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RUSSIA'S UNSTEADY ENTRY INTO THE GLOBAL ECONOMY¹

PETER RUTLAND

Russia has come a long way since 1991 in terms of opening up its economy to the outside world. Hundreds of Western firms have established themselves in Moscow, and doing business there is on balance much easier than it was in the past. The ruble has become a convertible currency, and Russian consumers have gained access to a wide range of Western consumer goods. It may come as a surprise to learn that, despite Moscow's repeated pleading for loans from the IMF, Russia has increased its exports to the developed economies, and has been running a trade surplus in excess of $15 billion a year.

However, the optimistic projections of the liberal economists who advised the Russian government to launch "shock therapy" in January 1992 have not yet born fruit. The rise in Russian exports has not been accompanied by a revival of Russia's domestic economy. On the contrary, many critics suggest that it has come at the expense of Russia's economic development. The trade boom has been driven by the export of oil, gas, and metals. Russian nationalists describe this as the "Kuwaitization" of the economy, and complain that their country has become "a raw materials appendage" of the imperialist West.

In more measured tones, one can acknowledge that Russia's incorporation into the global economy has taken the form of "shallow integration" - a rise in trade with the developed capitalist economies - and not "deeper integration," which would involve structural change, such as an increase in foreign investment. Many important projects in the oil and gas sector remain in limbo due to political infighting and legal confusion. The prevailing pattern of trade has led to intense conflicts within the Russian political system, which makes the future course of Russia's international economic relations somewhat unstable.

The more problems Russia has in gaining access to world markets, the more difficult it will be for the dwindling band of economic liberals in Moscow to prevent the formation of a protectionist coalition, which would try to revive Russian manufacturing and farming behind high tariff barriers. However, the global economy today is dominated by increasing inter-dependency and a steady increase of cross-border flows of goods, capital, and labor. Judging by the experience of the past four years, the Russian state is in such a debilitated condition that it is unlikely to be able to stand up against such forces.

Successes and failures

Five years into the economic transition, Russia's economic record is a mixture of unexpected successes and obstinate failures.² The private sector accounts for some two thirds of economic activity (more, if one includes the shadow economy). Most Russian firms now operate

¹Forthcoming in Current History (Washington DC) October 1996.
²An invaluable source for economic information is the quarterly Russian Economic Trends (Moscow: Russian European Center for Economic Policy), and their monthly updates.

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as independent joint stock companies, setting their own prices and seeking their own customers and suppliers without being subject to the dictates of central planners. Few would have expected the entrenched cadres who ran the Soviet economy to have so readily switched to market relations - but the collapse of the central planning system in 1991 left them no choice. A dynamic financial sector has emerged as if from nowhere, with 2,500 commercial banks aggressively pursuing profits and creating new financial instruments with such bewildering speed that legislators and regulators cannot hope to keep up with them.

Almost as remarkable as the emergence of market institutions has been the government’s ability since 1994 to bring down inflation by kicking the habit of printing money. Consumer prices rose by just 0.7% in July 1996. If sustained, this would mean annual inflation for 1996 of 20-25%, down from 215% in 1994 and 130% in 1995. The ruble has become convertible for current operations, and is more or less holding its value in real terms against the dollar. In 1995 the budget deficit was held to 3.9% of GDP, according to official calculations. The IMF was sufficiently confident in the government’s stabilization program that in March 1995 it granted a $6.5 billion stand-by loan, and a $10.1 billion Extended Fund Facility a year later.

However, progress in some directions sits alongside absolute lack of change in many sectors of the economy. Agriculture remains almost entirely unreformed. State and collective farms have changed their legal name, but continue to function as before - except they are starved of the subsidized fuel, fertilizer, and machinery which they depended on in the past. The nation’s 200,000 private farmers lack capital, are denied the best land, and account for less than 5% of the nation’s food production. Many urban families rely on their garden plots to supplement their diet.

Table 1: Economic performance in 1995 and first half 1996

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>% change over 1994</th>
<th>1996</th>
<th>% change over first half 1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1,659</td>
<td>-4</td>
<td>1,065</td>
<td>-5</td>
</tr>
<tr>
<td>industrial output</td>
<td>989</td>
<td>-3</td>
<td>618</td>
<td>-4</td>
</tr>
<tr>
<td>agricultural output</td>
<td>276</td>
<td>-16</td>
<td>110</td>
<td>-7</td>
</tr>
<tr>
<td>capital investment</td>
<td>250</td>
<td>-13</td>
<td>133</td>
<td>-14</td>
</tr>
<tr>
<td>retail trade turnover*</td>
<td>553</td>
<td>-7</td>
<td>356</td>
<td>-2</td>
</tr>
<tr>
<td>exports ($ bn)</td>
<td>77.8</td>
<td>+18</td>
<td>41.6</td>
<td>+5</td>
</tr>
<tr>
<td>imports ($ bn)*</td>
<td>57.9</td>
<td>+15</td>
<td>30.2</td>
<td>+11</td>
</tr>
<tr>
<td>real personal income</td>
<td>-</td>
<td>-13</td>
<td>725,000</td>
<td>0</td>
</tr>
</tbody>
</table>

(monthly, in rubles)

*Includes estimates of unrecorded activity

Most worrying of all is the fact that despite the surprisingly rapid emergence of market institutions, output continues to plummet in a downward spiral. (See Table One.) Industrial and agricultural production has slumped by about half since 1991. Optimists argue that much of the lost output was "negative value added" - that is, the production of military hardware, grandiose irrigation projects, and the like, which would have no value in a market economy. Even allowing for this, however, it is clear that the production of items that industry and consumers would find useful (oil, trucks, clothes, food) has fallen and continues to fall - even in 1996. The Russian economy is experiencing a structural collapse greater than that of the U.S. "Great Depression" of the 1930s, and the turnaround is not yet in sight. On the positive side, one can note that the depression has brought about some much-needed structural change. Services rose as a proportion of GDP from 43% in 1993 to 53% in 1995, while manufacturing fell from 50% to 29%.

So deep is the fall in output that it has eroded the country's tax base, making it very difficult for the federal government to raise revenue to pay for national programs - for defense, pensions, and subsidies for outlying regions of the Far East and Arctic North. To a worrying extent, the government's success in macroeconomic stabilization has involved shoving the costs of adjustment onto those in society least able to object: peasants, pensioners, and workers.

The growing fiscal imbalance threatens to overwhelm the government's achievements in monetary policy. In order to cover the yawning budget deficit, which rose to some 6% of GDP by mid 1996, the government began selling treasury bills (many bought directly by the Central Bank), and has tolerated the issuance of bills of exchange of dubious provenance by banks and enterprise. These machinations could unleash another financial crisis (worse than those of October 1994 and August 1995), and cause a fresh round of inflationary money creation.

On the other hand, with each passing year the government's ability to regulate the new financial institutions improves. It is possible that Moscow will continue its gravity-defying balancing act, and will manage to preserve monetary and price stability - even amidst a collapsing economy. President Boris Yeltsin's reelection in July 1996 adds weight to the optimistic interpretation - despite a worrying flurry of pre-election largesse, in which Yeltsin spent around $4 billion clearing the backlog of wage and pension arrears. Russia's economic policy will remain in the steady hands of Prime Minister Viktor Chernomyrdin, who has been at the helm since December 1992.

An important feature of the wrenching process of economic adjustment has been a sharp increase in inequality - between social groups, and between regions. While Moscow and some other metropolitan centers are experiencing a boom, most of the rest of the country has slipped into a subsistence mode of existence. While the "New Russians" enjoy $4,000 dinners in
Moscow, the children of coal miners in the Far East are hospitalized with tapeworm because they have been eating improperly-cooked dog meat.³

This situation is so contradictory that one assumes it must be transitory. Russia is still in transition, the argument goes, and one can expect market forces to finally prevail - next year, maybe the year after. The alternative is that Russia could succumb to a restoration of the socialist economy (if Gennady Zyuganov had won the presidential elections, for example). In fact, neither of these futures is particularly realistic, and Russia will probably remain trapped in the contradictory status quo for the foreseeable future. A glance at China, Brazil, or India suggests that uneven development of the sort which Russia is experiencing may well be an integral feature of the functioning of the modern capitalist economy. Russia’s contradictions stem not from its incorrigible uniqueness when confronted with modernity, but in fact indicate that it has re-joined the modern world economy.

How is it possible that a society can simultaneously witness the accumulation of wealth and a rise in poverty? How can it be that some sectors of the economy are experiencing a boom while others are stagnant? The key factor to bear in mind is that the Russian economy is no longer functioning as a closed system whose logic is essentially internally determined. Rather, the economy has opened up to the influence of international economic forces, and many key economic decisions are being driven not by the whims of planners in Moscow, but by price signals emanating from London, Frankfurt, and New York. It is the international dimension which is responsible for squaring the circle, for explaining how it is that Russia can simultaneously experience a boom and a slump in economic performance; reform and stagnation in institutional change.

Liberalization has made foreign trade highly profitable, and the export-oriented sectors are islands of wealth-generation in a sea of economic recession.⁴ The proceeds of the export industries are divided between the elites who control the extractive industries (symbolized by Prime Minister Viktor Chernomyrdin, the former head of the natural gas monopoly Gazprom) and those who run the new commercial banks. Perhaps 65-75% of these elites come out of the ranks of the old nomenklatura. The remainder are new entrepreneurs, with a diverse range of previous careers - from academic institutions to the criminal underworld.

Given the political and economic instability in Russia, businessmen and corporations generally prefer to put the proceeds from trade into foreign bank accounts or real estate, rather than invest in new oil wells or assembly plants in Russia. Favored locations include Cyprus, London, and the French Riviera. The liberalization of foreign trade provided them with this

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option, and, like capitalists in Argentina and Brazil, they have seized it with a vengeance. "Capital flight" by individuals and corporations runs at about $10-15 billion a year, and has cumulated to some $40-50 billion since 1991. (Only a fraction of this sum is captured in official trade statistics.) With the genie now out of the bottle, the government faces the daunting task of trying to lure this money back into Russia. In order to understand how this state of affairs arose, it is worth reviewing the development of Russia's foreign economic relations since 1991.

Patterns of foreign trade

Even during the Communist era, Russia was not cut off from the world economy. The Soviet Union traded heavily with East Europe, and to a lesser extent with the West, but this trade accounted for less than 20% of Soviet GDP, and took place under strictly monitored conditions that only changed slowly from year to year. The situation became more dynamic in the 1980s. The rise in world oil prices in the 1970s was a boost for the Soviet economy, but the stagnation of oil prices and the fall in the U.S. dollar after 1985 dented Soviet export earnings and turned up the economic heat on Mikhail Gorbachev, who ran up international debts of $67 billion in order to fund his perestroika program.

Since 1991 the exposure of Russian economic decision-makers to the pressures and incentives of the global economy has increased massively. This applies equally to consumers, industrialists, and politicians - although the impact is very unevenly distributed within these groups across the length and breadth of Russia.

Under the Soviet Union exports stood at about $59 billion in 1990, of which $11 billion went to Eastern Europe. (Official Soviet figures showed exports of $104 billion, with $52 billion going to Eastern Europe. Measuring foreign trade in the planned economy was an inexact science.) The Soviet trade balance deteriorated from $4 billion surplus in 1985 to $5 billion deficit in 1989, as the ailing economy sucked in more imports, paid for by international loans.

Since 1991, Russia has seen a sharp fall in trade with Eastern Europe and a boom in exports to the West. The Comecon system of centrally-negotiated trade between the East European states (denominated in the elusive "transferable ruble") suddenly collapsed in 1990-91. Customers in East Europe and in Russia lacked the dollars to purchase imports outside the Comecon system, so by 1993 the trade volume between in Russia and its Comecon partners had fallen to 20% of the previous level. East Europe's share of Russian foreign trade fell from 44% in 1990 to 24% in 1993.

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Most trade restrictions and price controls were lifted as part of the "shock therapy" launched by Yegor Gaidar in January 1992. Limits on dollar transactions were eased and the ruble became for most practical purposes a convertible currency. Enterprising Russian businessmen soon found customers for Russia's oil, gas, metals, minerals, and timber in the West.

The export boom has been sustained despite the continuing recession in the domestic economy. Exports to countries beyond the CIS slumped in 1991 but began recovering in 1992, and by 1995 had grown above the 1991 level. (See Table Two.) Imports fell by nearly half after 1991, and only started to grow in 1994. These trends continued in 1995: exports to countries beyond the CIS rose 25% and imports rose 12%, while exports to the CIS fell. Only in the first half of 1996 was there an increase in the share of trade with the CIS.

Most of the rise in exports was due to an increase in volume of shipments. The prices of core Russian export commodities such as oil, aluminum, and copper fell during most of the period 1991-95, not least because of the flood of Russian products onto the world market. In 1995, for the first time, the Russian terms of trade improved by about 10 percent.

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports</th>
<th>Imports</th>
<th>Trade Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>50.9</td>
<td>44.5</td>
<td>6.4</td>
</tr>
<tr>
<td>1992</td>
<td>42.4</td>
<td>37.0</td>
<td>5.4</td>
</tr>
<tr>
<td>1993</td>
<td>44.3</td>
<td>26.8</td>
<td>17.5</td>
</tr>
<tr>
<td>1994</td>
<td>50.1</td>
<td>28.3</td>
<td>21.8</td>
</tr>
<tr>
<td>1995</td>
<td>64.3</td>
<td>41.6</td>
<td>22.7</td>
</tr>
</tbody>
</table>


Imports (such as grain) paid for out of the federal budget fell from $30 billion in 1991 to $12 billion in 1993.¹ In their place Russian consumers started to show their preference for Western products. Imports probably account for 50% of the consumer goods now sold in Russia.

1992-93 saw the rapid "dollarization" of the domestic economy, as consumers and firms fled from the rapidly inflating ruble. Perhaps one quarter of the transactions in the Russian economy are denominated and/or paid for in U.S. dollars. With an officially-reported average wage equal to around $120 a month, however, most Russian consumers will be buying more Snickers bars than TV sets.

Russia's trade with CIS member-states deserves separate mention. In Russia's neighbors, economic reform has generally been slower, and economic decline even steeper, than in Russia itself. Russia continued to subsidize these countries through 1992 and 1993, but thereafter Moscow radically cut the level of implicit subsidies. Russia continues to have problems getting Belarus and Ukraine to pay for their energy deliveries, however. Even though Russia has switched to dollar accounting and advance payments for most of its trade with CIS neighbors, their indebtedness grew to around $9 billion by the end of 1995.

In July 1995, a new customs union came into effect between Russia, Belarus, and Kazakhstan, formally lifting all customs controls on goods from those countries. However, effective controls have not yet been put in place along Russia's long borders with Kazakhstan, Belarus, and Ukraine. Although Moscow has a strong geopolitical interest in maintaining a sphere of influence in the territory of the former USSR, it is no longer willing to pay the price in economic terms. In what could be the birth of a Russian variety of "neo-colonialism," Russian firms have shown a strong interest in acquiring assets in CIS countries - proposing debt-equity swaps with gas transit companies from Moldova to Lithuania, for example. Russian oil and gas companies, such as Lukoil, became active in development projects with Azerbaijan and Kazakhstan. Russia is able to hold these countries hostage given their current dependence on pipelines across Russia for access to Western markets. In November 1995, for example, Lukoil won a 33 percent share in the project to exploit the Karabakh field in the Caspian Sea.

Assessing Russia's export boom.

While Russia's ability to expand its exports to the West is good news, there are several grounds for doubting whether it will provide a sustainable, long-run basis for Russia's integration into the global economy.

First, it is important to distinguish between trade creation and trade diversion. The former contributes to economic growth; the latter just involves switching from one customer to another. Since 1991 Russia has seen more trade diversion than creation, since the surge in exports to the West has coincided with a slump in trade with the other ex-Soviet states and with the former East European trading partners. Russia's failure to experience trade creation and an export-led growth recovery can be attributed to several factors: the severe dislocation of domestic economic
activity, the breakdown of trade with East Europe, and the maintenance of trade barriers for key commodities in the West.

Second, a look at the commodity composition of Russian exports provides some evidence for the "Kuwaitization" of the Russian economy - that is, the expansion of natural resource exports and a slump in foreign sales of high value-added industrial products. Western advisors had suggested that rapid trade liberalization would cause a boom in manufacturing exports, thanks to Russia's combination of low wages and a highly skilled workforce. This failed to materialize. Russian manufacturers lost their protected markets in the former Soviet Union and East Europe, and at home were exposed to an influx of imports, from clothing to electronic goods, that were better designed, more technologically advanced, and often cheaper than their Russian counterparts.

Energy alone accounts for about 40% of Russian exports, and precious stones, metals, and chemicals make up most of the remainder. Such basic products do not encounter any quality problems in Western markets, and their export is encouraged by the fact that energy prices continue to be regulated within the Russian economy - despite repeated promises to the IMF to desist such practices. Oil and gas sells for about 70% of the world market price - but many Russian customers do not pay their bills, so the actual price paid is even lower. The availability of energy at below world prices makes it easy for metals producers to undercut rival suppliers on the global market. At the same time the low domestic price make it advantageous for oil and gas producers to sell to Western Europe rather than inside Russia.

These points about relative pricing suggest that the export boom may be a house built on sand. Russian energy and mining industries have one foot in the world market and the other foot in the grave of the command economy. The export boom has in part been predicated on the slow pace of development of market economy. The persistence of price differences also helps explain another striking feature of the Russian transition economy - its failure to recycle the proceeds from exports back into the Russian economy.

Thus Russia has developed a schizophrenic economy, and there is a real danger that the core export sectors, such as energy and metals, could be dragged down by the continuing domestic recession. Non-payments by the Russian customers of the energy industries, including government budget organizations, is a chronic problem. During the high inflation years these debts wiped themselves out within months, and the economy had a sort of dynamic stability. With the slowing of inflation and the tightening of monetary policy, the debt problem has become more severe. In 1995 efforts by energy producers to cut off supplies to housing districts and to military bases provoked a storm of political controversy, and in September a decree was issued banning such actions. The same problems resurfaced in the summer of 1996.
Even within the energy industry itself, money is not being recycled back from the foreign trade operations to the producers out in the oil and gas fields of Western Siberia. Oil and gas firms are among the worst offenders when it comes to delays in the payment of wages to their workers. Paradoxically, in November 1995 one of Russia’s major oil producers, Nizhnevartovskneftegaz, was effectively placed into receivership because it was unable to pay wages or taxes. Many steel mills and timber processors face a similar plight. The ruptures in the internal economic system mean that even the export sectors are not getting the investment they need: oil output continues to fall at about 3% a year.

The Russian government was and is bitterly divided over the correct strategy for resolving the contradictions involved in Russia’s foreign trade. The existing system initially arose out of the principled commitment of the members of the Gaidar team to trade liberalization. They were mostly eased out of office during 1992, but the reforms they had instituted remained largely in place. Since then the main pressure for further liberalization has come from Russia’s international lenders. The leading reformer who stayed inside the government was First Deputy Prime Minister Anatolii Chubais, who orchestrated the privatization program and then took over overall responsibility for economic policy in November 1994 (until his dismissal in January 1996). Chubais favored pressing ahead with full liberalization, while Oleg Davydov, the Minister of Foreign Economic Relations, called for a return to stricter controls. In political terms, Davydov seemed to be winning the argument, since protectionism was one of the few policies around which the politicians in the fractious Duma could unite. However, real power lies with the president and government, and there the commitment to moderate reform remains strong.

The big losers in Russia’s trade liberalization have been the nation’s farmers and food processors, light industries (such as textiles), and manufacturers of consumer goods (such as TVs). Defense plants have seen their orders slump by more than 80%, and civilian heavy engineering has not done much better. Some manufacturers have fared better than others. Auto makers have seen truck sales collapse (due to the decline in military and farm orders), but most have seen auto sales hold up, helped in part by steep tariffs on car imports and the absence of foreign-owned assembly plants. The defense industry lobby still has many representatives in the lower reaches of the government, but they have consistently lost out in Kremlin power-struggles. They lack money - a crucial political commodity in modern Russia - and are disoriented and somewhat discredited because of their close association with the failed Soviet political system. They have pinned their hopes on finding new foreign customers for Russia’s space, aviation, and nuclear technologies, and on a revival of Russian arms exports. Russia’s share of global arms
deliveries jumped from 4% in 1994 to 17% in 1995, but this still represents only some $2 billion a year - much less than the profits of the energy barons.⁹

Recent developments

The government realized in 1995 that the only way to make Russia an attractive place for Russian investors (let alone foreigners) was to create a climate of political stability and low inflation. Moscow was able to build upon their tight monetary policy and introduce a "ruble corridor" in July 1995. The Central Bank announced that for the next three months it would intervene to keep the ruble’s value between 4.300 and 4.900 to $1. The corridor was later extended, until May 1996, when they switched to a "crawling peg" system, under which the ruble is allowed to gradually depreciate in line with domestic inflation. At the same time the Central Bank announced that Russia would conform to IMF Article 8 on current account convertibility. Investors welcomed the predictability and stability which came with a managed exchange rate, but the move angered commercial banks, who had profited from currency speculation. Oil and metal producers also complained that by slowing the depreciation of the ruble the corridor made exports much less profitable - yet the figures show exports in fact continued to rise.

The nominal exchange rate went from 3.560 rubles/$ on 1 January 1995 to 4.630 rubles/$ on 31 December. Allowing for domestic inflation means that the real value of the ruble appreciated by about 30 percent in 1995. In 1996 the ruble fell gradually, to 5.230 rubles/$ on 31 July. Foreign exchange reserves rose from $3 billion to $11 billion over the course of 1995, but fell back to $4 billion after the bout of pre-election spending in spring of 1996.

The main issue over the past year has been the continuing pressure from the international business community, principally the IMF, to persuade the government to complete trade liberalization. However, this pressure met resistance from domestic lobbies who stood to lose from the changes, and from the Finance Ministry, who regretted the lost revenue.

Oil and gas export quotas were lifted from July 1994, and the system of special oil exporters (which served as a surrogate quota system) was abolished in March 1995. Many export duties were cut in the fall of 1995. In July 1995 higher import tariffs were introduced for many products, including food, although the top rate was dropped to 30 percent. The government repeatedly promised, then postponed, to lift all export duties on oil and gas. When this was finally done, in July 1996, the duties were replaced by a differential oil pipeline transit fee which may have the same impact as the abolished duties.

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Investors stay wary

Despite the opening of the economy to foreign trade, foreign investors remain wary of Russia’s political and economic uncertainty.

Direct foreign investment has cumulated to some $5.5 billion, with about $1.9 billion coming in 1995.\(^{10}\) This compares dismally with the $83 billion which flowed into China between 1984 and 1994, and $10 billion into Eastern Europe.\(^{11}\)

In theory, investors should have been attracted by the large untapped markets, cheap labor, and vast natural resources. In return, foreign investment would lower the cost of capital in Russia and bring in new technology and managerial expertise. In practice, investors were scared away by political uncertainty, crime, corruption, and the inability of the legal system to enforce contracts. Foreign corporations need to establish close ties with a Russian partner in order to steer through the political and legal minefield, and even this is no guarantee of success. There are no restrictions on profit repatriation (except for operations with treasury bonds), and the 1991 investment code guaranteed foreigners equal rights - but did not provide for any special incentives.

The legal situation governing mining concessions and production sharing is obscure, and was not resolved by Yeltsin’s December 1993 decree on the subject. The much-needed Law on Production Sharing eventually won parliamentary approval in December 1995, but the final version contained several clauses that were seen as disadvantageous for foreign investors \(\ddagger\) such as granting the government the right to amend contracts retroactively, and quotas for the purchase of Russian equipment. A step forward was the lifting in July 1996 of taxes on imports of equipment paid for with foreign loans, which had been introduced in March 1995.

One of the biggest investment projects on the horizon is the $40 billion plan to rebuild the telecommunications system. However, the Russian government has not been able to strike a deal with a foreign partner. A plan to sell off 49% of a telecommunications holding company, Svyazinvest, collapsed in December 1995 when the winner, the Italian STET, withdrew its $1.4 billion bid three weeks after the auction, claiming financial misunderstanding.

The largest single deal in dollar terms was the 1990 agreement with De Beers, giving the latter company the right to market 95% of Russian diamond exports in return for a $1 billion credit. Diamond exports earn Russia more than $1 billion annually, although De Beers repeatedly accused Russia of selling more than its allowed quota on the world market. Only after acrimonious negotiations was the deal extended in 1996.


In the crucial oil and gas production sector only about a dozen joint ventures with foreign investors are actually in operation. Russian corporations often form alliances with provincial authorities in the oil regions in order to block foreign projects. Elf's 1992 deal in Saratov was delayed by the political deadlock with regional authorities, and even by 1996 was still not pumping oil. In March 1994 Marathon, Shell, Mitsui, Mitsubishi, and McDermott agreed to move ahead with a $10 billion oil development project in Sakhalin in the Russian Far East, but two years later, the ground has not yet been broken. Talks with Texaco and Norsk Hydro for development of the giant TimanDPechora field in the far north (requiring $80 billion investment) have dragged on for three years. The Russians are balking at the 17-25% rates of return which Western firms require for projects inside the former Soviet Union.

The mass privatization program launched in 1992 saw the transfer of ownership to managers and workers, with only a handful of foreign owners purchasing a controlling share in Russian firms (a few pulp mills, for example). In the second round of "cash privatization" the choicest assets, such as Norilsk Nickel and the Surgut oil and gas company, were sold in return for loans arranged by Russian banks. Foreigners were effectively excluded from these shares-for-loans auctions, which were won by insiders ÷ either a subsidiary of the company being sold, or the bank that was running the auction.

The national leaders of Russia, Germany and the U.S. have shown the political will to promote trade and investment, but that has been insufficient to overcome the internal barriers to foreign investors.

A bilateral investment treaty was signed with the U.S., but has still not been ratified by the Duma. Under the June 1992 summit agreement, the U.S. OPIC can provide political risk insurance for projects in Russia up to a total of $3.4 billion coverage, plus an additional $500 million for defense conversion. The Gore-Chernomyrdin commission has been meeting regularly and monitoring progress in economic relations, from chicken exports to aerospace joint ventures to uranium sales.

International aid and the debt problem

Supervision of the integration of Russia into Western markets was left in the hands of the existing international financial institutions. (Russia became a full member of the IMF in June 1992.) No special agencies were created along Marshall Plan lines to coordinate the transition. Western governments have tried to use debt negotiations to force Moscow to implement liberalization and stabilization policies. The evidence from the Third World suggests that this approach can help reduce balance of payments deficits, but has a mixed impact on growth and a negligible impact on inflation. A similar picture is emerging in Russia.
Relations between Russia and the IMF soon fell into a familiar ritual. An IMF mission flies to Moscow and lays down stringent conditions for the next standDby loan and/or G7 package. The Russian government haggles, but eventually agrees to take steps to free energy prices, lift export restrictions, and meet targets for the budget deficit and monetary growth. The weeks turn into months, and for one reason or another the Russian government fails to meet the IMF conditions. Despite this, so as not to embarrass the reformist wing of the Russian government, some fraction of the promised loan is dispatched. And then the cycle begins anew.

Soviet debts rose from $29 billion in 1986 to $67 billion at the end of 1991. Russia, which took over responsibility for all the Soviet Union’s international debts (and assets) in December 1992, could not make the $15.6 billion and $21.2 billion payments due in 1992 and 1993.

In April 1992 the G7 countries announced a $24 billion aid package (of which $10 billion was debt relief). Russia failed to meet the conditions laid down by the IMF for disbursement of the loan, and most of the package was not paid out. All sorts of promises were made in the runDUp to the 25 April 1993 referendum (testing confidence in Yeltsin’s policies) - a $49 billion aid package, and a new IMF Systemic Transformation Facility, which would transfer $4-6 billion to the former Soviet Union without the sort of strict conditionality usually attached to IMF loans. Russia was granted $2.9 billion in World Bank loans in 1994-95. 12 US aid to Russia in 1995 was cut to $379 million (compared to $1.6 billion in 1994). 13

In late 1994 Moscow said it intended to cover half the projected budget deficit for 1995 by selling $12 billion of securities in international markets, a strategy which hinged upon IMF approval of their budget. The government signed a memorandum with the IMF in September 1994, and 1995 was the first year in which the IMF conditions were broadly adhered to.

Negotiations continued over Russia’s international debts, which reached $130 billion by the end of 1995. (Of that sum, $19 billion were new Russian debts, and the remainder accumulated interest and payments on the Soviet debt.) In June 1995 the Paris Club of government creditors agreed in principle to reschedule the $36 billion owed them by Russia. Repayment of principal would take place over 25 years, beginning in 2002. In November, a similar deal was drawn up with the London Club of commercial lenders, who hold some $28 billion of debt. On the international secondary debt market, Russian debt fell from a peak of 40 cents on the dollar in October 1994 to 20 cents in February 1995, climbing back to 34 cents by year’s end.

Russia’s debt problem reminds one of the adage: “If you owe the bank a little money, you’re in trouble. If you owe the bank a lot of money, the bank is in trouble.” It seems as if the

international community cannot afford, politically or economically, to push Russia into default. But this ongoing problem of Russia’s unpaid debts is not very reassuring to new investors.

Trade access

Aside from rolling over Russia’s huge debt, the Western powers showed only modest enthusiasm for embracing Russia as a new trading partner. In June 1992 the US granted Russia Most Favored Nation (MFN) status, and in January 1993 Russia was awarded General System of Preferences (GSP) status by the European Community (EC). This means in principle that Russian exports should be subject to the same tariffs as those from other countries. (The average GSP tariff is 10% instead of 6%.)

However, in international trade treaties the devil is in the details. In practice, a variety of exemptions mean that Russian goods face an average tariff level of 7% in Europe and 5% in the US and Japan—almost twice that faced by developing countries. In addition, many of her key exports have been subject to non-tariff barriers, with Russia accused of dumping goods on Western markets at less than production cost. By 1993 EC quotas affected 40% of former Soviet food exports, and 68% of metals exports. In June 1993 Russia was informed that it would be denied entry to GATT because of the price distortions on its internal market and the lack of an adequate system for registering exports and imports. In 1994 Russia had to introduce voluntary restrictions on aluminum exports to forestall anti-dumping action by the US and European Union. In June 1994 Russia signed a cooperation agreement with the EU, which laid down a vague agenda for lifting trade barriers, while postponing talks on free trade till 1998.

Unlike the Central European countries, EU membership is an impossible dream for Russia. Even Russian entry into the new World Trade Organization seems unlikely in the immediate future. Foreign Economic Relations Minister Oleg Davydov complained that the other countries “are already sitting at the table, and we are standing at the door.”

The more problems Russia has in gaining access to world markets, the more difficult it will be for the dwindling band of economic liberals in Moscow to prevent the formation of a protectionist coalition, which would try to revive Russian manufacturing and farming behind high tariff barriers. However, the global economy today is dominated by increasing inter-dependency and a steady increase of cross-border flows of goods, capital, and labor. Judging by the experience of the past four years, the Russian state is in such a debilitated condition that it is unlikely to be able to stand up against such forces.

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1"Kaminski and Yeats, op. cit., p. 13.