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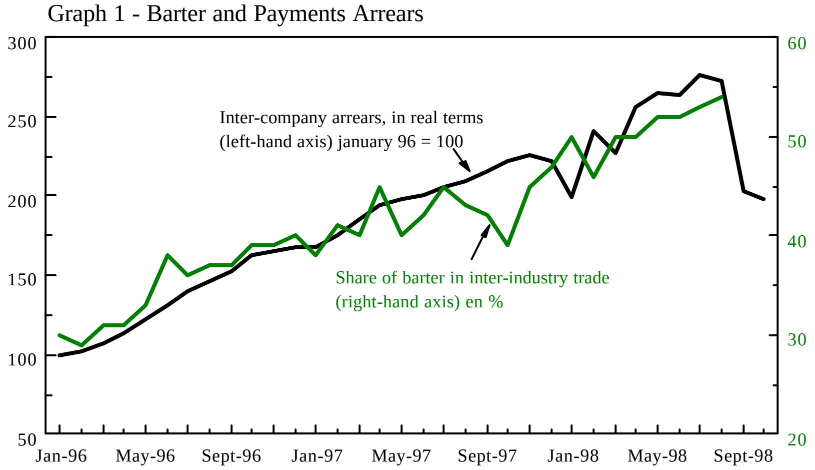
WHAT RULES FOR THE ECONOMY IN RUSSIA?

The decisions of 17 August 1998 constitute a clear break in the history of the Russian transition. On the one hand, the abandonment of the "corridor" policy, which had provided the framework for change over the last years, has ended the relative price stability obtained three years ago. On the other hand, the partial default on State debt, and the unilateral moratorium on the foreign commitments of the banking sector indicate that these two agents have become insolvent. At the same time, the various strategies of resistance to competition and financial discipline, which a majority of enterprises have adopted, have indeed been validated by the financial crisis: logically the latter has affected most those agents who are the best integrated into the cash economy and monetary transactions. Consequently, these events have also accentuated a profound characteristic of the Russian economy, which has been visible for a number of years: the conjunction of increasingly weak discipline at the microeconomic level, coupled with an ever-narrower capacity for action at the macroeconomic level with respect to reforms of the economic structure.

Russia's reforms have had the objective of building a decentralised, competitive economy which should lead to a better valuation of resources, but the country has not been able to establish the bases for such a long term strategy: problems of acceding to markets faced by new producers and the rent-seeking strategies of numerous intermediaries presently constitute major obstacles to competition. Futhermore, insolvent companies have not been subject to sufficient financial constraints for an alternative form of adjustment or market exit (ie. bankruptcy) to be imposed. Year after year, such firms have been able to obtain easy credit from banks that are more or less closely linked to them. Furthermore, they have increasingly resorted to informal practices including: the accumulation of payment arrears, both with respect to the tax authorities and to employees or suppliers, or payments in kind, allowing them to avoid paying off their debts in money (Graph 1).

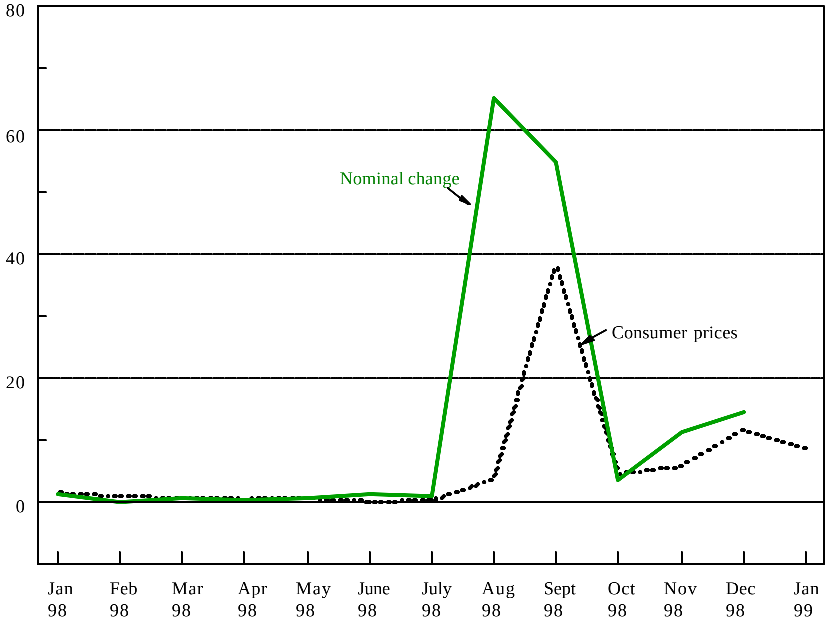
Graph 1 - Barter and Payments Arrears



Source : Russian Economic Trends, Russian Economic Barometer.
Note : Inflation in September 1998 led to a fall in the stock of arrears.

Both of these powerful trends reflect the incapacity of the State to impose payments discipline on all agents, especially with respect to creditor rights, and ultimately bankruptcy rights. This led to a reduction in the capacity of companies, especially in financial terms, to implement medium-term development strategies. Thus, barter trade, which today covers more than 50% of inter-industry transactions, constitutes an increasingly damaging obstacle to microeconomic behaviour. Neither the relative structure of prices, nor accounting frameworks, nor even company cash-flows provide information useful to guiding a restructuring strategy. Under these conditions, it must be asked how it would be possible to develop productive activity geared to profit maximisation. How is cash-flow to be channelled towards debt reimbursements or the acquisition of capital equipment, when such funds are not available in cash? This de-monetisation of the economy has been a major factor suffocating banks and the State progressively. Thus, the former have been caught up in their own inability to ensure regular income flows: their loan portfolios and equity holdings remain limited and badly managed, while most of their resources are committed to speculative activities or the buying up of State bonds, which were frozen in August 1998. Similarly, falls in tax collection and the rise of interest payments on public debt as a share of earnings have worsened State finances. The latter has tried to respond with spending cutbacks, while also accepting payments in kind for certain tax debts. However, as with the major banks, the issuing of new internal and external debts has progressively become the sole response to growing illiquidity.

Graph 2 - The Exchange and Inflation Rates (Monthly Variations in %)



Source : Datastream.

The August Crisis

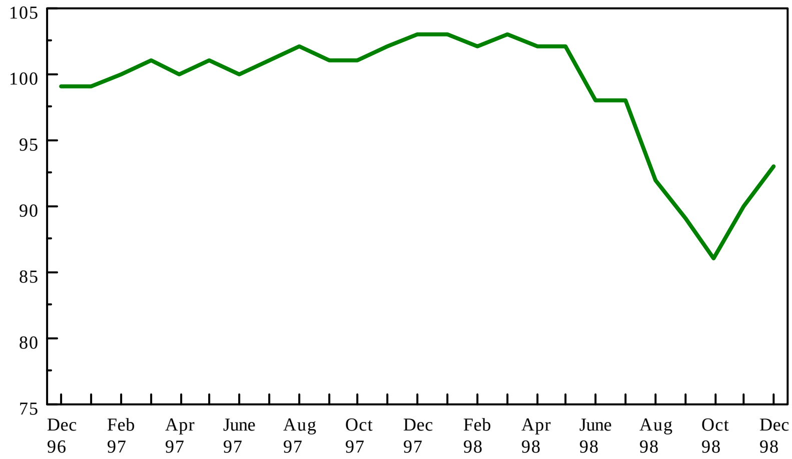
The collapse of energy prices and the rise in financial tensions that followed the Hong-Kong crash (in October 1997) precipitated the final slide into crisis: interest rates which have remained high since then have considerably worsened the burden of servicing public debt and have expanded the deficit. Following a final attempt to stabilise the budget, at the beginning of June 1997, and the last programme signed with the IMF in July, the mass exit of investors became uncontrollable in early August. This led to a collapse of markets, and subsequently to their progressive blockage: the State was no longer able to refinance its debt while the banks became illiquid, one after another. At that point, the government had no choice but to resort to printing money or to default on payments[1]. Spreading out from the weakest and least performing companies, the drying up of the monetary economy finished by reaching into the heart of the State and the financial system. Thereafter, the only remaining, liquid rouble assets still available are bank notes, a share of bank deposits and a small stock of short term bonds issued by the central bank.

Apart from the political elimination of the liberal reformers, who were present in all governments as of 1992, the immediate consequences of the decision of 17 August was a 60% depreciation of the exchange rate and a strong surge in inflation in September, followed by relative stabilisation in the following months (Graph 2). Industrial production, which had been declining since the spring, fell brutally in September, before returning clearly to growth in the fourth quarter of 1998 (Graph 3). Price-competitiveness and negative real interest rates in the autumn account for this turnaround, but also raise doubts about the length of the upturn. Thus, the renewed shift to a strong trade surplus is more the result of the collapse of imports and real household income rather than a pick-up in exports. More generally, it is to be feared that companies which are still subject to weak adjustment constraints will rapidly run out of room for manœuvre. The renewed function of the financial system has been far slower, with a very limited upturn in the inter-bank market, whereas progress is slow in two strategic areas, namely: the restructuring of banks and the negotiations on foreign debt. The continued losses of

1. See Jérôme Sgard, "Le Brésil et la Russie face à la crise financière", ***La Lettre du CEPII***, March 1998.

reserves the Central Bank is experiencing, despite the return to a trade surplus, also indicate that capital flight has not stopped. Such data demonstrates that the budgetary stabilisation observed at the end of 1998 is still fragile, and raises strong doubts in particular concerning the monetary stability of the country, as well as with respect to its relations with international creditors.

Graph 3 - Industrial Production (January 1996 = 100)



Source : Goskomstat.

Beyond these short term trends, the strongest pattern to have emerged since the 17 August 1998 concerns the weakening of the institutions and instruments of the central State, both in terms of macroeconomic stabilisation, as well as with respect to its capacity to redefine and implement a coherent reform strategy. On this basis, an attempt may be made to identify the principle axes of a policy that would allow the relative stability at the end of 1998 to be protected, and thereafter move towards a medium-term strategy.

What is to be done after the disaster?

Fiscal Policy

The principal consequence of payment defaults is that the Russian State has for a long time lost all but a marginal capacity to finance the public deficit. Excluded from international capital markets, in conflict with multilateral organisations, and incapable of re-launching a domestic debt market or borrowing from the banks, the State is also unable to issue money, if inflation is not to be risked. Given such insolvency, the State will probably be condemned to a strict budgetary control on a cash flow basis, in which it can only commit resources as and when tax receipts are available. Financial and institutional reconstruction of the State must therefore be at the centre of any medium term strategy. This would apparently rest, on the one hand, on a definition of tax federalism, whose negotiation could by facilitated by the relative agreement currently prevailing between the Government and the Duma. Similarly, recent measures to fight corruption could indicate a break-through, if they lead to a real change in the rules, and not merely a change in the individuals holding power. On the other hand, for the State to gain some margins for manoeuvre it must be able to acquire the bulk of Russia's energy rent.

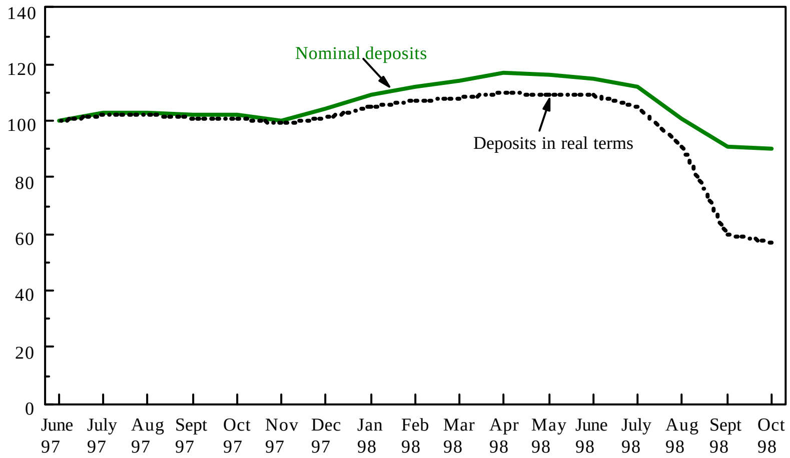
Money

Currently, any new shock to prices could lead to a situation in which there is a two-fold shift to a non-monetary economy and to dollarisation. This would reduce the rouble's role to that of a simple unit of account for State transactions (the payment of taxes and spending). The monetary aggregates for the rouble are already at very low levels, which are found in situations of hyperinflation. Between June and September 1998, the deposit base in roubles fell by 21%, due to substantial withdrawals, to which a further 24% should be added due to an inflation tax (Graph 4): in sum, outstanding rouble deposits were equivalent to a mere 4.3% of GDP, at the end of the period[2]. On top of a shift of monetary functions into dollars, as was observed in Latin America during the 1980s, Russia is also witnessing a notable destruction of the functions of money themselves. If such trends continue, they will make monetary regulation of the economy impossible, destroying also the capacity of the economy to provide coherent, relative prices.
Given such risks, the Russian authorities will not be able to stray away long from having a strong monetary framework. It is most probable that they will ***de facto*** adopt a currency board regime, even if it is not formally institutionalised. No political group seems presently willing to peg the rouble completely to a foreign currency, thus putting the central bank on "auto-pilot". Such a move, however, would simply institutionalise existing constraints and make their management easier, without limiting State action

2. This level is exactly the same as that experienced by Argentina at the end of 1990, two years after a sharp inflationary crisis, and six months prior to the establishment of the currency board. In Poland the level stood at 21%, in 1990.

further. Moreover, such an exchange rate regime does not exclude the possibility of control of short term capital movements, in order to limit speculative flows and direct the use of forex receipts towards priority sectors and agents. In contrast, while a currency board implies having a very strict macro-financial framework, it is in no way a substitute for a strategy seeking to strengthen micro-economic discipline.

Graph 4 - Outstanding Deposits in Roubles (June 97 = 100)



Source : Russian Central Bank.

The Financial System

To this end, the reconstruction of the financial system should be based on two priorities: first, a coherent payments system needs to be stabilised nationally, especially via the consolidation of the ***Sherbank*** savings bank, while the functions of the central bank must be reinforced. Second, the reconstruction of market institutions, especially banking supervision, should precede the re-launching of the surviving banks. This is particularly true for the regional banks, which are less affected by the crisis, and which, since 1998, have tended to set up "regional empires" based on the same kind of opaque relationships with local authorities that had been prevalent nationally before the August 1998 crisis. Such trends cannot but worsen the forces breaking up the national economic area. Similarly, the large Moscow banks, which had been broken up by their own managers last August and September, are presently resurfacing under new names. Their assets have been transferred away with impunity, while their debts have been left to depositors or the State. Seldom has the defiance of public authorities been so flagrant.

Apart from macroeconomic management, which will remain rigid for a while, defining a strategy for viable reform should be based on an assessment of past microeconomic failings: a precondition for any shift to a decentralised economy is that companies adopt financial, tax and contract discipline. Such a reinforcement of the institutions and norms of the market, throughout the national economic area, ultimately requires a solid State and the rule of law. If these are not achieved, there is the risk that Russia will very soon turn its back a little more on market reforms, leading to a further weakening of public institutions, the decline in living standards and the slow disintegration of the economy.

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