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**TITLE: AN APPRAISAL OF THE ECONOMIC SITUATION IN  
RUSSIA**

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## AN APPRAISAL OF THE ECONOMIC SITUATION IN RUSSIA<sup>1</sup>

Leonid Abalkin<sup>2</sup>

Ladies and gentlemen -- esteemed colleagues -- I represent The Institute of Economics of The Russian Academy of Sciences, a non-governmental, independent research center, which analyzes the condition of the Russian economy and prepares recommendations for the further development of economic reforms.

The appraisals [of the Russian economy] and conclusions that you will hear today, will probably differ substantially both from the official appraisals issued by the Russian government and carried by the Government press, and from those reported in the Western mass media which tends to echo the official view with minor commentary. Such reliance on the official assessments often spawns serious problems when the actual results differ very substantially from initial predictions; while many entirely natural, logical developments appear unexpected, accidental.

I will begin with a general appraisal of the course of reform and its results, and then move to the more concrete present situation, to present problems.

Radical economic reform has been going on in Russia for seven years. I will comment on precisely this period. What have we managed to accomplish in these seven years? I would not say that we accomplished a great deal, but all the same not a little has been done.

First, and most importantly, no one imposed economic reform on Russia. She chose this course herself, and chose it from prolonged and excruciating suffering. Today, economic reform has become the historical destiny of Russia, her choice. This point is very important because, having made this choice, Russia has determined its course, finally and irrevocably. And this means that the future fate of reform, speaking broadly, does not depend upon the destiny or activities of particular individuals or leaders. I repeat, the choice was difficult, but it is made and its further development is irreversible and, I underscore, is *independent* of the

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<sup>1</sup>This Report consists of a lecture by Dr. Leonid Abalkin at George Washington University on the occasion of his visit to the United States as a member of the International Academy of Sciences to attend the annual meeting of the American Academy of Management. His lecture, given on December 12, 1994, has been translated from the Russian by Council staff.

<sup>2</sup>Dr. Abalkin is Director of the Institute of Economics of the Academy of Sciences of Russia, was Vice Prime Minister from 1989 to 1990 in the first reform government under Gorbachev and Chairman of the State Commission for Reform. He is at present Chairman of the Department of Socio-Economic Problems at Moscow State University, and Editor-in-Chief of the journal "Voprosi Ekonomiki" (Problems of Economics).

destiny of any individuals. Thus, the most important question is not the speed of reforms, but precisely their irreversibility. This is the first and foremost result.

Next, the government's monopoly of property has been destroyed and the total statization of the economy has been ended. The complex and contradictory process is underway of forming a modern, differentiated economy. We are just at the beginning of this path, but the decisive step has been taken; this is the second, great achievement of radical reform.

Third, the institutions of a market economy, elements of its infrastructure, and its legal and legislative base have begun to take form and are partially in place. In this, too, we have only begun but these are very important changes which lay the foundation for a future, highly effective economy.

Fourth, radical changes have taken place in the consciousness of people. Behavioral stereotypes are being shattered. A rejection of governmental paternalism has occurred; a striving for initiative. [Russians are beginning to] understand that their well being is dependent upon their own initiative; upon their energy, creativity, entrepreneurial activity, professional knowledge and so on. With these changes in mass consciousness, a new, numerous breed of entrepreneurs have emerged who are skilled and willing to work in new, market conditions. These people often lack specific knowledge, experience, but this is already a massive group, energetic, goal oriented, but of course not homogeneous.

At the same time, there were miscalculations and blunders in the reform. From the beginning of 1992, in the worst tradition of radical Bolshevism, an effort was made to violate the logical development of reform, crudely to force the pace. These measures were taken without serious economic calculations, but basically out of political ambitions. As a result, the economic and socio-political crisis in the country deepened severely, and in many ways reform slowed.

In speaking of these steps as prompted by political ambitions, I wish to add another factor the influence of which should not be minimized. These steps were taken in large part under the pressure of the International Monetary Fund (IMF), which strove to apply its standard methods and practices to Russia. I must unfortunately note that specialists of that respected organization poorly comprehend Russia, its unique features, and are not willing to take them into account. The recommendations and actions of the IMF are reminiscent of the fabled Dr. Procrustes. We are all familiar with the myth of Procrustes, who laid people in a bed of a preordained and inflexible size.

There is also that kind of model, fixed by such parameters as the size of the budget deficit as a percentage of GDP, or the average rate of inflation, and other analogous standard parameters. If, for instance, the head does not fit in, it is simply chopped off and Russia is

bereft of science. If the legs are a bit too short they get stretched by pulling increased taxes from the economy after which the person walks shakily enough because he is deprived of his natural strength.

Ultimately though, the main fault is not that of the advisors, but of those who take the advice for action in practice, namely those Russian leaders who follow such advice. As a result we have an enormous in its dimensions and extremely destructive crisis, which is now in its fourth year. There is no stabilization underway, and none is foreseeable in the near future.

Now we are becoming used to hearing the government speak of "stabilization" once or twice a year, before each political campaign. Before elections, or a referendum, or whatever, "stabilization" is immediately announced. And when the political campaign is over everybody forgets about stabilization until the next event.

I am gradually approaching the events of 1994 in Russia. The scale of production decline in 1994 hit an all time record against previous years. The volume of industrial production declined by 23% compared with 1993. In consumer goods the decline reached 28%. If you add to this decline the decline in previous years, you will see that we are not facing the usual "normal" crisis, but the collapse of the economy. This is not simply word-play. An ordinary crisis carries within it the potential for subsequent recovery. But collapse differs in that it does not contain any impulse for recovery.

An especially difficult situation is forming in the investment area. If no money is invested in the economy, no stabilization will occur, let alone a recovery.

Consider the chart "DYNAMICS OF CAPITAL INVESTMENTS INTO THE RUSSIAN ECONOMY" (page 4). The figures show the dynamics of capital investment by year in percentages of each immediately preceding year. The columns show absolute volume compared to 1990. The first column shows the base year, 1990, at 100%. The remaining columns show each subsequent year as a percent of 1990. The calculations are, of course, in constant prices. Note the decline. This year the figure will be 28.4%! This is close to catastrophe.

There is another extremely negative aspect of the decline which must be taken into account. As a result of decline, Russian producers are increasingly losing the market; not only the international market, but the domestic market as well. Russian producers are increasingly being ousted from the domestic market, and here vacuums do not occur. So that even after recovery begins, if it begins at all, it will be very difficult to increase production when the consumption market is already occupied. The next chart, "IMPORT SHARES IN RETAIL TURNOVER (%)" (page 5) shows how the percentages have changed in recent years. It shows that the import shares in the totals of the internal consumer market. It was about 14% in 1991, and is now almost 40%.

## DYNAMICS OF CAPITAL INVESTMENTS

### INTO RUSSIAN ECONOMY

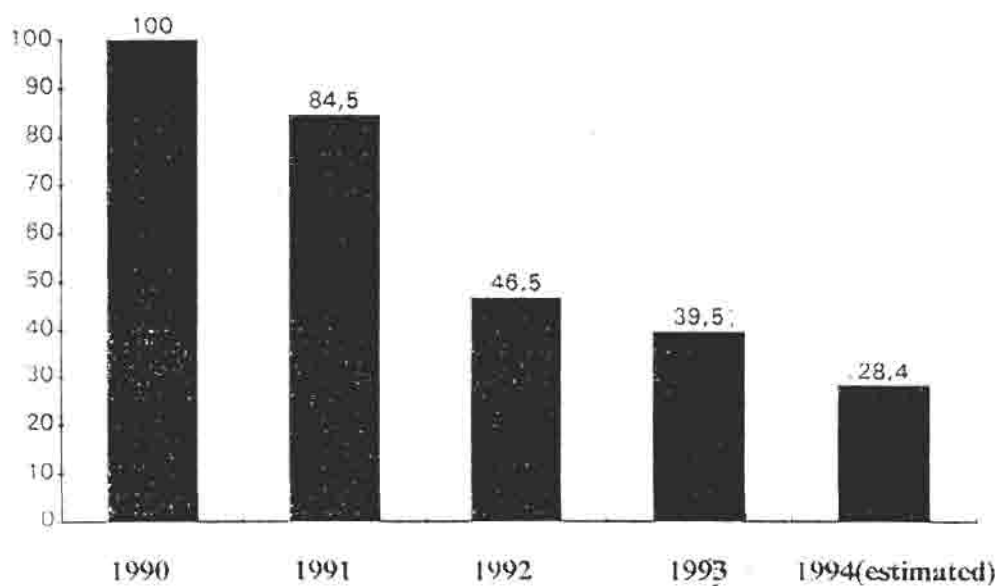
#### Capital Investments

(in percents to the preceding year)

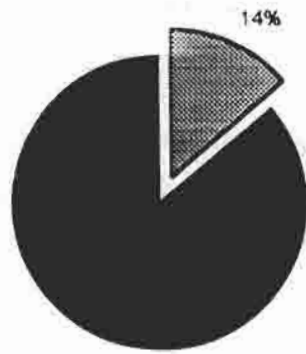
1991 - 15,5  
1992 - 45  
1993 - 15  
1994 - 28  
(10 months)

#### Volume of Capital Investments

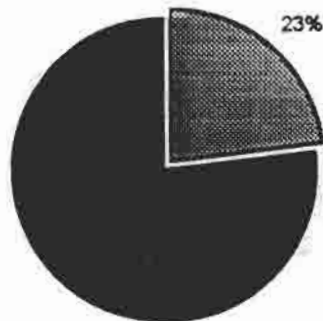
in percents to the year of 1990



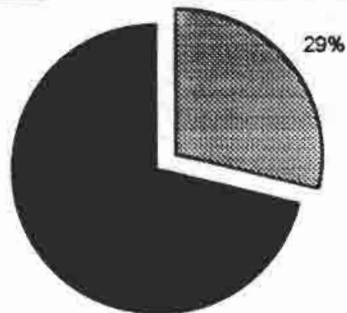
IMPORT SHARE IN RETAIL TURNOVER



1991



1992



1993



1994



These are very serious problems, which have now reached such proportions that they threaten the economic security of Russia. This theme of national economic security has attracted the attention of both government organs, and Russian scholars.

We have analyzed this issue at our Institute, and have already presented the results of our research. The results have been sent to the appropriate government organizations, and have been prepared for publication. The next issue Number 12 of the journal "Voprosi Ekonomiki" (Problems of Economics) will contain a series of articles on the national economic security of Russia.

Now I would like to turn to a different theme, perhaps somewhat complex, and specialized. The problem is that many aspects of the Russian economy are all too often looked at superficially, without analysis of the deepseated structural transformations which have taken place in recent years. To identify these structural changes by traditional methods, say by macro-analysis, is not possible. We need a different, more fundamental academic approach.

We are talking about major deformations that have occurred in the structure of the Russian economy. Let us take investments as an example. What has happened to the sources of investment? They were there four years ago. Why did they disappear? I am not talking about government investments, but total investments. A deformation has taken place which is tied to an artificial reduction in the number of financial sources of investment.

I will explain, but I have mentioned that several specialized issues are involved here. As you know, we underwent a price liberalization. Prices rose sharply. But prices on fixed capital goods were frozen by the administration. A disproportion arose between consumer goods and services on the one hand, and capital goods on the other. If the value of fixed capital is frozen, normal amortization sources are not created. Through taxes on profits the government removes from all enterprises, private and governmental, part of their basic capital.

There are a vast range of deformations related to income distribution, but I will talk about that later.

The structure of the economy is sharply worsening. Presently, the economy is experiencing an emphasis on raw materials greater than during the Soviet period. I will not elaborate on this point at present, but will entertain any specific questions. -- I have gone too fast. I would like to give you a very typical illustration.

About one month ago, Mr. Yasin, who is presently Minister of Economics, but who was then Chief of the President's Analytical Council, presented a lecture. His topic was "Problems of Investment in Russia." Now, I was sitting next to one of my colleagues, whom most of you will know, Academician Lvov. I proposed to bet him that Mr. Yasin would not mention amortization or depreciation policy. Mind you, this report was dedicated specifically to



investment policies. Who do you think won the bet? It is obvious -- he did not utter one word about amortization or depreciation policy.

I wish now to speak of finance, money circulation, and inflation. From February to August a sharp change took place in Russia in this area. The average inflation rate decreased from 21% in January, to 10% in February, and gradually to 4% in August. This was taken as the beginning of stabilization and viewed widely as a major achievement.

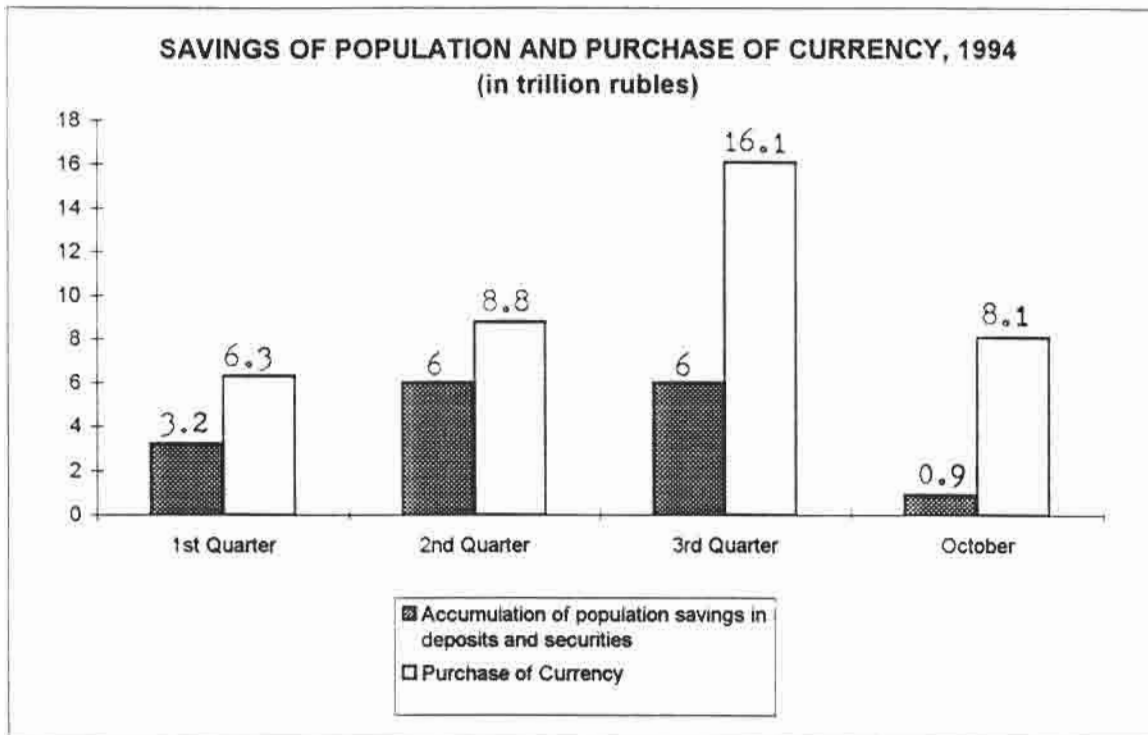
Of course, if you look at this process separately, in isolation, it constitutes a positive, beneficial trend. But our analysis showed that this was achieved by artificial measures, and was temporary. Two factors were determinant. The first was an artificial restraint on government spending -- the government simply did not pay its obligation during this period. Of course this does not engender confidence in the government on the part of the people, that's obvious. But such a resort cannot last long.

During the first half of the year, the government fulfilled one quarter of its total annual obligations. Three quarters remained for the second half. The government could have failed to pay for two more months, July and August. This is a relatively quiet period, Parliament is on vacation so this practice could have lasted for eight months! But public dissatisfaction grew, Parliament was due to return in mid-September and would demand answers, and it became obvious when there would be an explosion.

Everything pointed to the end of September and the beginning of October when inflation would explode, leading to the severe drop of the rouble rate. Mistakes can be made for a week or two, that is well known. But there was another development taking place simultaneously that was poorly analyzed by our specialists, and by Western experts. In order to restrain inflation, a powerful process was introduced for the withdrawal of monetary income of the population available for the purchase of hard currency, first and foremost of American dollars.

Please see the chart: "SAVINGS OF POPULATION AND PURCHASE OF CURRENCY" (page 8). The left bar indicates the population's bank deposits and purchase of securities, and the right bar represents the purchases of hard currency. It is easy to see how the priorities of people's savings patterns changed. It is broken down by quarter in 1994, while the pair of bars on the right are for the month of October, 1994.

After the bankruptcies of a series of banks, the people's trust in government securities and banks dropped dramatically, and the population switched to purchasing hard currency as the most reliable means of protecting personal income. This trend clearly illustrates one of those structural changes -- the growing demand for hard currency -- which were taking place. In just ten months, the population has bought about US \$13-\$14 billions. So, we "creditized"



the population to the tune of 13-14 billion dollars. And at the same time we are going all over the world begging for \$500-\$600 million.

Now the government says that public savings are increasing sharply, every fifth rouble goes into savings. But, here the government is combining two contradictory concepts: real savings in bank accounts and securities, and the purchase of hard currency. I mentioned before the shift in the structure of income and expenditures of the Russian people.

Please see the chart "STRUCTURE OF POPULATION'S MONETARY INCOMES AND EXPENDITURES, (%)" (page 10). This chart gives data on 1993 and 1994. Let me first cover expenditures, the right hand column on the chart. The purchase of goods and services has declined a bit as a percentage of the total. Taxes and mandatory payments also decreased. Money deposited in savings accounts and securities went up a bit (but not every fifth rouble [as claimed by the government], but every sixteenth rouble of income). Note the sharp increase in the purchase of hard currency. If you combine these last two items, you get the 20% "savings" the government is talking about. However, this is not a source of investments. This money is being spent on luxury goods, expensive resorts, et cetera.

I will not discuss the moral aspect of this issue -- it is a different topic -- but it does touch on a problem with cash in the economy which last year was more serious.. It was a very serious issue, it was forcing inflation. Now this proportion has decreased sharply.

I would also like to comment briefly on the dramatic shift in the structure of incomes of the Russian people, including high and low wages paid for labor; that is, the payment received for all forms of labor. As you see from the left hand column on the same chart, the proportion of wages from labor decreased sharply, by 14% in just the one year 1993-1994. Social transfers, such as pensions and student stipends remained stable. However, the percentage of income derived from property, or from operations with goods, or interest and dividends, rose sharply.

We compared our income structure to those of the West: including the U.S., U.K. and Germany. In none of these other countries with market economies did we find the proportion of income from labor so small as in Russia. In these foreign countries it constitutes about two thirds. The percentage of income from property is not, as a rule, more than 20% in those countries. Social transfers vary from country to country depending upon the socio-economic policies chosen by each.

**Structure of population's monetary incomes and expenditures (%)**

<b>Monetary incomes</b>	<b><u>1993</u></b>	<b><u>1994</u></b>		<b><u>1993</u></b>	<b><u>1994</u></b>
<b>1. Wages</b>	<b>64,1</b>	<b>50</b>	<b>1. Purchase of goods and services</b>	<b>70,7</b>	<b>66,5</b>
<b>2. Social transfers (pensions,stipends, allowances)</b>	<b>15,8</b>	<b>15,5</b>	<b>2. Social duties and payments</b>	<b>8,2</b>	<b>7,3</b>
<b>3. Incomes from property and enterprenership activities</b>	<b>20,1</b>	<b>34,5</b>	<b>3. Savings invested into securities and deposits</b>	<b>4,7</b>	<b>6,9</b>
			<b>4. Purchase of currency</b>	<b>5,7</b>	<b>13,8</b>
			<b>5. Increase of cash money</b>	<b>10,7</b>	<b>5,5</b>
<b>Total incomes</b>	<b>100</b>	<b>100</b>	<b>Total expenditures</b>	<b>100</b>	<b>100</b>

The last topic is the budget deficit and how it ought to be covered, please see the chart: "EXECUTION OF FEDERAL BUDGET IN JANUARY-SEPTEMBER, 1993" (page 12).

This is not the entire structure of the budget. This is data from a nine month period only. If we take total expenses, you see that almost half are encompassed by deficit. The deficit is currently 11.2% of the GDP. And, it is covered mainly by Central Bank credits and incomes. You can also read in official statements that the Central Bank is at fault for inflation because it grants large loans. What remains unsaid is that the number one recipient of these loans is the Russian government. And to get loans back from our government is almost impossible.

I would like to wrap up now, as I have overextended my time. A new model is now being proposed to cover the budget deficit for 1995. The government would like to stop borrowing from the Central Bank, and instead cover the deficit by issuing government notes and bonds. By itself, the idea may seem not so bad, but it is proposed without serious analysis, without calculation of the size of the financial market. The danger arises that a financial market that is just being born, will essentially be filled by government securities, leaving no room for private commercial securities.

We are often asked -- What is your solution? Where to you see the exit from the situation we are in? The last time the government approached us it was in the context of the preparation of a new three-year program for the development of reform for the period 1995-1997. In mid-October we completed our recommendations and passed them on to the government.

It is hard to say what the government will do with this report. Perhaps it will be as before -- put into the waste basket. A large group of my colleagues, contributors to this report, asked me -- "Why should we try our best with this if nobody wants it?" But I, like a preacher, called upon their patriotism, conscience, good will, honesty, moral and professional duty. But, in order that our work leave some trace, we decided to publish our recommendations, and they appear in the latest issue of "Problems of Economy" under the Title "From Crisis to Stabilization of the Economy, and its Future Growth".

I would like to pass this issue to Professor Millar. It contains all that I have written earlier about our crisis. It would be difficult to describe in a few words the contents of the program, but it proposes making a sharp structural maneuver in the economy that should be in effect for a year to a year and a half. This is in order to eliminate deformations in the Russian economy, and to provide the ground for stabilization and to stimulate business activity. It is of great importance to restore the trust of the people in the government and banking structures. That cannot be done with mere words or promises. It comes through public experience.

# EXECUTION OF FEDERAL BUDGET

IN JANUARY-SEPTEMBER, 1993

	Trillion roubles	In % to GNP	In % to annual budget		Trillion roubles	In % to GNP	In % to annual budget
Total expenses	95,2	23,2	48,9	Total Income	49,4	12,1	37,9

Deficit 45,8 11,2

including:

Central bank  
credits 34,6

Central bank  
profit 1,6

Government  
bonds issue 5,0

Foreign credits 3,9

## NOTE:

GNP in January-September 1994  
was 407,7 trillion roubles, that was  
84% of January-September 1993 level

It is important to broaden the social base of reforms; at present this base is ever-shrinking through the sharp reduction of the middle-class. Expansion of the middle class can come most quickly first and foremost by active development of small enterprise and small business initiatives, and through the engagement to that end of local structures and authorities. That is essential for Russia as a federal state. And just such a local movement of small business would permit rapid expansion of the social base, and creation of the basis for a middle class as a necessary condition for social and political stability in the society.

We are thinking in realistic terms, we are not promising a speedy solution to the economic situation... *[tape interrupted]* ...But the professional part of this program is presented in detail, concretely concerning institutional development, banking policy, and all manner of topics; and those who are interested may make a copy of the report and have it translated.

I am now over my time limit, but I am sincerely grateful for the attention with which you have been listening. Thank you.