Paul J. J. Welfens*

Overcoming the Russian Transformation Crisis

Russia's attempts at transformation into a market economy have so far resulted in a prolonged and steep economic decline. This is in stark contrast to developments in other formerly socialist countries where an initial period of economic decline was followed by strong growth. What are the reasons behind the adverse development of the Russian economy? What policy changes are required to bring Russia stability, growth and prosperity?

Post-socialist Russia's first attempt to accomplish transformation towards a stable open market economy failed in August 1998 when the government and the central bank chief had to step down in the context of a massive devaluation of the rouble combined with a unilateral debt moratorium and a forced restructuring of short-term government GKO bonds. While in early 1998 it seemed that Russia – recording an inflation rate of below 10% and a deficit-GDP ratio of roughly 7% – was close to declaring the victory of its transformation approach (a victory which had been declared even earlier in economic literature[1]) the politico-economic crisis of August/September 1998 revealed that most of the transformation elements had been parts of a Potemkin-type transition. The first-time slow growth of 0.4% in 1997 was not followed by a desirable acceleration of output; rather, negative growth is to be expected for 1998/99. Indeed in 1997 there was no growth of the official economy since the figure of 0.4% includes an estimate for the growth of the shadow economy.

In Russia the people are facing a dramatically worsening economic situation and prospects of political turmoil. After a fall in output of one-third in the period 1991-97, the years 1998/99 will bring another fall of about 5% per annum. After the August 1998 crisis, when Russia defaulted on its rouble bonds, the switch to floating exchange rates went along with a depreciation of the currency by three-quarters. Within six months the external debt – expressed in rouble terms – more than tripled. Hence the central government had to reduce expenditures sharply so that spending on infrastructure, health care, education and research & development have fallen sharply. How could renewed economic growth be achieved under such circumstances? Russia will thus face further economic decline, and with two elections coming in 1999/2000 there is a serious risk of political radicalization and instability – all this in a country with a dissatisfied military, major nuclear forces and a large potential for nuclear proliferation.

As regards government financing there was a broad failure to introduce an effective tax collection system so that government was forced to resort to short-term unsustainable bond financing in 1997-98, which ended with a unilateral GKO moratorium and a major banking crisis. The consequences of unsuccessful transformation are a dramatic shrinkage of the official economy, impoverishment of large strata of the population, a dramatic fall in life expectancy – 58 for males in 1998 – and a shrinking of the population by some 700,000 annually (from 149 million in 1990). Against this background there is a risk of a vicious circle during which output, population and per capita real income will continue to fall.[2] Such a development could be tragic for Russia, Europe and the world economy at large. A virtuous circle instead would fully develop a market economy – possibly with some state-owned firms remaining for some time – and achieve prosperity in Russia.

An Analytical Look at Selected Indicators

Macroeconomic development in Russia has been characterized by a sharp economic decline in the period 1990-97, when the contraction of output and

* European Institute for International Economic Relations at Potsdam University, Potsdam, Germany.

[1] A. Aslund: How Russia became a Market Economy, The Brookings Institution, Washington D.C. 1995.

[2] P. J. J. Welfens: EU Eastern Enlargement and the Russian Transformation Crisis, New York and Heidelberg 1999.

Table 1
Macroeconomic Indicators for Russia

	Changes vis-à-vis previous year and shares in %							
	1990	1991	1992	1993	1994	1995	1996	1997
Gross domestic product[1]	–0.3	–0.5	–14.5	–8.7	–12.7	–4.2	–4.9	0.4
Agricultural production[1]	–3.6	–5.0	–9.0	–4.0	–12.0	–8.0	–5.1	0.1
Gross domestic capital formation[1]	0.1	–15.0	–40.0	–12.0	–24.0	–10.0	–18.1	–5.0
Freight transportation[2]		–7.4	–23.6	5.0	–24.3	–10.2	–17.7	–9.8
Freight transportation[3]		–7.4	–13.9	–11.5	–14.2	–1.0	–4.6	–3.6
Freight transportation (km)			+9.7	–16.5	+10.1	+9.2	+13.1	+6.2
Retail turnover[1]	12.0	–3.2	–3.0	1.9	0.1	–7.0	–4.1	2.5
Real private income[4]		7.5	–50.5	11.2	13.0	–13.0	–0.9	3.5
Nominal wages	15.0	81.0	994	878	276	114	57.3	19.7
Real wages		–3.0	–33.0	0.4	–8.0	–28.0	6.4	4.3
Consumer prices[5]	6.0	160	2510	840	215	131	21.8	11.0
Unemployment rate[6]			4.7	5.5	7.4	8.8	9.3	9.0

[1] Real. [2] In tons. [3] In tons per km. [4] 1990-1993: December vis-à-vis December of the previous year; 1994-1997: annual average. [5] 1990: annual average, 1991-1997: December vis-à-vis December of the previous year. [6] End of period; ILO-method.

Sources: DIW/IfW/IWH: Die wirtschaftliche Lage Russlands, in: DIW Wochenbericht 18/1998; own calculations.

investment was particularly strong (Table 1). With a transition policy which included the introduction of competition cum privatization and economic opening-up, a sharp initial decline but strong economic growth thereafter were to be expected as efficiency gains and the positive output effects of investment, innovation and rising trade should dominate aggregate output dynamics. Such a development was indeed the case in Poland, Hungary and the Czech Republic, so that the question arises why the Russian developments differed from this path. Russia recorded its first post-socialist growth in 1997 when GDP increased by +0.4% – a figure which includes shadow economic activities as estimated by Goskomstat. This suggests that growth dynamics in the official economy were still poor in 1997 when a further aggregate output decline mainly was counteracted by growth of consumption and – for the first time since 1990 – market services for final consumers.

A striking feature of the Russian transformation is that the volume of goods transported, measured in ton-kilometers, declined strongly in each year in the period 1990-97 – even more strongly than GDP in the same period. Socialist firms were known to face monopolistic supplier problems and therefore tended to avoid outsourcing; hence the transition to a market economy should have been a strong stimulus to domestic (and international) transportation – even if economic efficiency gains would have reduced the average weight of products, the number of ton-kilometers should have increased. This holds especially since the introduction of competition should have enlarged the average market radius. A minor caveat here is that the spatial division of labour in the USSR often ignored transportation costs.

Figures for the former GDR and Poland (Table 2) show no persistent decrease in freight transportation; on the contrary, a strong medium-term increase is observed after 1992 in Poland. Rising transportation figures partly reflect intensified competition as consumers and firms enjoy broader opportunities with respect to (intermediate product) suppliers. Indeed, one may state the hypothesis that an indicator of successful market-oriented transformation of a formerly socialist economy is a long-term increase in freight transportation – after the initial collapse in the freight volume parallel to the sharp economic decline of the first transition stage. From this perspective Russian transformation has largely failed since the percentage decline in freight transportation on the basis of ton-km was stronger than for output in the period 1991-97, except for the years 1995/96. In the period 1991-94 there was no increase in the average market radius if we take a positive and significant growth rate of freight transportation on a km basis as an indication of market enlargement. Thus spatial competition has hardly intensified; this is much in contrast to what one would expect from a successful transformation.

The structure of industrial output – measured in current prices – changed considerably in the first transition stage, while changes measured in constant

Table 2
Freight Transport in Poland 1990-97

	Millions of tkm			Growth	Km growth
	Trucks	Railway	Total	%	%
1990	40293	83530	123823	–	–
1991	39641	65146	104787	–15.37	–5.37
1992	42037	57763	99800	–4.76	1.82
1993	40744	64359	105103	5.31	8.18
1994	45365	65788	111153	5.76	6.53
1995	51200	69116	120316	8.24	5.37
1996	56513	68332	124845	3.76	3.51
1997	63688	68651	132339	6.00	4.31

Sources: GUS: Rocznik Statystczne, Warsaw 1995, 1998; own calculations.

prices were much more modest.[3] Evaluated at world prices the share of the energy sector (electric energy plus fuel) was high in the ex-USSR where it reached 1/3 of industrial output in 1991, and it still accounted for a similar figure in 1998. The relatively high share of light industry in 1991 is inflated by the relatively high prices assigned under central planning to this sector. Comparing 1994 sectoral shares and the respective figures for 1991 at world market prices one finds that the structural change was much weaker than indicated by nominal indicators. Especially the decline in light industry and in metallurgy was smaller than it seems at first sight. It is, however, true that the share of industry in overall output fell by some 6 percentage points in 1991-94, while that of transport and communication tripled from a low base of 5% to reach 15% in 1994, when the production of services exceeded the production of goods for the first time.

Insufficient Competition and Lack of Structural Change

From a theoretical point of view major output effects can be expected from a country which is moving from inefficient production towards the production possibility frontier while adjusting the structure of output in line with relative world market prices. However, such benefits will only occur under the pressure of competition and if adjustment costs are limited. The larger the discrepancy between initial relative prices and world market prices, the higher will be adjustment costs – indeed one could use a quadratic adjustment costs function which positively depends on relative price distortions. Russia's main problem with efficient structural change comes from lack of effective governance in most industries on the one hand – due to insider privatization and reluctance to accept strategic foreign investors – and on the other hand from insufficient competition.

There were hopes that expansion of the energy sector – dominated by Gazprom – would be an easy way to generate higher export revenues and thereby to finance imports of modern capital equipment. However, rising Russian exports of energy face the problem of immiserizing growth,[4] i.e. a strong boost in export volumes will contribute to falling world market prices and declining terms of trade; this could result in a negative welfare effect. Indeed, falling world market prices – which had come under the pressure of a general global excess supply – contributed to a falling absolute export revenue in late 1997 which in turn brought about a current account deficit in 1998, thus reinforcing the fall of the rouble.

Some authors have argued that Russia is not facing serious monopoly problems since a comparison of Russia and the USA reveals similar firm-size distributions.[5] This view is seriously flawed since comparing large US companies with large Russian companies without taking into account differences in corporate organization and governance is inadequate. Many large US companies are strongly decentralized – e.g. on the basis of regional profit centres – while most large Russian firms were characterized by a low degree of internal decentralization. Indeed, the aggregate degree of decentralization in a market economy is determined both by the scope of markets and the degree of intra-firm decentralization. Moreover, while consumers in the USA (using the internet, price agencies or mail retailing) are very mobile and active in markets with a large radius – with many suppliers competing – the poor state of the Russian transportation and distribution systems reinforces the role of regional monopoly positions.

Russia's competition policy made only slow progress in the early 1990s.[6] Dominant market positions are officially tolerated even if a firm has a 2/3 market share. Moreover, since the competition authority is not politically independent there are

[3] E. Gavrilenkov, V. Koen: How Large was the Output Collapse in Russia? Alternative Estimates and Welfare Implications, International Monetary Fund, Working Paper WP/94/154, December 1994.

[4] J. N. Bhagwati: Immiserizing Growth, Reprinted in: American Economic Association: Readings in International Economics, Homewood, Ill. 1967.

[5] A. N. Brown, B. W. Ickes, R. Ryterman: The Myth of Monopoly: A New View of Industrial Structure in Russia, The World Bank, Washington, October 1993.

[6] H. Hoelzler: Privatisierung und Einführung von Wettbewerb in Rußland, European Institute of International Economic Relations, Discussion Paper No. 53, Potsdam 1996; P. J. J. Welfens, K. Gloede, H. G. Strohe, D. Wagner (eds.): Systemtransformation in Deutschland und Rußland, Heidelberg and New York 1998.

enormous opportunities for rent-seeking. Weak competition policies and an ongoing soft budget constraint, due to the lack of effective implemention of bankruptcy laws, create insufficient incentives for efficient restructuring for most of the large firms. In addition to these aspects there is the special problem of the military industrial complex, which underwent only limited change.

Structural Change

From a consistent systemic transition, economic opening-up and enormous relative price changes for production factors and goods may be expected so that a thorough structural change within industry should be observed. Moreover, given the socialist systemic bias against services a rising share of services in overall output should also be expected. While the service sector has indeed expanded strongly and reached 49.4% in 1998 there was very limited structural change in industry.

The former USSR/Russia has been characterized – much in contrast to the USA or Canada and, more importantly, the early reformer China – by a legacy of declining industrial structural change and increasing overspecialization in the 1980s (see Table 3) plus inconsistent transformation policies in the 1990s.

Successful structural change in the course of systemic transition and economic opening-up will show up in the form of a high rate of intersectoral reallocation of labour so that the standard deviation of sectoral employment growth rates – measured across

Table 3
Industrial Specialization and Structural Change in Canada, the USA, China and the USSR (1980 and 1990)

	Intensity of Structural Change		Absolute Change	Degree of Specialization		Absolute Change
	1980	1990	1990/80	1980	1990	1990/80
Canada	3.4	3.7	0.3	10.3	11.8	1.5
USA	2.9	3.3	0.4	11.9	12.3	0.4
China	2.4	3.3	0.9	14.0	10.8	–3.2
USSR	1.8	0.8	–1.0	18.3	19.7	1.4

Calculations:
Intensity of Structural Change: Moving average (five years, in degree): $\cos \beta = [\Sigma s^{it} s^{i(t-1)}]/[(\Sigma s^{it})^2(\Sigma s^{i(t-1)})^2]$

Degree of Specialization: $h = 100\,[1+(\Sigma s^i \ln s^i)/ h^{MAX}]$; $h^{MAX} = \ln$ (number of the i sectors); s^i = share of i in value added; indicator h lies in the interval [0,100]

Sources: UNIDO and own calculations.

sectors – should be rather high. Boeri[7] distinguished nine sectors and found for the case of the Visegrad countries that the Czech Republic had a relatively low degree of structural change, so that it is not surprising that the country has witnessed much slower growth than Poland or Hungary where the degree of structural change increased in 1993-95 compared with 1991-93. The economic catching-up of the former GDR has also been linked to strong structural change.[8]

In Russia the stagnation problem results from the fact that too few sectors are contracting, which in turn hinders potentially dynamic sectors from expanding on the basis of cheaper and more easily available workers. A crucial problem in this context is related to the ineffective bankruptcy law and correspondingly weak labour market dynamics. Hungary successfully coped with a similar problem by introducing the personal responsibility of managers for postponing bankruptcy procedures.

In early 1998 Russia had 2 million registered unemployed with a share of long-term unemployed of roughly 1/5; however, the number of unemployed was in fact 6.4 million, which was equivalent to an unemployment rate of 9.3%. In addition, the number of workers on forced holiday and forced part-time work was 4 million – based on average monthly figures in 1997.[9] The fact that without much industrial structural adjustment – consistent with world market prices and competition – there is already an unemployment rate of around 10% points to potentially much higher unemployment once the thorough restructuring and bankruptcies of uncompetitive firms takes place. It is this difficult transition period which has not been passed in the first seven years of Russian transformation. This decisive transition stage can probably only be reached if there are favourable conditions for new firms and foreign direct investment on the one hand, and, on the other hand sufficient external credits which allow the funding of the transitorily rising budget deficit in the phase of high unemployment.

Workers have been reluctant to change firms for many reasons. Besides shortages in the housing

[7] T. Boeri: Heterogeneous Workers, Economic Transformation and the Stagnancy of Transitional Unemployment, in: European Economic Review, Vol. 41, 1997, pp. 905-914.

[8] U. Heilemann, K. Löbbe: The Structural Renewal of Eastern Germany: Some Initial Observations, in: P. J. J. Welfens (ed.): Economic Aspects of German Unification, New York 1996, pp. 9-38.

[9] DIW/IfW/IWH: Die wirtschaftliche Lage Rußlands, in: DIW Wochenbericht 18/1998.

market, employee-ownership privatization schemes have reduced regional and sectoral mobility. Moreover, uncertainties due to wage arrears also have slowed down the mobility of risk-averse workers. Government wage arrears are largely due to the deficit and debt problems of the central government.

The Debt and Banking Problems

Facing an external debt of some $ 150 billion and having earmarked $ 8.5 billion for foreign debt service, which is equivalent to one-third of the federal budget, the budget situation is getting out of control in Russia in 1999. This holds less in the traditional sense of focusing on the budget deficit which, according to budget plans, is to be limited to 2.5% of GDP at the federal level. Rather, the overall ratio of debt service payments – on domestic and foreign debt – has reached a critical ratio of 50% of all central government expenditures in 1999. The situation is truly critical since the central government's plan for foreign debt servicing assumes that some fresh lending of about $ 9 billion will be possible and only about half of the scheduled debt service will have to be made.

Should a further strong devaluation of the rouble occur, the debt service burden would be aggravated even more and bring about an absolutely unmanageable situation on the expenditure side. The government would probably accumulate further wage and pension arrears and cut outlays on health expenditure and education dramatically.

In this dramatic situation Russia urgently needs breathing space if economic reformers are to have any chance of rebuilding the economy. New loans should mainly be given for banking reform and to allow the restructuring of Russian debt, while some of the foreign debt from Soviet times might actually be forgiven. Clearly, new loans cannot be given without conditions that focus on the necessary ingredients for economic growth and political stability.

Foreign debt is roughly equivalent to cumulated capital flight in the period 1990-98 which shows that there is a crucial lack of confidence problem in Russia. Indeed, the collapse of the banking system – including the payments system in a technical sense – has stimulated capital flight, reduced savings rates and undermined the investment which is so crucial for economic modernization, jobs and growth. Without a functional payments and banking system the government is also unable to collect taxes properly; rather, it will face more and more barter tax payments, which makes monetary payments of wages in the government sector almost impossible: wage arrears will rise. Revitalizing the banking system is most crucial for systemic transformation, growth and confidence; even the large Uneximbank had to announce default on Euro bonds in early February 1999, so that the allegedly safe dollar-denominated foreign debt is no longer secure while even the staunchest defender of the Russian banking system must recognize that the architecture of the financial system is a disaster. The state-owned Sberbank dominates private retail banking in a rather monopolistic – i.e. inefficient – way, while 1500 private banks, facing no effective prudential supervision and acting without the umbrella of a guarantee fund, have in many cases engaged in dubious so-called investment banking.

The 12% limit for foreigners willing to acquire a stake in a Russian bank has turned out to be absolutely disfunctional. It seems that the government hoped to attract foreign exchange inflows without having to yield any control to foreign bankers. However, the majority of poorly managed banks in Russia urgently need effective corporate governance and efficient restructuring so that strategic foreign investors should actively be sought who are willing to acquire at least one-third – possibly not more than two-thirds – of major banks, which then would be modernized. Even such sweeping policy changes in foreign direct investment policies would be of little help if international organizations do not step up technical assistance and contribute to establishing a functional prudential supervision system. With functional banks confidence will return, tax arrears can be reduced, the savings rate will increase and new investment growth could be achieved. Moreover, the declining share of monetary transactions and the falling ratio of real money balances (m) to output would be reversed.

In the early 1990s m/Y (m:=M/P) declined because of hyperinflation; in the mid-1990s it did so as a consequence of currency substitution. While the monetary wealth-GDP ratio increased in Poland, the Czech Republic, the Slovak Republic and Slovenia in the first seven transition years it fell sharply in Russia (Table 4).

The ratio of bank assets relative to the sum of bank assets plus central bank assets also declined in the 1990s – an indicator which King and Levine[10] consider important for financial development. Since a rising development level of the financial sector positively affects economic growth[11] we have another missing impulse for sustained growth in Russia. Russia's

Table 4

Ratio of Real Money Balances (Broadly Defined) to GDP for Selected Post-Socialist Countries

(Annual ratios v=m/Y for 1991-97 and percentage change in 1997)

	1991	1992	1993	1994	1995	1996	1997	dv 97/91
Poland	31.6	35.8	35.9	36.7	36.5	37.5	39.5	7.9
Hungary	54.8	59.2	56.8	52.2	49.8	49.0	48.0	–6.8
Czech. R.	n.a.	69.4	70.3	73.9	75.6	72.2	73.8	4.4[a]
Slov. R.[1]	n.a.	64.3	67.5	67.9	69.3	71.6	70.7	6.4[a]
Slovenia	n.a.	28.1	32.8	38.3	42.2	44.6	47.0	18.9[a]
Rumania	46.7	28.9	9.1	21.5	25.4	28.9	24.9	–21.8
Bulgaria	76.0	79.0	78.3	79.5	67.2	78.9	35.7	–40.3
Estonia	n.a.	n.a.	n.a.	26.2	25.0	27.0	30.7	n.a.
Russia	68.4	32.3	19.1	16.0	13.6	13.1	14.4	–54.0

[1] Money stock M2 at year-end. [a] Change in v in the period 97/92.

Sources: EBRD: The Economics of Transition, Vol. 6/1, Statistical Appendix, London 1998; own calculations.

financial sector is also underdeveloped with respect to insurance companies so that the pricing of risk is quite incomplete.

It is unclear why Russia has not implemented an incentive-compatible prudential supervision system and deposit insurance. The government simply ignored the problem as the state-owned Sberbank had a market share of about 70% in private retail banking, so that government ownership of Sberbank in effect substituted for deposit insurance. A quasi-monopoly of a state-owned bank, however, is a very poor substitute for competition plus prudential supervision of private banks. Paradoxically it was Sberbank whose reluctance to roll over short-term GKOs in August 1998 contributed to the rouble devaluation crisis.

Some Unpleasant Questions about the IMF

The IMF has contributed to the Russian disaster by focusing exclusively on deficit and inflation figures while ignoring the credibility problem of government wage arrears and the lack of structural change in Russia. It encouraged Russia to adopt a fixed exchange-rate regime in 1995/96, which was absolutely irresponsible without prior broadening of the Russian export basket. A country with exports in which oil and gas strongly dominate is bound to fail with a fixed exchange-rate strategy once oil prices start falling heavily – it was well-known that oil prices are more volatile than US stock market prices. The early liberalization of capital flows, also encouraged by the IMF, was another part of counterproductive external support. For the IMF it was also apparently quite unclear that implementing the rule of law and building credible institutions are prerequisites for a functional market economy. A market system will not yield major economic benefits if firms have no confidence in contract enforcement and hence shy away from outsourcing and economic cooperation. To date nobody at the IMF has taken any responsibility for the highly unprofessional support strategy in Russia; not even a comprehensive report has been published (in contrast to the IMF's reporting on the Asian crisis).

Economic growth could benefit from high foreign direct investment inflows, especially since they would

[10] R. G. King, R. Levine: Finance and Growth: Schumpeter May Be Right, in: Quarterly Journal of Economics, Vol. 108, 1993, pp. 717-737.

[11] For empirical evidence see A. Demirgückunt, E. Detragiache: Financial Liberalization and Financial Fragility, Contribution to the Annual World Bank Conference on Development Economics, Washington D.C. 1998.

contribute to restructuring and export expansion if focused on the manufacturing sector. From this perspective the amount of FDI inflows is one important aspect, and the other is the structure of FDI, which was biased towards the energy sector in Russia. One may note that Hungary and Poland attracted foreign direct investment inflows of 2-4% of GDP in the years 1996-98, and that most went into retailing, banking, telecommunications and manufacturing industry.

Confidence in government will not return and growth will not be achieved if government wage arrears are not eliminated and the rule of law is not established. Government, which is assumed to set the rules of the game in a market economy, will not be trusted – and will face massive tax arrears from a tit-for-tat response by the private sector – if it is in continuous breach of contract. The EU could help with a one-time preferential loan of about Euro 5 billion to jump-start a process of orderly budget behavior. This support should be conditional on Russia's establishing an International European Foundation in Russia to which the loan has to be repaid in roubles. Having thus obtained considerable equity capital, the European Foundation would then mainly finance projects related to environmental protection with positive international spillover effects, international tourism and international youth exchange. Hence both Russia and western Europe would benefit from such an institutional innovation. The political leadership of Euroland requires a long-term view of the foreign and economic policy of the Community and its member states. The Russian government must give up illusory transformation approaches, but even the boldest politicians in Russia will be unable to change course without being given several years of breathing space.

Towards a New Transformation Strategy

Economic transformation cannot succeed and prosperity will not be achieved if confidence in the banking system is not restored and if Russia is not firmly integrated into the world market and international organizations. Previous Russian governments adopted rather inconsistent policy strategies and failed to implement prudential supervision in banking and to establish clear central bank responsibilities. The fact that the Central Bank of Russia transferred a major portion of its foreign exchange reserves to an obscure fund management company on the island of Jersey in 1993-97 in order to shield the funds from foreign creditors points to major deviations from established central bank practices. Such behaviour is bound to undermine the confidence of the general public and of the international community in the new Russia. As regards trade and international investment, reluctant restructuring of industry and insufficient foreign direct investment inflows in manufacturing left Russia's export potential underdeveloped. This is a serious shortcoming given the prospects of falling export revenues from the energy sector in a period of depressed international oil prices. After the massive devaluation of the rouble in the six months after the August 1998 crisis the incentives for rising net exports have improved; however, there is still a lack of restructuring and foreign direct investment inflows.

The first transformation attempt largely failed as the rule of law, efficient governance in privatized companies and competition in a monetary economy – and therefore growth – could not be established. In late 1998 Russia instead went back to barter trade which accounts for some 70% of the transactions of large firms. There are regional monopolies in many sectors and a near collapse of public order and government; the government has accumulated high wage arrears while expenditures on health care, education and R&D were shrinking at the same time. Due to the resistance of some factions in the Duma, the parliament failed to privatize land and real estate so that the government cannot collect taxes on land and real estate, which in OECD countries represent an important element of tax receipts at the local or national level. Note that real estate and land represented some 200 percent of GDP and 50% of overall private household gross wealth in 1997. The more underdeveloped the income tax system, the more important is privatization of land and real estate in major regions in order to generate property tax revenues. Since land and real estate are immobile, taxation of such private property is equivalent to a firm long-term tax revenue. An adequate tax system is more important than strongly relying on seignorage, which has been suggested recently in the context of combining a currency board and a crawling peg.[12] With most transactions among firms conducted as barter trade the scope for high seignorage is small; this holds all the more as currency substitution is wide-spread in Russia – with more than 50% of all transactions made in US dollars.

[12] A. Jochem: Currency Board and Crawling Peg, in: INTERECONOMICS, Vol. 33, 1998, No. 6, pp. 289-293.

Conclusions

Time is running out in Russia. If tax collection results in 1999 are below expectations a serious aggravation of the economic and political crisis seems unavoidable. The OECD countries all have reasons to help avoid disaster in Russia. While it is clear that the Russian government itself must adopt major changes in its transformation policy, the EU should help to prevent a sustained Russian crisis. Japan's failure to effectively combat the Asian crisis of the NICs has cost the country dearly in terms of lost reputation in the triad. This failure is in clear contrast to the active US leadership in regional crisis management in Mexico and Brazil in the 1990s. The EU must not passively watch the Russian crisis; instead, financial support for Russia must become part of a wider Agenda 2000 programme. Nor should the Community allow the IMF to continue its poor strategy for stabilizing Russia.

It is not too late to launch a second transformation process in Russia which could bring stability, prosperity and growth in the medium term. The necessary ingredients are clear and require a new policy approach on the part of the Russian government, the majority of the parliament, regional and local governments and international organizations. Supply-side measures are urgent, as well as some demand-side impulses in the form of massive infrastructure investment in Russia.[13] International organizations could come up with a comprehensive technical assistance package for all layers of government plus a broad long-term credit programme – of some $ 20 billion annually over five to ten years – if a new long-term reform policy package is adopted. Its main elements must be the following:

☐ establish clear responsibilities and reporting standards at all layers of government and the central bank

☐ adopt the rule of law in an effective way and minimize corruption plus mafia activities

☐ define government priority tasks and develop adequate tax financing plus revenue-generating privatization

☐ restructure the inefficient banking system and introduce strict prudential supervision in order to overcome the confidence problems in the banking sector and to raise the savings ratio

☐ stimulate economic growth by higher investment, rising R&D, modern education/retraining schemes and creation of new firms

☐ avoid quantitative trade restrictions, introduce adequate import tariffs – declining over time – and stimulate foreign direct investment inflows across all sectors

☐ stimulate export growth and export diversification

☐ restructure all major firms and impose competition laws in goods and factor markets

☐ privatize firms in a way which allows the achievement of effective governance plus productivity growth and wealth creation; in many cases this could involve strategic foreign investors; society could benefit via a modest (possibly regressive) capital gains tax from successful restructuring and effective governance as new wealth is created

☐ introduce social policies at the local and regional level in order to help individuals and families facing extreme hardship

☐ establish an active Russian role and reliable cooperation within all major international organizations. Russia should adopt a new understanding of international politics in the sense that formerly Soviet command and control approaches have to be replaced by efficient bargaining strategies within 'international clubs'. If at least one major international organization were to be located in Russia this would help to bring about a new way of international cooperation.

Once Russia achieves sustained economic growth and political stability there are good opportunities for high growth of income, trade and foreign direct investment and a new role for Russia in the world economy and its international organizations.

Hunger, financial chaos and political unrest in Russia are bound to undermine stability in the Ukraine and eastern Europe – there is even the risk that destabilization effects would raise the costs of an EU eastern enlargement. As time is running out in Russia, and the IMF as well as the US administration are passively watching the destructive Russian dynamics, the EBRD and the EU should play a much more active part in the future. With Germany and Finland sharing the EU presidency in 1999 one may expect an extra effort by the Community to exert political leadership and to stabilize Russia and the whole of Europe. This, however, assumes that the EU as well as individual countries in western Europe are willing to support the desperate transition in Russia with at least some $ 15 billion annually over several years.

[13] P. J. J. Welfens et al. (eds.): Towards Competition in Network Industries: Telecommunications, Energy and Transportation in Europe and Russia, Heidelberg and New York, forthcoming.