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## **MACROECONOMIC SITUATION IN RUSSIA: GROWTH, INVESTMENT AND CAPITAL FLOWS**

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**Summary:** This paper analyses recent economic trends in Russia, evaluates the fiscal performance and discusses the growth potential and issues of capital flight. There has been considerable growth of industrial output between 1999 and 2002. Investment and industrial output are strongly correlated as is industrial output and the oil price. As regards budget revenues, the oil price development is quite important. This paper discusses the tax structure and the expenditure side of the government budget, in particular the size of debt service payments requiring a structural budget surplus at the federal government level. Employment has started to increase in 2000 so that a long term negative employment development has changed. Issues of the current account and the exchange rate dynamics are also considered. The analysis compares long term output growth and investment growth in Russia and the US. Finally, perspectives of chaebolization of the Russian economy are discussed.

**Zusammenfassung:** Dieser Beitrag analysiert aktuelle Entwicklungstrends in der russischen Wirtschaft, bewertet die fiskalische Leistungsfähigkeit des russischen Staates und diskutiert Wachstumspotenziale sowie das Problem der Kapitalflucht. Zwischen 1999 und 2000 gab es in Russland einen signifikanten Anstieg der industriellen Produktion, wobei diese stark mit der Investitionsquote sowie dem Ölpreis korreliert ist. Im Hinblick auf die Staatseinnahmen ist die Entwicklung des Ölpreises sehr wichtig. Der Beitrag diskutiert ebenfalls die Steuerstruktur sowie die Ausgabenseite des russischen Haushalts und betrachtet dabei insbesondere die Höhe der Schuldentilgung, die einen strukturellen Budgetüberschuss der russischen Regierung verlangt. Die Beschäftigtenzahlen steigen seit 2000 an, so dass der langanhaltende Negativtrend der Arbeitsplatzentwicklung gestoppt werden konnte. Daneben werden ebenfalls Zahlungsbilanz- sowie Wechselkursentwicklungen thematisiert sowie die langfristige Entwicklung des BIP und das Investitionswachstum in Russland mit den entsprechenden Zahlen der USA verglichen. Zum Schluss werden Perspektiven der so genannten *chaebolization* der russischen Wirtschaft diskutiert.

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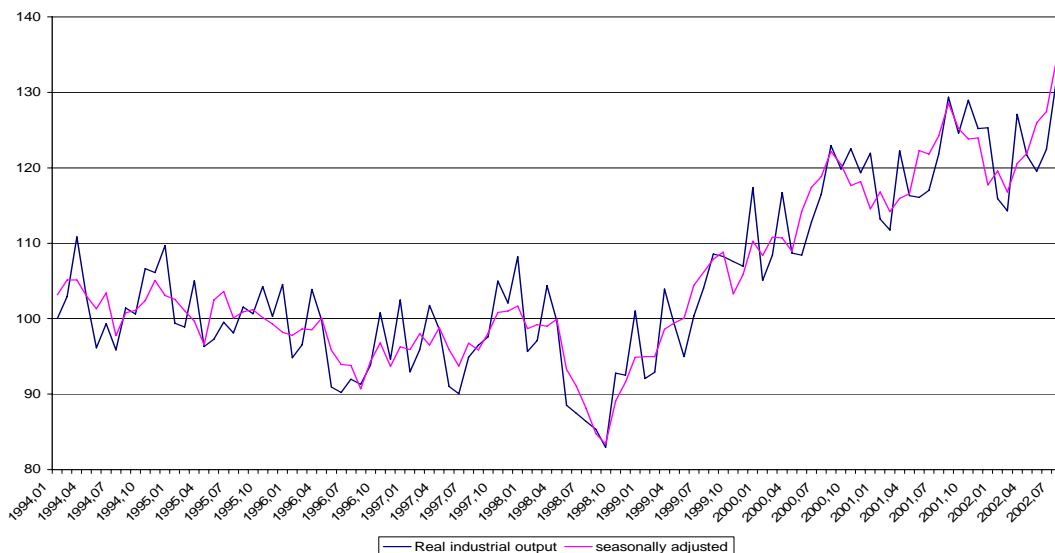
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## 1. Recent Trends

The Russian economy demonstrated relatively strong performance in 1999-2001 and is still doing well in 2002. At least macroeconomic indicators for 2002 look better than was thought likely in late 2001. Expected growth of about 4,0% compares favorably with a limping Europe and US. After rising in the second quarter of 2002, oil prices remained high in mid 2002, and Russia was able to profit from a strong current account and continued windfall revenues. In the fall of 2001 and early in 2002 during the period of decreased oil prices and economic slow down in Russia, growth prospects were much more cautious.

Following an increase in the price of oil, economic activity increased in Russia in the second quarter of 2002 and the recovery continued in the mid-year, so that industrial growth in January-September grew 4,0% y-o-y, up from 2,6% in the first quarter y-o-y (see graph below). By the end of 2003, this growth figure should be even higher. The low growth in early 2002 was largely the result of a strong contraction in November-December 2001, brought on by decreased investment activity in the face of lower oil prices and gloomy prospects for the global economy. Conversely, mid-year acceleration in growth was stimulated by increased investment activity. At the same time, growing consumer demand stimulated domestic production, while appreciation in the euro kept imports at bay. A seasonal slowdown in economic activity is expected by the end of 2002, but this should not be as drastic as in 2001. This, however, will work out if oil prices remain at a level above \$20 per bbl.

**Fig. 1: Growth in Industrial Output, 1994-2002**

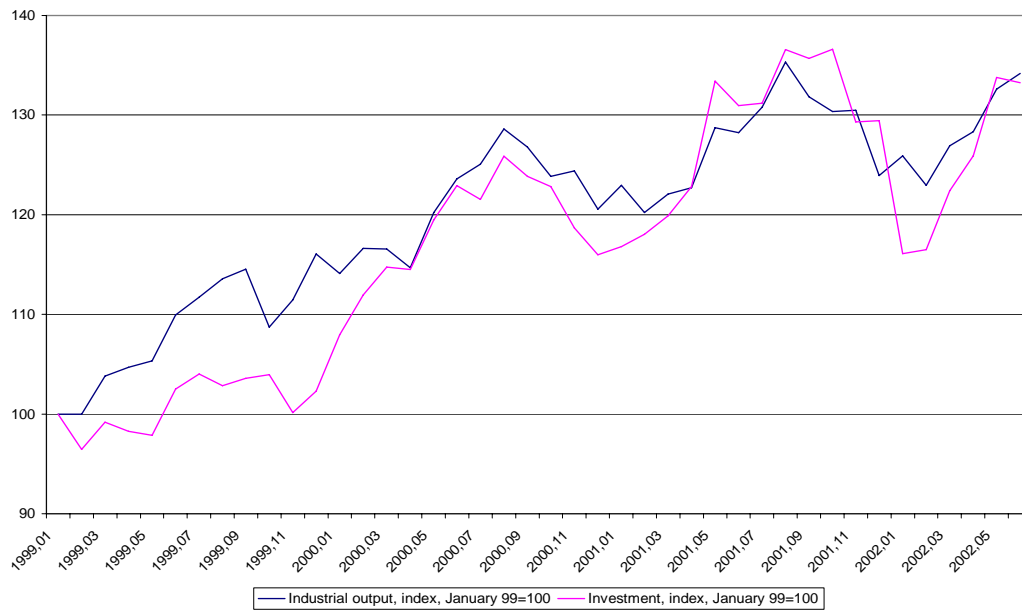


In spite of relatively high growth rates in the Russian economy in 1999-2000 (average annual GDP growth was about 6%), the economy is operating at well below its potential and the current growth mechanism is not sustainable in the long run. This mechanism, which took root in the aftermath of the 1998 crisis and has developed

considerably since 2000, depends largely on investment by exporters, in particular oil and gas companies. Investment affects industrial output significantly and therefore is, with a lag of around three months, reflected in real incomes and consumer demand, thus stimulating the rest of the economy. Russia is thus at a crossroads: if it can modify the existing growth mechanism, then higher and more sustainable growth rates are perfectly plausible in the long term. If not, then growth is likely to continue its decline. Lowering the entry barriers for businesses, cutting back the “red tape” and establishing a climate that will nurture their expansion are necessary preconditions for the emergence of this new growth mechanism. Reform of the financial sector is another key element. Those issues will be discussed below.

The graph below shows that the growth mechanism that has developed in Russia over the past several years is still in place and output is largely driven by investment, mostly in the energy sector. Economic activity is thus driven by investment and tends to pick up mid-year. In fact, the graph below shows seasonally adjusted investment in fixed capital and industrial output for the period from 1999. From this graph it is clear that the relatively low output growth in early 2002 was largely the result of a contraction in output at end of 2001. From March, the economy once again began growing.

**Fig. 2: Seasonally adjusted industrial output and investment, 1999-2002**



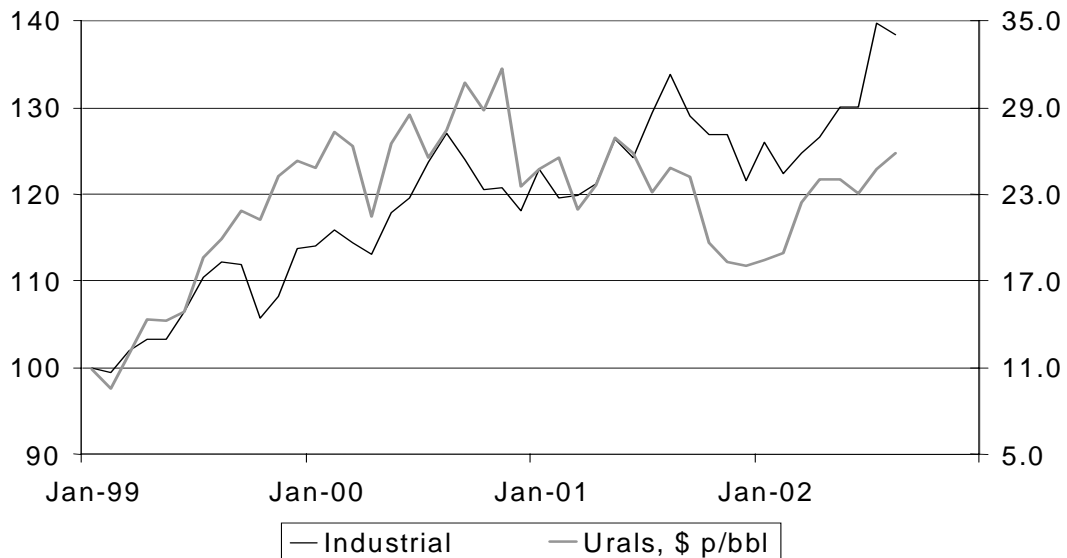
The graph points to a clear correlation between investment and industrial output growth. The shape of the growth curve would be essentially the same if some more aggregate output monthly indicators were taken, such as output in the five basic sectors (industry, agriculture, trade, transportation, construction). It is known that over 50% of investment in Russia is within the energy and transport sectors. The latter is closely linked to the oil and gas industry since it includes pipelines. Therefore, overall industrial output is in fact determined by the investment plans of a lim-



ited number of exporters (other capital intensive export sectors, such as metallurgy and the chemical industry, also play an important role). This in turn affects GDP. The reason for this is that increased investment by exporters pulls up profits and wages in the manufacturing sectors which produce investment goods. Production and incomes in certain other related sectors also increase. With a lag of around three months, consumer demand goes up as well (aided also by increases in public sector salaries which likewise depend on profits from the energy sector, Russia's largest tax payer), thus stimulating production in a broader range of industries. Investment can thus be seen to be a catalyst for economic growth.

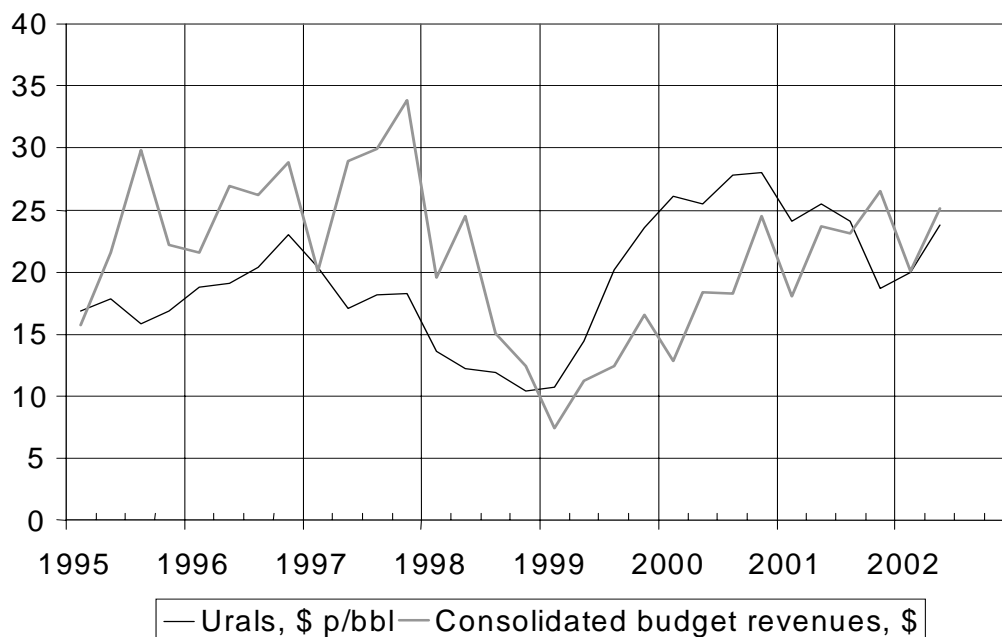
The rise in oil price between 1999 and 2000 contributed to higher profits for oil companies, which in turn translated into growing investment. Similarly, a fall in the oil price at end of 2001 resulted in a drop in investment and hence industrial output (see graph below).

**Fig. 3: Seasonally adjusted industrial output and oil price**



The Russian budget is also very much dependent upon oil price, which can be seen from the next chart – the government was able to accumulate more budgetary revenues during the period marked by high oil prices.

**Fig. 4: Oil price and budget revenues, 1995-2002**



Fiscal performance will be discussed in the next section. Concluding this section we should acknowledge that in the short term, the government can do little to replace the existing growth mechanism. If oil prices stay at their current level, above \$20 p/bbl, we can expect a further recovery in investment, a modest acceleration in growth mid-year and a slowdown each autumn, thus replicating the trend seen over the past few years. At the same time, it is quite clear that with respect to growth rates the Russian economy was (and still is) operating well below its potential, a problem compounded by continued capital flight, a topic also discussed below.

Since the initial potential for “cheap” growth from the low base and easy increase in capacity utilisation provided by the 1998 crisis had to some extent been exhausted, growth rates naturally slowed in 2001 and 2002. At the same time, slow progress on reforms failed to compensate for this shrinking growth potential. The government’s most recent medium-term fiscal program therefore projects rather moderate growth rates for 2003-2005. In April 2002, the Russian president criticized the government for a lack of ambition, implying that it was assuming a continued dependence on oil prices and therefore essentially no change in the growth mechanism. This fresh call for an acceleration in structural reforms could have well been prompted by strengthening diplomatic relations between Russia and the West.

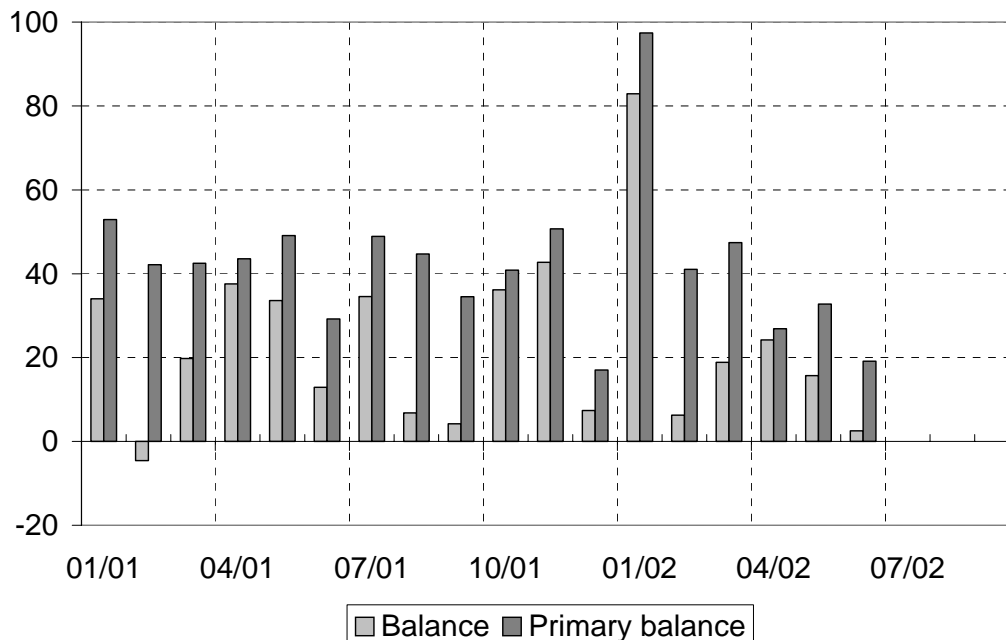
Reform has already begun in many key areas: tax, the natural monopolies, land, the labour market, pensions, the judiciary and deregulation of the economy. This process is still incomplete and hence the results may fail to impress. However, there have also been clear problems along the way. Certain regulations were found to be inconsistent, requiring a number of amendments to be passed, some of which (involving the Tax Code and Labor Code, for example) have had the effect of creating instability and hampering the business climate. The presence of an unreformed pub-

lic administration has also impeded the general reform process. The government has been ordered to develop a concept for administrative reform by the end of 2002, but with the 2003 budget already formulated, actual restructuring is unlikely to start before 2004. As a result, progress on reforms through the end of 2002 and in 2003 is likely to be gradual and growth rates moderate.

## 2. Fiscal performance

Government launched comprehensive tax reform in 2001 and 2002, a good time since oil prices remained high. The government reduced profit tax, personal income tax, social tax, and abolished some other minor taxes. As a result collection of the personal income tax increased and in fact fiscal performance was good in the past several years, allowing government to run surpluses and accumulate finance reserve against the background of foreign debt payments. At the same time, some problems originated from the reforms of corporate taxation. Low revenues in early 2002 raised concerns over the country's fiscal situation. In fact the drop was the result of a decline in profit tax collection and relatively low VAT collection, the former perhaps the reaction of businesses to the elimination of investment privilege and the latter due to the fact that the government started returning VAT to exporters (see graphs below).

**Fig. 5: Federal fiscal balances in 2001-02, R bln**



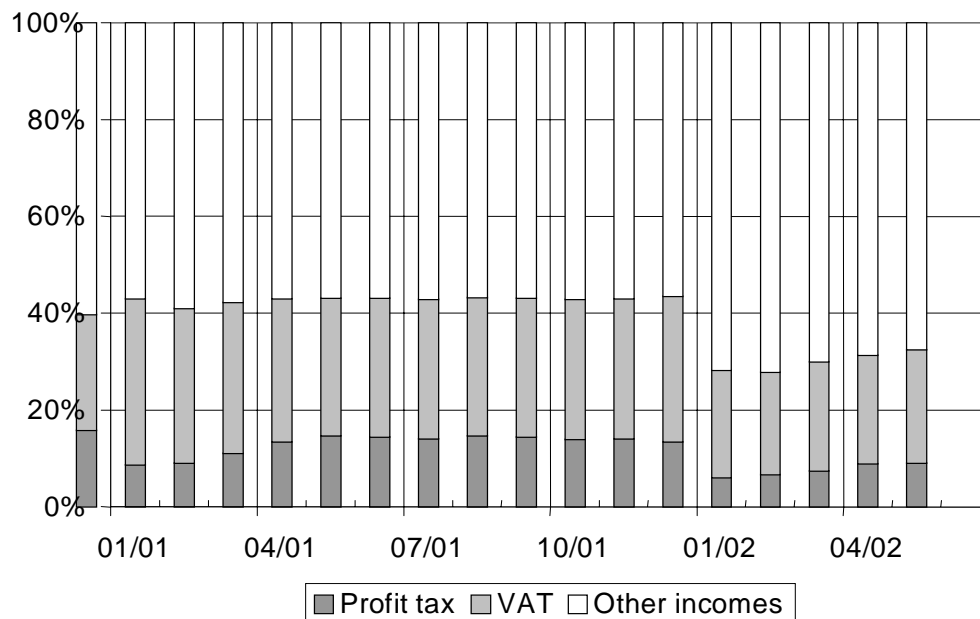
As often happens in Russia, businesses cashed in on the opportunity and applied for returns on “exports” that had actually never left the country. As a result, VAT re-

turns to exporters in some regions were actually many times greater than their export revenues.

*Above all, it is the lack of common honesty in Russia, in its narrowest and most ordinary sense, which astounds. This fatal flaw in character deprives the government of the opportunity to wield any reliable executive power, by robbing it of a necessary number of honest, faithful lower-ranking officials.*

Historian and philosopher, Ivan Aksakov, penned these words in the mid 19th century. Little appears to have changed in Russia over the past 150 years.

**Fig. 6: Cumulative profit tax and VAT as percentage of total revenues, 2001-02**



Nevertheless, following usual mid-year improvements in economic performance, fiscal performance recovered early in the second half of 2002 and tax collection increased substantially (also due to increased oil price), thus providing a solid start for the \$6 bln financial reserve, which the government expects to accumulate by the end of 2002.

The draft budget for 2003 and the execution of the 2002 budget were the most debated issues in mid 2002. The draft budget for 2003 suggests a surplus of 0.5% of GDP (\$2.2-2.3 bln). This is insufficient to pay off the country's principal foreign debt (\$10.8 bln). At the same time, the government is planning to roll over domestic debt. This means that the fiscal gap can be mostly covered by the planned \$6 bln reserve. The rest (\$3.0-3.1 bln) will come from domestic sources (such as borrowing, privatisation receipts and sale of state inventories).

In general, the government's fiscal plan for 2003 looks realistic, although growing non-interest spending does raise concerns. In 2003, this spending may be 40%

above the 1998 level, while GDP is likely to be up only 30%. Such populism is understandable given that elections are coming up in late 2003 (Duma) and early 2004 (presidential). Once these are over, the government will hopefully make significant cuts in budget spending.

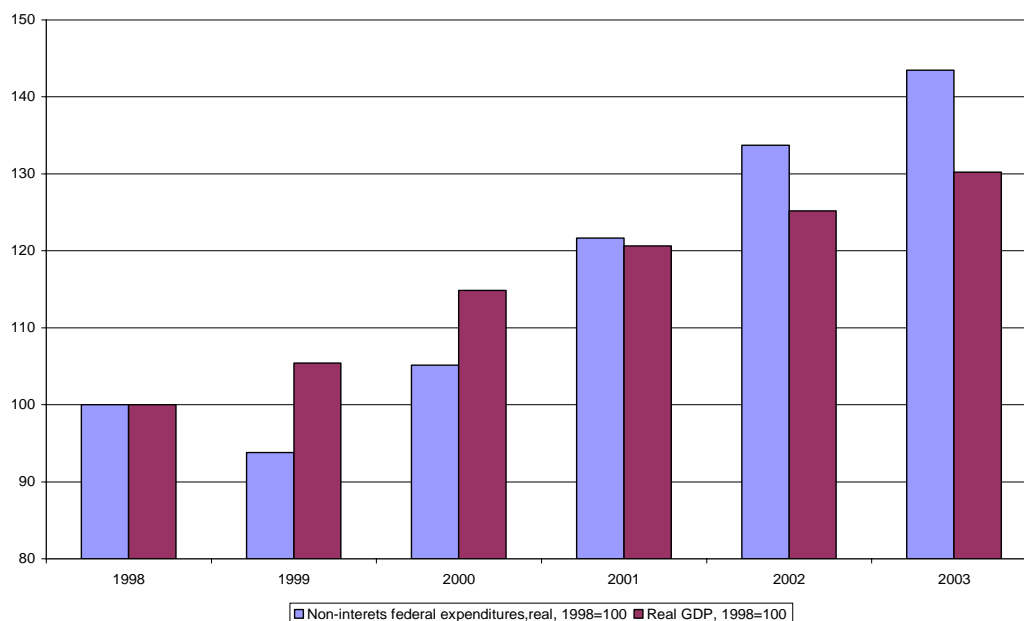
In addition to the foreign debt payments, there has been a clear upward trend in non-interest spending in 2002 and this has also contributed to the shrinking surplus, which is going to be much lower in 2002 than a year ago. Growth in government spending is potentially more dangerous than planned debt payments and a cause for increasing concern. If there is any dramatic change in external conditions, then it will be extremely hard to backtrack and cut down on public spending. The situation is essentially the same for the consolidated budget.

As is well known, Russia's debt service payments are the highest in 2003, mostly due to a R10,8 bln hike in principal payments. These payments will actually require a surplus of about 2,9% of GDP. If the government cannot achieve this, then it will need to make use of the financial reserve left over from 2002. Total foreign principal debt payments due in 2003 are R345,6 bln, which make the expected fiscal surplus look woefully inadequate. In fact, the financing gap can be covered by the reserve fund and domestic sources of R95,2 bln (of which R51 bln will come from privatization receipts and R20 bln from the sale of state inventories). The government has expressed a reluctance to borrow internationally and the Finance Ministry claims that foreign borrowing will not exceed \$1,25 bln next year. While drafting the budget government appeared more likely to look for options closer to home, such as the Pension Fund, which is rapidly accumulating "excessive" resources. This will be non-market borrowing at low interest. Finance Minister Alexei Kudrin acknowledged that the fund has already acquired R10 bln of government non-tradable securities at relatively low interest in the first half of 2002.

The government considered, as usual, optimistic and pessimistic scenarios for 2003. The key difference between them is the assumed price of oil (\$21,5 p/bbl and \$18,5 p/bbl, respectively). Revenues are forecast on the basis of the optimistic scenario, while forecast spending is based on the more conservative scenario. Nominal GDP rises to R12,98 trln in the first case and the exchange rate is R33.7/\$1. In the second case, GDP is R12.65 trln with an average exchange rate of R34/\$1. According to government forecasts, GDP will therefore be somewhere between \$372 bln and \$385 bln.

The availability of Pension Fund monies could tempt the government to hike non-interest spending and this could be a source of macroeconomic instability. The graph below shows that after the 1998 crisis, non-interest spending contracted in real terms, but by 2000 had already grown back above the 1998 level. It accounted for 11.8% of GDP in 1998 and, as the graph shows, were above this level by 2001. The projected rapid growth in non-interest spending in 2002-03 is the result of a number of populist decisions made without any consideration for restructuring of the public sector. Public sector wages were increased substantially this year. In 2003, the government plans to raise them again, this time by 33%.

**Fig. 7: Non-interest expenditures and GDP in real terms (1998=100)**



*Note: Figures for 2002 and 2003 are from the budget and draft budget for those years (excluding social tax, effective since 2001). In fact, growth in non-interest spending in 2002 should be higher.*

As was mentioned earlier, the period of “cheap” post-crisis growth, when output was growing largely due to higher capacity utilization, was coming to an end. To maintain sustainable, high growth rates, the economy requires modernization and investment. Since spare fixed capital capacities have been largely exhausted over the past few years, the economy required more labour to maintain growth in 2002. In fact, overall employment was up 2.8% y-o-y in 1Q02 and 2.5% y-o-y in 2Q02, the highest growth rate in several decades. At the same time, growth in efficiency on an aggregate level slowed relative to previous years.

The country’s economic efficiency could actually suffer as wage increases in the public sector increase public sector employment at the expense of the private sector. Employment in such budget-financed sectors as “administration”, “healthcare, sports facilities and social services”, “culture and the arts” and “education” increased by 2.7%, 2.2%, 4.0% and 1.5% y-o-y respectively, while the number of people employed in production dropped 3%. As a result, the number of people working in these sectors is now comparable with total numbers employed in production (around 22% of the country’s total employment figure). This industry produces around 30% of GDP, while the four sectors above, the so-called “non-market services”, generate just 10%.

However, recent surveys indicate that now with spare fixed capital capacities exhausted, skilled labour (or rather the lack thereof) could itself become a limiting factor on growth. In recent years, the Russian population has been shrinking at the rate of 0.5% a year and this trend is expected to accelerate. The table below shows the effect demographic trends are already having on macroeconomic indicators.

From 1998-2002, annual average growth in GDP per capita was 0,5% higher than growth in GDP, and the cumulative effect should therefore mean considerably higher GDP per capita by the end of 2002.

In this respect, recent policies aimed at increasing public sector wages without first restructuring the sector, should be considered counterproductive. Such policies stir up forgotten paternalism and contribute to the misallocation of labour.

**Tab. 1: GDP and Employment between 1995 and 2002**

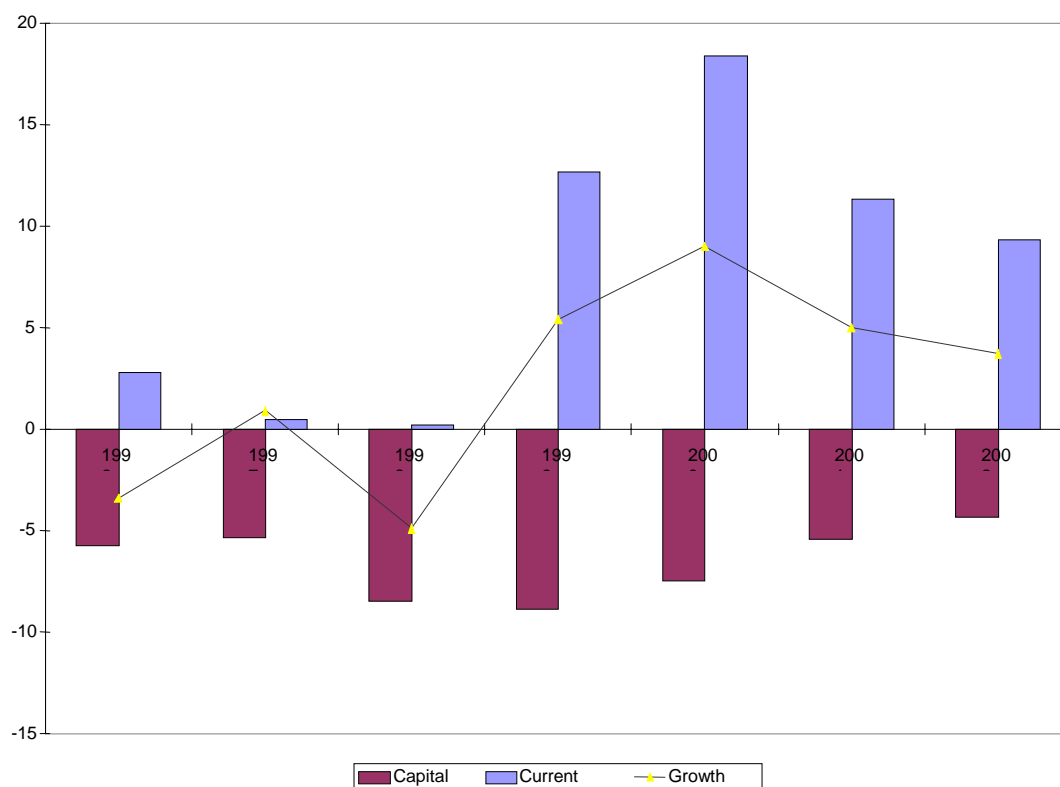
	1995	1996	1997	1998	1999	2000	2001	2002
GDP per capita	-3.8	-3.1	1.2	-4.4	5.9	9.6	5.6	4.3
GDP	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	3.8
Employment	-3.0	-0.8	-2.0	0.1	-3.1	1.5	0.3	2.4

In 2001, the government was able to hike spending on the back of higher-than-expected tax receipts. This was done instead of building up the stabilization fund. Fiscal performance in 2002 is not as good as last year's. Thus it would be a good time to hit the brake on spending. Instead of this, the government has begun to borrow from the Pension Fund.

### **3. Growth potential and capital flight**

Calculations show that if the oil price stays above \$20 p/bbl, investment will continue growing, thus stimulating the rest of the economy. As stated above, with respect to growth rates the Russian economy was (and still is) operating well below its potential, a problem compounded by continued capital flight. The graph below confirms that growth rates are very much dependent on oil prices and hence on the state of the balance of payments. Growth rates are roughly equal to the difference between the current account and capital flight (both measured as a percentage of GDP). In fact, the rate of growth is determined by that part of the export earnings that remains in the country. This rule for determining growth rates assumes that foreign direct investment (FDI) volumes are immaterial in net terms. This was certainly the case in Russia after the crisis, when net direct investment in the country was close to zero or even negative (i.e. Russia's own direct investments abroad were roughly equal to or exceeded FDI in Russia). Note: the 1997 positive growth rate was achieved, despite a weak current account and capital flight, due to record high capital inflows.

**Fig. 8: Growth, current account and capital flight**



As the current account falls, the Russian economy is not only operating below potential, but that potential itself is shrinking. The decline in the current account is driven by real ruble appreciation and this trend is expected to continue. In order to achieve higher growth rates, there are therefore three theoretical options: (1) reduce capital flight while allowing real ruble appreciation, (2) increase capital inflows, or (3) devalue the ruble to increase the strength of the current account.

If the price of oil remains at or around its present level, then the ruble is unlikely to devalue. However, even if it does, option (1) is still a precondition for higher growth rates. Since high growth rates were achieved by increasing capacity utilization at existing enterprises in 1999-2000 and because this potential has now largely been exhausted, establishing a better business climate aimed at reducing capital flight and attracting foreign capital, thus rebuilding capital stock across the economy, therefore remains the most reasonable way of achieving higher growth rates. This should also contribute to a transformation in the sector structure of the economy.

#### **4. Growth and the chaebolization of the Russian economy**

Over the past few years, the Russian economy has delivered high rates of growth parallel to the emergence of increasingly stronger vertically-integrated conglomer-



ates (for more details see GAVRILENKOV, 2002). A similar pattern was observed in the evolution of Asia's economic system. However, the benefits of these conglomerates on the Russian economy may be short-lived. One trait of such a system is a weak financial sector – in particular with respect to banks – and this is a major obstacle to growth. Another trait is high entry barriers for new businesses, which hold back the pace of new business development and reduce the potential for growth.

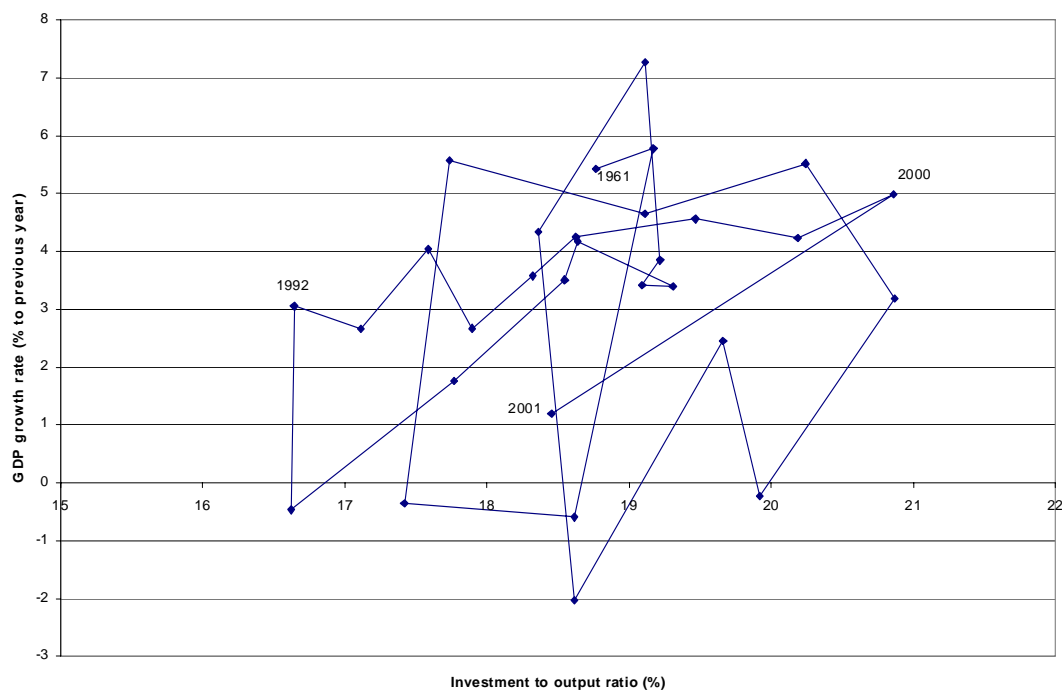
At the same time, the misallocation of investment in the absence of a strong financial sector contributes to the preservation of a sectoral structure to the economy and this, too, slows down growth rates, as greater resources pour into investment, while returns fall. Russia is again at a fork in the road. As was discussed above, one option is to reduce the entry barriers for business and develop the private financial sector. This could bring about a resumption of high, sustainable growth rates. The other is the road to a further strengthening of the “chaebols” as substitute intermediaries between savings and investments. This would build the foundation for a new crisis.

After a decade of contraction, the Russian economy badly needs high rates of growth in order to catch up with western economies. Russia also needs that growth to be sustainable. However, experience in many countries has shown that periods of high growth are often followed by stagnation or even contraction. This was true for the Asian economies, which grew fast in the 1960s to mid 1990s, but were severely hit by the crises in 1997-98. These were not financial or currency crises; their origins were much more fundamental and can be found in a number of serious macro-economic imbalances resulting largely from poor institutions. This is a lesson that might serve Russia well.

Traditional growth theory assumes the existence of equilibrium or a balanced growth path, such that an economy tends to revert to its previous trajectory after a shock. The graph below is based on historical US figures (with investment-to-output ratios on the horizontal axis and GDP growth rates on the vertical axis). As can be seen, both variables have fluctuated within a relatively narrow range for several decades. This points to the fact that the economy has attained a kind of equilibrium, with 3% growth against an average investment ratio of around 19%.

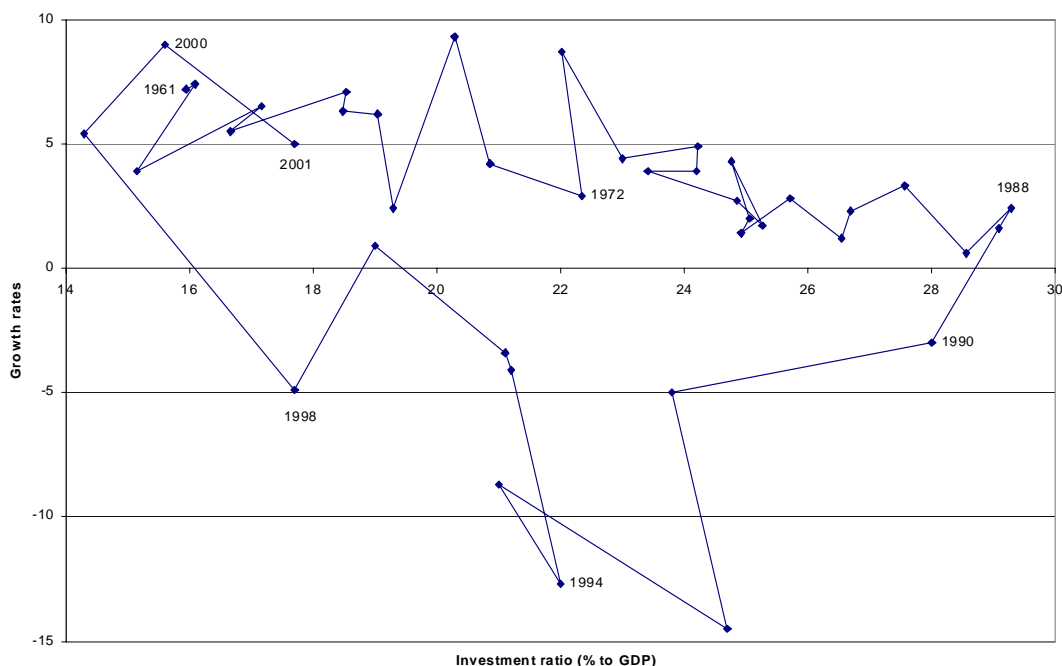
Similar graphs can be traced for other countries. In the case of developed economies, the results are similar to the graph above. Since investment ratios have remained relatively stable for decades, capital stock has been growing at roughly the same rate as output. At the same time, output has been growing faster than labour. This is important, as it means that in developed economies growth is largely driven by productivity rather than factor accumulation. Growing productivity contributes to higher incomes, which in turn stimulates production.

**Fig. 9: The US economy**



The graph for Russia (see below) looks very different. Over the period from 1961 to the end of the 1980s, growth rates gradually slowed while the investment ratio doubled. As a result, capital stock grew eight times over the space of 30 years, while output only tripled. Faster growth in investment than output points to falling efficiency and misallocation of investment resources in the long run. Since the share of investment in GDP was steadily increasing in the absence of capital inflows, this means that consumption in Soviet Russia was growing at a slower pace than GDP, contributing to greater macroeconomic imbalances.

**Fig. 10: Russia**

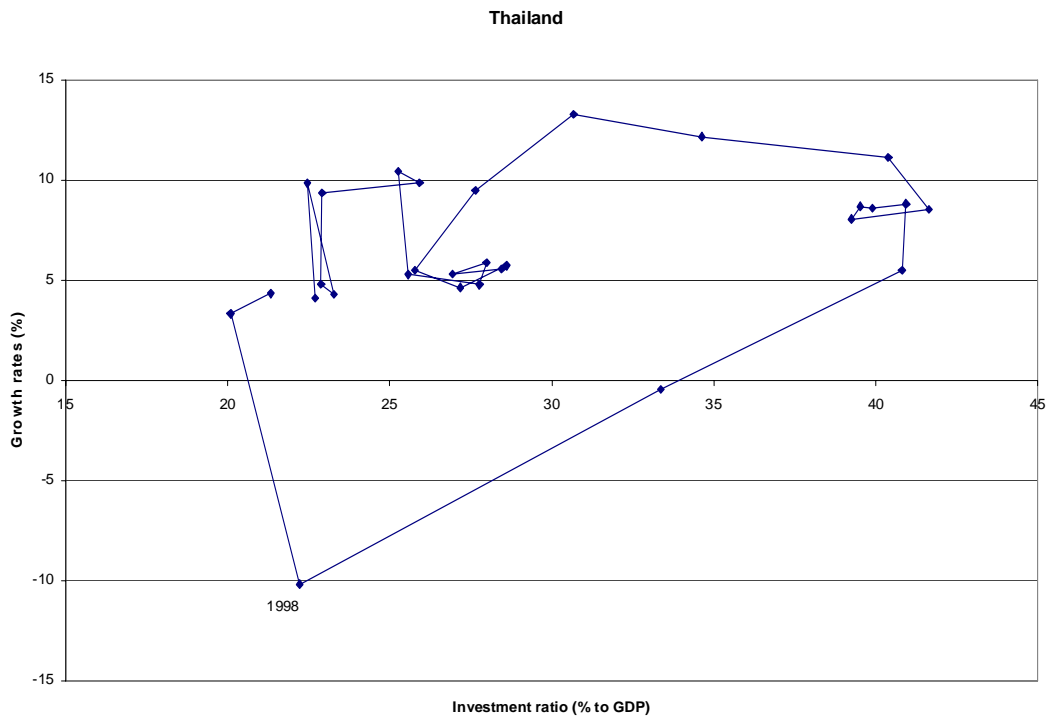


Partial liberalization at the end of 1980s resulted in a contraction in inefficient investment, which – although a step forward – also meant a decline in output. The start of Russia’s transition crisis can therefore be attributed to the end of 1980s, a little earlier than the formal start of market transition in 1992.

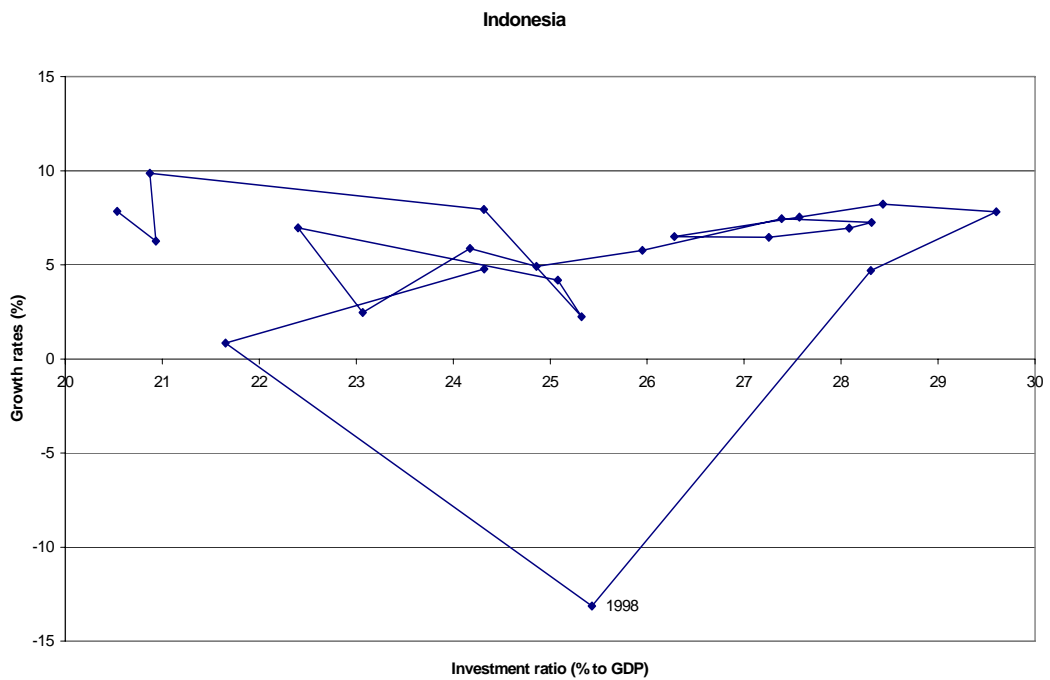
The graph also shows that the period after the 1998 crisis happened to close a forty-year circle. As a result, the Russian economy was growing as fast in 1999-2001 as at the start of the 1960s, with the same investment ratio below 20% of GDP. Unlike the US or other developed economies, Russia has never been close to finding equilibrium.

Similar cycles can be seen for other economies, such as those in South East Asia. The graphs below show Thailand and Indonesia (similar patterns can be seen for Korea, Malaysia and other ‘crisis countries’). Again, these economies have delivered unbalanced growth, with investment ratios increasing despite a lack of acceleration in output. The fact that growth has lagged behind capital accumulation again points to inefficient allocation of investments. Unlike in Russia, fast capital accumulation in the Asian economies occurred against a background of capital inflows, thus supporting growth in consumption. However, in the case of both Russia and Asia, a breaking point was certainly to be expected.

**Fig. 11: Thailand**



**Fig. 12: Indonesia**



High growth rates in Russia in 1999-2002 were achieved in parallel with a strengthening in the vertically-integrated conglomerates, which emerged on the basis of metal, oil and gas exporters. Equally important is the fact that most of this growth was delivered by existing enterprises. New businesses, including small enterprises, were not growing as rapidly as they might. The economic system developing in Russia is therefore similar in many respects to those of Asian countries. There were indications that Gazprom had acquired a number of agricultural farms and food processing enterprises in Southern Russia. Meanwhile, oil companies were taking control of the manufacturing sector and metal producers were focused on acquisitions in the machine building sector, including car manufacturers and companies producing heavy machinery for road construction. In the autumn of 2001, the world's largest producer of nickel and other non-ferrous metals, Norilsk Nickel, announced plans to invest in agriculture and food processing. These exporters have therefore begun to invest in a broader range of companies across the economy. In the short and medium term, this may contribute to a substantial improvement in the country's macro indicators.

However, one of the major drawbacks of such a system is the development of very close ties between business and the government, be it federal or local. This means a lack of transparency in decision-making, less competition (both domestic and foreign), greater protectionism and more acute corruption. To some extent, this reflects the country's administrative system, in which the political and business elites have joint interests and tend to cooperate closely. A system such as this does not need a developed banking sector and financial markets, since the reallocation of financial resources can generally be arranged within the vertically-integrated conglomerates, or "chaebols". In the case of Russia, each chaebol is closely tied to one or several affiliated banks. Gazprom, which set up Gazprombank, is one such example. The result is a lack of transparency that explains the reluctance by Russia's corporate sector to accept international accounting standards.

A weak financial system is a common feature of the Asian economic model and the administratively driven system. A properly developed financial system should act as an intermediary between savings and investments and assume the risks of misallocation of capital. Therefore, transition crises are only natural in such systems and the crises experienced in Asia cannot be treated merely as banking or currency crises; their origins find themselves in poor institutions.

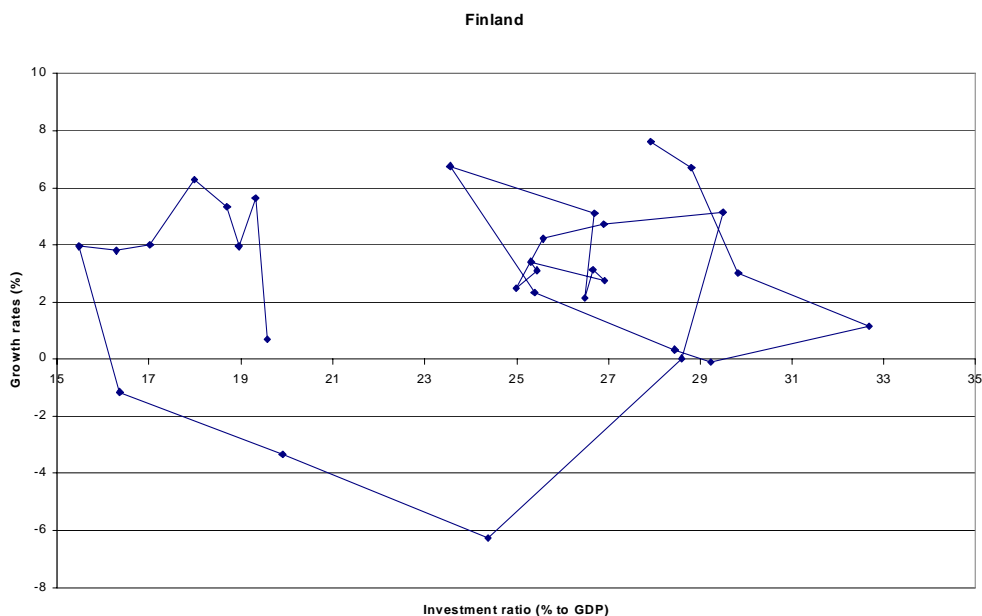
Aside from potential instability of growth, an underdeveloped financial sector may also contribute to other problems. Since an economic system dominated by a limited number of large conglomerates does not usually offer attractive financial instruments, it may be difficult to accumulate private savings and carry out the pension reform that was planned by the Russian government. International experience also shows that large vertically-integrated conglomerates suffer from relatively poor corporate governance, such as extensive use of cross-subsidization. In short, such a system may deliver rapid success, but it also gives rise to illusions among policy makers.

Russia is therefore now at a fork in the road. If it continues to evolve according to the Asian model, its economy will most likely follow a similar loop-type trajectory. After a period of growth, a new crisis will therefore be inevitable. However, if it can develop a more efficient financial system, there is a chance that high growth rates may be achieved against the backdrop of a relatively low investment ratio, probably not exceeding 22-23% of GDP. A more efficient allocation of investment should also support sustainable growth.

Finland is a good example of a successful transformation. Since the Soviet Union was one of its major trade partners, the Finnish economy was to some extent affected by the same diseases as the Soviet economy. Finland developed capital-intensive industries focused on exports to the Soviet Union. The graph below shows that Finland's investment ratio used to be as high as in other crisis countries. The foreign trade shock which occurred in the early 1990s contributed to devaluation of the Finnish markka. This was accompanied by high unemployment, a contraction in output and a fall in investment activity. An adjustment period then brought about the emergence of a more efficient financial system. As a result, Finland was among the fastest growing European economies in the second half of the decade. New sectors of the economy, such as telecommunications, appeared in place of the previous capital-intensive industries.

Russia's future therefore does not lie in the further exploitation of its natural resources, but in developing new export-oriented sectors. Reform of the financial sector is a necessary element of such a policy, as is the removal of "red tape". Ease of start-up for new enterprises and the expansion of successful businesses should also stimulate reform of the banking sector and the financial sector in general.

**Fig. 13: Finland**



## **References**

GAVRILENKOV, Evgeny (2002): Economic Growth and Crises: Evidence From Russia and Some Other Hysteretic Economies, Carnegie Moscow Center, Working Paper No. 5.