Strategic Aspects of Economic Growth in Russia

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We analyze the potential ingredients for sustained economic growth in Russia. Taking into account experiences in NICs and recent research we suggest that there is a lexicographical order of policy elements for achieving economic growth. Achieving growth mainly requires to establish a functional capital market, to encourage structural change, to nurture entrepreneurship and to stimulate trade expansion in the field of manufacturing products, while imposing some capital controls on short term inflows. Adequate foreign direct investment policies also are crucial which must include political stability and radical tax reform. We propose several strategic elements for growth policy, where adequate external support could be helpful.

1. Introduction

Per capita income has fallen by some 50% in the 1990s in Russia where the failure of transformation culminated in the August-1998 crisis which largely destroyed the banking system, led to massive foreign and domestic debt problems of the government and undermined the prospects for sustained growth. With Mr. Putin likely to become the new president in 2000 and the Chechnya war coming to the end political foundations for economic stabilization have improve. The increasing oil price and sustained global economic growth in 1999/2000 are external factors that support economic growth perspectives in Russia. However, it is unclear which external and internal ingredients for economic growth are necessary and feasible in the new Russia.

Exports and imports have declined in the period 1996-99, namely from $90 to 73 billion for exports and from $74 to 52 bill. for imports. The decline in exports only partly reflected the transitory decrease of oil prices in 1997/98. The only positive results of 1999 are a rise of foreign direct investment inflows reaching about $3 bill. and a modest acceleration of output – after a massive contraction of - 4.6% in 1998. GDP per capita has fallen by about one-half between 1990 and 1999 which is a dramatic loss in economic welfare and is only slightly counterbalanced by a much greater product variety than under the command economy. Russia's per capita GDP, which stood at $3000 in 1997 fell to $1900 in 1998. By contrast, Poland's per capita GDP, which was $3000 in 1994 ($2000 in 1991) has increased strongly and will surpass $4000 in 2000 – it might double again in the period 2000-2010. Russia's basic

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policy choices after the presidential election of 2000 will determine whether the country continues its economic stagnation or launches a successful catching-up process both vis-a-vis eastern Europe and the EU.

The Transition Report of the EBRD (1999) shows that firms in Russia have largely followed a pattern of restructuring similar to firms in central and eastern European countries although the extent of restructuring of privatized firms and new entrants in Russia was somewhat less than in the Visegrad countries. This suggests that Russia should have experienced similar growth to that of the Visegrad countries, but the development in Russia clearly was much worse; the issue is how to explain this. Economic geography, political problems and economic policy pitfalls as well as inefficient external support will be shown to be the main reasons behind Russia's serious economic problems. The strong 1999 economic revival of Asian NICs which faced massive devaluation and economic contraction in 1996/97 stands in marked contrast to Russia's modest revival in 1999 (see Tab. A1). Adopting adequate policy measures – plus institutional progress with a strong focus on the rule of law – should lead to growth rates of at least 4 per cent which might also help to reduce capital flight.

Tab. A.1.

GDP and Foreign Direct Investment in Selected Transition Countries

	GDP per capita (US $)		Cumulative FDI-inflows 1989-1998	
	1991	**1998***	(mn US $)	per capita (US $)
Slovenia	6333	**9779**	1192	596
Czech Republic	2467	**5479**	9957	967
Hungary	3230	**4730**	16459	1627
Poland	2037	**3887**	15066	389
Slovak Republic	2052	**3793**	1762	326
Russian Federation	(280)	**1867**	8901	61
Romania	1245	**1695**	4510	200
Bulgaria	872	**1315**	1323	159
Ukraine	169	**846**	2626	52

* Estimate.

Source: European Bank for Reconstruction and Development, Transition Report 1999.

Among many factors accounting for differential regional development, there is the topic of economic globalization which basically means that there is a strong growth of trade and foreign investment worldwide (Welfens, 1999a; Welfens et al., 1999). The following analysis will emphasize that Russia is ill prepared to benefit from globalization since it has neglected development of manufacturing exports. In our analysis we take a brief look at the economic problems in Russia, the issue of external support and prospects of EU Eastern Enlargement and of economic catching-up of Russia.

2. Economic Problems of Russia

Among the main policy pitfalls committed in Russia in the 1990s is the rather inefficient mass privatization which failed to combine full private ownership, restructuring and structural change in a framework of market competition. While the share of private sector value-added has increased from 5% in 1991 to 50% in 1994 and to 75% in 1999, government still is quite influential in the allocation of resources. Government has a minority position in many firms and can use widespread tax arrears to arbitrarily interfere with management – all this contributes to inefficient governance of firms. Besides actual government involvement there always is fear of discretionary government action since government is not facing clear constitutional and other constraints which would limit government intervention.

Many politicians still have not accepted that a market economy must rely (almost) exclusively on uniform price signals. Rather they want to interfere in company decisions via regulations on the one hand, and, on the other hand, via differentiated prices and interest rates. This, however, leads not only to a politicization of the private sector; it also leads to efficiency losses. The only unrestricted market segment is the shadow economy, which some observers put at 40-50% of official GDP. While many self-service activities are legal and crucial for individual survival, many black market activities clearly contradict the legal system and thus undermine the rule of law. No real market has been established for land – except for a few regions – and this means that banks can hardly expand their loan business because there is lack of collateral.

Disregarding the export of natural resources which is mainly crucial for financing imports, Russia's economic opening-up process has been a failure – the share of exports of skill-intensive goods to OECD countries has fallen to almost zero in the period 1993-97. The unemployment rate in 1998/99 was close to 13% and the external debt/export ratio reached 201.9%, which is equivalent to a foreign debt/GDP ratio of 55%[1]. These are all signs of economic fragility, which are further compounded by the decline of population of 2 million in the period 1991-99. With consumer price inflation increasing from 11% in 1997 to 84% in 1998 and to about 37% in 1999, Russia is facing high inflation rates and therefore currency substitution again.

The ruble might face further real devaluation in the future. After the August 1998 crisis floating of the rouble was introduced and a range of currency restrictions were introduced so that convertibility progress achieved earlier was partly reversed. The surrender requirement for exporters was raised from 50% to 75%; access of foreign banks to the foreign exchange market became regulated, and a deposit/advance payment system was adopted for import transactions. Some of these restrictions were eliminated in mid-1999 in order to agree on the new IMF program. There has been a unification of the exchange rate, and foreign banks are again allowed to buy foreign exchange for current account balance purposes. The import deposit/advance payment rule has been phased out since late 1999. The current account balance-GDP ratio switched from 1% in 1998 to some 10% in 1999. This current account surplus, however, does not imply a strong increase in foreign exchange reserves of the central bank since there is a high level of capital flight. Moreover, the current account surplus is not reflecting a strong increase in exports; rather imports have fallen more strongly than exports. Russia's integration into the world market thus is fragile.

Russia has suffered a severe economic contraction in the 1990s and high capital flight, which indicates lack of confidence of Russians in government and poor

[1] As of 1998.

economic perspectives. As regards confidence of foreigners the figures for cumulative foreign direct investment inflows indicate that foreigners – here potential investors – also have little confidence in government and growth prospects in Russia. Moreover, estimates based on gravity equation models of foreign direct investment (Ganuschtschenko, 1999) indicate that Russia has exhausted only a small fraction of about 20% of its FDI inflow potential; taking into account the fact that one-off privatization effects should raise FDI inflows above the normal level of a market economy of comparable income level – see the overexhaustion of FDI inflow potential in the case of Hungary, which strongly relied on FDI inflows in the context of privatization – the Russian figures look even worse. If Russia were to achieve growth of two percent above the OECD average – assumed to be 2.5 percent – in the decade after 1995, its FDI inflow potential would almost double.

Tab. A.2.

Foreign Direct Investment:
Gravity Projections for Selected Transition Countries

	Russia	%	Ukraine	%	Belarus	%	Poland	%	Hungary	%
observed 1995	2368		312		23		7108		8324	
no change										
Estimate 1	19475	12	2799	11	922	2.5	7973	89	2756	302
Estimate 2	7330	32	457	68	165	13.9	5360	133	933	892
2005 I*										
Estimate 1	35059	7	5039	6	1785	1	14354	50	4962	168
Estimate 2	24514	10	1530	20	552	4	17926	40	3120	267
2005 II**										
Estimate 1	41332	6	5941	5	2105	1	16922	42	5850	142
Estimate 2	31378	8	1958	16	706	3	22946	31	3994	208

* Assumption is that growth is two percent above OECD.
** Assumption is that growth is four percent above OECD.

Source: Ganuschtschenko (1999), EIIW Working Paper No. 80, University of Potsdam, forthcoming.

3. External Support for Russia

As soon as Russia became an IMF member country it benefited from technical assistance of the IMF and the World Bank. In December 1991 the USSR was dissolved; a year later many reform steps were adopted, including introduction of VAT and price liberalization plus the abolishment of the state trading monopoly. The exchange rate was unified and a mass privatization program was adopted. In July 1993 a new currency (rouble) was introduced and the rouble zone collapsed in November. The currency crisis of 1994 encouraged government to introduce a currency corridor. In 1996 an IMF three-year program was agreed to and foreign economic liberalization was almost completed. In 1998 average import tariffs stood at about 12%; however, in 1999 new export taxes were adopted. In late 1996 the first sovereign Eurobond placement occurred; in September 1997 the admission of Russia into the Paris Club (sovereign debt club) was achieved and a London Club deal was completed which helped to achieve a manageable foreign debt position. However, in August

1998 a major financial crisis occurred, including default on short-term GKO bonds. Moreover, there was a partial foreign debt moratorium and a massive exchange rate devaluation. The government was dismissed. It took until July 1999 for a new IMF program to be adopted.

Most of the IMF advice – disregarding much needed technical advice – has been illfounded and contributed to the August 1998 crisis (Welfens, 1999b; 1999c). In this crisis an unsustainable Russian short-term deficit financing coincided with poor Russian crisis management in a situation of adverse policy shocks, namely falling oil prices and massive capital outflows as a consequence of the Asian crisis which led to a global saven-haven reaction of investors. The federal governmentr's unilateral debt moratorium and forced restructuring of government destroyed the banking system, which held short-term government debt. No market economy can thrive without a viable banking system. Foreign banks active in Russia are of little help because they concentrate on financing trade and international investment; they rarely accept cash (rubles or dollars) from domestic residents because banks are afraid of getting involved in money laundering, tax fraud and capital flight.

Russia suffers from lack of credible institutions, which is partly due to poor institutional design but also due to government wage arrears which undermine the functioning of the administration and the rule of law in general. As government itself is often in breach of labor contracts it is not surprising to find that contracts generally are difficult to realize in Russia. Without confidence in the rule of law and the validity of contracts individuals will be hesitant to use markets, and this in turn impairs prospects for economic growth. Moreover, competition policy in Russia is weak, and there are still many regional monopolies which cause output and welfare losses. Even if Russia's export-GDP ratio – ignoring trade with transition countries accounting for about one-third of exports – was close to 18% in 1998 this does not translate into a tradable sector fully characterized by competition. In a large economy – such as the US, Russia or China – only the combination of free trade and strong competition policy can achieve such competition in the whole tradable sector. By contrast, small open economies with rigorous free trade policy can neglect domestic competition more easily as the share of internationally traded tradable products is much higher than in a large economy.

In the 1990s the IMF never had any consistent strategy for supporting transformation, economic opening-up and economic growth in Russia – three elements which naturally should go together. The main IMF pitfalls were the excessive focus on government deficit reduction and antiinflationary policy plus support for a fixed exchange rate strategy in the mid-1990s while neglecting institution-building and proper sequencing in external liberalization; the Canadian experience of the 1960s with floating and many theoretical arguments should have made it clear that a country whose main exports are natural resources (with highly volatile world market prices) – i.e. the country lacks diversified exports – should have flexible exchange rates. Moreover, a country with a very weak banking system should not move to capital account liberalization as Russia did in the mid-1990s under the influence of the IMF. Despite the 1998 collapse of the Russian transformation, the IMF has not changed its approach. The only excuse the IMF might have is that it has been designed to help establish convertibility and to cope with balance of payments crises and regional or global financial instability but not to support systemic transformation. The IMF needs, however, a strategy which goes beyond giving loans and focussing on selected macroeconomic variables. Since Russia is not yet a member of the WTO the whole topic of external liberalization is quite unfinished. By contrast, Poland tripled exports in the period 1991-98; in 1998 exports stood at $30.3 bill. and imports at $43.9 bill.; the ratio of external debt to GDP has fallen from 61.5 % to 29.9 % in the period 1991-98; foreign direct investment in 1998 and 1999 was close to $7 bill. Modern growth accounting suggests that economic opening-up might have contributed significantly to Poland's economic growth which was in the range of 2.6% to 7% in the period of 1992-99 (-7.0% in 1991).

The EBRD with its project financing seems to have done a better job in supporting transformation in Russia. However, the EBRD's 1999 Transition Report „Ten Years of Transition" discusses in its main chapter transition problems and experiences for 26 transition countries only under the headings liberalization, privatization, stabilization plus institution-building; none of the nine chapters – except on a few pages – deals systematically with the problems of economic opening-up, that is trade, capital flows and external debt. International organizations such as the EBRD and the IMF thus have adopted only a partial strategy of transition support, and one may wonder why these two (and other) organizations have not cooperated in a better way to achieve efficient support for sustainable transformation in the whole of Eastern Europe and the former USSR.

The new Russia is a society of extreme inequalities where it is difficult to move into the relatively dynamic cities of Moscow and St. Petersburg which in a complex long-term process could stimulate regional convergence of per capita income; there is, however, illegal migration which nurtures crime and mafia activities. None of the Visegrad countries – except Romania – have shown a similar rise of inequality, and few countries in the world have to cope with such massive corruption and crime as in Russia. After 1998 Russia's ranking in the international institutional investor index fell below 100. An improvement certainly requires that growth prospects of Russia become much more favorable than they are at the turn of the century.

4. Trade, FDI and Growth in a Transitional Perspective

From basic textbook models and from empirical analysis one expects that economic opening-up and growing trade can contribute to output growth. The expansion of the tradable sector is crucial because productivity growth in the tradable sector typically is higher than in the nontradable sector so that the relative price of tradable in terms of nontradable will rise with economic development and per capita income, respectively (Balassa-Samuelson hypothesis). As regards the link between trade and growth, a strong impulse comes from rising exports of manufacturing goods as is argued by Ito (1998, p. 196) who, however, does not give any reason for his argument and findings, respectively – the finding is that Indonesia and Nigeria both had a share of manufactures in export earnings of about 1% in 1975 but by 1992 the share had risen to 48% in Indonesia whose per capita figures surpassed Nigeria in the 1980s where the share had remained almost unchanged.

Learning by Exporting Hypothesis

We will develop some ideas about the link between export growth, productivity gains and economic growth. Economic opening-up will normally stimulate economic specialization in line with comparative economic advantage, which raises economic welfare as consumption can be increased. This standard textbook argument, however, does not explain why rising exports of manufacturing products go along with relatively strong productivity gains. Six effects indeed could be important for this link, namely with respect to producing manufacturing products:

- Manufacturing production requires combining various suppliers inputs – buying from the market – and value-added of the respective firm in the export sector. Learning to organize a complex production process for production with a focus on world markets generates important know-how, which can be applied in other sectors, too. Moreover, there should be feedback effects on domestic suppliers in the sense that firms looking for competitive domestic suppliers (and for imported inputs) will push for restructuring and modernization among prospective suppliers. This could generate network effects in the sense that if more firms are familiar with the grammar and syntax of the market economy language, the scope of market transactions could increase.
- Manufacturing production offers many opportunities for product differentiation and imitation which thus creates options for raising value-added over time; in the export sector there is also a continuous change in the structure of demand which stimulates learning, flexibility and structural change.
- Exporting manufacturing products naturally encourages looking for cheap foreign inputs and thereby helps to transfer foreign technology via imported intermediate products. Productivity gains indeed can often be achieved by intelligent importing. Singapore and Hong Kong are well-known examples in this respect.
- Exporting manufacturing products will be stimulated if neighboring countries also engage in export promotion and thereby stimulate economic growth. Following the logic of the *gravity equation* which emphasizes that economic geography matters, the simultaneous liberalization of trade in neighboring countries can be expected to bring higher growth effects than isolated liberalization.
- Exporting manufacturing products brings one into contact with potential foreign investors in the manufacturing industry who will acquire competitive firms or engage in greenfield investment in the long term. As such foreign investors typically enjoy technological advantages and produce a broader variety of products in various subsidiaries, such investors often will find it rather easy to define an efficient technological graduation strategy for the new subsidiary.
- Finally, we add a well-known aspect but modify it in an important way. The (manufacturing) tradable sector is quite competitive so that inefficient specialization will result in high losses and bankruptcy. The pressure of world market competition thus helps avoiding the trap of inefficient specialization with no or poor productivity gains. This in turn could stimulate FDI inflows because foreign investors will anticipate that a high degree of manufacturing openness will reduce the risk of inconsistent government intervention.

The above reasoning is consistent with the empirical findings of Sachs/Warner (1996; 1997) whereby in a convergence regression model natural resource abundance is found to negatively affect growth. In the convergence model the hypothesis is that the lower the income level the higher is the growth rate. The growth rate is influenced by the gap between the equilibrium income level and current income where the equilibrium income level is affected by structural variables and policy variables. Such policy variables include openness to trade, market efficiency, and the national savings rate. Structural variables are initial income, access to port facilities and natural resource abundance. The Sachs/Warner analysis argues that trade liberalization alone could raise average growth rates in Africa by 0.7 percent a year in formerly closed economies.

Lessons from Asia

Asian NICs successfully combined export expansion and domestic growth after 1960. Outward oriented economic policy often was combined with restrictions on imports and investment inflows although long-term international subcontracting in the Republic of Korea and other Asian countries was equivalent to foreign investment inflows. These inflows have indeed increased in the 1980s and 1990s. High savings rates and an elastic labor supply from agriculture supported growth of industry and exports, respectively.

In several studies on Singapore, Korea and Taiwan – for the 1970s and 1980s – Young (1992; 1994; 1995) along with Krugman (1994) and Kim/Lau (1994) argued that the Asian NICs' rapid growth is mainly attributable to factor accumulation rather than a miracle. The basic message of these studies has been that total factor productivity growth played only a small role for growth in Asia so that high Asian growth will not be sustainable once there is no longer an elastic excess labor supply from agriculture.

However, as emphasized by Ito (1998), the studies of Sarel (1995; 1996) and Bosworth/Collins (1996) who focus on the more recent decades – the 1980s and 1990s – have found rather high estimates for total factor productivity growth in Indonesia, Malaysia and Thailand and higher estimates for Korea, Singapore and Taiwan. So technological progress might come with sequencing and the stage of economic development, respectively. In Asia Singapore, Thailand and Indonesia were able to attract high FDI inflows in the 1980s and 1990s; in the 1990s Taiwan and Korea also increasingly relied on FDI inflows while becoming successful foreign investors themselves. According to Ito (1998) stages of development and economic catching-up should be distinguished (modified Rostov approach).

Applying this reasoning to Russia and other transforming economies, successful catching-up will depend upon a prudent sequence of growth-enhancing steps which must include adequate policy impulses. Achieving sustained export growth of manufacturing goods seems to be a medium-term key element for catching-up. As output per capita starts to increase, the opportunities to produce and export diversified products as well as products based on economies of scale improve which finally should lay the ground for high profits and increasing R&D expenditures (relative to value-added) as well as skill-intensive export expansion in the next growth stage.

As regards export growth and economic growth, respectively, the Asian NICs' progress is partly in line with the new growth theory (Rower, 1986; 1990) which emphasizes economies of scale and human capital formation as ingredients of sustained growth. To the extent that foreign investors invest more in training of employees than domestic firms FDI inflows have a higher growth effect than the simple aspect of capital accumulation would suggest.

Impediments for Economic Catching-up in Russia

The most basic steps upwards in the per capita income league have not been realized in Russia in the 1990s. According to a global survey of the World Bank, policy instability and lack of the rule of law (crime and corruption problems) – both of which may be summarized under political stability and credibility – are a serious impediment for foreign investors as are high and unclear tax laws. Moreover, local mafia activities are spreading in many regions including major cities which thus suffer from low investment growth in the official economy. Restrictions for migration into Moscow and St. Petersburg induce illegal „immigration“, and many of those illegal residents get involved in mafia activities.

Tab. A.3.

Obstacles for Doing Business:
Survey Results among Foreign Investors Worldwide

	CIS (1)	*World (2)*	*Developing countries (3)*	*Developed market economies (4)*	*1/4*
High taxes/tax regulations	80	59	62	50	1.6
Political instability	52	32	36	12	4.3
General uncertainty on costs of regulations	44	29	30	17	2.6
Crime and theft	48	38	43	11	4.4
Corruption	84	47	54	18	4.7

Source: World Bank (1997).

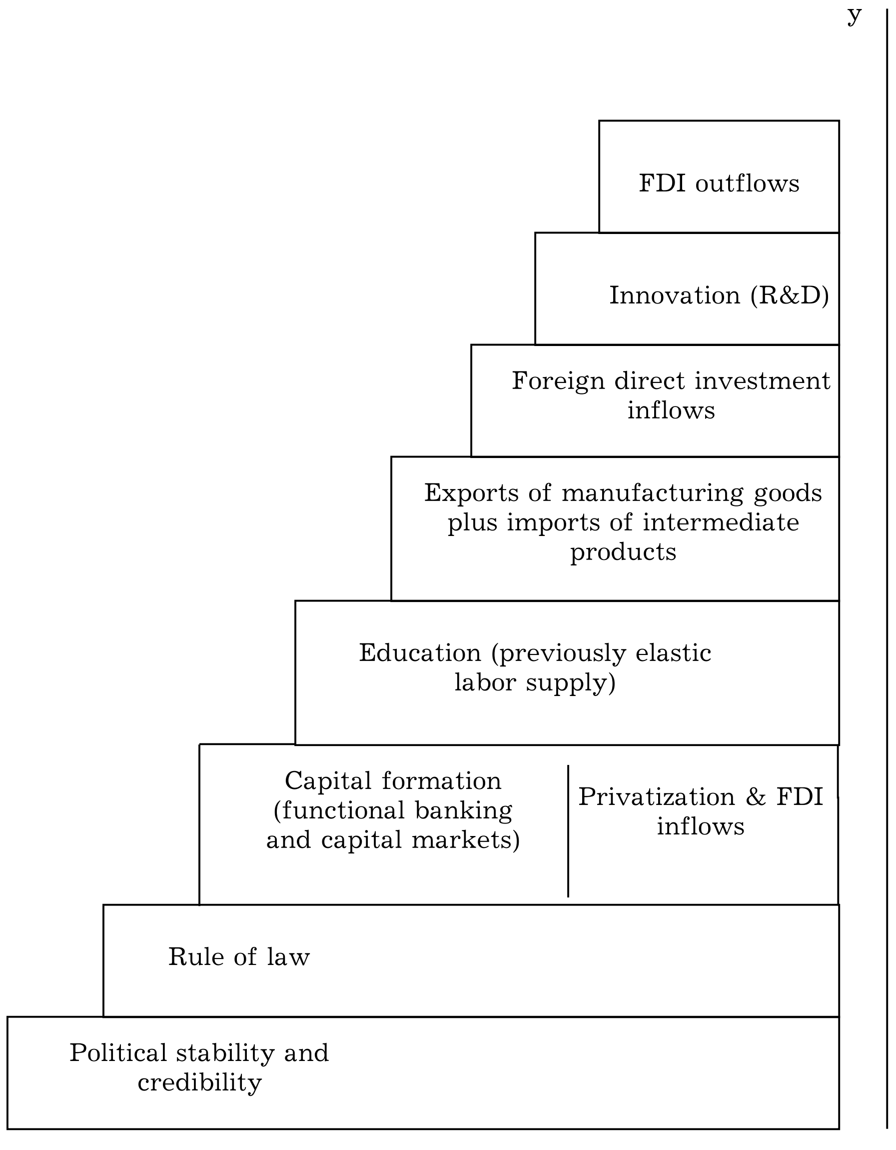
Most of FDI in Eastern Europe was found to be market-seeking so that cost motives are not of prime importance at first sight. However, an EBRD survey has shown that the type of FDI varies strongly according to the host country's progress in economic transition. FDI projects in postsocialist countries which are more advanced in transition show three characteristics (Lankes/Stern, 1997):

- FDI projects are more export-oriented
- FDI projects are more integrated into the foreign parent's multinational production process
- FDI projects are more likely to exploit the host country's comparative advantage.

According to the survey administrative discretion and trade barriers raise costs and make logistics more complicated. Moreover, first-mover advantages are an important motive among foreign investors with a focus on serving local markets. Efficiency-seeking export investors with a rather strong focus on costs therefore might rather wait some time until the impediments for exploiting potential cost advantages have reduced. Export-oriented investors are likely to shy away from countries with much policy instability as this imposes enormous risks for the investment decision.

One may consider political stability and credibility as a more general ingredient for economic catching-up because otherwise there is no basis for investors – domestic or foreign – to engage in high long-term investment. In a nutshell we can summarize the previous arguments with respect to catching-up in the following figure which shows the most basic ingredients at the bottom of the steps upwards. A major problem would occur if society and government, respectively, fail to adopt the first two steps, namely establishing political stability and credibility on the one hand, and, on the other hand, adopting the rule of law. Visegrad countries faced limited problems in this respect since prospects for EU membership worked as an institutional anchor. Due to the transition problem FDI inflows will play a role in an early stage of economic catching-up, namely in the context of privatization.

Fig. A.1. Requirements for Catching-up (y = per capita GDP)



5. Visegrad Countries and EU Eastern Enlargement

Long-term growth of Slovenia, Poland and Hungary in the 1990s has rested on privatization, restructuring, growth of manufacturing exports and foreign direct investment inflows. Governments adopted the rule of law, a rather independent central bank and a relatively stability-oriented macroeconomic policy. While other Visegrad countries were slower in generating economic growth one cannot overlook that trade orientation has generally become focussed on the EU and that the investment climate has improved as a consequence of institutional reform. In a positive perspective the 10 east European accession countries could form a flying geese pattern with Germany/the EU-15 playing a similar role as Japan did in the 1970s and 1980s vis-a-vis Asian NICs. The logic of the trade gravity equation and the joint institutional anchor of prospective EU membership could contribute to such a positive regional growth scenario. By contrast a regional instability scenario could arise in the context of economic divergence in eastern Europe and of stagnation plus political conflicts in Russia and the Ukraine.

The EU Helsinki Summit 1999, which endorsed EU eastern enlargement talks with ten postsocialist countries and offered Turkey the status of a candidate country has raised many complex issues. Among the many issues is the question of the kind of integration the EU will have vis-a-vis the Ukraine and ex-USSR regions, including Russia itself. There is little doubt that continuing economic crisis in Russia, the Ukraine and Belarus will contribute to political radicalization in all three countries and potentially a new Cold War between Russia and the West. Moreover, without political stability and economic prosperity in Russia and the Ukraine one has to anticipate a massive growth of organized crime and its export to eastern and western Europe. The so-called Russian mafia already is quite active in the Visegrad countries and also in Western Europe and the US. Finally, there is the risk that high political instability in Russia will undermine stability in Visegrad countries and elsewhere so that the cost of EU eastern enlargement will be much higher than in the presence of stability and growth in Russia. From this perspective it would be desirable that the EU – and the accession countries – actively support the Russian process of transition and integration into the world economy.

6. Towards a New Strategy for Russia

Time is running out in Russia as the presidential elections in 2000 offer a last opportunity in the 20th century to adopt a sustainable successful transformation strategy for a country with desperate problems:

- Life expectancy of men has fallen from 65 in 1987 to 58 years in 1994 – in the second half the life expectancy of men and women started to increase slightly.
- The cumulative drop in output was nearly 50% in the period 1989-1999; whereas some Visegrad countries recorded growth rates above three percent over several years in the 1990s, Russia had only one year of output increase – a growth rate of about 1% in 1997[2]. Prospects for economic growth of the official economy in Russia are still very modest in 2000/2001. Russia needs economic growth if the transition process is to survive politically, and growth requires export promotion,

[2] 3.2% growth was also recorded in 1999.

restructuring and higher net investment.

- The number of drug addicts has increased from several hundred thousand to about 2 million people in the decade 1989-98. The Russian health care system as well as the educational system already are strained to their limits. With high unemployment and ongoing economic stagnation health care problems will further accentuate.
- The Gini coefficient has almost doubled between 1992 and 1998. The obviously strong income differentials in Russia lets one expect that the few noveaux riches will put pressure on the political system in order to prevent certain measures and to obtain specific favors; lack of competition and a rise of subsidization could be one consequence; a new budget deficit crisis could be another one. As regards local governors they tend to ask for high contributions from the private sector – „voluntary taxes“ are the basis of considerable extra budgetary funds in some regions of Russia. This causes inefficiency and lack of political transparency; so far the IMF and other international organizations have mainly dealt with the federal budget but have tended to ignore the phenomenon of extrabudgetary funds.
- The percentage of skill-intensive exports to OECD countries has fallen from a small share to almost zero in the period 1993-97. Without specialization according to comparative advantage and mobilization of skilled labor for export expansion Russia cannot generate sustained growth. Until 1999 the West never had to cope with high growth rates of Russian exports in skill-intensive sectors although this would have to be expected if the transition had been on track. From this perspective the EU and eastern Europe (and some other countries) still have to show that they are willing to accept strongly increasing Russian exports in manufacturing industry. However, the problem should be manageable because once Russia records high economic growth, export prospects for Western firms will strongly improve.
- There is enormous capital flight of an estimated $20-30 bill. p.a. which represents (transitory) lost savings of 5-7% of GDP. Only a small part of these funds finds its way back to Russia in the disguise of portfolio capital flows or FDI flows from Cyprus and other Western locations. Russia needs to eliminate the reasons for capital flight, including political instability and sharp rouble devaluation. Russia should adjust its laws in a way which allows one to attract more foreign direct investment in order to achieve effective and efficient restructuring in some key sectors.
- While Moscow and St. Petersburg – together with some oil rich regions – are booming about two-thirds of the economy is facing stagnation or decline. Regional integration is a big challenge in Russia as is more factor mobility within the country.
- There is massive currency substitution in Russia where some estimates put the stock of dollars in private households close to $40 billion which is more than twice that of domestic M1 whose ratio relative to GDP is unnaturally low because of past banking crises and hyperinflation. It will be difficult to reverse currency substitution, but reform of the banking system certainly is inevitable.

Neither the German nor the Finnish EU presidency of 1999 which would have been natural starting points for a broad widening of economic and political relations between the Community and Russia were able to achieve considerable progress vis-a-vis Russia; the German presidency was overshadowed by the Kosovo War, and the

Finnish presidency was clouded by Germany's „language war" and the Chechen War fought by Russia. Disappointment on both sides, the EU and Russia, is a mild description for the historical 1999. However, to date the EU has no effective concept for Russia; nor has the Russian government under President Yelzin adopted a consistent strategy for transformation, opening-up and growth. One should, however, not rule out that both domestic policy revisions and changes in international strategies (IMF, better cooperation of EBRD and OECD) could improve the situation in Russia decisively.

Russia needs to adopt twelve medium-term measures:

- political stability which requires constitutional reform in the long run and negotiations on a common vision among major parties;
- fast membership in the WTO and more active membership in the OECD and other international organizations;
- broad attempts to strengthen the rule of law so that people and investors have more confidence in government and market institutions;
- a broad reform of the banking system and introduction of deposit insurance plus competition in retail banking;
- realistic and stability-oriented macroeconomic policies including a privatization policy which stimulates growth and considerably raises long-term revenues;
- adopting stricter competition laws and demonopolization of network industries;
- adopting full privatization and free trade in some sectors so that the benefits of private property and free trade can be seen by everybody;
- promotion of manufacturing exports in order to stimulate growth;
- improvement of regional and local investor regulations so that a domestic or foreign investor no longer will need about 100 signatures to embark upon a major investment project. Foreign direct investment will be growth-enhancing only under certain conditions, i.e. the degree of complementarity and substitution between FDI and domestic investment will play a crucial role (De Mello, 1999);
- serious attempts to nurture new firms and encourage private entrepreneurship;
- measures to attract considerable foreign direct investment in all major sectors of the economy;
- a new economic dialogue with Visegrad countries and the EU.

Both the European Commission and the European Parliament should adopt a special initiative for Russia (and the Ukraine) and put pressure on Japan and the US to contribute actively to stabilizing Russia. Several networks in the political, economic and scientific sphere should be created to integrate Russia into Europe and the world economy. If the EU is not up to the historical challenge of creating a pan-European market economy at the beginning of the 21st century, Europe might have lost a unique opportunity for creating stability and prosperity in a wider Europe and worldwide. Facing an unstable Russia would absorb much political energy and could lead to a new Cold War – with the loss of the peace dividend on both sides – which would undermine the EU's position in the triade. While the US benefits from growth in Asia and Latin America, the EU could face stagnation in Russia and the Ukraine on the one hand, and, on the other hand, in Africa. It is in the EU's own interest to stabilize Russia and to thereby restrict the massive westward expansion of mafia activities (German managers of firms active in Russia have received blackmail letters in the German homes in 1999!).

The EU should set up a special Russia monitoring group which would evaluate regularly the developments in Russia and would come up with proposals for projects which could help to achieve sustainable transformation in Russia (and the Ukraine plus Belarus). The east European accession countries should be encouraged to play a more active role in supporting transformation in Russia. Given relatively low wages and much experience in transformation the Visegrad countries should play a more active role within a broader EU strategy for stabilizing Russia. Finally, the Community should strongly consider which new options – beyond full membership – it could offer to outsiders, including Russia and the Ukraine.

Tab. A.4.

Macroeconomic Indicators, Russia 1997-2000

	1997	1998	1999	2000
GDP-growth in %	1	-5	3	2,4
Inflation in %, Dec.-Dec.	11	84	37	22
Exchange rate Rouble-US$	6	10	25	31
Unemployment rate in %	11	13	12	14
Export in US$bill.	88	74	70	80
Import in US$bill.	74	59	40	50
Current account balance in US$bill.	4	2	18	17
Current account balance in % of GDP	1	1	10	8,5
Budget deficit in % of GDP	-7	-5	-4	-2

Source: OECD (2000); for 2000: DB Research.

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