

Russia's Economy: Financial Lessons Learned

Alexander Nekipelov

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All experts agree: The current economic situation in Russia is much better than could have been anticipated during the August/September timeframe of 1998. Former Prime Minister Yevgeny Primakov's government together with the central bank in September and October of 1998 managed to prevent the outright disintegration of the payments system, a dangerous slide into hyperinflation, and the uncontrollable fall of the ruble.

Domestic and foreign specialists alike had regarded as inevitable a default on external debt obligations in the spring of 1999. But due to skillful maneuvering in monetary and fiscal policy, the authorities succeeded in restoring economic stability.

Measures aimed at starting foreign exchange controls and fighting corruption were also initiated. Only as a result of this work could the economy avail itself of the opportunities that emerged in the wake of the considerable drop in the exchange rate. Imports were severely cut whereas import-substituting domestic production was pushed ahead. Thus, a two percent growth rate is expected for 1999 in overall GDP, with seven to eight percent growth in the industrial sector.

The situation has also improved in the financial sphere. The number of profit-making enterprises has increased as has the cash component of their current assets. For the first time in recent years federal budget targets for incomes and expenditures in 1999 will be realized. In addition, the increase in oil prices on the world market has had a positive impact.

Primakov's successors, Sergei Stepashin's government, interpreted these positive processes as evidence that Washington Consensus policies, if pursued in a coherent manner, were perfectly correct and should continue.

This was clearly stated in a joint declaration of the government and central bank on July 13, 1999. The authorities committed themselves to tough monetary and fiscal policies, a further liberalization of the economy (import reductions, cancellation altogether of export tariffs, cancellation of the recently introduced barriers designed to block capital flight) and the implementation of certain structural reforms.

Vladimir V. Putin, the current Prime Minister, has adhered to this approach, which at this point is flawed for several reasons.

First and most important, it fails to take into account the fact that efficient post-August stabilization mechanisms had nothing to do with correcting basic distortions in the economic system. Widespread lack of efficient control over enterprise management by the owners of capital remains at the heart of the problem. Management often ignores demand constraints, supplying produce in exchange for non-payments or illiquid money surrogates. Asset stripping at state and privatized enterprises, capital flight as well as criminalization of economic activity are all rooted in a lack of adequate regulation of property rights. Corporate governance reform and the rationalization of the management of state assets should be seen as indispensable measures for transforming the economy into a genuine market economy. They are not just two among numerous "structural reforms."

Eliminating Obstacles to Normal Market Transactions

A fundamental misunderstanding of the nature of the current economic system makes the government believe it can gradually solve the issue of arrears by a resolute application of bankruptcy procedures and responsible fiscal

policy. The “virtual economy” in Russia is one of the most important manifestations of distortions in the economic system and it therefore cannot be eliminated without the above mentioned changes in property rights.

However, this is not sufficient. A one-time monetization of all overdue debt in the economy will be needed to switch on adequate bankruptcy mechanisms and eliminate the obstacles currently inhibiting normal market transactions. Rationalization of property rights is also very importance to overcome the deep investment crisis. No investment-led growth is probable until economic units are oriented to maximize of their net worth.

Secondly, the issue of liberalization should not be tackled in a simplified way. One has to take into account the fact that a market process of reallocation of resources produces two challenges: The first involves the issue of employment and the possibility of largescale structural unemployment. The government has to decide whether it is ready to intervene or prefers to stand aside, waiting for market mechanisms to settle the issue. In fact, government invariably intervenes, and it is better when it does so in a planned manner. The second challenge requires that the government and its supporting institutions successfully convince the general population that the market will indeed work for them. The transition in Russia to a market economy has been so rocky that many people continue to perceive the market as non-optimal, at least as not working for them. Many prefer to bear additional hardships to preserve or restore the status of the country in a way that would reflect its modern scientific and technological potential. Of course, in fact, this can be done best if an adequate industrial policy is designed and implemented.

As far as the financial sphere is concerned, premature liberalization is very dangerous, and Russia has its own experience of this. Taking into account the immaturity of the country’s financial infrastructure and its heavy debt burden, it would be correct to limit domestic convertibility of the ruble to current account transactions and to introduce rational capital controls. Efforts should focus on making the ruble perform all money functions domestically and on restructuring Russia’s financial institutions instead of dogmatically following neo-liberal prescriptions.

Some economists criticize the government’s approach on the grounds that tough monetary and fiscal policies are counterproductive in the Russian case. They believe that printing more money could increase the utilization of productive capacities and crowd out non-payments and barter transactions.

It is smart to be skeptical about such recipes. If “money shortage” is a systemic phenomenon, one cannot expect to overcome it by manipulating supply. Also, according to Keynes, deficient demand means households or firms do not want to spend money — perhaps because they do not have it to spend.

Alexander Nekipelov, a member of the Board of ECAAR-Russia, is director of the Institute for International Economic and Political Studies at the Russian Academy of Sciences.

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