The economic collapse of Russia

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Russia's protracted economic downfall is now history. In 1999, Russia's deep economic crisis touched bottom, and growth has since resumed. Yet although growth in the recent years has been healthy, the consequences of the crisis were dramatic and will be felt for years to come.

Many published studies aim to analyze Russia's transition to a market economy and elucidate why such a deep crisis took place and lasted much longer than in other transition economies. Some authors have emphasized the inevitability of the crisis and, indeed, its necessity in order to adequately carry out the transition. Generally speaking, in their view the length of crisis is explained by incomplete reforms and a misguided state interference in economic matters.[1] At the opposite extreme, other authors remind us that the institutions required for an adequate functioning of a capitalist economy do not arise spontaneously and are rather difficult to put into place. In their view, the onset and unnecessary length of Russia's crisis is explained mainly by a lack of needed institutions, and by misguided economic policy measures which had deleterious effects on the economy and, by the same token, made the existence or emergence of those institutions even more difficult.[2]

The objective of this paper is to contribute to an explanation to the economic decline in Russia during its transition to capitalism, i.e., between 1992 and 1999. Our own understanding of the situation is

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[1] See for example, Aslund (1995) and, more recently, Aslund (2002).

[2] Sapir (1997), Hedlund (1999).

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much closer to the latter explanation of Russia's fate rather than the former. But we refrain from positing further arguments about the importance of institutions necessary for a smooth and dynamical functioning of capitalism, or the lack thereof in post-communist Russia; rather, we emphasize the economic aspects. We will argue that Russia's disappointing economic performance stems mainly from the overall vision underpinning the transition to capitalism, and to specific economic policies emanating from that vision.

The structure of this paper is as follows. In the next section we recount basic facts regarding Russia's economic depression in the 1990s. We then discuss our understanding of some important economic policies applied, stressing peculiarities generally overlooked by mainstream scholars. Third, we analyze the impact of some of the main economic policies of the Russian transition and ponder whether more suitable alternatives existed. The fourth section briefly analyzes the resumption of economic growth from 1999 onwards. The last section presents our conclusions.

1. Main stages of Russia's economic downfall

In contrast to most of Eastern Europe, the Russian recession was not triggered by a radical program of transition to the market. When Gorbachev took power in 1985, he inadvertently and fatally eroded the Soviet economy, plunging it into recession.[3] Moreover, the collapse of the communist regime dismantled its previous mode of functioning, i.e., what some French economists call "regulation regime".[4] Some vital economic links among firms, sectors, regions and even nationalities were severed, the relationship between the productive, commercial and financial spheres was disrupted, and the nature of management of firms was upset. In 1991 as the Soviet Union fell apart, Russia's output plunged 5%.[5]

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[3] Hewett (1988), Aslund (1991), Goldman (1991).

[4] Boyer (1987).

[5] All data, unless otherwise indicated, is taken from the Vienna Institute for International Economic Studies (WIIW). See tables 1 and 2.

In the autumn of that year, in the midst of economic disaster, Boris Yeltsin took control of the country and named a technocrat, Yegor Gaidar, as Deputy Prime Minister in charge of economic affairs. Gaidar did not focus on the economic crisis but on 'reform' and 'transition', which started with radical liberalization and stabilization measures. The foremost concern was to achieve financial stabilization by liberalizing prices and markets. Once this was achieved, economic growth would follow. Given the existence of a large monetary overhang, however, the price level was bound to rise significantly. To obtain a one-time price jump and not on-going inflation, strict monetary and fiscal policies were needed. This meant credit rationing and a balanced budget through tax reform, as well as cutting subsidies and other expenditures.

In January 1992 so-called shock therapy began, but it soon came to a standstill and eventually failed. Prices rose beyond expectations and companies facing money shortages evaded the restrictive policies by means of barter and mutual debt. After a few months the restrictive policy collapsed due to a mountain of inter-enterprise debts, pressure from industrial circles, protests of a confused and impoverished population and ferocious opposition in Parliament. The fiscal and monetary policies were relaxed and the economy fell into a dreaded inflation and devaluation spiral.

We now put forward a brief description of the main stages of Russia's economic evolution after the economic therapy up to the 1998-99 crisis. Tables 1 and 2 display the main economic variables for the period 1990-2002.

1.1. *The inflationary period (1992-95)*

The attempted shock therapy put an end to queues and shortages but brought inflation and, as a political consequence, it undermined the solid consensus that Yeltsin enjoyed in his first year as president. The other elements in the package did not produce expected results either. The withdrawal of the state (liberalization) gave way to chaos and criminalization of the economy. Although the accelerated privatization launched at the end of 1992 did manage to placate the opposition of industrialists who emerged as its main beneficiaries, it did not put an end to the plundering of assets nor did it bring higher productivity

TABLE 1

RUSSIA: SELECTED ECONOMIC INDICATORS

	1990	1991	1992	1993	1994
Gross domestic product, index, real	100	95	81,2	74,1	64,7
GDP/capita (USD at PPP), index 1990=100	100	97,4	87,5	82,9	74,2
Gross industrial production, index	100	92	75	65	51
Gross agricultural production, index	100	96	87	83	73
Goods transport, index	100	93	80	71	61
Food industry	100	91	76,4	69,6	57,7
Light industry	100	91	63,7	49	26,5
Textile industry	100	92	62,6	47,6	25,7
White metallurgy	100	91	68,2	58,7	53,4
Ferrous metallurgy	100	93	78,1	64,8	53,8
Gas	100	101	98	93,1	87,5
Oil [1]	100	89,3	77,1	68,2	61,3
Machinery	100	90	76,5	64,3	44,3
Electricity	100	100,3	95,3	90,5	82,4
Final consumption expenditure	100	94	89	88	85
Household final consumption	100	95	93	94	95
Government final consumption	100	89	78	73	71
Gross capital formation	100	98	62	44	30
Gross fixed capital formation	100	85	49	37	27
Employment total, index	100	98,0	95,7	94,1	90,9
Employment in industry, index	100	98,2	93,5	91,2	81,4
Registered unemployment rate in %		0,1	0,8	1,1	2,2
Gini index	0,233	0,26	0,289	0,398	0,409
Average gross monthly wages, real	100,0	97,0	65,3	65,5	60,4
Retail trade turnover, real	100,0	96,4	92,9	94,1	93,9
Consumer prices, index	100	193	3133	30495	124117
Inflation rate (%)		92,6	1526,5	873,5	307,0
Producer prices in industry, index	100	238	5702	59407	259530
Current account, USD million	−4300	7100	4179	12792	7844
Current account in % of GDP	−0,4	0,9	5,9	7,7	2,8
Gross external debt, USD million	56200	70100	80200	112784	121600
Exports total, fob, EUR million [2]		.	41336	50881	56690
annual change in %			.	23,1	11,4
Imports total, fob, EUR million [2]	.	.	33136	37793	42448
annual change in %			.	14,1	12,3

[1] Preliminary.
[2] Based on *Labour Force Survey* data.
3 In 1998 data refer to October.
[4] Based on balance of payments statistics, including estimate of non-registered trade. Converted from USD to EUR using the ECB EUR/USD foreign exchange reference rate.

Source: The Vienna Institute for International Economic Studies (WIIW) database incorporating national statistics; WIIW forecasts.

TABLE 1 (*cont.*)

1995	1996	1997	1998	1999	2000	2001	2002
62,0	59,8	60,7	57,4	61,1	67,2	70,6	73,6
73,9	73,2	68,1	65,4	70,8	80,0	86,4	91,5
50	48	49	46	51	57	60	62
67	63	64	56	58	63	67	69
60	57	55	53	56	59	61	64
53,1	48,3	46,8	47,2	49,1	56	n.a.	
18,5	13,3	12,8	11,5	12,9	15,6	n.a.	n.a.
19	13,9	14,1	11,9	15,2	19,3	n.a.	n.a.
55	52,8	56	53,7	59,1	68	n.a.	n.a.
59,2	56,2	56,7	52,2	61	70,8	n.a.	n.a.
86,6	85,7	84	84,7	88,1	87,2	n.a.	n.a.
58,9	57,9	58,7	58,1	58,3	61,8	n.a.	n.a.
40,3	34,7	35,7	32,5	38	45,7	n.a.	n.a.
79,9	77,5	75,9	74,4	73,7	75,2	n.a.	n.a.
83	81	83	81	80	85	91	97
92	88	92	89	86	93	101	110
72	74	72	73	75	76.85 + M58	76	78
27	23	22	12	11	20	23	23
25	20	18	16	17	20	22	23
88,2	87,6	85,9	84,7	84,9	85,4	85,9	87,2
75,2	71,8	65,3	62,1	62,7	63,8	64,4	64,7
3,2	3,4	2,7	2,7	1,7	1,4	1,6	1,8
0,381	0,387	0,401	0,399	0,4	0,399	n.a.	n.a.
43,5	46,2	48,4	42,0	32,7	39,6	47,5	55,3
87,6	87,9	92,0	88,8	83,2	90,5	100,1	109,1
369247	545747	626518	799437	1484554	1793341	2180702	2529615
197,5	47,8	14,8	27,6	85,7	20,8	21,6	16,0
873241	1316760	1514279	1621787	2577020	3777912	4497604	5026072
6963	10847	-80	219	24616	46839	34959	31091
2,2	2,8	0,0	0,1	12,6	18,0	11,3	9,0
120500	125000	130800	189200	178600	161400	150800	152100
63005	70731	76623	66467	70820	113672	113748	113501
11,1	12,3	8,3	−13,3	6,5	60,5	0,1	−0,2
47856	53702	63474	51798	37061	48552	60025	64521
12,7	12,2	18,2	−18,4	−28,5	31,0	23,6	7,5

Table 2

or investment.[6] In short, although signs of progress in constructing a market economy did appear, the job turned out to be more difficult and expensive than expected. In the midst of an inflationary spiral and political agitation, the recession continued its course, standards of living fell for most of the population, and income was concentrated in the hands of a few.

Table 1 shows that the 1992-95 period was the most dramatic throughout the entire post-communist economic experience. GDP fell about 24% in real terms (having already fallen about 20% between 1990 and 1992). Employment fell much less, i.e., about 8% and real wages 33%. Household consumption remained stagnant: it fell 7% between 1990 and 1992, but remained at practically the same level between 1992 and 1995; it later fell at a rather minor rate up until 1999. We shall discuss below the apparent conflict between the evolution of real wages on the one hand and consumption and living standards on the other.

1.2. *Stabilization and financial boom (1995-97)*

Stabilization finally took hold halfway through 1995, due mainly to two factors: the introduction of a fixed exchange rate regime and the support of the IMF. Given the relatively abundant reserves, the monetary authorities were able to introduce a 'bandwidth' to stabilize the ruble and thus anchor down price increases. After the failure of various programs, the IMF provided Russia with the first important credit, but tied to restrictive policies that were eventually applied. In this context, the fiscal deficit was reduced from over 20% of GDP in 1992 to around 6% and was for the first time financed not by monetary emissions but mainly by public debt.[7] The following year, on the eve of the presidential elections (July 1996), the IMF continued its

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[6] In late 1991 Yeltsin announced rapid privatization of small enterprises and housing. Though at first he was not keen on privatizing industrial giants, by mid 1992 as stabilization stumbled and political opposition mounted, he turned to massive privatization of industry in order to gain political support, maintain the reforms' offensive and make radical change irreversible. And he kept his word in this aspect of the transition: by mid 1994 nearly 70% of those employed in industry were working for private enterprises (Chubais and Vishnevskaya 1995, p. 95).

[7] OECD (1997, table 3), Cheasty and Davis (1996, pp. 4 and 19). Throughout the paper, the figures on the fiscal deficit are taken from the IMF and the OECD, which include expenditure in debt service.

support for Russia with a new three-year credit of 10 billion dollars. In light of the euphoria provoked by Yeltsin's electoral victory, the loan led to a restructuring of Soviet debt (in moratorium since 1992) and opened the door to foreign private capital. Halfway through 1996, large amounts of foreign financial capital began entering Russia, whose economy was at the time optimistically catalogued as 'emerging'. Foreign investors bought shares in Russian companies, ruble-denominated treasury bonds, eurobonds issued by the government and even debts of private companies (banks in particular) and regional governments. Economic recovery seemed at hand.

1.3. *Towards the crisis (1997-98)*

According to government and IMF calculations, stabilization of prices and the exchange rate were to clear the way for productive investment and growth. The re-election of Yeltsin and the euphoria of the financial markets pointed to the same conclusion. However, the real economy improved little. GDP dropped 4% in 1995 and 3.5% in 1996. In 1996 the budget deficit went up again to 9.3% of GDP.[8] Moreover, debt financing brought about a dizzying growth of public debt, albeit from a low base. The banking system flourished in part through the infusion of foreign capital, but the banks decided to invest in public debt and the stock market rather than lend to industrial enterprises, which continued their meager survival by resorting to barter and mutual debts. Stabilization, for its part, gave rise to other problems. A strong ruble, revalued in real terms (i.e., its purchasing power increased), simultaneously reduced the domestic competitiveness of (by now) ruined domestic industries, exporters' profit rates and the trade surplus that Russia had enjoyed for years. To sum up, capital infusion brought few gains and was spent on public debt and, worse, on conspicuous consumption, corruption and capital flight.

Financial markets, however, did not focus on the weakness of the Russian economy until the summer of 1997, when the South-East Asian crisis broke. The crisis coincided with the first indications of economic growth in Russia in almost a decade. In 1997 the Russian GDP grew 1.5%. After autumn 1997, authorities concentrated their

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[8] OECD (2002, table 6).

efforts on regaining the trust of financial markets and supporting the ruble. In July 1998 the IMF joined in with a large rescue package. Both the Russian government and the IMF insisted that there was no space for a controlled devaluation since any attempt to bring the ruble down slowly would inevitably spin out of control, provoke runaway inflation, and bury the macroeconomic stabilization that was the only noticeable gain after years of reforms. In the end, defense of the currency turned out to be fruitless and expensive, costing around 10 billion dollars in reserves. Various factors brought this (perhaps inevitable) result: the steep fall of oil prices in late 1997 and early 1998, the appearance and increase of a current account deficit, and the failure of an emergency package that was intended to reduce the fiscal deficit. The initial disbursement of the IMF loan disappeared in a few weeks, after which authorities declared themselves defeated.

1.4. *The crisis of 1998 and its aftermath*

On August 17, 1998, Russian authorities reneged on the service of domestic public debt, announced a moratorium on private external debt and let the ruble float unhindered.[9] This provoked a large devaluation, collapse of the stock exchange and of the external debt market, a temporarily paralysis of the domestic payment system, interruption of all inflows of external capital including IMF funds, collapse of most big banks (which were severely exposed on the domestic debt market and had high debts in dollars), and brought significant unemployment in the ranks of new middle class professionals. The impact of the financial collapse was felt in the rest of the economy through a devaluation that severely inflated the ruble price of imports, thereby reducing real income and increasing the burden of all debts denominated in foreign currencies. Finally, the financial meltdown unleashed a political crisis that led to the naming of a new team of old Soviet-era heterodox apparatchiks: Evgenii Primakov as Prime Minister and Viktor Gerashchenko as the central bank governor.

In the weeks following the crisis, most Western analysts predicted a terrible 1999 for the Russian economy. Indeed, financial malaise brought about the collapse of the ruble, which dropped from

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[9] On the 1998 crisis and its aftermath see Bracho (2000, pp. 440-47).

9.7 to 24.6 per dollar, pushing inflation for 1998 to 86%. But defying most expectations, the financial crisis was rapidly overcome, and in 2000 the value of the ruble declined by only 28% while inflation dropped to 20.8%.

Primakov's fiscal policy also delivered better-than-expected results. Between 1998 and 1999 government revenues grew by almost 20%, and the budget deficit fell from 5.2% of GDP to 1.1% of GDP. These were the best results in years. Financial markets, which had almost disappeared during the crisis, also recovered strongly. With a rise in share prices in real terms of 204% during the year, the Russian stock exchange was the best performing in the world, even though total capitalization of markets continued to be very low. Prices of the Russian and Soviet debt in the secondary markets also recovered. In short, the financial crash did not give way to a new cycle of misery, but to a sounder macroeconomic environment and, more importantly, to healthy economic growth, which continues six years later. We shall discuss the features of this growth below.

2. Peculiarities of Russia's economic policies

There is no clear consensus on how to characterize the economic policies implemented during Russia's transition. Mainstream accounts argue that monetary policy was at first loose and then became stringent from mid 1995 onwards (when stabilization was achieved), while loose fiscal policies and lukewarm trade liberalization prevailed throughout 1992-98. Our first task will be to show how this story is somewhat misleading, because in fact: 1) state expenditure fell dramatically, not only in absolute terms but also in relation to GDP; 2) most firms suffered from lack of credit even during the inflationary years; 3) domestic industry was systematically subjected to stringent foreign competition from the very beginning and up to 1998. We briefly comment on each of these points.

First, it is true that a large fiscal deficit existed throughout the inflationary period and even beyond, up to the financial crash in August 1998. It is misleading, however, to portray the deficit as a result of 'loose fiscal' policy, a term that implies excessive public expenditure. Most mainstream economists see the deficits as stemming at least

partly from wasteful expenditure, mostly on ill-conceived subsidies (mainly from 1992-95) and expansion of the bureaucracy.[10] But an influential Russian liberal economist, Andrei Illarionov, took this argument to its logical conclusion by arguing that the Russian government was extracting more than enough revenues (given the country's low level of development) and was producing large deficits because it spent too much.[11] In any case, few mainstream economists recognize the negative impact of the relative and absolute fall in public expenditure on the social fabric, and still less on output.[12] So it seems worthwhile to review briefly the quantitative story of public expenditure. We show below how it relates to the fall in output.

Throughout our period (1992-98), total public expenditure fell sharply in relation to GDP and catastrophically so in absolute terms. As table 2 readily shows, government final consumption expenditure had fallen by one third between 1990 and 1993, while government investment probably fell by a much larger percentage. Between 1993 and 1999 government expenditure was further reduced by over 50%. During perestroika the public sector (federal plus regional plus extrabudgetary funds) spent over 50% of GDP, yet by 1998 this figure had fallen to 35.1% of GDP.[13] Thus, in less than a decade it decreased 30% in relative terms. However, since GDP fell dramatically during those years, the absolute fall in public spending was on the order of 70%, a catastrophically low level for a nation with 150 million inhabitants which not long before had enjoyed full employment and decent levels of education and health.[14] The persistent reduction in public expenditure brought the fiscal deficit down sharply from a high of over 20% of GDP in 1992 to 8.1% in 1997 on the eve of the financial crisis. However, since the deficit remained large, the Russian government was constantly accused of 'profligacy'. The fact is, however, that budgets were being cut almost year after year, yet there was little help forthcoming from the revenue side. The Soviet budget collected reve-

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[10] Grafe and Richter (2001), Leitzel (1995, pp. 60-63), Sachs (1994, pp. 45-48), Aslund (1995, pp. 204-05).

[11] Illarionov (1998 and 1999). See also Aslund (1995, p. 204).

[12] See Grafe and Richter (2001) for a partial exception to this.

[13] McKinnon (1993, p. 123), OECD (2002, p. 44).

[14] As a result of its spectacular fall, the Russian Federal budget in the late 1990s dropped below that of New York City. Remarkably, public expenditure in Russia has descended to its present levels without provoking even greater social, political and demographic cataclysms.

nues of over 50% of GDP. But liberalization from perestroika onwards brought a large fall in public revenues to a low of 31.3% of GDP in 1995, which rebounded to 36.9% on the eve of the crises.[15] Yet this 'rebound' was to a significant extent fictitious because, from 1995 on, taxes were increasingly paid, especially to local and regional budgets, in specie (goods and services) and by other overvalued non-monetary transactions. Thus 'healthier' federal revenues fell more rapidly than the rest and reached a low of only 10% of GDP in 1997.[16] Moreover, revenues fell to an all-time low of 29.9% of GDP in 1998. In conclusion, persistently high deficits were mainly the result of a stark decline of public revenue. This in turn was caused by the fall in output, a defective tax system, falling oil prices, widespread evasion and, last but not least, a flawed privatization policy by which the state gave away its best assets to a clique of oligarchs whom, it turned out, could not be properly taxed.

Second, the so-called lax monetary policy of the inflationary period (1992-94) is deceptive because cheap centralized credits benefited a relatively few favored sectors, large, well-connected enterprises and mostly privileged commercial banks that serviced the former. The rest of Russia's 'real economy', especially its industrial enterprises, had little access to credit. Since commercial banks lent little, most industrial enterprises suffered a lack of credit.[17] At best the limited credit that existed was used to finance working capital to pay for inputs and wages, and had to be supplemented with the use of barter and money

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[15] On the decline of public revenue during perestroika see McKinnon (1993, pp. 120-61). On the decline of public revenue after shock therapy (1992-98) see Lopez-Claros and Alexashenko (1998).

[16] On the importance and significance of non-monetary means of tax payments see Gaddy and Ickes (2002) and Commander and Mummsen (2000). The data is taken from OECD (2002, p. 44).

[17] Some mainstream accounts ignore the 'duality' of the monetary policy in the 1992-94 period: see for example Boone and Fedorov (1997) and Sachs (1994). Cheap credit to favored enterprises was not only crowding out a future private sector, but other less fortunate state enterprises as well. Other authors state such duality as a fact, but fail to qualify their overall view of the period (one of 'loose monetary policy') and consequently emphasize that even before 1994 output was in many instances also falling due to lack of credit: see for example Aslund (2002, pp. 235-43) and Delpla and Wyplosz (1995). At the other extreme, in his account on "who lost Russia", Joseph Stiglitz (2002) fails to acknowledge such duality by suggesting without nuance that, at least up to 1998, monetary policy was too stringent. Though, as we do, he stresses (*ibid.*, pp. 156-57) the negative impact of the credit crunch on output.

surrogates.[18] At worst credit fuelled capital flight. When credit became even scarcer in mid 1995, most enterprises increased non-monetary means to keep production going. Thus output did not suffer from the resulting *credit crunch* as much as would have been the case if recourse to non-conventional means of payment had not taken place.[19]

Third, throughout our period, the Russian economy was kept completely open to foreign competition by heterodox means.[20] This institutional setup was extremely complex, and confusion prevails as to the real content of reforms. It is important, therefore, to take up the matter in greater detail.[21]

In early 1992, at the onset of the market shock, the market exchange rate was so low that, expressed in dollars, the average wage amounted to only US$ 12 a month.[22] In fact, however, most of Russia's imports in 1992 entered at a much higher exchange rate (in terms of the ruble's purchasing power) than the market rate. This was due to a practice inherited from the Soviet period of massive import subsidies.[23] In 1992, 45% of imports were 'centralized', meaning they were done by, or on behalf of, the state and then sold at subsidized rates in the domestic market.[24] The IMF reported that while the 'quasi-market' exchange rate in January 1992 was 110 rubles per dollar, the average exchange rate used for centralized imports was only of 5.4 rubles per

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[18] Commander and Mummsen (2000), Thompson (1997, pp. 1159-87), Johnson (1994, pp. 971-97).

[19] OECD (2000a).

[20] It is common to argue, as does a World Bank working paper, that contrary to what occurred up to 1998, "domestic industry and agriculture did not face significant competition from abroad" (Tarr 1999, p. 8). For other similar views see Dabrowski (1993, p. 79), Layard and Parker (1996, p. 64), Michalopoulos and Tarr (1996, p. 11) and OECD (2000b, p. 7).

[21] For a more detailed analysis see Bracho (2004).

[22] Boone (1993, p. 215, table 4). Aslund (1995, p. 146) states that in December 1991 the average wage was only 6 dollars a month.

[23] Neither Tarr nor Dabrowski, whom we have quoted saying that Russia remained closed to imports, mention these subsidies. Aslund (1995, pp. 149-50) and Sachs (1994, p. 47) do, but they typically discuss them solely from a fiscal point of view, ignoring their impact on the effective trade regime. As a mainstream economist, Fischer (1994, pp. 10-11) seems to be an exception on this account when he states:

> "This subsidization of imports means that foreign credits have not contributed to the financing of the domestic budget deficit and also means that domestic industries have been adversely affected by subsidized competitive imports".

[24] Aslund (1995, p. 149).

dollar.[25] Though subsidized imports were supposedly for specific goods of vital importance for the economy and the population, they were in fact handed out quite indiscriminately. In addition to imports subsidized directly or indirectly by the state, individuals also imported in order to convert proceeds from illegally exported goods. Further, an estimated 25% of total imports in 1992 took the form of barter.[26] They were then handed on to workers as a supplement to wages or sold in the market, quite probably at much lower implicit exchange rates. Finally, these subsidies show that foreign trade was indeed only partially liberalized with the 1992 market shock. The paradox was that, in a peculiar way, state intervention helped keep Russia's domestic market more open to imports than it would have been otherwise. A curious instance of using non-liberal means to achieve liberal ends.

Regarding import controls, at the outset of the transition the Russian government adopted a free trade regime. There were no quotas or other non-tariff restrictions and imports paid no duties. Further, they paid no taxes (VAT) either. A legal framework for imports began to emerge in July 1992 when Russia introduced a 5% tariff that exempted many goods, including foodstuffs, which continued to enter tax free.[27] This tariff did not affect imports from CEI countries, which in most cases maintained preferential status throughout the transition.[28] At the same time, although many of Russia's main exports were meeting prohibitive tariffs and other restrictions in many countries, the government made no effort to introduce anti-dumping legislation to protect its markets.[29] This was conceived and instrumented much later.

Imports started paying VAT only in early 1993.[30] Yet not only were food products exempted, given their 'high priority' status, so too was a large and hardly justified list of diverse goods. Significantly, this

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[25] IMF (1992, p. 22 and p. 79, table 26). The average figures for the first half of 1992 were a market rate of 155 rubles per dollar in contrast with a subsidized rate for imports of 20 rubles per dollar (World Bank 1992, p. XVII).

[26] Russian Economic Trends (1994, p. 79).

[27] IMF (1994, p. 225).

[28] Glaziev (1993) and IMF (1994, p. 260).

[29] Glaziev (1994, p. 84).

[30] Lopez-Claros and Alexashenko (1998, p. 13).

list included a wide range of textiles and footwear,[31] at a time when the textile industry was literally collapsing. Food-product imports began to pay VAT only after mid 1995, but many exemptions persisted. Unsurprisingly, an IMF paper stated that during 1995-96 only some 30-40% of recorded imports paid the full rate of VAT.[32] So much for applying the domestic tax regime to legal imports.

Turning to the customs regime, tariffs were increased in September 1992 and a new tariff structure was enacted in April 1993, with rates varying from 5 to 15%, with an average tariff of 8.1%.[33] From 1994 to 1997, as the gap between internal and external prices diminished, and pressure for protection from domestic producers mounted, the tariff system was periodically revised. By 1996 the average tariff was between 14 and 15%.[34] In June 1998, two months before the financial crash, another important revision of the trade regime took place and the maximum tariff dropped from 30 to 20%. By 1999 the average tariff was a modest 13%.[35]

Although average tariffs were relatively low, exemptions were again the rule. For example, in mid 1993 the National Sports Foundation (NSF) was granted the privilege of importing goods tax free.[36] Other 'nonprofit and social organizations' soon followed, such as the Afghan War Veterans Union.[37] These 'nonprofit' organizations concentrated on the most profitable slice of the market, i.e., the most highly taxed goods (subjected to excise duties) such as alcohol, tobacco and automobiles.[38] By late 1995, when the NSF lost its privilege of

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[31] The lists of imports exempted from the VAT are included in the Instructions number 49 (30 January 1993) and 118 (1 April 1993) of the State Customs Committee of Russia.

[32] Lopez-Claros and Alexashenko (1998, p. 14).

[33] IMF (1994, p. 226).

[34] Lushin and Oppenheimer (2001, p. 294).

[35] OECD (1999, p. 1).

[36] Lopez-Claros and Alexashenko (1998, p. 20), Grafe and Richter (2001, p. 147).

[37] Easily foreseen, these schemes led to widescale corruption and eroded the feeble and incipient customs system. As Lopez-Claros and Alexashenko (1998, p. 20) put it: "once the tax-exempt status has been granted [...] there is no mechanism in place to check that the exemption is being used for the purpose originally intended".

[38] While the car industry made great efforts to get substantial tariff protection, these privileges seriously undermined them. A report on the Russian automobile industry in 1994 was adamant that new tariff barriers would give a respite to the battered industry. However, Lopez-Claros and Alexashenko (1998, p. 20) sustain, perhaps exaggeratedly, that due to those privileges "virtually all cars" imported to Russia from early 1993 to late 1995, were tax free. See also Sosnovskaya (1995, pp. 12-16).

importing tax-free alcohol and cigarettes, it had become, with an annual turnover of 3-4 billion dollars, by far the larger importer of these goods. The end of the NSF's privileges did not eliminate the problem. Other organizations kept their privileges and a sister organization of the NSF in Belarus, with which Russia maintained a free trade accord, continued business unabated.[39]

But the post-communist Russian trade regime, already moderately liberal and rife with exemptions, was thoroughly eroded by smuggling and 'semi-legal' imports. In fact, the bulk of consumer goods entering the country, albeit with important differences by type of product, did so by 'shuttle trade', through *chelnoki* or by outright smuggling, which usually meant the corruption of customs authorities.[40] *Chelnoki* gained notoriety in internal and external markets, given the supply constraints faced by domestic producers and the relative lack of formal import channels. They operate with low costs, import all types of consumer goods (principally textiles and footwear) especially from Asia, mainly China and Turkey. At the outset of the transition, they paid neither tariffs nor taxes of any sort. Later on, in early 1993, a presidential decree gave them the right to import, tax free, up to 5000 dollars per head.[41] This quite high threshold was easily circumvented and in any case the possible extra cost it entailed was a small price to pay for the legal cover that the decree provided. Their legal regime changed from one of semi-legality to one of exception and privilege since, at best, they did not pay normal tariffs that other traders allegedly did.

Once introduced into Russia, *chelnoki-goods* were sold primarily through the informal economy, usually beyond the reach of tax authorities, though not of racketeers. The privileges enjoyed by *chelnoki* created resentment and protest among both formal importers and domestic producers.[42] But *chelnoki* and the interests created around them (traders, municipal authorities, airlines, etc.) staunchly defended their privileges. Beginning in 1993, as a response to pressure from

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[39] Lopez-Claros and Alexashenko (1998, p. 20).

[40] The *chelnoki* are individuals that travel abroad in chartered planes or shuttle flights (thus 'shuttle trade') to buy goods for resale at home.

[41] *Rossiskie Vesti*, Moscow 6 April 1993.

[42] In the case of footwear, one of the sectors most affected by the *chelnoki* trade, this most unusual alliance between importers and domestic producers crystallized in the Footwear National Union, an organization that has as its top priority lobbying aggressively against *chelnoki* privileges (Mexican Embassy in Russia 2001).

diverse quarters, federal authorities often changed regulations on *chelnoki*'s activities, without seriously affecting their preferential status in a sustained way.[43] *Chelnoki* were and remain a crucial actor on the Russian import landscape.

In addition to *chelnoki*, smuggling in one form or another, lubricated by rampant corruption of customs authorities, was widespread during the transition. Although formal importers complain about *chelnoki* privileges, most importers engage in some sort of smuggling; that is, they import more, or different, or more valuable, merchandise than they formally declare. Most transnational corporations based in Russia operate in an *ad hoc* way that lubricates the process. They take care of publicity and trademark development from their offices in Moscow, while formal importers and distributors of their products are independent and usually politically well-connected Russian companies that do the 'dirty work'.

Given the exceptions, *chelnoki*, smuggling and corruption, imports that pay complete tariffs and normal taxes, especially in consumer goods, were and still are a small fraction of the total. One author of this paper made a crude estimate of the level of semi-legal and illegal imports of two very different consumer goods, footwear and TV sets.[44] He estimated that these extralegal imports supplied at least 72% of the footwear sold in Russia in 2000. In the case of TV sets, an industry in which much less informal production can be expected, the share was around 70% in 2000. Given similar tendencies in many consumer goods, from appliances to textiles, these estimations are probably quite representative.

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[43] In 1999 a disposition "On the import of merchandise by individuals" stipulated that individuals could import free of tax 50 Kg of goods whose total value does not exceed $ 1000 plus up to 200 Kg (total $ 1000) with a tariff of 4 euros per kilo. In contrast, at that moment formal importers of footwear paid a duty of 20% and another 20% on VAT (*Vedomosti* 19.12.01).

[44] Bracho (2004, pp. 98-100).

3. Macroeconomic policies and Russia's economic descent

As previously suggested, Yeltsin and Gaidar's rise to power did not bring economic recovery, rather it aggravated the fall in production. When many homemade goods were unable to withstand competition of higher-quality or lower-priced foreign goods that became available, this became *prima facie* evidence that they were in fact inefficient. In other words, it was taken for granted that a sizeable share of the inherited productive apparatus was inefficient, either because it turned out goods of very low quality or because its input coefficient was well above international norms, or both. Given this viewpoint, the state should not hinder the fall in output, seen as the necessary *destruction* that sets free resources, that are swiftly used more efficiently elsewhere, i.e. in sectors or branches with competitive advantage.

To analyze Russia's economy thoroughly, we should first discuss a basic economic premise underlying Russia's transition to capitalism. We want to ponder the wisdom of the efficiency criterion implicit in an outlook that sees massive unemployment of people and machines as a natural, or indeed indispensable, prerequisite in the transition towards a more efficient economy, a criterion that owes much to Schumpeter's *creative destruction*. It is well know that the principle of effective demand implies a thorough rejection of that notion, insofar as it is built upon the premise that when idle resources exist, it is better to put them to use rather than keep them unemployed.

Recalling the period when Keynesian economics was dominant, neoclassical economics not only agreed with this conclusion, they took it further, in what became a very enriching cross-fertilization of ideas. Indeed, it was accepted that, in the presence of domestic distortions, a decentralized market economy will not achieve its Pareto optimum and so resources may be left idle. Moreover, in order to adequately measure efficiency of any activity, an indicator denoting the Domestic Cost of Resources (DCR) was proposed. As the reader may recall, estimates of DCR are based on the assumption that market prices are distorted and do not reflect the true scarcity of factors and products.

The DCR relates factors that take part in production at shadow prices, with value added also taken at shadow prices.[45] The numerator of the resulting quotient includes the social cost of direct and indirect factors used, plus the social cost of working and physical capital; the denominator is the gross value of production excluding the cost of direct and indirect inputs, all measured at shadow prices. The quotient expresses the inverse of the social productivity of factors of production. When comparing this result with the shadow price of the foreign exchange, we obtain a relative indicator of the efficiency of domestic production. For any *i* activity we thus have:

$$DCR_i = \frac{\omega L_i + \pi K_i}{Y_i - \Sigma S_i}$$

where π and ω denote the shadow price of capital and labor, *L* and *K* the amount of labor and capital required, respectively; *Y* and *S* the gross value of production and of direct and indirect required inputs, also valued at shadow prices, respectively. Now the initial decision taken by Russia's economic authorities, to do nothing to avoid the complete demise of factories that could not withstand competition of imports, would have been sensible only if it could be shown that they were inefficient, but with an efficiency criterion that considers social rather than private costs and prices. We know of no study where social costs and prices have been estimated for Russia, and in publications that argue that equipment left idle was in fact inefficient we have been unable to find any quantitative support for such a conclusion.

In any event, to better see what assumptions are involved in the discussion, we here give an approximate (though admittedly very rough) measure of efficiency. Since in post-communist Russia capital investment had already been made, and the workforce was available, and given that after the first shock a large share of both was left idle, the shadow price of capital equipment and the workforce was practically nil. Thus, efficiency of production would have only required, *grosso modo*, the international price of the commodity involved to be above the cost of the imported inputs (and the cost of domestic raw materials that could be exported). We strongly believe, contrary to those who claim that the vast majority of Soviet industrial plants subtracted rather than added value, that a large proportion of the

[45] Schydlowksy (1984).

forgone production would have passed the efficiency test at the time, if costs and prices could have been correctly measured.[46] Therefore, we believe that Russia's economic authorities wasted opportunities and resources, thus unnecessarily aggravating the collapse in output which ensued immediately after the dismantling of communism.

To demonstrate that the strategy adopted was not necessarily the only one available, we recur to a very simplified example of an alternative, but nonetheless not completely heterodox, economic policy. To start, assume that in a firm that produces good A the domestic cost is 3 rubles, of which the imported inputs are worth 1 ruble and the domestic cost component 2 rubles. Given a nominal exchange rate of 1 ruble per dollar, the dollar price cannot be below $ 3. Suppose further that the international price of A is $ 2, and that this is also the prevalent price in the domestic market. The firm is obviously non-profitable as well as non-competitive, and will have to close.

Suppose now that the authorities realize that a domestic distortion is involved, and follow very sensible neoclassical advice that when such a domestic distortion exists, the state should intervene, subsidizing or taxing at the point where domestic distortions occur (Johnson 1965). Assume then that the firm is given a subsidy of 1.30 rubles, so long as it produces good A with the equipment at hand and exports it at a price of $ 1.90. The firm would thus obtain a unit profit of $ 0.20 (1.90 minus 3.00 plus 1.30), and would suddenly become profitable and competitive.[47] Of course, subsidies could also be granted for sales in the domestic market, provided the firm lowers its price proportionally to its cost reduction.[48]

If workers are unemployed, and if credit is granted to firms in order to carry out production, then domestic output will expand. Further, part of the extra output can be sold abroad, or substitute imports, or both, because home-made good A is cheaper in domestic

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[46] Gaddy and Ickes (2002), the main exponents of the thesis that Soviet industry destroyed (and destroys) rather than adds value, fail to give any empirical evidence to support such a strong assumption. On the other hand, as Woodruff (1999a) argues, this untested assumption is superfluous to their suggestive model of Russia's virtual economy.

[47] We assume that lower quality can be compensated with lower prices, which in many cases is very realistic.

[48] A relatively similar result would obtain with a devaluation of the ruble, compensated with subsidies to the poor in order to make up for the price rise that a devaluation may entail.

and foreign markets. For the economy as a whole, there will be a rise in production, employment and wages, because in producing A, resources are used that were idle and have no alternative use. The rise in output also brings a rise in profits, which would not have ensued if the firm had closed and workers were unemployed.

The local production of good A has two further implications. On the one hand, insofar as it is associated with higher employment and wages, as well as greater profits, it induces a higher level of demand for other branches or sectors of the economy. On the other hand, given that competitiveness has been enhanced, output expansion is accompanied with net earnings, or net savings in foreign currency, that become available for other uses. Suppose that idle capacity and unemployment in other sectors coexist, because aggregate demand is too low, or has to be kept in check due to insufficient import capacity. The higher level of wages and profits stimulates a higher level of demand, even as greater savings, or availability of foreign currency obtained through the production of good A, make it possible to satisfy the 'extra' demand with domestic production, without worsening the trade balance. Consequently, in principle, it would be possible to apply macroeconomic expansionary policies, or allow for an autonomous rise in demand that would contribute to the rise in production in other sectors.

Our previous discussion might be dismissed with the argument that the policy we contrast with the one actually implemented would have been utterly unrealistic for Russia in the 1990s. We do not agree with this conclusion, apparently based in Hegel's dictum "All that is real is rational". Even if an alternative policy could not have been implemented, it is still important to carry out the comparison in order to evaluate the costs entailed by Russia's predicament in which all other alternatives were unworkable. In fact, we do not agree with the idea that, given the prevailing institutional and political set-up, a different, and more progressive, economic policy would have been impossible. It is certainly not the case that the kind of policy we propose here was applied and failed. It is true, as we suggested, that between 1992 and 1995 the state handed out subsidies that were generally used to buy foreign exchange or Spanish villas rather than fund production or restructuring (Sachs 1994). But these subsidies, channeled through cheap central bank credits, were handed out with little or no rational criteria (no industrial policy) to state enterprises that

had no corporate supervision (no policy of management of state assets, not even for the large industrial conglomerates), in a macroeconomic environment of high inflation where capital flight and corruption were rampant and domestic producers confronted severe foreign competition. This social misallocation of resources was partly a consequence of the state's weakness, and also a transition strategy ill-suited to Russia's conditions.

Indeed the case for a 'weak state', suggesting 'no other alternative was possible', must not be overstated. Reformers repeatedly claim that they received a state machine in tatters, that their options were extremely limited and that, subsequently, their policies were imposed by necessity, not by ideology.[49] But this is no more than an *ex post* rationalization of events which, to reformers' surprise, went fatally wrong. In fact, when authorities launched reforms in early 1992, they were adamant that they would succeed, not least because the conditions for reform had greatly improved in a number of ways. On the crucial factor of state power, the failure of the *coup d'état* in August 1991 and subsequent events brought an end to the war between the center and the republics, the main source of economic and political chaos in the last days of perestroika. As Yeltsin himself put it when the victory of the republics came to its logical end and with it the disappearance of the USSR:

> "Now we have better chances for recovery. At last the Russian Federation has become an independent state and the war of laws, which took a lot of our efforts and time, is now over".[50]

The situation also brought greater legitimacy. Yeltsin and the Russian Parliament had both been recently elected in democratic elections and their legitimacy was reinforced thanks to their memorable role in defeating the *coup*. Moreover, having been the center of the empire, Russia quickly absorbed the bulk of the Soviet federal institutions and their executives. Finally, Russia inherited the bulk of Soviet

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[49] See for example Gaidar (1995).

[50] Boris Yeltsin, Russian President televised address 31.12.1991 in *Izvestia*, December 31, 1991. Before the *coup d'état* Gaidar shared the opinion that conditions for reform were bound to improve. In an essay written shortly before the *coup* he wrote (Gaidar 1993, p. 75):

> "The conflict (between the republics and the center) unleashed a war of laws that provoked the paralysis of economic activity. The hostilities cannot last long and, when over, will give way to a new economic center in the Soviet Union".

oil, gas and other natural resources, crucial for keeping the country going (in freezing temperatures) and earning foreign exchange to thus reinsert Russia in the world economy. In short, when the strategic decision was taken that – with ups and downs – guided all reform effort, the situation was certainly far from ideal but it was certainly not hopeless and had considerably improved in a number of crucial aspects. Reformers' hopes for improvement were not illusory. They failed to materialize, and tragically, not only or mainly due to difficult inherited conditions, but also to misguided policies inspired in a market ideology entirely out of sync with Russia's reality.

Finally, a policy with features similar, though of course not identical, to the one we are contrasting *was* briefly carried out by Primakov during his administration. Let us not forget that conditions inherited by Primakov were no better than those inherited by Gaidar. Indeed reformers and the IMF were adamant that, given unfavorable conditions and lacking a team of 'proper reformers', Primakov was bound to fail.[51] But they were again proved wrong.

We now turn to an analysis of how more specific policies, i.e. monetary, exchange rate and trade liberalization policies, at the heart of the reformers′ package, affected aggregate demand and supply. Ideally, to assess the impact of selected policies, in isolation and in their interaction, it would be best to have a comprehensive macro econometric model. Such a model does not exist, and we think that attempts to construct it for Russia for the period under consideration, where changes were so dramatic, would fail. Therefore, we shall combine economic theory with empirical observation to carry out our appraisal.

Keynesian-type factors that depressed effective demand were behind the across-the-board drop in output that took place during 1992-98.[52] The main factor was certainly the collapse of government demand. Credit restriction surely played a similar role on aggregate

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[51] After years of making forecasts that turned out to be too optimistic, the IMF predicted that the Russian economy would contract by 6% in 1999 (IMF 1998, table 1). However, it turned out to be utterly wrong again, as the Russian economy grew by 5.4%.

[52] Though output fell across the board, it did so at differentiated rates by sectors. This must be explained mainly by supply conditions and the structural adjustment induced by the sudden opening of a previously semi-closed economy. In this section we concentrate on the overall fall in output explained by Keynesian factors; but we shall come later to the differentiated fall by sector.

demand, not so much by affecting consumption, because Russian consumers never had access to credit anyway, but by depressing fixed investment and investment in working capital.

The fall of government expenditure affected government investment much more than it affected consumption (see table 2), since the former fell continuously and sharply throughout the recession; in fact, government investment began to fall in 1989 and showed no recovery for over a decade. It was thus a factor that pulled down output throughout the recession. The collapse of investment dampened current output directly by depressing demand for capital goods and indirectly, through the Keynesian multiplier, by cutting demand for other goods and services. Since investment demand in Soviet times was extremely high, its sharp fall was bound to produce a large impact throughout the economy.

Supply conditions were also adversely influenced by the curtailment of government expenditure.[53] Nobody would deny that in the USSR, and later in Russia, subsidies were often used to mask inefficiency, if not outright corruption. However, it is also true that in many cases subsidies reduced unit costs and thus contributed to improving supply conditions. Indeed, many firms in Russia were kept alive (and continue till today) by a range of formal and also quite unusual subsidies.[54] In any event, by slashing direct subsidies, the fall of government expenditure cancelled much protection that had previously shielded enterprises and goods from internal and external market competition.

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[53] Conventional Keynesian analysis sometimes downplays the importance of effective supply when analyzing short-period changes in economic activity, concentrating only on demand. This emphasis may be adequate when considering relatively minor changes or shocks in highly developed economies, where ample supply exists in all branches of production and where supply can easily accommodate demand below full employment. However, supply conditions cannot be assumed away when analyzing transition economies. Here the changes we have to consider are usually drastic. Moreover, even though at the beginning of the transition these economies usually had large unutilized capacities in the manufacturing sector, in specific industries capacities were insufficient or inadequate, due to the disruption brought about by the collapse of the previous regime (see Bhaduri 1992, Laski 1996, Greenwald and Stiglitz 1988).

[54] In the inflationary period (1992-94) these subsidies were mainly cheap centralized credits. Afterwards they were mainly cheap energy (principally gas and electricity) achieved by low prices and non-payments of energy bills. A World Bank paper has valued these subsidies as high as 4% of GDP on average in the 1993-97 period (Pinto, Drebentsov and Morozov 2000, p. 16). For the role of implicit energy subsidies in post communist Russia see Gaddy and Ickes (2002), Woodruff (1999a and 1999b).

Lack of credit availability also worsened supply conditions. Particularly during the stabilization period (1995-98), high interest rates deteriorated the equity position of firms that had access to credit, due to higher debt service, which made them less prone to invest in fixed and working capital. More importantly, tightening availability of credit surely had pronounced negative effects especially on small- and medium-sized firms, which are normally credit-rationed and did not have abundant possibilities of participating in barter agreements. Further, non-performing loans rose, and the balance sheets of banks exposed to the real sector deteriorated, so that their lending capacity and expectations worsened. Moreover, credit restriction probably also had an indirect negative effect on demand. Indeed, whatever its original cause, a leftward shift of the supply function will also induce a leftward shift of the demand function, because reduction in output entails a fall in employment, wages, and in demand for intermediate and wage goods.

Finally, we must analyze the consequences of trade liberalization and currency appreciation on supply and demand because, as we saw in the previous section, they figured prominently throughout 1992 to 1998. Since this is an area of considerable importance, it seems useful to first discuss the issue in general terms.

Several reasons suggest that trade liberalization may affect demand. One is the complementarities between some import items with domestic production.[55] Another reason is that investment and consumption may be stimulated when imported and sophisticated goods, which were previously very expensive or unavailable, become available and cheaper. Thirdly, trade liberalization also raises imports and accordingly absorbs demand previously directed to domestic production. All in all, we conclude that the net effect on demand for domestic output is uncertain.

The effect of the exchange-rate policy on demand is also ambiguous. A widespread view holds that currency appreciation, such as the one that took place in Russia, depresses aggregate demand when the Marshall-Lerner condition is fulfilled, due to its negative impact on net exports. Another view, however, emphasizes the expansionary impact of real currency appreciation, owing to the fall in mark-ups

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[55] For example, if trade liberalization stimulates the demand for imported capital goods, construction activities may also be encouraged.

and the possible shift from profits to wages, bringing a rise of consumption. Evidence from other experiences shows that these positive effects on internal demand may offset, or surpass, the worsening trade balance brought by currency appreciation.[56]

Finally, trade liberalization and currency appreciation are also likely to affect supply, by improving access to inputs which were previously unavailable, or by reducing the price of inputs, or both. Other things being equal, profit margins will tend to rise and firms will tend to expand their supply. Of course, other things will not be equal, especially because both trade liberalization and currency appreciation also bring a reduction in the price of competitive imports that negatively affect domestic production. Therefore the net balance of currency appreciation and trade liberalization on domestic supply is ambiguous.

Now, regarding Russia's experience, it may be surmised that trade liberalization and currency appreciation did not stimulate investment which, as previously mentioned, fell dramatically throughout 1992-99. Also firms seem to have foregone better or cheaper inputs that became available thanks to trade liberalization and currency appreciation. In other words, firms' supply conditions do not appear to have significantly improved due to import liberalization and currency appreciation. In fact, as investment collapsed, imports of inputs do not seem to have increased greatly during the period under consideration.

It appears, however, that consumers did benefit, and substantially, with trade liberalization and currency appreciation, with a subsequent positive impact on consumption. This conjecture follows from our previous finding that household final consumption managed relatively well in the midst of Russia's depression. The stability of consumption is *prima facie* hard to reconcile with the dramatic fall of employment and real wages during 1992-98, unless we accept that the saving coefficient of households fell. That fall may have to do, at least partially, with the attraction that imported goods had on Russian consumers; especially since other factors that the literature associates

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[56] The Krugman and Taylor paper (1978) is still very much worth reading. See also Taylor (1988).

with changes in the rate of savings do not appear to have had a significant role.[57]

What about the overall impact of trade liberalization and currency appreciation? Apparently the impact was negative; that would seem to be the conclusion if one simply considers that during 1996-2001 Russia's manufacturing imports greatly exceeded manufacturing exports. Indeed, in 1996 manufacturing exports were about US$ 23 billion (total exports: US$ 88 billion) and manufacturing imports were about US$ 27 billion (total imports: US$ 61 billion). In fact, the manufacturing imbalance is a striking peculiarity of Russia's economic evolution, particularly when remembering that we are dealing with a former super-power, and that the USSR's domestic production was heavily biased in favor of manufacturing.[58]

However, it would be too rash to conclude that the large manufacturing trade disequilibria was entirely due to trade liberalization and currency appreciation, since there were also other forces at play, particularly the (previously mentioned) lack of adequate supply conditions. Worsening supply conditions prevented firms from taking advantage of any potential gains brought about by the trade opening that arose with the dismantling of the communist regime. Generally speaking, if supply capacities are limited and if they further deteriorate due to insufficient and expensive credit, or for other reasons that limit supply, exports and substitution of imports will be lower than they might have been. The trade balance will thus improve less or worsen more than it might have and this, in turn, will have a deleterious multiplier effect on demand. But of course currency appreciation and rash trade liberalization surely played a role in the manufacturing trade deficit.

We conclude from our discussion that, as a result of all economic policy measures previously analyzed, demand and supply conditions

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[57] In the vast literature on the subject, a shift from profit to wages, easier access to consumer credit, or a fall in prices, are commonly assumed to stimulate a fall in the rate of savings. However, in Russia, the share of wages in value added declined even as the Gini coefficient was rising, pointing out to higher concentration of income; consumers do not appear to have benefited from easy credit, and prices were on the rise.

[58] As a reference for comparison, in 2001 Korea and Mexico exported each about US$ 135 billion in manufactured goods. Moreover, that same year the share of manufacturing exports in total exports was about 90% in Korea, 85% in Mexico, but only 22% in Russia.

were negatively affected. However, having said that, it is important to advance one step further and look at specific peculiarities that deserve greater consideration. In particular, industries and sectors felt the impact of economic policy measures in very different ways. More to the point, even if overall effective demand was falling, and supply conditions deteriorated in general, many industries and enterprises, and principally those enjoying very large comparative advantages – i.e. those based primarily on natural resources –, were better able to withstand the collapse.[59] And industries that did not enjoy large comparative advantages suffered greater than average contraction. Originally, the move away from the plan and towards the market was expected to shift Russia's productive structure away from heavy industry and production goods and towards consumer and light goods.[60] In its annual report for 1993, however, the central bank of Russia (Central Bank of the Russian Federation 1994, p. 14), recognized that profound change in the structure of the economy was

> "leading to an *increase of weight* in the economy, i.e. an increase in the share of fuel and power industries and a decrease in the share of manufacturing industries";

that is, the structural adjustment was, so to speak, taking place 'backwards': towards an industrial structure ever more dominated by heavy industry. By 1994, consumer goods industries in Russia were already doing generally worse than heavy industries which, contrary to what many observers expected, turned out to be more competitive in world markets.

By 1994-95, roughly at the onset of the stabilization period (1995-98), output stabilized in competitive industries such as aluminum or oil, while in other sectors, such as textiles and machinery, it continued to fall. Indeed, one important feature of Russia's economic evolution throughout 1992-98 is the steady and persistent decline of the consumer goods industry (see table 1). The drop in output of light

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[59] There were however several major exceptions due to peculiarities in Russia's economy inherited from the USSR as a superpower. Parts of the military, aerospace, nuclear and other high technological industries were competent and up to date, but in the short term depended almost entirely on state demand and, mainly for political reasons, had no access to external markets.

[60] See for example Gorbachev's interventions in the XIX Conference (1988) and the XXVIII Congress (1990) of the CSPU (Gorbachev 1988, p. 14, and 1990, p. 12).

industry was especially dramatic, but the food industry also contracted drastically.

At first sight, this development is difficult to reconcile with the evolution of consumption, and especially with household consumption, which fared relatively better than the rest of aggregate demand and, to some extent, was able to endure the crisis. Nevertheless, this apparent anomaly disappears once we take into account that consumer imports grew at astonishing rates: the data show a collapse in output of domestic consumer goods and relatively high levels of consumption, and also a significant increase in imports of consumer goods.

In fact, imports grew fairly quickly from 1992 until 1998. At the same time, the proportion of consumer goods in total imports grew even more rapidly. The effect of both trends was dramatic: between 1991 and 1996 imports of consumer goods jumped almost 6 times and in 1996 accounted for more than 50% of total imports.[61] This suggests three conclusions. First, in a few years an impressive change in the Russian traditional import pattern took place, from capital to consumer goods, which is consistent with the collapse in investment. Second, the abrupt fall in domestic output of consumption goods was up to a point countered by a steep rise of imports in equivalent goods, which is consistent with the maintenance of a relatively high level of consumption. Third, by whatever means, the Russian market was kept significantly opened throughout the transition, which is consistent with our previous argument regarding trade openness during Russia's transition. But of course the steep rise of consumer imports and the collapse of the domestic consumer goods industry are two faces of the same coin. These imports siphoned of consumer demand, which would have otherwise gone towards domestic industry.

Finally, the long period "is but a slowly changing component of short-period situations; it has no independent entity" (Kalecki 1968, p. 263). In fact, the economic policy measures implemented brought about contraction of output; consequently employment and wages, as well as profits and capacity utilization, were lower than they otherwise might have been. So investment and capital accumulation were probably discouraged, and the long-run growth trend was negatively affected. Just as important, by delaying modernization of capital stock,

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[61] In 1991 the share of imports in total consumption was only 14% but had jumped to 52% in 1996 (Gaidar *et al.* 1998, p. 807).

physical as well as human, the contraction in investment depressed future output and jeopardized Russia's economic and political prospects.

4. Some remarks on Russia's economic recovery

A striking peculiarity of Russia's 1998 shock is that the devaluation and the financial collapse which led to a steep fall in real income, and therefore in demand, did not generate the economic recession that was expected. Industrial production dropped immediately after the financial collapse, but recovered strongly at the end of 1998 and has continued growing. Corrections of the trade balance and the current account were also impressive. In the months previous to the devaluation, the trade surplus that Russia's economy generated for years was drastically reduced, leading to the appearance of a current account deficit during the first two quarters of 1998 on the order of 5.1 billion dollars. But the trade surplus sharply improved overnight (pulling the current account with it), as a result of the steep fall in imports caused by the devaluation. It has been kept high up to now by a sharp rise in oil prices. Still, manufacturing exports remained stagnant and the manufacturing trade balance improved due to import contraction.

Even though we cannot analyze here the peculiarities and causes behind Russia's recovery from the crisis, a few observations are in order. First, the recovery, and especially the correction of the manufacturing trade deficit, was helped by a change in relative prices that made many firms, or parts thereof, quite efficient and competitive which, before the devaluation, were supposedly non-competitive and inefficient. This clearly illustrates a point previously mentioned, namely the danger of making a criterion of efficiency from results based on market costs and prices prevailing at a particular moment. Still, it would appear that it is easier to recover space previously lost to imported goods in the domestic market, than to gain space by exporting to foreign markets.

Second, there is a question of why in Russia currency devaluation turned out to be expansionary, while in other countries it has been followed by output contraction. This is a difficult question whose complete answer would require more work, but we posit three

important reasons. One is that manufacturing imports were heavily biased towards final consumer goods, and imports of manufactured inputs were somewhat modest. It would appear that import substitution may be much easier for final consumer goods than for production inputs. Also, when the share of imports in direct costs is relatively small, the shift from wages to profits, that tends to ensue from devaluation and to contract domestic demand, plays a smaller role.

A second reason has to do with the relatively minor impact on the industrial sector of the banking crisis that followed currency depreciation. Apparently in Russia the recovery of industrial production was not hindered by the collapse of the banking system. This for the simple reason, as we suggested, that the link between the real and the financial sector had been rather tenuous throughout the transition. Apart from big export companies, few companies had access to credit. They survived (and still do to a point) thanks to barter, the use of IOUs and credits, which they issue among themselves.[62] The scarce use that the average Russian company makes of the banking system (apart from being a way to make payments) turned out to be a positive factor during the crisis.

A third reason appears to have been the pragmatic package implemented. In fact, Primakov and Gerashchenko opted for a policy that was conservative enough to dampen inflation and devaluation spiral, but without paralyzing the economy too violently or in a politically risky manner. Their declared formula of returning to a 'controlled monetary emission' to finance the fiscal deficit, which local and foreign economists ridiculed, turned out to be quite effective. It did not generate hyperinflation and avoided the alternative of reducing expenditure in a draconian manner, which would have entailed a refusal to finance the deficit with monetary emission – in a context where there were no domestic or external credit sources available. In any case, public expenditure fell quite substantially from an average of 38.6% of GDP in 1997-98, to 33.6% in 1999-2000, though at the same time funds channeled to the debt service were reduced by half: from 5.3% of GDP (1996-97) to 2.7% of GDP (1999-2000).[63] Thanks to the moratorium on foreign debt and the virtual default on internal debt, financial meltdown was followed not by an increase in debt service

[62] Seabright (2000), Gaddy and Ickes (2002).
[63] Russian Economic Trends (2002).

payments but by a decrease. This allowed relatively greater government spending in the real internal economy which helped to stimulate demand and growth. As high oil prices and economic growth boosted government revenues (from a low of 29.9% of GDP in 1998 to 37.9% of GDP in 2000), the fiscal deficit was turned around and in 2000 Russia posted a substantial fiscal surplus. The introduction and/or reinforcement of certain exchange controls and measures to give the central bank greater leeway in managing the exchange market (orthodox economists liked neither) helped to contain hard currency demand.[64]

One final remark concerns the future. For years, light industry was severely affected by the crisis. It was called inefficient and did not have resources for investment. However, though there was little investment and restructuring, relatively few companies were closed for good. The majority maintained a substantial percentage of idle capacity and a semi paralyzed workforce that was later mobilized to meet the increase in domestic demand. Though hard data are difficult to find, we surmise that, given the enormous industrial capacity that Russia inherited from communism, a large (though rapidly diminishing) human and physical potential still remains. And while it is clear that healthy growth in the mid and long term requires serious restructuring and substantial investment, utilization of some of those unused resources (i.e., the aviation industry) could still help to stir modernization and technical progress in Russia.

5. Conclusions

As we argued at the beginning of the paper, institutional factors were undoubtedly paramount in explaining the total lack of investment that underpinned Russia's economic collapse. We have shown, however, that economic policies implemented also played a role in hindering investment and growth, making matters worse. Present economic

[64] Exporters were forced to sell at least 50% and later up to 75% of their hard currency income in the official exchange market and the central bank had clear preferential treatment over other participants in the primary exchange market. These and other measures helped reduce capital flight that has burdened the Russian economy since it began the transition to a market economy.

literature focuses on the complex institutional frameworks that allow healthy and sustainable economic growth. Indeed, there is little doubt that societies that enjoy well-defined property rights, a transparent and effective legal system, a rational tax structure and so forth are better positioned to generate growth and well being. But most of these institutions are the result of years of historical evolution and can hardly be implemented at a moment's notice. Does this mean that sustainable growth can only be forthcoming after years and years of 'structural reforms' that succeed in putting all these institutions in place? That is, when, by all parameters – excepting growth and wealth themselves – less developed countries become developed ones? This is the awkward impression that most of this literature inadvertently gives. But it is a mistaken impression. Modern economic growth takes place at times and in places where 'institutional frameworks' are far from what conventional economics considers ideal. In fact, these frameworks are as much a result of economic growth as the reason behind it.

We are aware of the constrictions imposed by globalization and the inefficiency of the Russian state. But the existence of these constrictions does not imply that the utopia of creating a market economy at full speed and at whatever cost, from the ashes of seventy years of communism, was a better or indeed the 'only alternative'. We are convinced that notwithstanding those limitations, Russia's economic collapse could have been cushioned by more active and purposeful public policies. As we suggested, this conclusion is backed by the pattern of growth that eventually took place in the wake of the financial collapse. Before the crash, the brutal de-industrialization that occurred was commonly considered a natural, even a 'healthy' event that shed 'unwanted and useless' goods. But the growth induced by import substitution that followed suggests that the Russian economy was over-exposed for too long to foreign competition. Before the crash, the Russian government, utterly obsessed with the 'fiscal crisis' and coached by the IMF, tried desperately to implement ever-tougher policies to raise revenues and cut expenditures. But due partly to taxes generated by import-substitution growth, the fiscal crisis that plagued Russia for so long seemed to vanish in thin air – though admittedly rising oil prices were also a major factor in this development. Growth, even on the basis of products and employment that (well-off) Western scholars enjoy ridiculing, turned out to be better for the treasury, the Russian people and the economy as a whole, than the alternative of

having no goods or jobs at all. The question is if a financial meltdown was needed to expose this common-sense truth that many economists seem to find so difficult to grasp, i.e., if other policies could have brought about some of the conditions that ultimately made the resumption of growth possible from 1999 on. We hope this paper makes clear the case for a positive answer.

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