

# ECONOMIC TRANSITION OF RUSSIA

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# Contents

- Key factors of Russian economic development
- Conditions of the transformation
- Objectives and goals of the transformation
- Transformation procedures
- Macroeconomic situation during the transition
- Results of transformation
- The 1998 financial crisis
- Economic growth 1999-2008
- Russia during the global financial crisis
- Challenges for the future development

# John Maynard Keynes in 1925



- “The economic system of Russia has undergone such rapid changes that it is impossible to obtain a precise and accurate account of it... Almost everything one can say about the country is true and false at the same time”

# Key factors of Russian economic development

- The largest country in the world - 17,075,400 square kilometres



# Key factors of Russian economic development

- The world's largest reserves of mineral and energy resources



# Key factors of Russian economic development

- Conflict between the center and the periphery (diversity of population, nationality and religion)
  - 160 different ethnic groups and indigenous people
  - Religion groups – Russian Orthodox Christianity, Muslim, Buddhism, Catholic, Protestant, Jewish, beliefs (shamanism, pantheism, paganism, etc.)
  - Induction into religion takes place primarily along ethnic lines
  - Majority of ethnic groups are settled in certain areas
  - In modern Russia several ethnic groups have a partial sovereignty – 21 republics with its own constitution, president, and parliament within the Russian Federation
  - The public finances are generated in the regions, transferred to the center, and only then re-allocated back to the regions

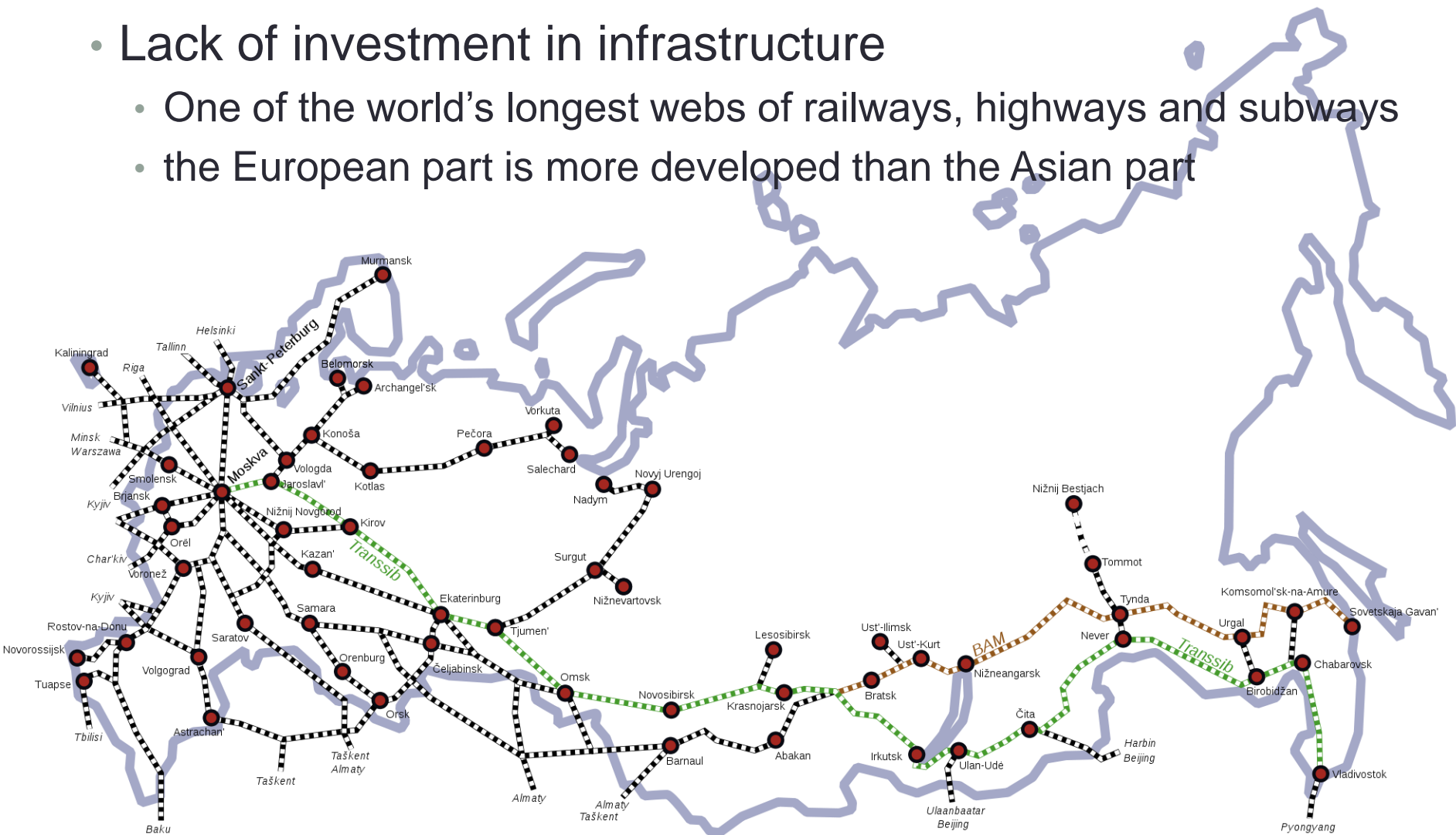
# Key factors of Russian economic development

- Conflict between the center and the periphery (diversity of population, nationality and religion)



# Key factors of Russian economic development

- Lack of investment in infrastructure
  - One of the world's longest webs of railways, highways and subways
  - the European part is more developed than the Asian part





# Key factors of Russian economic development

- Vast territory
- Natural resources
- Conflict between the center and the periphery
- Lack of investment in infrastructure
- Authoritarian nature of governance to control the territory
- Huge expanses on defense and military
- The origins of investments are mainly internal

# Starting conditions of the transition in late 1980s - social

- Low level of social inequality
  - as low as in Scandinavian countries
- Relatively low level of corruption
- Relatively low crime and mortality rates
- Immense investments in the human capital
  - Free high-quality education in every level
  - One of the best education system in the world
  - Free health care to all citizens
  - Relatively high life expectancy level
  - Highly developed theoretical science and innovation at the theoretical level

# Starting conditions of the transition in late 1980s - economic

- Centralized bureaucratic allocation replaced market allocation
- Economic policy making was strictly hierarchical
- Macroeconomic situation – closed economy with the volume of money exceeded the volume of goods;
- Microeconomic situation – people demanded other goods than those supplied
- No initiative behavior among people and enterprises
- Economic distortion of prices
- Structural dysfunction of the economy (with prevailing heavy-industries enterprises)
- Budget deficit – more than 6% of GDP
- Excessive foreign debt – 30 to 40% of GNP
- Falling oil prices
- Economic growth – 1 to 3%

# USSR economic experiments of systematic changes

- 1920s – NEP – New Economic Policy
- 1930s – Industrialization & Collective farming
- 1950s – Khrushchev's reforms
- 1960s – Brezhnev's reforms
- 1980s – Gorbachev's reforms – transition to indicative planning; introduction of some market mechanisms – leased enterprises, family farming, joint ventures with foreign capital
  - ended up with political democratization
- Reforms did not change the planned nature of the economy

# Objectives

- Restructuring of the national economy
- Macroeconomic stabilization

# Goals

- Deregulation and promotion of competition
- Prices and interest rates liberalization (if to let go the prices, the output might be saved)
- Liberal foreign trade policy (open market)
- Establishment of property rights
- Development of the market economy institutions

# Starting the transition



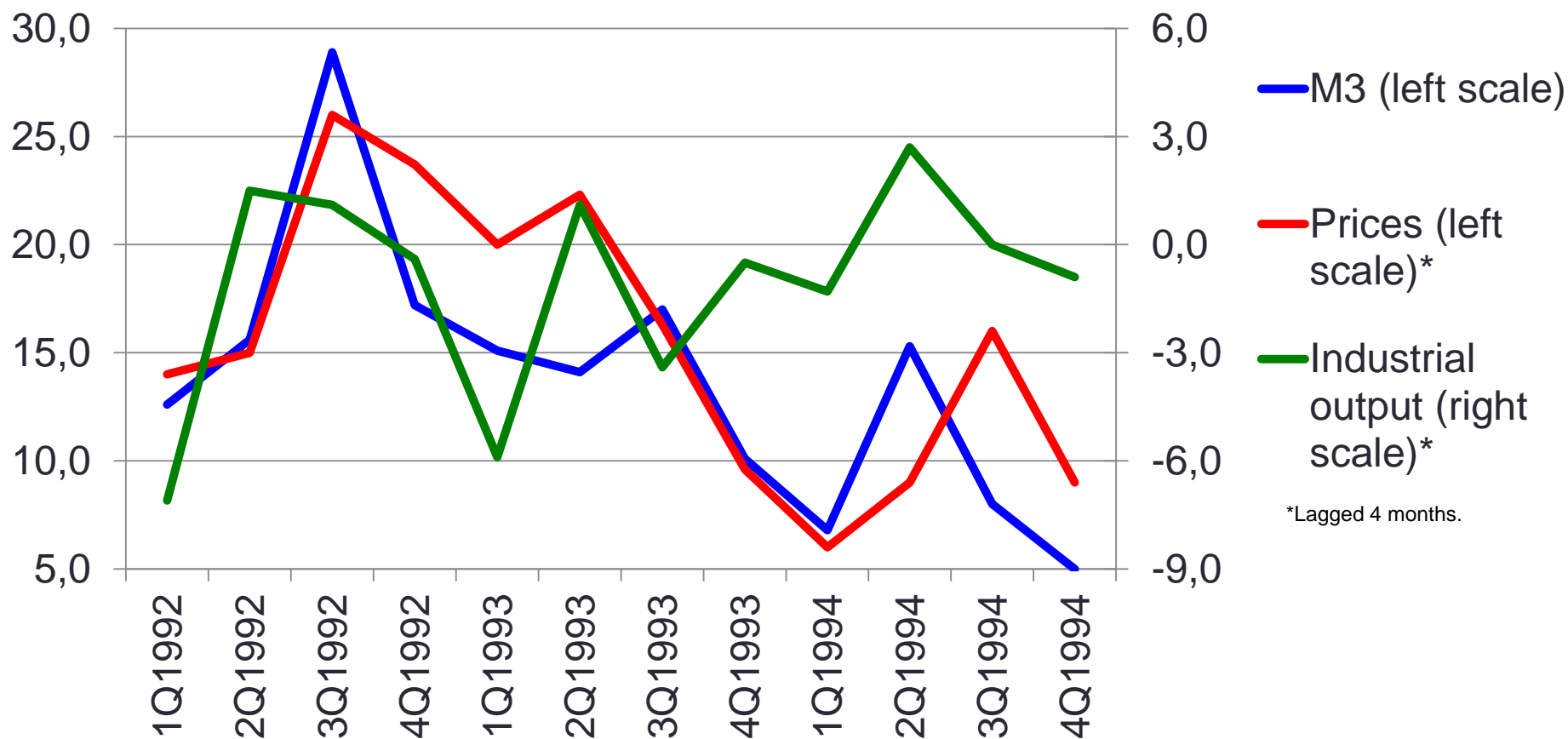
Boris Yeltsin



Yegor Gaidar

# Price liberalization – early 1992

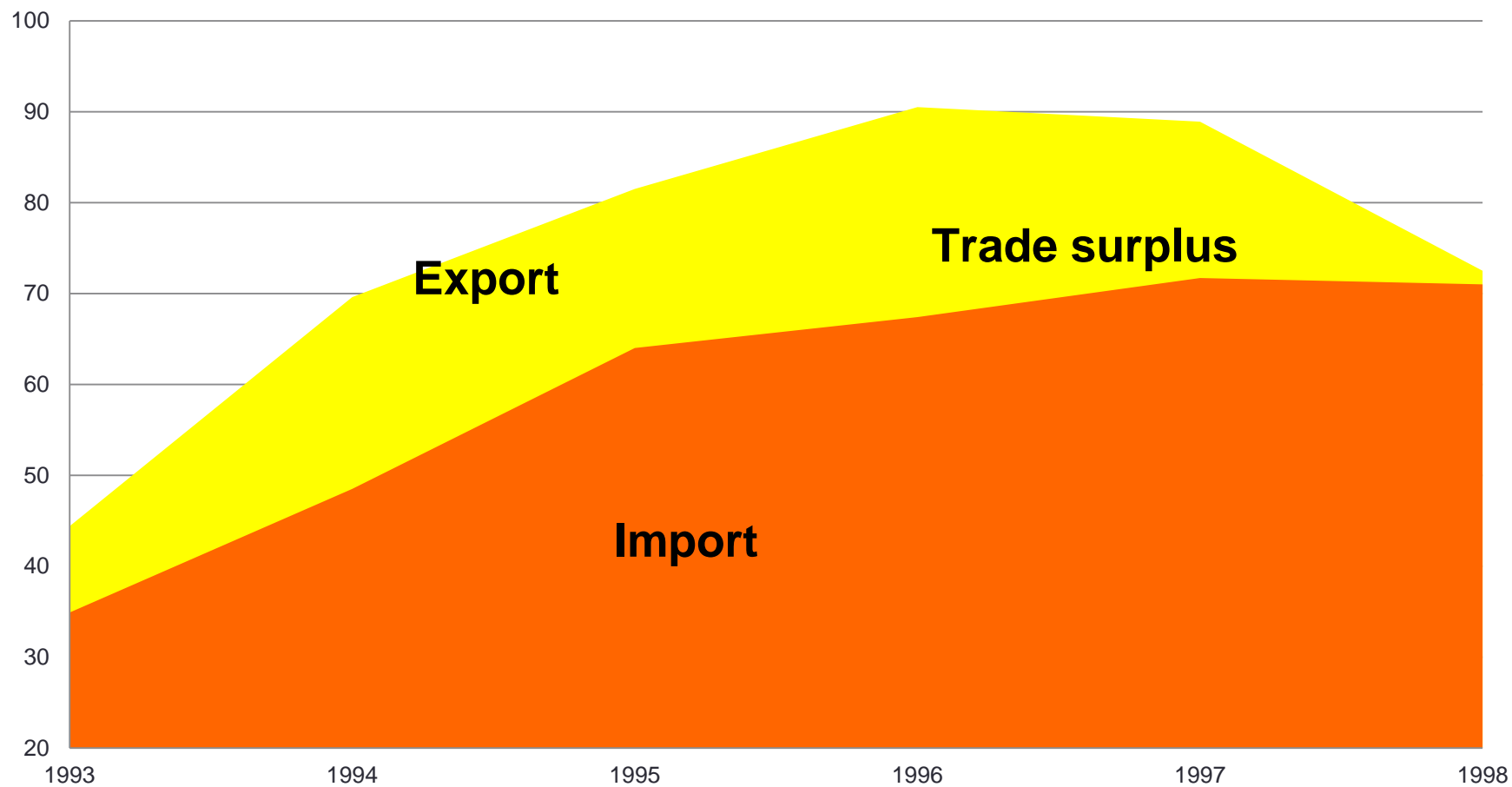
Average monthly growth rates of money supply (M3), prices and industrial output by quarters, %



\*Lagged 4 months.

# External liberalization - 1992

Russia's foreign trade, billion \$





# Privatization – since 1988

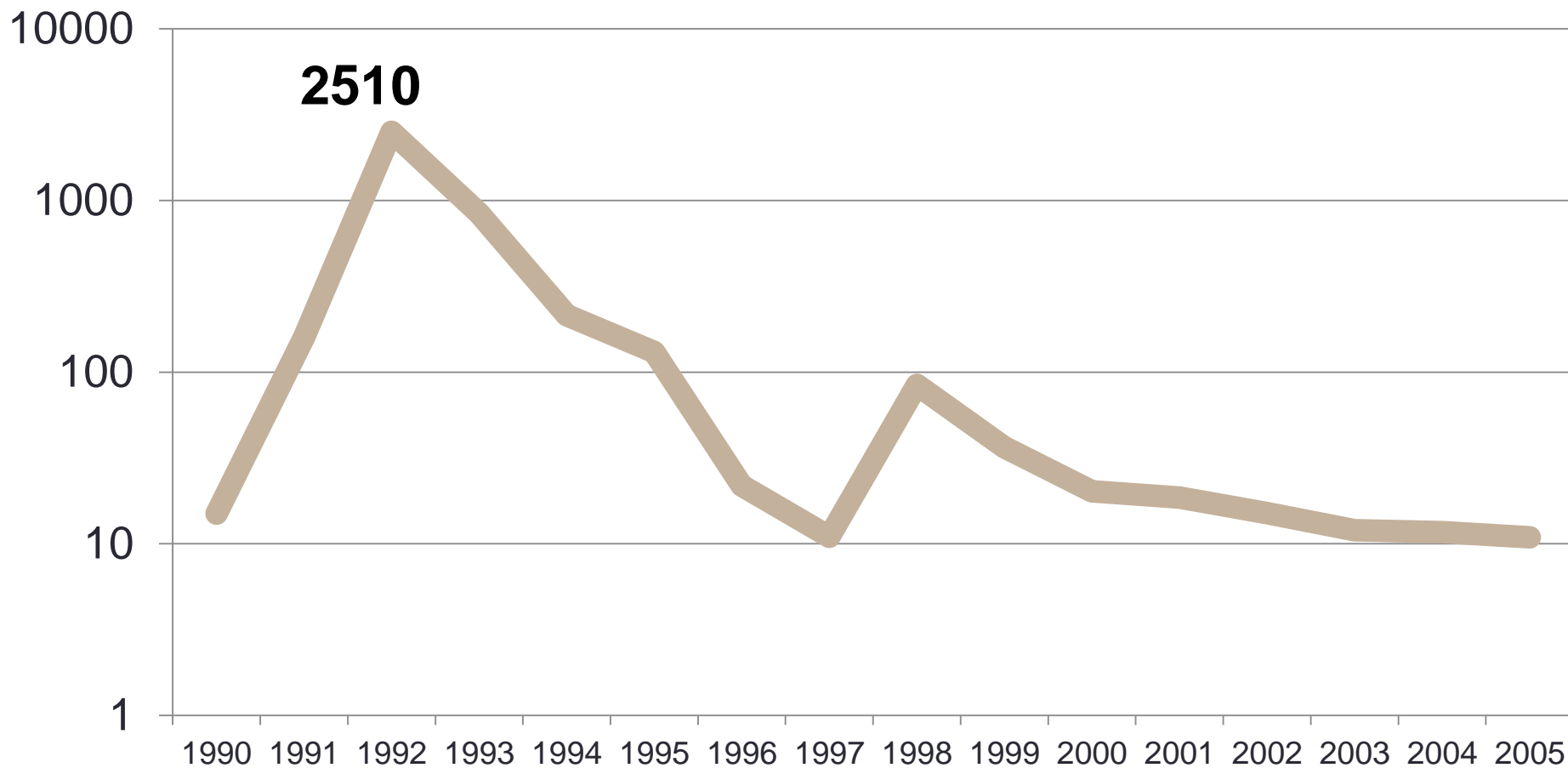
- Spontaneous privatization (1988-1991)
  - control over some industrial assets was acquired by their managers
  - this accounted for only several thousand enterprises, a small part of the Soviet industry
- Voucher privatization (1992 - 1994)
  - each voucher were corresponding to a share in the national wealth
  - vouchers were distributed equally among the population, including minors
  - vouchers could be exchanged for shares in the enterprises to be privatized
  - low price of vouchers \$7-10 – less than an average monthly wage
  - most shares were acquired by the management of the enterprises

# Privatization – since 1988

- Loans for shares (1995)
  - included most oil, gas and other natural resource-based companies, which were highly profitable ones and were supposed to be sold for cash
  - industrial assets were leased through auctions for money lent by commercial banks to the government
  - the auctions lacked competition, as they were largely controlled by favored insiders
  - scheme that gave rise to the class of Russian business oligarchs, who have concentrated enormous assets
  - banks and enterprises involved in the scheme stopped seeing an interest in maintaining high inflation

# Macroeconomic instability

Annual inflation rates in Russia  
(December-to-December increase in CPI, log scale)



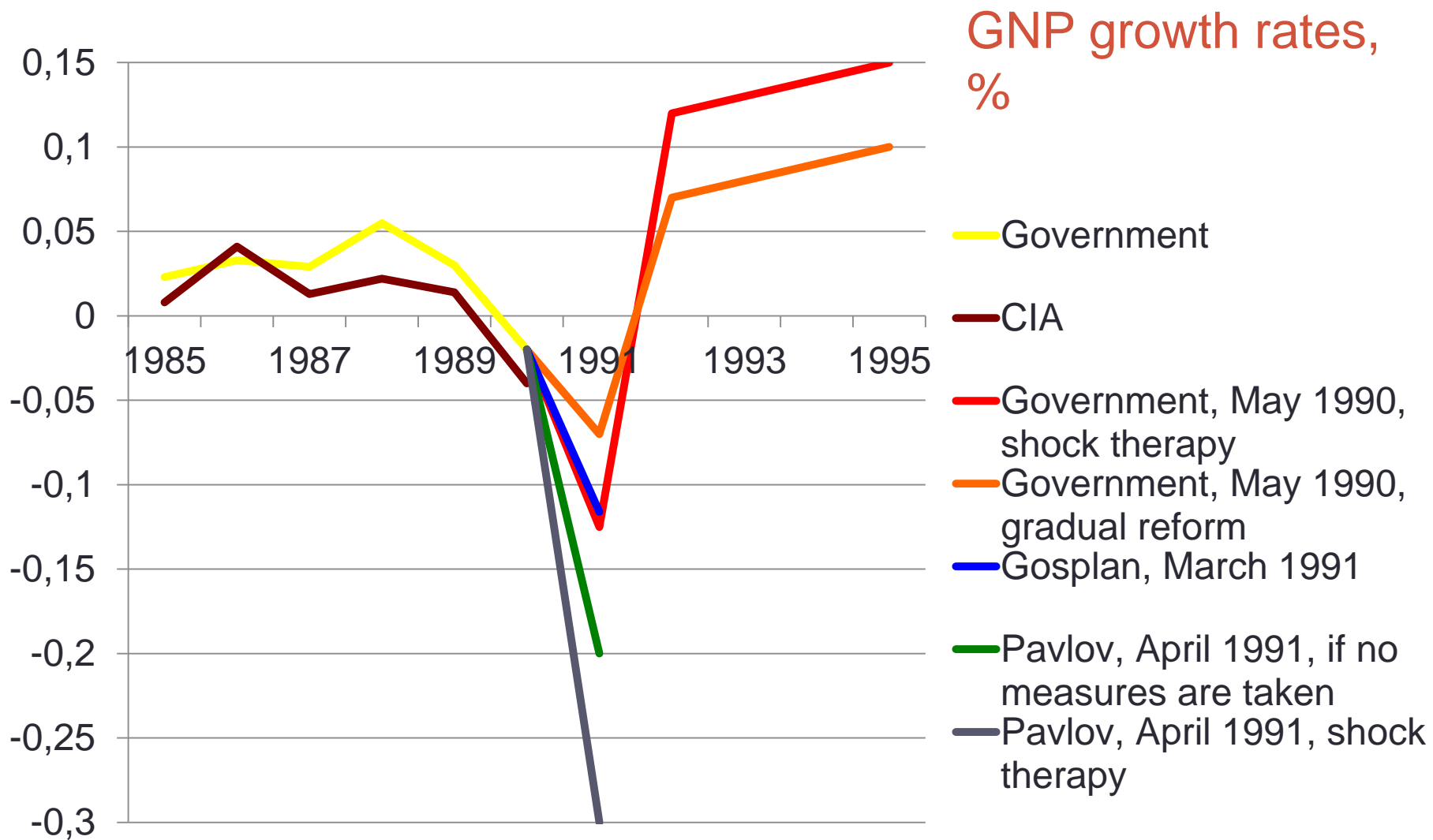
# Anti-inflation policy – 1992-1998

- First half of 1992 (Gaidar). Growth of money supply was restricted; inflation fell to 10% a month in summer 1992; as a consequence, massive non-payments emerged
- First half of 1994 (Chernomyrdin). Tightened monetary policy allowed to bring down inflation to 5% a month in summer 1994; again, non-payments increased
- mid 1995: exchange rate based stabilization; inflation brought down to 6% a year (July 1998 to July 1997); currency crisis in August 1998, acceleration of inflation

# Why high inflation was so persistent?

- There was no consensus among major lobbying groups, how to finance reforms, therefore it was impossible to balance the budget
- Problems with tax collection: high level of tax evasion in the 1990s. The government was willing, but not able to increase tax revenues
- Attempts to tighten monetary policy caused non-payments

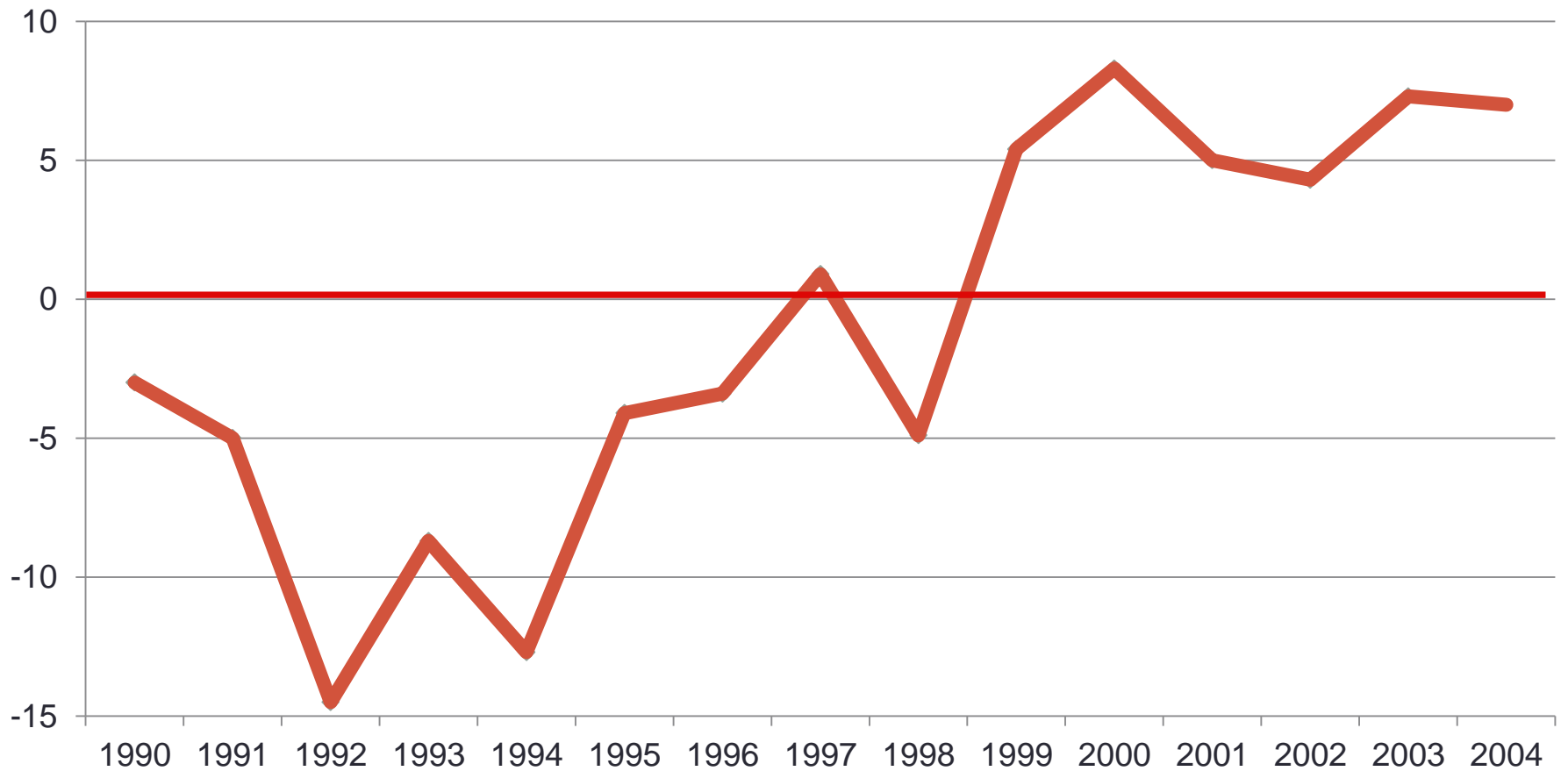
# What was expected?



# Results (1991-1998)

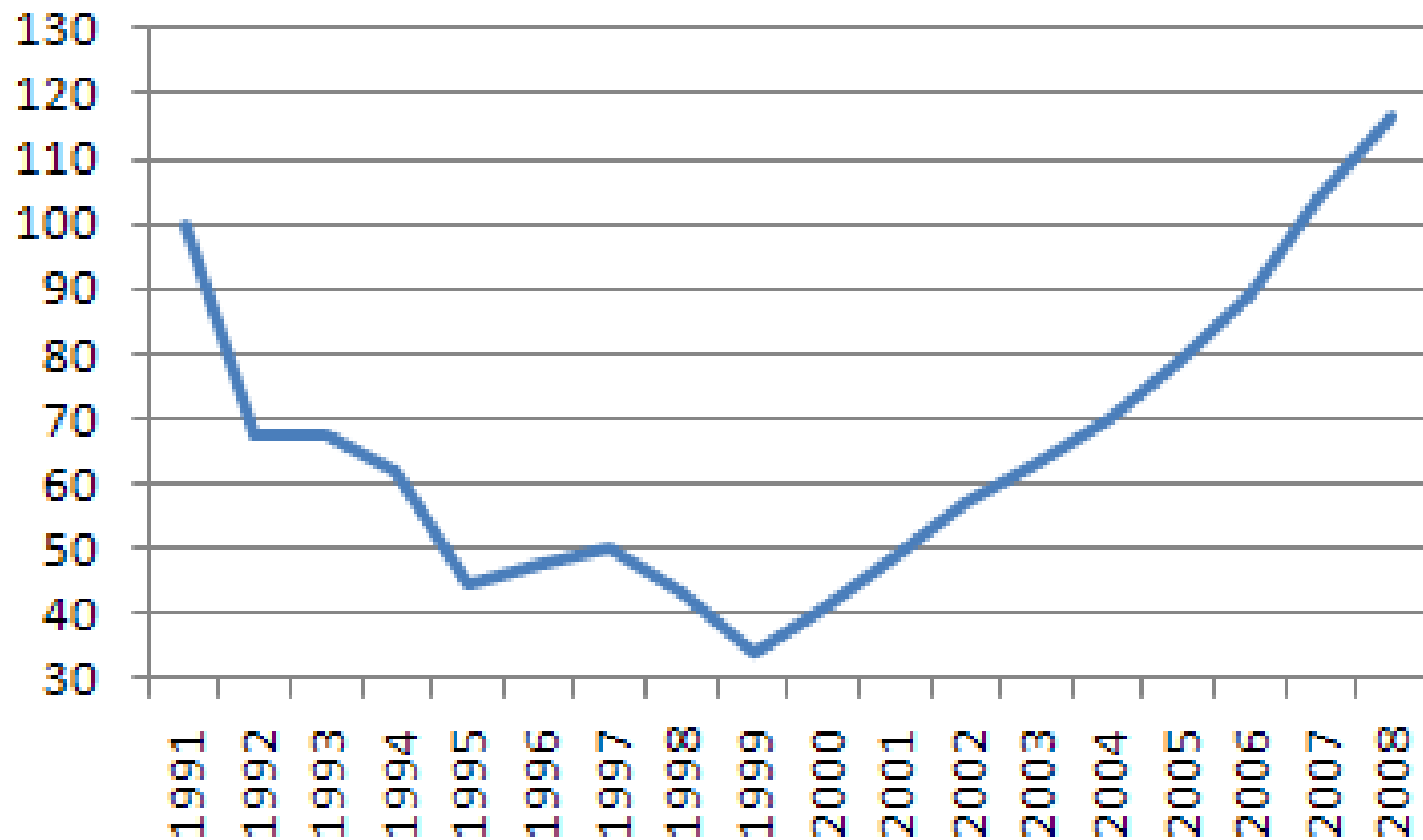
- Free market
- Private business – 70% of GDP
- Huge fall in output
- High inflation
- Income redistribution
- Privatization – controversial results
  - people's disapproval & emergence of oligarchs
- Organized crime and corruption
- Capital flight – \$20 billion a year
- The development of barter economic relations and dollarization
- Unemployment and poverty
- Deterioration of education system, health care, demographics
- Inadequate pension system
- Inefficient legal system
- Existence of shadow economy

# GDP growth rates, %



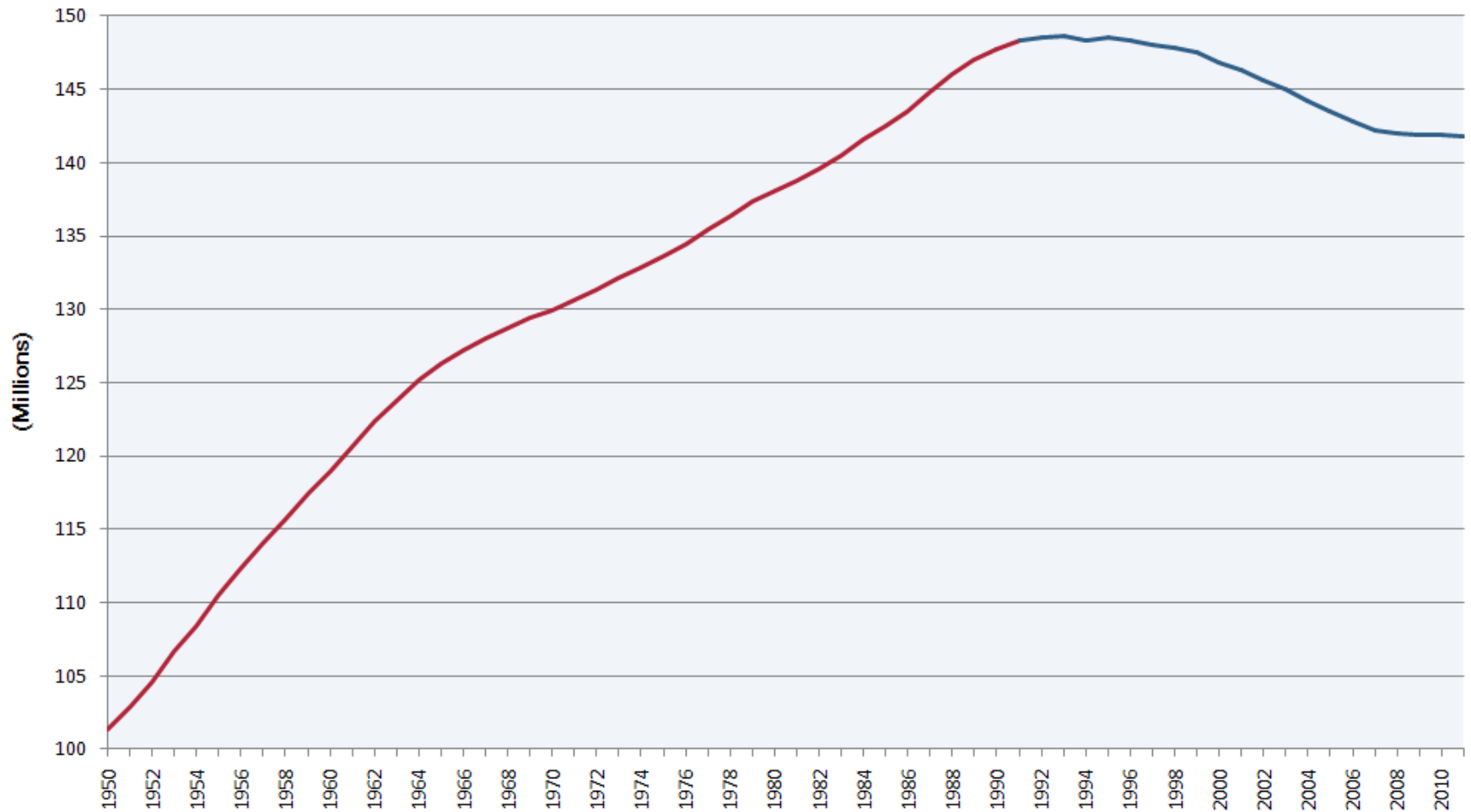


# Personal incomes - % of level in 1991



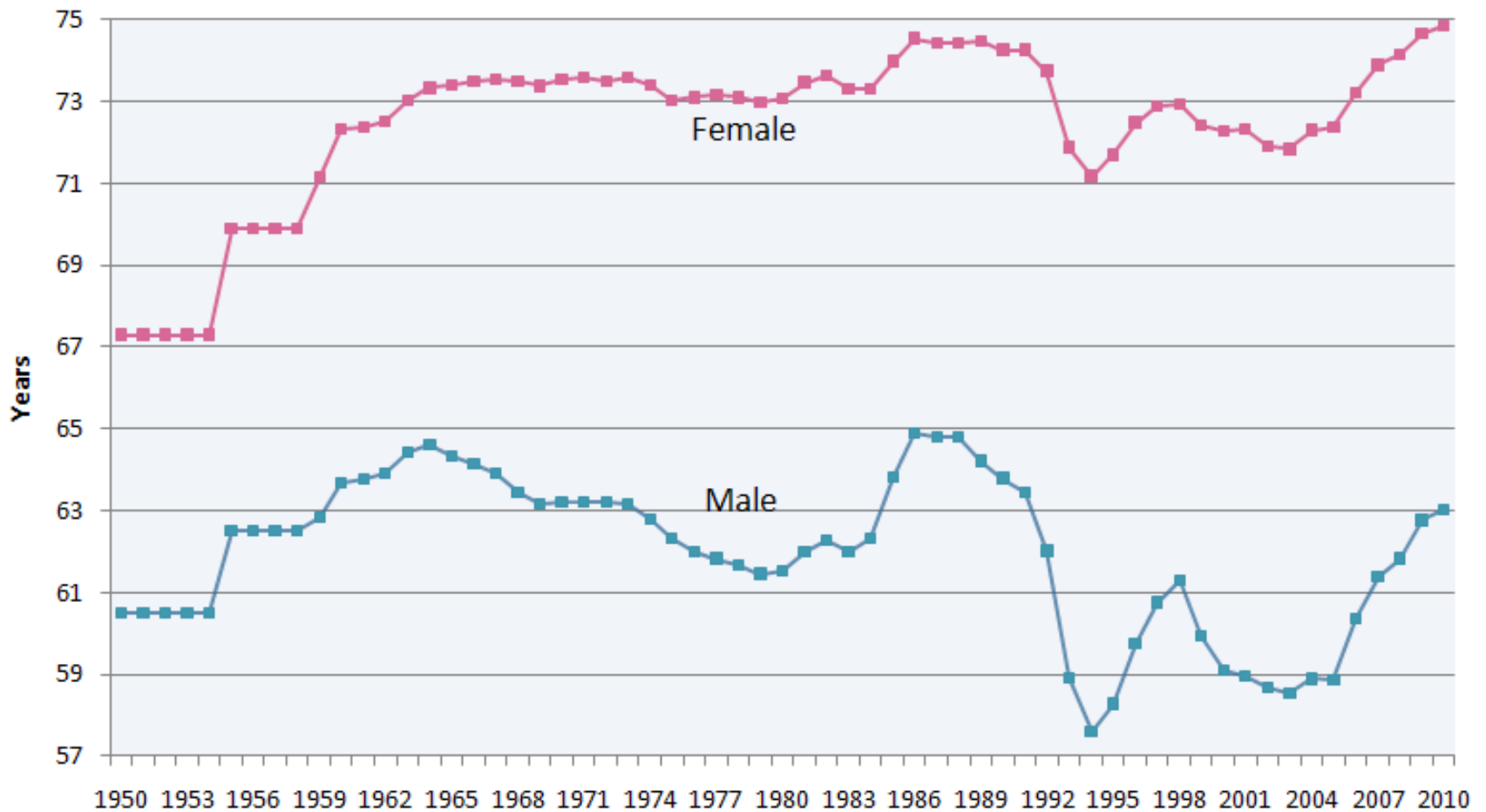
# Human development

Population of Russia



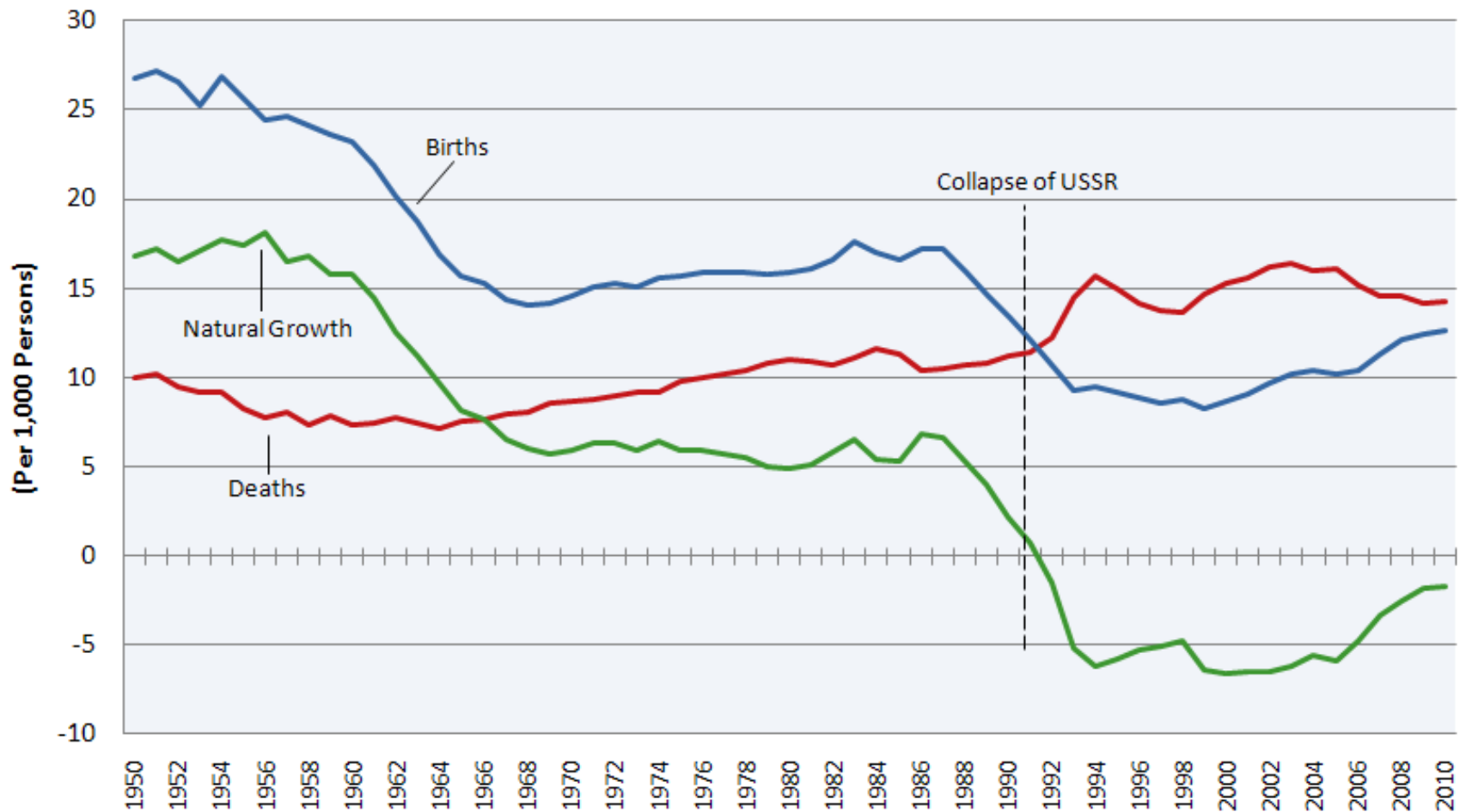
# Human development

## Russian Life Expectancy



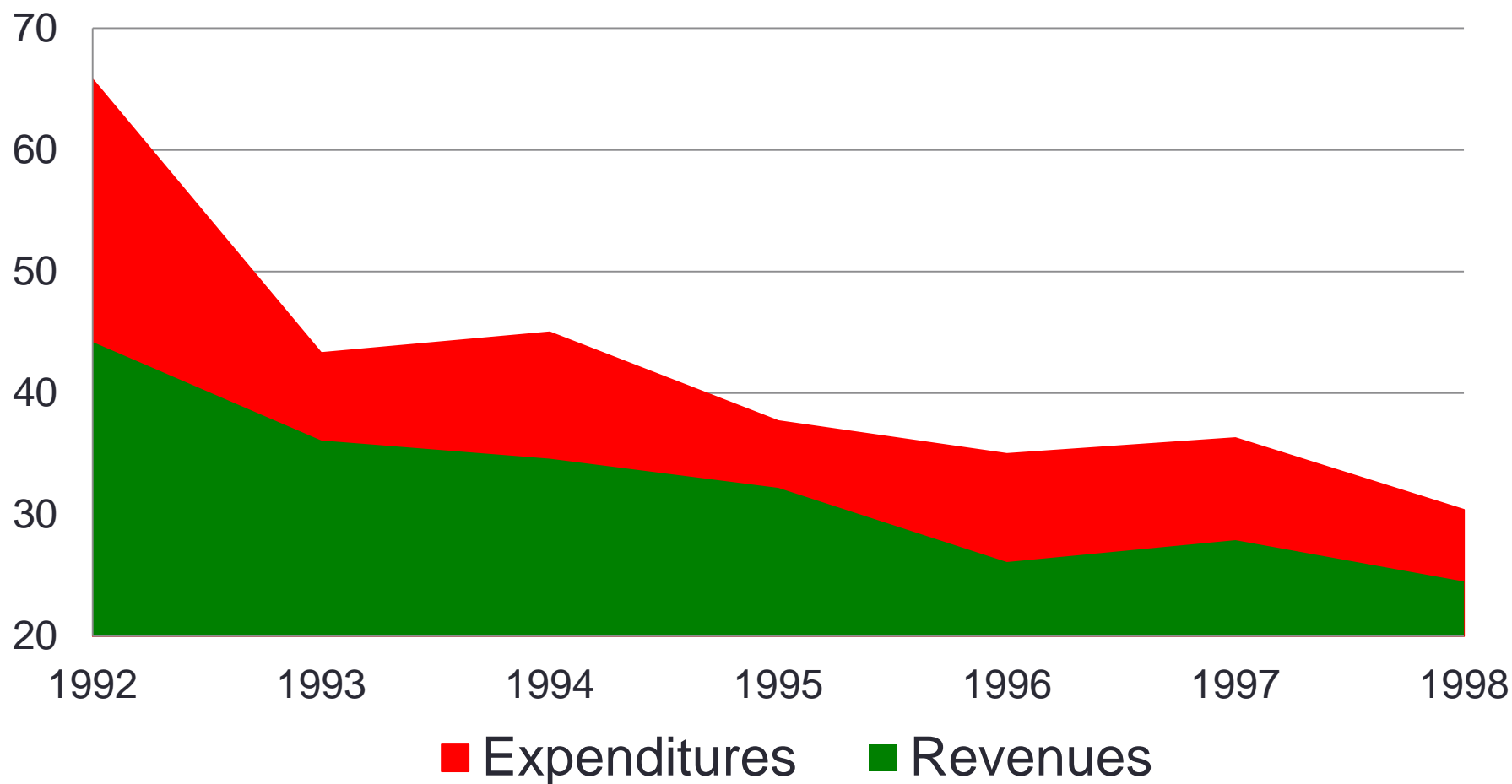
# Human development

## Natural Population Growth of Russia



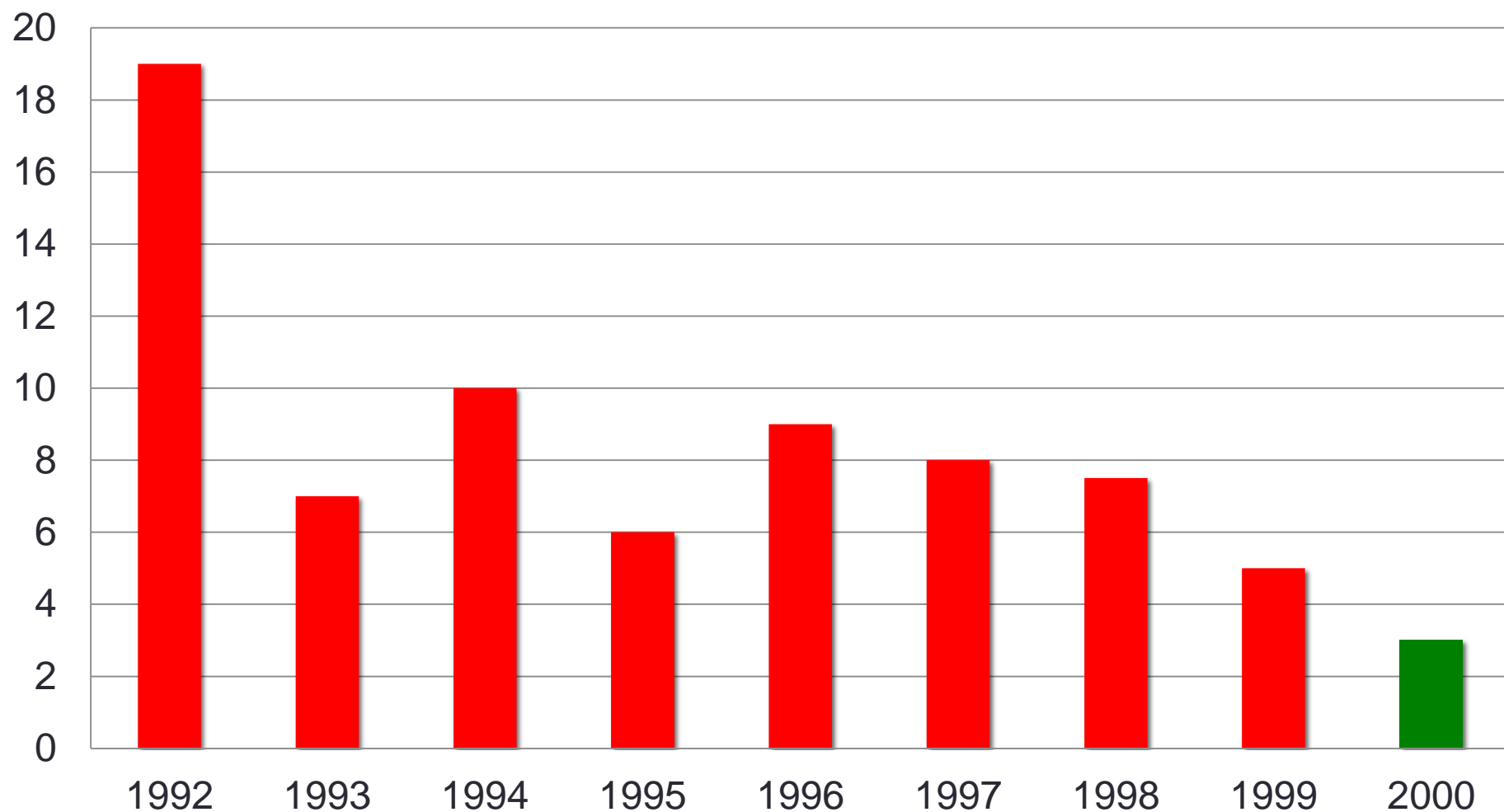
# Russian financial crisis – August 1998

Consolidated government revenues and expenditure,  
% of GDP



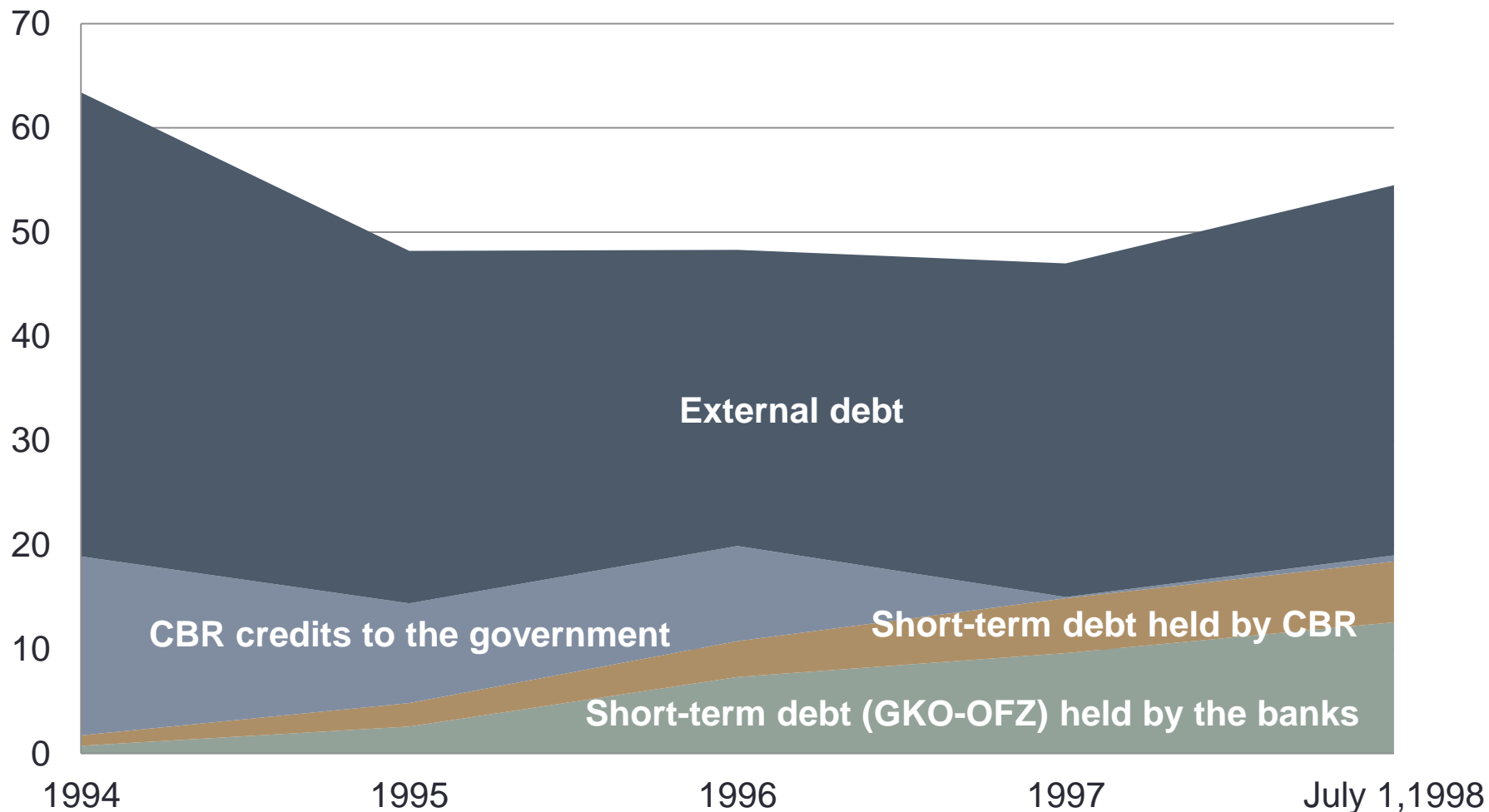
# Russian financial crisis – August 1998

## Budget Deficit, % of GDP



# Russian financial crisis – August 1998

Government debt, % of GDP



# Russian financial crisis – August 1998

- 1997 - Inflow of portfolio investment of \$46 billion or 10% of GDP
- High volatility of exchange rate – ruble/USD (high valuation of ruble)
- Extremely high interest rates
- 1998 – world price for Russia's oil – 10\$ per barrel
- The government was not able to refinance it's debt



# Measures – August 1998

- Devaluation of the ruble
  - At the moment the ruble/dollar trading band was expanded from 5.3-7.1 RUR/USD to 6.0-9.5 RUR/USD
  - Later the RUR/USD rate was set to move freely within the wider band
- Default on domestic debt
  - To prevent mass Russian bank default Russia's ruble-denominated debt would be restructured
- A moratorium on payment to foreign creditors
  - A temporary 90-day moratorium was imposed on the payment of some bank obligations, including certain debts and forward currency contracts

# Russia's 1998 financial collapse

- In a matter of days the exchange rate lost over 60% of its value
  - more than in all most Latin American and Southeast Asian countries (except for Indonesia)
- Prices increased by nearly 50% in only 2 months after the crisis
  - as compared to less than 6% annual inflation July 1998 to July 1997 before the crisis
- Real output fell by about 6% in 1998
  - after registering a small increase of 0.6% in 1997 for the first time since 1989, it fell in January - September 1998, i.e. mostly before the August 1998 crisis

# Why was the drop so drastic?

- Some of the standard explanations
  - Bad institutions
  - Natural resource dependence
  - Bad policies
- For a medium income level country, Russia is trade wise open
- Financial dependence proved important
  - Short-term debt was concentrated and fast growing
  - Dependence of financial intermediation on foreign funding
  - The dual financial system: households and most companies using domestic markets; some big companies and banks dependent on foreign markets

# Measures 1998-1999

- Budget reform
  - Expenditures and arrears reduction
  - Revision of expenditures
- Taxation reform
  - The creation of efficient taxation system
- Changes in banking sector
  - The worst half of the banks was closed
  - Strengthening the governance of banks
  - The payment system improvement

# So why the talk of a safe haven?

- Politicians were not in the business of doom-saying
- Shifting blame to where it belonged: global imbalances
- Good grounds why a pure financial crisis might handle Russia softly
  - Small financial sector with limited role in investment finance
  - Strong public sector financial position – taxation reform
  - Households with no financial wealth, little debt: no wealth effect on consumption
  - Labor markets expected to be very flexible

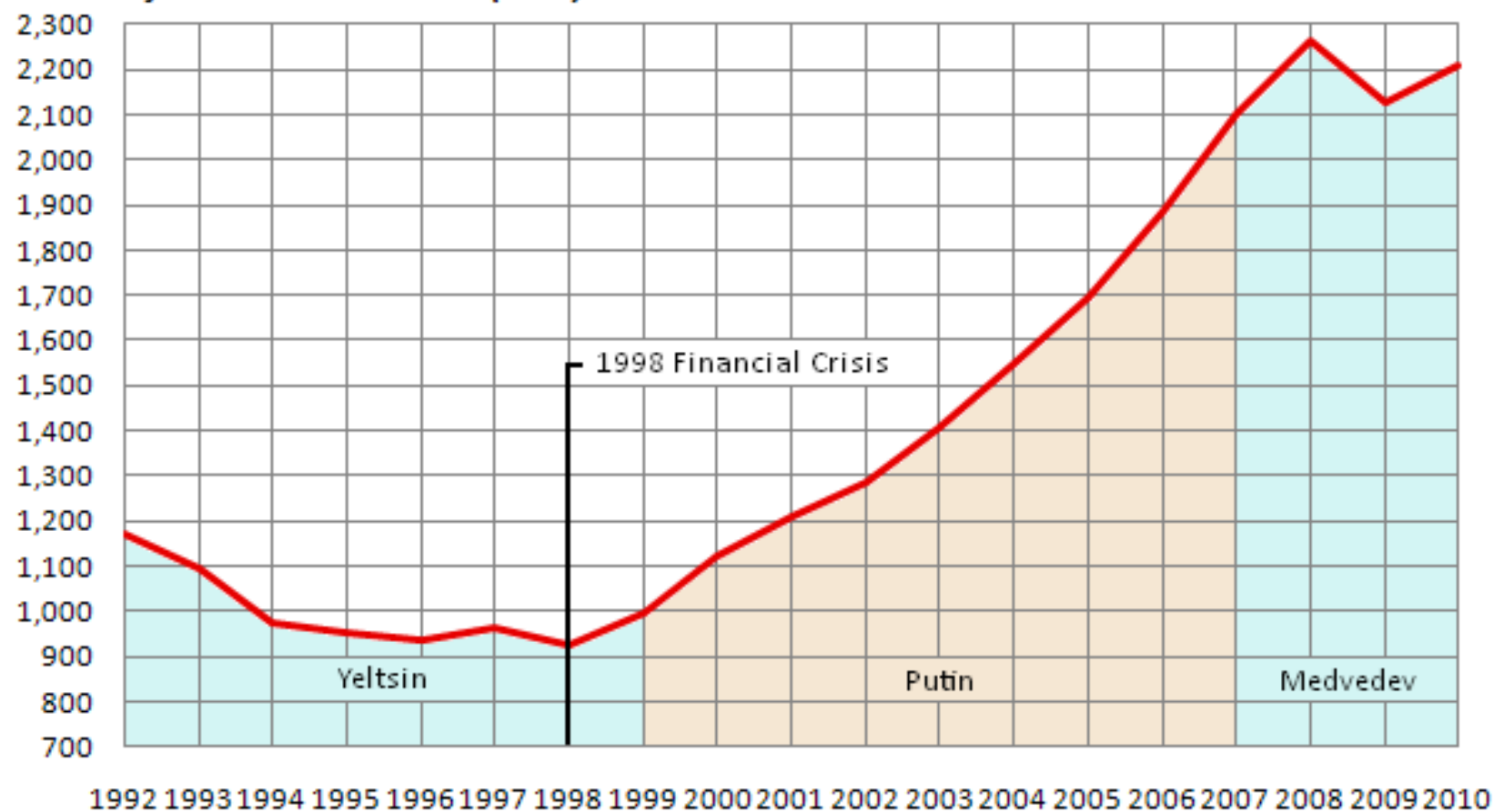
# After the crisis

- Boom in industry
- After devaluation, domestic producers were taking advantage of new export opportunities and made shift from foreign to Russian made goods
- Devaluation of the previously overvalued currency restored the previously lost competitiveness
- Output was falling in the beginning of 1998, but started to grow in October (unlike in East Asia, where output fell after the currency crises)

# Economic growth – 1999-2008

## Russian GDP (PPP) Since Fall of Soviet Union

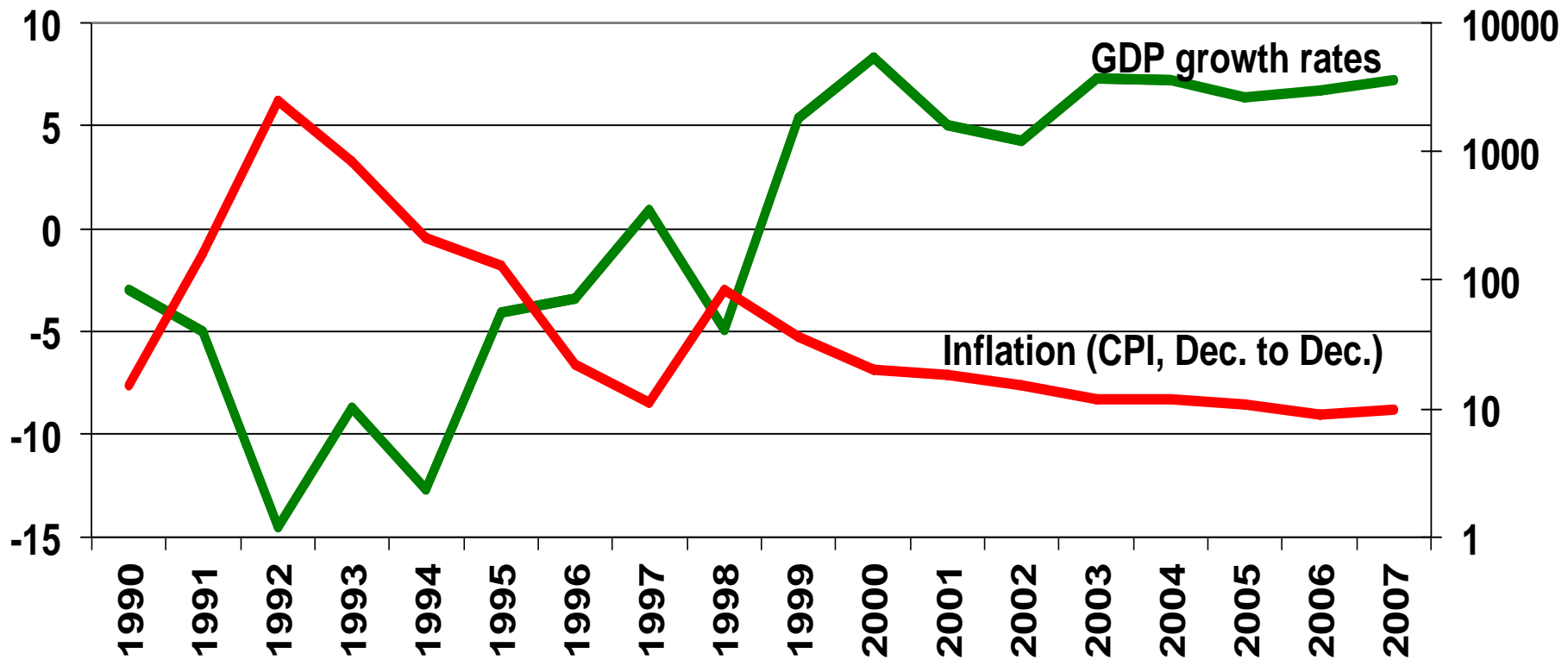
*Billions of International Dollars (2008)*



1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010  
Source: International Monetary Fund (<http://www.imf.org>)

# Output is growing, inflation is under control

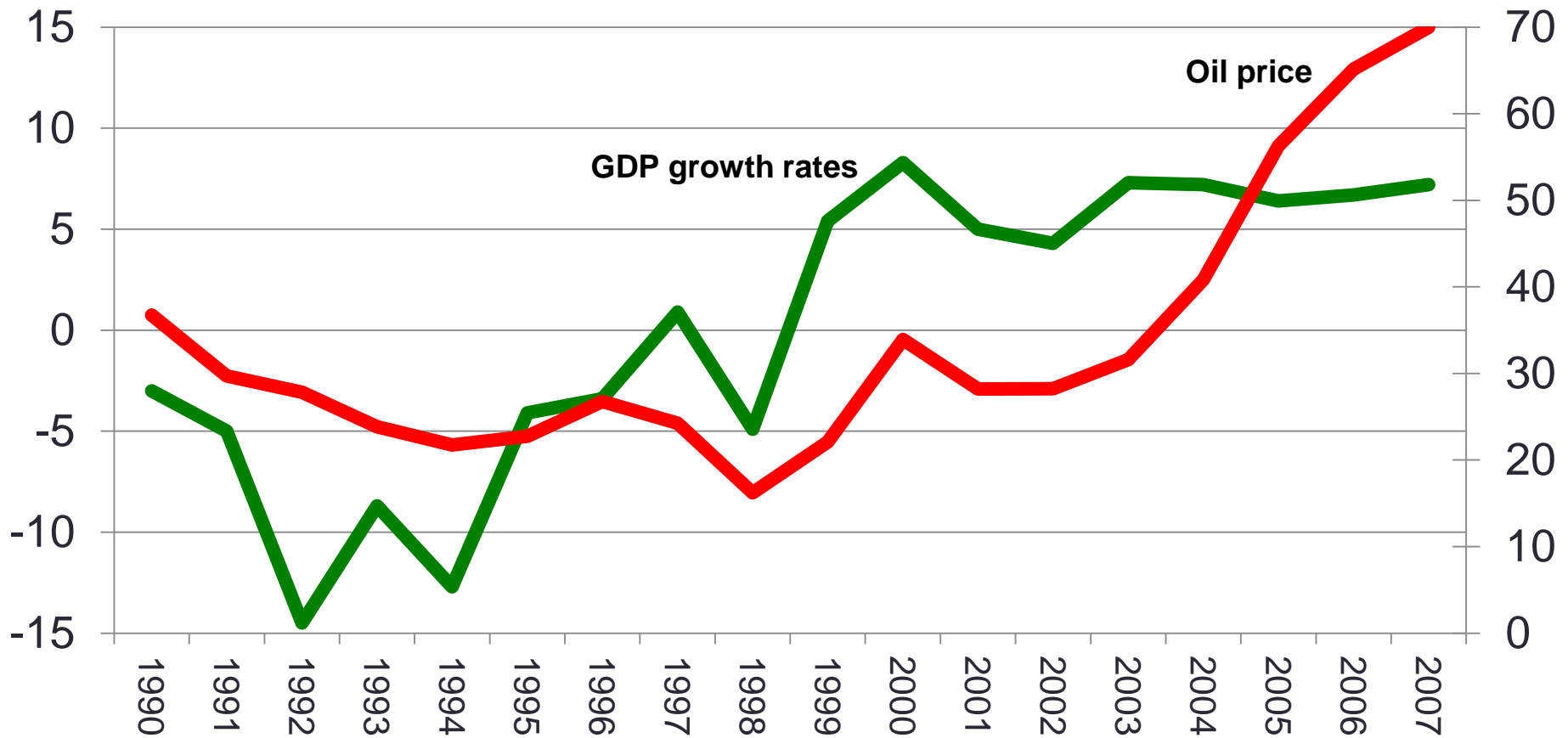
GDP growth rates and inflation (right axis, log scale), %





# Oil price grows, GDP does not accelerate

Oil prices (\$ per barrel, right scale)  
and GDP growth rates (% , left scale)



# Russia's anti-crisis policies – 2008-2009

- Basically similar to those in other countries
- Package of tax reforms, reducing the tax burden
- Emphasis on monotowns, pensions, minimum wages - crisis fighting as a social policy measure
  - Since 2005 - emphasis on social policy, with view on demography (national priority programs). In practice - expenditure on health, education and housing are stable as share of budget, increasing in line with total expenditure
  - Since 2007 - decisions to increase pensions, minimum wages, public sector salaries were made
- Structure of the banking system left no alternative to "favoring" state-controlled banks as liquidity channels

# Challenges for the future

- Unpredictable export revenue
  - Oil price
  - Energy efficiency needed for maintaining export volumes
  - Changes in gas markets
- Regaining budget surplus
  - Re-accumulating reserve funds is a high priority
  - Expenditure pressure due to recent hikes, long-term needs
  - Revenue problem due to declining share of energy sector in GDP
- Exchange rate policy
  - Increased flexibility of nominal rate, no pure inflation targeting
  - Real exchange rate appreciation pressures as financial inflow resumes
- Financial system development
  - Rolling back the state
  - Need for long-term domestic funding
- Pension reform
  - Increasing dependency ratio
  - Previous failures to depart from pay-as-you-go
- Competitiveness of jobs