Recovery of Investment in Russia: Why is it Fading Away?[1)]

Wolfram Schrettl

«It is necessary, first and foremost, to clarify what stands behind our economic growth ...»
V.V. Putin, State of the Nation Address, July 2000[2)]

«(The economy) ... has not yet reached a state of upturn and stable development.»
V.V. Putin to WTO Director M. Moore, March 2001[3)]

1. Motivating Facts

For the past decade, up to the first half of 1999, arguably the most dramatic indicator of Russia's economic crisis was the decline of aggregate capital investment by a stunning 80 percent (in *real* terms)[4)]. For a while afterwards, the most promising indicator of a beginning economic recovery has been the accelerating surge of aggregate capital investment, with its rate of growth reaching almost 18 percent for

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[2)] See Putin (2000).

[3)] See Reuters, March 31, 2001.

[4)] For a long time, many Russian politicians and economists alike produced attempts at rationalizing the decline of investment activity. These focussed *inter alia* on the supposedly excessive investment-to-GDP ratio inherited from the Soviet regime. Early warnings about the consequences of the dramatic decline in investment left Russian policy-makers quite unimpressed. For some analysis, see Schrettl and Weissenburger (1995), pp. 110–13. A contributing factor to that stunning policy of neglect may be of a political nature: Russian communists were the first political grouping to ring alarm bells about the decline of investment. What they had of course in mind, was a resurrection of old-style state-directed investment activity. Unfortunately, their pro-investment stance seems to have made it almost impossible for the other political groupings, especially the Russian liberals, to side with the communist's concerns. It was only recently that other political factions, including the liberals, began to be equally alarmed.

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the year 2000[5] as a whole, again in real terms. Unfortunately, the most recent data point to a rapid slowdown of investment growth, with the latest (annualized) rate falling to below 8 percent for the first two months of 2001. Although monthly data should clearly not be overinterpreted, indications are that the slowdown is accelerating, with growth rates of investment falling first to 9.2 percent (year-on-year) and then to 6.3 percent in January and February 2001, respectively[6].

Policies that might be conducive to a revival (or at least a continuation) of the previous positive trend seem to presuppose some diagnostic clarity as to why those developments, i.e. the post-crisis recovery of investment and, possibly, its subsequent slowdown have occurred. Clearly, there are some quite plausible explanations. However, as we shall see below, at least one of them seems to have been neglected so far, with potentially serious consequences.

It is hardly surprising that not all segments and sectors of the economy participate equally in the movements of aggregate investment. The specific structural patterns of investment deserve attention. As we shall see, by looking at investment from the perspectives of company size, capital-intensity, and sectoral profit shares several pertinent insights and policy lessons can be derived.

2. What Prompted the Recovery of Investment, Post-Crisis until 2000?

The two ubiquitous explanations for the recovery of investment that had begun in the first half of 1999 are (i) the sky-rocketing prices for crude oil and other primary energy resources and (ii) the devaluation of the Russian currency from around 6 rubles to the US-dollar to, by now, almost 29 rubles to the dollar. While these two factors clearly played their roles, they can neither provide an exhaustive explanation for the recovery nor are their implications yet fully understood.

2.1. Eliminating Conceivable Candidate Causes

As a prelude, it may be instructive to see what clearly cannot have been among the root causes of the rebounding investment activities. For instance, claims can hardly be made that any of the following factors played much of a role:

- a victory over corruption (there seems to be a general consensus that corruption continues unabated to this day, with a victory far off[7]);
- the onset of the Putin era (that came almost a year later and the retirement of Yeltsin was perceived as quite a surprise at the time);
- the end of an absurd tax regime (the new tax code became law only much later and, anyway, is being implemented only from 2001);
- an end to corporate governance failure (still only a goal, possibly a remote one);
- an end to monopolies (still only a goal, possibly a remote one);
- an end to the policy of avoiding bankruptcies (still only a goal, possibly a remote one);

[5] See Goskomstat (2000b).
[6] See Goskomstat (2001a, b).
[7] For a controversial account of the issue, see Cox (2000).

- an end to the refusal to carry out large-scale restructuring (still only a goal, possibly a remote one);
- an end to the non-availability of long-term external investment financing (still only a goal, possibly a remote one);
- an end to the lack of trust in state institutions;
- the end of legal uncertainties (only snail-pace improvements);
- the end of oligarchs (may have begun, if at all, only with Putin's rise to power);
- the achievement of macroeconomic stability (inflation had been reduced to very low levels, and was practically wiped out in the area of producer prices; already prior to the crisis of August 1998; moreover, inflation at first actually accelerated together with the recovery in investment);
- an end to inequality and poverty (poverty actually increased prior to the recovery in investment and was only somewhat reduced in the wake of the recovery),
- the end to disruption of the CIS economic space (some improvement in the wake of the recovery, but still a matter of concern).

It is true that in some of those respects a trend towards improvement can be discerned. Taken together, this may amount to a sizeable aggregate effect. However, in no way can it explain the sudden recovery from early 1999. This applies in particular to the possible improvements in the institutional framework.

It is instructive to note what German Gref, Minister of the Economy of the Russian Federation, had to say a few days ago on the issue of institutional change under present Russian conditions. He argued that Russia is beset by a general «crisis of trust,» i.e. a lack of confidence (i) of economic actors in the institutions of a market democracy, (ii) of economic actors into each other, and (iii) of the rest of the world into Russia. The problem, so he suggests, «*cannot be solved by passing ... normative acts and resolutions. It takes time* ... to develop a new 'credit history' of the citizens, the companies, the state, and the whole society» (italics added)[8].

Perhaps irritatingly, many of those institutional changes were touted as indispensable, both within and outside of Russia (not least by the IMF), for a recovery of investment, and hence growth, ever to materialize. As it happens, most of those alleged barriers to growth either continue to exist to this day or, at best, have been overcome only long *after* the onset of the recovery. In any case, they proved at the time to be quite surmountable[9] – although admittedly only at a steep price, as we shall see later.

Thus, the usual exhortations to put an end to the institutional deficiencies of the Russian economy are by no means misplaced. They should of course continue unabated. However, it is obvious that some other, weightier factors were at play which managed quite successfully to turn the economy around. Those factors need to be well understood, not only to answer the question about the causes for that post-crisis growth spurt but, more important, also to make sure that those factors of growth, once successfully identified, will not loose their vigor again and will instead

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[8] See Gref 2001a, pp. 3–4.

[9] This observation refutes, for the case of Russia, the claim made for the case of Africa, that a lack of political stability and of secure property rights are the only unsurmountable barriers to growth; see Freeman and Lindauer (1999).

be strengthened and to continue be effective in the future. It is reassuring to know that Russian authorities, while finally and fortunately emphasizing the importance of eliminating institutional deficiencies, seem to be aware that policies can be more important than institutions, and that new laws alone, no matter how desirable and well-designed, may fail miserably in turning the economy around. In the words of German Gref: «Recently, I paid an official visit to ... the former GDR. ... They are having economic growth there for only the second year now. ... Mind you, *the East Germans had credits and had no need to write any laws: they just pulled down the Berlin wall and all the best laws, moreover, laws created by Germans themselves, were at their service.* They thought they would manage to accomplish everything in two or three years. *But still they actually needed ten years.*»[10)]

2.2. Standard Causes: Oil Price and Exchange Rate

Clearly, a flood of oil dollars alone is not enough to fundamentally transform the Russian economy. However, the increased dollar revenues which reached Russia as a result of the oil price explosion greatly helped both the oil-exporting sector and, via an ever higher (though recently somewhat reduced) tax on oil exports, also the federal budget. In combination with the steep devaluation of the Russian currency, the increased dollar revenues were further multiplied when translated into rubles. That much is generally agreed.

2.3. Profits in the Enterprise Sector

The Russian enterprise sector, which previously seemed to have been characterized by the prevalence of loss-making businesses, in the post-crisis period began to boast a veritable explosion of profits.[11)]. In addition to the increased revenues in the energy sector, there were two main contributing factors behind that profit surge. On the *demand side*, following the devaluation of the ruble, a quite sudden and drastic redirection of domestic purchasing power set in, away from imported goods towards goods of domestic origin, i.e. import substitution. Again, that much is generally agreed.

However, an at least equally important development on the *supply side* is still either completely neglected or in no way seen as linked to the economic recovery:[12)] The point is that enterprises benefited from *sizeable cost reductions due to drastically lowered real wage levels* (see Fig. 1).

The steep post-crisis decline in real wages had come about due to equally steep price increases in the immediate aftermath of the August 1998 crisis that had then not been followed immediately by compensating increases in nominal wages. The initial decline in real wages had amounted to almost 40 percent. However, already from the the beginning of 1999 real wages have begun to recover rapidly. For the year 2000 as a whole, real wages grew at a rate of more than 22 percent. In the meantime, about half of the initial decline has been recouped. According to the lat-

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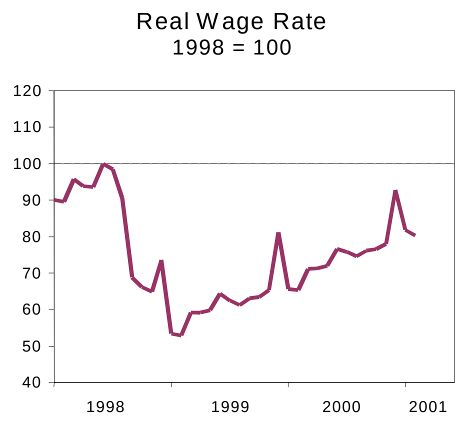
10) See Gref 2001b, p. 3.

11) Notwithstanding a still huge number of loss-making enterprises.

12) For an exception, see DIW (2000), p. 198, et passim.

est figure, the growth of real wages is continuing unabated. Year-on year growth rates of real wages amounted to no less than 23.7 and 22.8 percent in January and February 2001, respectively[13)].

Now, a popular argument holds that wages, for being far too low, cannot have amounted to a real barrier to the recovery. That argument emphasizes the low share of wages in GDP. Even if one is prepared to accept the view (supported by official data) that wages take an extremely low share of GDP, possibly as low as 40 percent[14)], then this would not affect the view advanced here: namely, that the post-crisis reduction of real wages by initially about 40 percent and, by now, still about 20 percent entailed an extremely strong *reduction* in the enterprise sector's wage costs. The figures signal an enormous order of magnitude: As a first approximation, initially as much as 16 percent of GDP and, by now, still up to 8 percent of GDP ended up, in the form of additional profits, in the enterprise sector rather than in the pockets of wage earners – an enormous reallocation of national income. More sophisticated calculations are of course conceivable, but they are unlikely to alter that picture fundamentally.



Sources: Goskomstat: Social'no-ekonomicheskoe polozhenie Rossii ..., Moskva, various issues.

Fig. 1. Real Wage Rate

Far from being considered beneficial, the reduced wage level is seen by many observers only from the perspective of private household incomes, i.e. in its effect on demand. It is therefore regarded as a negative factor, not only for living standards, as would of course be understandable, but also for the return to economic growth[15)]. If one is willing to accept the claim that the Russian economy is characterized by huge amounts of underutilized production capacities, then welcoming reduced household incomes[16)] would indeed make little sense as it could only hamper the further recovery of the economy.

Why then was lack of household demand not a problem for the recovery, despite declining (real) household incomes? The key to the answer is simply that household demand has been redirected to domestic producers on a very large scale rather than only on a marginal scale. Thus, it is of course true that aggregate

[13)] See Goskomstat (2001b).

[14)] The inclusion of unofficial wage remuneration my change the picture considerably. In that case we only have to maintain that official and unofficial wages move more or less in parallel or at least that the respective movements do not annihilate each other. There is no evidence that would contradict that assumption.

[15)] Some Russian politicians are even calling for a doubling, if not more, of nominal wages.

[16)] Notice that aggregate private household incomes have declined despite a massive increase in their profit component (disbursed profits etc.), i.e. the latter's increase fell far short of compensating for the decrease of the other income components, mainly wages and old age pensions, with the decline of the latter initially even exceeding that of wages.

household demand had gone down considerably in the post-crisis period. However, only demand for imports has truly collapsed. Demand directed at domestically produced goods and services has however continued to grow.

Moreover, if idle capacities were an adequate description of Russian reality, then it would be hard to explain why producers had begun to *expand* existing capacities in the face of declining household incomes. In other word, that post-crisis surge in investment activities should not have occurred. The mere fact that is *has* actually occurred suggests that those idle capacities, although they no doubt exist in physical terms, carry little economic value. Therefore, from an analytical perspective, the *status quo* seems to resemble more a situation of full capacity utilization.

On that basis, and given the redirection of purchasing power towards goods of domestic origin, it seems that lack of demand for consumer goods was not a constraining factor for investment and growth. What weighed more heavily for the producers' decisions was the cost advantage resulting from reduced wages. The reduced costs directly translated into higher profits; aggregate enterprise profits in the Russian economy have indeed sky-rocketed in the post-crisis period. And, given an almost entirely ineffective system of market-driven financial intermediation, enterprise profits still are, followed by direct and indirect state subsidies, the dominant source of financing investment activities in Russia[17)].

2.4. A Digression on Domestic Energy Prices

As a digression, it may be worthwhile to comment on the argument that «artificially low» prices for energy (and other goods provided by semi-private monopolies) had been a major cause of the investment recovery. As domestic energy prices are rising and will have to rise further, so the argument goes, the recovery will come to an end. It is true that some of the respective prices have lagged behind, compared both to average domestic price developments and, even more so, to world market prices. However, the argument ignores the fact that it is *aggregate* profits that have sky-rocketed. The respective profit figures *include* the «lost profits» of the energy etc. sectors. Thus, although there probably was, and still is, a distorted distribution of profits due to distorted pricing, this is quite unlikely to have positively affected the economy-wide level of profits and investment. On the contrary, higher energy prices in particular should have given investment in the respective sectors a boost well in excess of the possible reduction of investment activity in the (negatively affected) other sectors. In short, with «correct» prices for energy the recov-

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[17)] Enterprise profits exceeded capital investment in the first half of 2000, with the shares in GDP amounting to 16.1 percent and 11.9 percent, respectively; see Goskomstat (2000a) and, for some related evidence, DIW (2000), pp. 845-846. The fact that aggregate profits exceed aggregate investment is quite a normal phenomenon – indeed is necessary for dynamic efficiency. However, in the present context it is yet another indicator for continued capital export, i.e. capital flight. (Although the true figures can safely be assumed to exceed the gap given above.) The investment surge therefore indicates that profits had become large enough to finance *both*, capital flight *and* investment. Notice that private household savings appear to have been substantial all along (Gregory, Mokhtari, and Schrettl 1999). Unfortunately however, although those savings were very successfully mobilized, they went either into financing the budget deficit (with the government eventually defaulting on much of the debt) or into capital flight, not only abroad but also in the form of cash dollars «under the mattress.»

ery of investment may have turned out stronger, rather than weaker, than was actually the case.

2.5. Orders of Magnitude

Back-of-the-envelope calculations suggest that each of the three factors behind that post-crisis profit increase, i.e. (i) the oil price hike, (ii) the devaluation of the ruble, and (iii) the reduced real wage costs, contributed in about the same order of magnitude to the recovery of investment. A conservative, though very rough, first-order approximation for the initial (annualized) impact of those factors points at magnitudes in the area of at least US-$10–15 billion *each*, i.e. a total impact possibly in excess of US-$30 billion. While the absolute numbers are of secondary importance, relative to an annual GDP not much above US-$200 billion these are extremely weighty magnitudes. Also, there is no a priori reason for assuming that the individual effects would, by way of interaction, tend to innihilate each other. At the same time, however, it is clear that all three factors are by now not as strong anymore as they had been in the early post-crisis period. This is especially true for the wage cost advantage which has been emphasized here. On present trends, the initial wage cost advantage will have disappeared entirely by the end of this year – at the latest.

3. Some Intermediate Lessons

3.1. A Warning: How to Turn the Recovery into a Straw Fire

Not only is there the widely accepted *tenet* that reduced real wages had nothing to do with the onset of the economic recovery in general and, more specifically, with the surge in capital investment. The lowered real wage level is even considered a drag on the recovery. Accordingly, a similarly popular (right across the Russian political spectrum) view calls, quite successfully as we have seen, for rapid growth of wages with the goal of making up for the welfare losses suffered, by wage earners, in the wake of the crisis. These two positions combined amount to a real danger that the recovery will be nipped in the bud due to a renewed profit squeeze. Actually, judged by the recent drastic slowdown of investment growth, that may already be happening. Given recent annual growth rates of GDP in the range of, at best, 4 to 7 percent, growth rates of wages in excess of 20 percent cannot but have cut into the profits of the enterprise sector which, in turn, are by far the most important source of investment finance. Therefore, it would appear to be of utmost importance that growth rates of wages developed more moderately. Without engaging in undue precision, a more moderate development of wages could in practice mean that they grow roughly *pari passu* with GDP, say at a rate not deviating far from 5 percent in either direction[18].

Unfortunately, the statements of leading politicians give no indication that the extremely rapid recent growth of wages will subside. This gives reason for concern. Note that politicians' statements are by no means irrelevant for the actual develop-

[18] Lacking precise data, any more sophisticated indicators for tolerable growth rates of wages, such as the extent to which hourly rates of wage growth are straying from hourly rates of productivity growth, would appear not to make much sense and, hence, to be inappropriate.

ment of wages. To this day, Russian wages are to a large part determined as multiples (via a system of coefficients) of government-set minimum wages. Thus, judged from the perspective of the disappearing wage cost advantage as a factor in the post-crisis surge of investment, it is not much of a surprise that the recovery is loosing steam fast.

A word on the impact of other two factors, the devaluation and the oil price, may be in order: In contrast to the lack of awareness about the potential negative impact of hugely overproportional (relative to GDP) growth of wages on the competitiveness of Russian producers, it is amazing that attitudes towards the advantages gained by the devaluation of the ruble are different. Quite frequently, fears are voiced that those advantages may be about to evaporate rather shortly – not really for good reason however, because the price of imported goods worth US-$ 1 has increased by around 350 percent in ruble terms as a result of the devaluation. At present rates of Russian consumer price inflation (around 20 percent) it would take about four years to annihilate only half of that competitive edge. Thus, although there is clearly cause for concern, it is certainly not as immediate as some would let us believe[19]. As to the final factor, the oil price, this is not the place to venture a prediction. So we leave it open.

3.2. A Look Back: An Unnecessary Agony and a Blessing in Disguise

Of the three factors that played, in our assessment, about equally strong roles in the post-crisis recovery, only the oil price must be considered as being truly exogenous, i.e. well beyond the control of Russian authorities. With respect to the other two factors however, the exchange rate and the wage level, the authorities have ample possibilities, directly or indirectly, to make their influence felt.

But over a long period of economic decline, no efforts were made to stop the «excessive» levels of either variable from stifling profits in the enterprise sector. Of course, talk about the loss-making enterprise sector was ubiquitous. But the most prominent calls were only for all those loss-making firms to be closed down, rather than for restoring their profitability in the way it has happened in the post-crisis period.

Why has it happened only so late? It is true that «protectionism» has been a rallying cry of quite diverse political grouping over many years, but it was to take the form of higher custom duties to stop a flood of imports from swamping the Russian market and wiping out many a domestic producer. The simple idea of abandoning an overvalued exchange rate was roundly rejected.

As to wages, the object of concern was, for good reason, poverty. But the drastic increase in income differentiation that can indeed be considered problematical got mixed up with the issue of the average level of real wages. The latter does under the given circumstances not at all seem to have been too low in relation to productivity. The beneficial effects of the post-crisis drop in real wages rather seem to indicate that the previous wage levels were not compatible with investment-in-

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[19] For an extreme (but by no means exceptional) view, see for example the comments in Rossiiskaya Gazeta (Vasilchuk 2000) already back in November of 2000: «If industrial growth had depended only on the devaluation or import-replacement, it would have stopped by the end of last year, or in 4–6 months after the start of the rouble stabilisation period in the middle of 1999.»

ducing profit levels. This latter statement evidently needs some qualification which will be given in the next section.

To the extent that real wages and the exchange rate could have been adjusted long ago, it seems that Russia could have been spared many years of economic retrogression. It seems to have been precisely the attempt to avoid economic decline, by upholding unrealistic levels of both the real wage rate and the exchange rate, that contributed strongly to the negative results of much of the 1990s. To the extent that the crisis of August 1998 forced the necessary adjustments onto an unwilling government, the crisis must properly be regarded as a blessing in disguise.

3.3. *Abysmally Low Wages: How to Increase Them*?

Needless to say, all those politicians who profess to be appalled by the abysmally low level of real wages do have a point. Wages are indeed much lower than would be necessary under different conditions. However, it is precisely the long list of institutional deficiencies (touched upon in section 2.1) that makes huge risk premia a precondition for capital investment. Therefore, the reduction of real wages to post-August 1998 levels, together with the devaluation and the oil-price hike, served as a trigger for finally making investment in the Russian enterprise sector an opportunity too tempting to be by-passed, at least for domestic investors.

This observation points to the need for a further strenghtening of the present efforts towards overcoming all those «institutional» barriers to economic growth. In the present context, this would result in a reduction of the risk premia necessary to entice both domestic and foreign investors. The reduced need to offer high risk premia would allow for a higher share of wages in GDP. Actually, it has been found empirically that reduced uncertainty as a result of remedied institutional deficiencies, of an enhanced degree of political stability, and especially of genuine democracy make a significant difference to the distribution of the enterprise surplus in the manufacturing sectors of national economies[20].

4. Some Structural Aspects of Investment: Symptoms of What?

4.1. Investment by Small Enterprises

Given the post-crisis recovery of investment, it may be tempting to conclude that the amount of uncertainty prevailing in the Russian economy does not matter much after all – that a deep cut in wage levels together with an equally deep devaluation (on top of some luck as to oil prices) might do. Such a view would be grossly mistaken. It is of course true that macroeconomic instability and uncertainty are not playing the same dominant role anymore as they did at times of hyper-inflation. However, uncertainty still exists, with the bulk of it now originating mainly from the legal and institutional environment in which companies are meant to operate. Although it is hard and probably unnecessary to measure the exact extent of that uncertainty, it is nevertheless quite possible to identify strong symptoms for the damage done.

It has already been noted that the post-crisis recovery of investment does not extend uniformly to all segments and sectors of the Russian economy. This observa-

[20] See Rodrik 1999.

tion *per se* may be overly surprising. However, upon closer inspection it appears that smaller enterprises are one segment of the economy which was largely exempt from the surge of investment[21]. Given that smaller enterprises figure prominently in most strategies for an economic recovery of Russia, their lagging behind may be considered rather irritating. Indeed, there is at least one specific reason for concern: It has been found that the negative impact of uncertainty on investment is substantially more damaging in small-firm dominated industries[22].

Thus, lagging investment activity of smaller firms serves as a telling diagnostic device indicating that uncertainty has by no means become irrelevant in Russia. On the contrary, the uncertainty rather continues to prevail in destructive amounts and, therefore, is in urgent need of being addressed by the authorities. In other words, improvements in all the problem areas that generate the uncertainty, ranging from the legal environment to policy actions, are called for as ever. Notice also that a positive quantitative effect of reduced uncertainty on investment activities would of course not be confined exclusively to smaller firms. Instead, the whole enterprise sector, small and big firms alike, can be expected to benefit.

4.2. Investment in Capital-Intensive Enterprises

Yet another observation pertains to the sectoral structure of investment. From a sectoral perspective, too, the recovery of investment in Russia was not uniform. More specifically, investment in highly capital-intensive activities, such as electricity generation, has remained rather sluggish in the post-crisis period, while investment in less capital-intensive activities was experiencing a strong surge. Again, this asymmetric form of recovery represents a telling symptom for a specific malady of the Russian economy: Far from depressing *all* investment activity uniformly, as is frequently suggested in popular accounts, insecure ownership rights exert much less of a negative effect on investment in activities that are characterized by relatively fast recoupment periods. The popular view is, however, correct for investment in capital-intensive activities that pay off only over very long periods of time. In the respective sectors, insecure ownership rights exert a comparatively much stronger negative influence[23].

4.3. Profit, Investment, and «Intermediation»

Further evidence pointing to the need for improving the institutional underpinnings of the economy can be derived from an analysis of some structural features

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[21] The statistics are admittedly particularly shaky in this area. That much granted, it is worth noting that, for example, during the initial surge of investment in the first half of 1999, investment of small firms declined by 14 percent; see DIW (1999), p. 885.

[22] See the theoretical and empirical evidence in Ghosal and Loungani (2000). There are several channels through which uncertainty may affect firms' investment outlays. These include the irreversibility of capital expenditures due to sunk costs, financing constraints that arise from information asymmetries between borrowers and lender, and attitudes towards risk. All factors tend to impede investment by smaller firms overproportionately.

[23] For empirical evidence on the impact of ownership risk on investment, see Bohn and Deacon (2000).

of profits and investments. While industry is the source of the larger part of economy-wide profits, housing and agriculture in comparison generated no profits at all or even suffered losses[24]. Industry also accounts for the largest share in overall investment. However, the latter share clearly falls short of industry's share in profits. The difference represents profits generated in industry, but not invested in industry (Fig. 2).

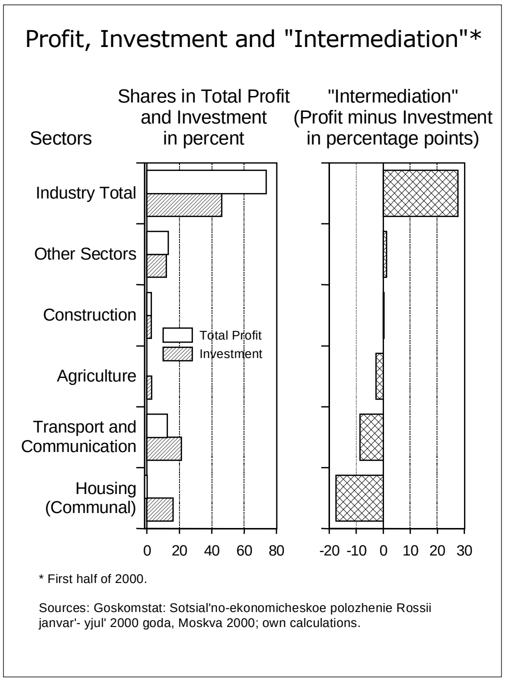

Fig. 2. Profit, Investment, and «Intermediation»: Sectors

By contrast, investments were made in particular in the housing, agriculture, and transport and communication sectors that were not matched by profits earned. In other words, industry may be seen as co-financing these sectors. This is all the more remarkable given the still large share of loss-making enterprises in industry.

Within the industrial sector, it can be observed that profits generated in non-ferrous metallurgy, fuel, and iron and steel, in particular, have not been fully used for investment in the same branch of industry. The reverse is true for the electric power and the food industries which are «net recipients» in this specific sense (Fig. 3).

The flow of funds described here may be the result of market-driven intermediation, as may be surmised in the case of the food industry, but it could also be due to some form of direct or indirect state intervention. The latter may well be true in the case of agriculture and the housing and communal branch, the largest net-recipient of resources.

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[24] The data available to the author at the time of writing are for the first half of 2000 only. The data for 1999 give practically identical results.

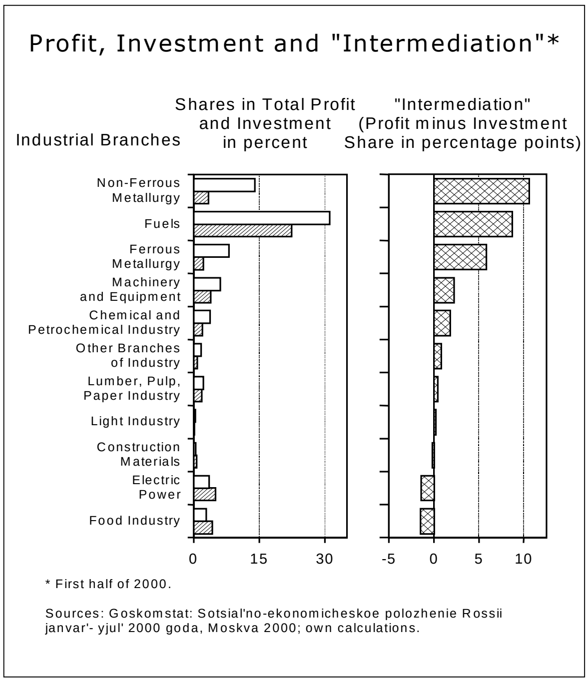

Fig. 3. Profit, Investment, and «Intermediation»: Branches of Industry

Thus, despite the surge of investment activity over the past two years, the negative impact of the general uncertainty, the insecure ownership rights, and the structural distortions still exists and can quite easily be diagnosed in the structure of investment. Therefore, a sizeable acceleration of investment can be expected from policies that successfully manage to remove structural distortions, reduce uncertainty, stabilize expectations, and build up the trust of those who put their wealth at risk by investing in the real economy of Russia.

5. Conclusions

Over the past years, countless reform measures have been initiated in Russia. Far too few of them can be said to have been implemented in ways that could be called desirable. Yet from the first half of 1999, the Russian economy began to experience an initially accelerating, and now apparently subsiding, recovery of economic activity which was especially pronounced in the area of capital investment. In order to ensure continuation of the rebound, it would appear that considerable efforts are justified towards understanding its root causes. Unfortunately, too many observers seem quite satisfied with the popular perception that the recovery is owed to the devaluation of the ruble plus the increase in oil prices. We have argued in the present note that neither is the diagnosis complete nor are the implications yet fully appreciated.

As to the diagnostic part, this paper suggests that, in addition to the oil price hike and the devaluation of the ruble, a third, about equally weighty factor has contributed to the recovery of investment activities in Russia. That third factor is the drastic decline in the real wage rate whose role has so far been largely ignored. However, despite the possibly small share of wages in GDP, that factor contributed, by reducing production costs, quite strongly – as a rough approximation by about one-third – to the post-crisis surge in enterprise profits which, in turn, were the main driving force behind the surge in investment.

As to the implications, it is only the increase in oil prices, among those three factors, that can be considered a truly exogenous (positive) shock. Neither the level of real wages nor the exchange rate are beyond the control of Russian authorities in the same way as the oil price. Now, there is no really good reason why the declines of the latter two variables, which came about practically by default in the wake of the 1998 crisis, could not have been engineered many years earlier. This points to the disturbing conclusion that Russia could have been spared many years of economic retrogression. Had Russia decided earlier to abandon unrealistic levels of both the exchange rate and real wages, much of the economic decline would simply not have happened.

As to the future, there is a real danger that past mistakes will be repeated. Rather than lamenting that real incomes have not yet returned to the pre-devaluation levels or that the «temporary and artificial factors that fueled growth have exhausted their potential,»[25] it would be much more helpful to ensure that authorities at least now take the right decisions. This means in particular avoiding the reemergence of real wages and of an exchange rate that reduce profits to levels which undermine the present surge of investment activity. While the issue of the exchange rate does not pose an immediate threat, authorities would be well advised to make sure that the growth rate of real wages does not stray too far from the growth rates of production and productivity. Note that this does not preclude growth of demand. *The present combination of real GDP growth rates below 5 percent and of real wage growth rates exceeding 20 percent could soon derail the recovery.*

Apart from that, the insistence of the present government on improvements in the area of property rights and in the legal and institutional setting is by no means misplaced. Indeed, the negative consequences of Russia's failure to adequately address these issues can clearly be diagnosed even in the economic recovery. Therefore, persistent work towards removing those obstacles will not only give economic growth a boost but will simultaneously permit an increase in the share of wages in GDP that is not harmful to the recovery. It needs to be recognized, however, that institutional change requires considerable time before becoming effective and, therefore, cannot be exclusively relied upon for keeping the recovery alive.

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[25] As does, for example, the prominent Russian journalist Latsis (2000).

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