real tradeable private assets will ultimately end up in the hands of the most efficient owners, who will bid them away from their initial owners in the expectation of securing higher returns.[7]

The corollary for Russia is that it does not matter if privatization was conducted through vouchers, private placement, or other means or who were the initial owners. The most capable extractors of government subsidies will eventually bid away property rights through money, force, or government connivance. In the upside-down Coase world of Russia, private property ultimately ended up in the hands of the most capable predators of public income, not in the hands of those who might use it to generate the highest possible economic return. Nominal privatization transformed explicit socialism into quasi socialism. The big financial-industrial groups, having an appearance of privateness, simply merged with the central government as the owners and allocators of national resources. The process of privatization in Russia turned out to be counterproductive and explains why it failed to generate growth. It also highlights the need to achieve real privatization, which requires separation of public and private budgets. No one should be deceived into thinking that these FIGs, as financial-industrial groups are known, are real private enterprises that sink or swim on their own.

DATA ON RUSSIA

Goskomstat (the State Statistical Committee) has had to create a system of "real" national income accounts that reflect the new economic realities of Russia. This is easier said than done, and

7. Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3, no. 3 (October 1960): 1–44.

the organization still has a long way to go. Socialist statistical systems did not have a Western system of national income accounts or the concepts of gross domestic (or gross national) product and national income. They counted only physical output, not value added and not services. The true problem is prices, which were not, and still are not, real market prices. It is hard, therefore, to subtract intermediate inputs and find the final value added. Also, changing estimates of the shadow economy arbitrarily distort the data on GDP and growth, making it hard to count and quantify new firms. The introduction of an explicit tax system (which replaced the old system of enterprises turning over their income to the state) encourages firms to understate output and profit. The output of small firms and providers of services tends to be undercounted. By contrast, as previously mentioned, the contraction of output may be underestimated because the value of exported natural resources increased when Russia phased out energy subsidies to Eastern Europe and the former Soviet Union. This unrecorded addition to GDP, about 15 percent over the 1990s, hides an equivalent contraction of real output. Despite its shortcomings, the State Statistical Committee still remains the primary source of raw data on the Russian economy.

Some State Statistical Committee data are reproduced in English in *Russian Economic Trends*, a publication of the London School of Economics (with the cooperation of the Russian government), financed by the European Commission's technical assistance program (TACIS). A monthly update of *Russian Economic Trends* is published with a few week's delay and is available on the World Wide Web. The data encompass such standard indicators as inflation, the budget, money supply, the foreign exchange market, financial markets, foreign trade, output and investment, consumption and wages, and unemployment.

The International Monetary Fund, World Bank, Organization for Economic Cooperation and Development (OECD), European

Bank for Reconstruction and Development (EBRD), and a number of commercial banks routinely publish assessments of the Russian economy. The CBR publishes a variety of statistical bulletins and pamphlets. It also maintains a summary data series on the Web, both in English and in Russian.

Three problems plague Russian data: consistency over time, consistency between sources, and general reliability. Every two or three years, the CBR significantly changes its definitions, measurements, and subsequent numbers on such basic matters as money, credit, good and bad banking assets, deposits, and banks' equity capital. Periodically, the health of the banking system is suddenly uplifted by abrupt statistical changes, which makes creating consistent historial series both difficult and suspect. The data on money and banking variables reported by the CBR and the State Statistical Committee do not match, with no obvious tendency. Our numerous inquiries to the leadership of the Central Bank, the State Statistical Committee, the Ministry of Finance, and the government about specific data changes, definitions, and mismatches revealed more uncertainty than clarity. The worst problem, however, is the outright falsification of the balance sheets of the banking system and major banks.

According to a published statement by the chairman of one of the largest Russian commercial banks, Inkombank, the CBR and the commercial banks reached an unwritten agreement in 1997 to use creative accounting in designing their balance sheets to hide sunk losses, which may wipe out the entire equity of major banks. The specific methods of this accounting convention remain secret.[8] The fraudulent construction of bank balance sheets is sanctioned to boost their creditworthiness. Private Western accounting firms are familiar with this problem; their typical

8. Vladimir Vinogradov, "Any Banker Is a Very Lonely Man," *Nezavisimaia Gazeta* (Moscow), December 25, 1997, p. 4.

published audits of major Russian banks contain a disclaimer that the audit is based on the data provided by the client and that the auditor is not responsible for the final numbers in the balance sheet.[9]

A huge academic literature (books and journal articles) has materialized on Russia. Most of that work focuses on personalities and various reform topics (e.g., privatization, price liberalization, political intrigue). That literature is highly contentious in that the proponents of the many reform plans put forth since 1985 try to defend their particular recommendations. There is a struggle for turf among the contending academic factions that had (or want) the ears of the Russian government. As a result, much of the literature is self-serving. Fortunately for our work, we can draw for insight and comparative analysis on an excellent transition literature not specifically devoted to Russia.[10]

9. Foreign accounting companies and auditors routinely disclaim responsibility for the integrity of the data in their published reports that set forth balance sheets and profit and loss statements of Russian banks. See, for example, Arthur Andersen's published audit of Bank Menatep in *Finansovye Izvestiia*, no. 95 (December 1, 1995): 3.

10. See Erik Berglof and Gerard Roland, "Bank Restructuring and Soft Budget Constraints in Financial Transition, *Journal of the Japanese and International Economies* 9, no. 4 (December 1995): 354–75; Enrico C. Perotti, "A Taxonomy of Post-Socialist Financial Systems: Decentralized Enforcement and the Creation of Inside Money," *Economics of Transition* 2, no. 1 (January 1994): 71–81; Enrico C. Perotti, "Bank Lending in Transition Economies," *Journal of Banking and Finance* 17, no. 5 (September 1993): 1021–32; Guillermo A. Calvo and Fabrizio Coricelli, "Inter-Enterprise Arrears in Economies in Transition," in Robert Holzmann, Janos Gacs, and George Winckler, eds., *Output Decline in Eastern Europe: Unavoidable, External Influence or Homemade?* (Dordrecht, Boston, and London: Kluwer Academic Publishers, 1995), pp. 193–212; Guillermo A. Calvo and Fabrizio Coricelli, "Credit Market Imperfections and Output Response in Previously Centrally Planned Economies," in Gerard Caprio, David Folkerts-Landau, and Timothy D. Lane, eds., *Building Sound Finance in Emerging Market Economies* (Washington, D.C.: The International Monetary Fund and the World Bank, 1994), pp. 257–94; Steve H. Hanke, Lars Jonung, and Kurt Schuler, *Russian Currency and Finance: A Currency Board Approach to Reform* (London and New York: Routledge, 1993);

Ronald I. McKinnon, *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, 2d edition (Baltimore and London: Johns Hopkins University Press, 1993); Guillermo A. Calvo and Manmohan S. Kumar, "Money Demand, Bank Credit, and Economic Performance in Former Socialist Economies," *IMF Staff Papers* 41, no. 2 (June 1994): 314–49; and Ronald I. McKinnon, "Financial Growth and Macroeconomic Stability in China, 1978–1992: Implications for Russia and other Transitional Economies," *Journal of Comparative Economics* 18, no. 3 (1994): 438–70.