

# **Decline of Growth Rates of the Russian Economy: Temporary or Long-term Tendency?**

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## **Interim Report**

**IR-03-032**

### **Decline of Growth Rates of the Russian Economy: Temporary or Long-term Tendency?**

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## Contents

Introduction .....	1
Alarming Facts of Year 2002 .....	1
GDP dynamics in the Russian Federation, 1999-2002.....	1
Counter-trends and Indication of Stabilization.....	5
Explanatory Arguments .....	9
Short-term Factors of Decline of Growth Rates .....	9
Long-term Factors of Decline of Growth Rates .....	12
Explanation of Stabilization Facts.....	14
Short-term Reasons .....	14
Dynamics and structure of money aggregates in Russian economy, 1999-2002.....	15
Long-term Factor.....	16
What to Do?.....	16
Instead of Conclusion: What Economic Advantages of the Russian Economy can attract the outside World ?.....	18
References .....	18

## **Abstract**

In 2002 Russian economy demonstrates the decline of GDP, investment and industry growth rates. But simultaneously we see features of stabilization too: inflation diminishes, reserves of foreign currencies grow, ruble is stable, etc.

What does all that mean? The miracle of 2000-2001 recovery is finished? We analyze the factors that lie behind these trends, both short- and long-term. What should the Russian government and society do to accelerate the rates of growth? What economic advantages of Russian economy can attract the worldwide community and business? The author of the paper tries to answer on these and related questions.

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# Decline of Growth Rates of the Russian Economy: Temporary or Long-term Tendency?

Sergey Mitsek

## Introduction

The article tries to answer the following questions: why the economic growth of Russia began to stumble in 2002? Is it short-term or long-term tendency? And what Russian government and business could do to accelerate growth rates? There are different works devoted to the current state of the Russian economy (see, for example, [13], [17]). In this report the author intends to explain his views on these issues.

A part of IIASA Dynamic System Project (DYN) is devoted to the models of economic growth with a stress on optimal patterns of it (see, for example, [15]). The author of this paper employs vice versa the traditional methods of economic analysis. But the analyzed trends can be formulated as mathematical equations and the problem of growth optimization is present here implicitly. That is why, one can view this article as a complement of DYN's activities by methods of the classical economic analysis.

## Alarming Facts of Year 2002

In 2002 the growth rates of **GDP** of Russia continued to fall after 2000-year rocketing rise (see Table 1; source of data [1], [2], author's analysis).

<b>Table 1.</b>				
<b><i>GDP dynamics in the Russian Federation, 1999-2002</i></b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>1) billions of rubles, current prices</b>	<b>4757</b>	<b>7063</b>	<b>8727</b>	<b>9684</b>
<b>2) rates of growth, constant prices %</b>	<b>5.4</b>	<b>8.3</b>	<b>5.0</b>	<b>3.9</b>
<b>Cumulative index (1998=1.000)</b>	<b>1.054</b>	<b>1.141</b>	<b>1.199</b>	<b>1.245</b>
<b>Note: The data for 2002 are recalculated in year terms based on the half-year data</b>				

**The Index of Basic Branches (IBB)**<sup>1</sup> in January-October of 2002 grew only on 3.8 % compared with the same period of 2001 (in January-October of 2001 it grew on 5.2 % compared with the same period of 2000). **The industrial growth rate** was 4.0 % compared with the same period of 2001 (5.2 % in 2001). Index of growth is composed of such industries as manufacturing, mining, agriculture, construction, transport and retail trade ( source of data [2]).

The decline of growth trends began already in June of 2001 and continues until now. The investments growth in 2002<sup>2</sup> declined drastically (see Table 2; source of data [1], [2], author’s analysis).

<b>Table 2.</b>				
<i>Investment dynamics in the Russian Federation, 1999-2002</i>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>Rates of growth, % per year</b>	<b>5.3</b>	<b>17.4</b>	<b>8.2</b>	<b>2.5</b>
<b>Note: The data of 10 months in 2002 are compared with the data of 10 months in 2001</b>				

**Foreign trade turnover** grew on **3.7 %** in January-September of 2002 compared with the same period of 2001 (**7.0 %** in January-September of 2001 compared with the same period of 2000). **Import** was the main factor in this shrinkage. From January 1999 till September 2002 it grew on 40 % in dollar rate after catastrophic drop in 2.5 times during 1998. Let us mention, nevertheless, that Russian dollar import now is still 35 % less than it was in August 1998.

Export, on the contrary is stable since July 2000 after the leap in the period 1999 – the 1<sup>st</sup> half-year of 2000. That means that the **current balance** worsens (see Table 3; source of data [2]).<sup>3</sup>

<b>Table 3.</b>					
<b>Export, import and current balance of payments in the Russian international trade, billions of dollars</b>					
<b>Year</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002<sup>4</sup></b>

<sup>1</sup> Index of growth is composed of such industries as manufacturing, mining, agriculture, construction, transport and retail trade.

<sup>2</sup> Russian official statistic agency (Goskomstat) reflects only investments in “basic capital” that is an approximate analogue of “property, plant and equipment” in the western statistics.

<sup>3</sup> Russian analytics and (even more important) decision makers should pay attention to the fact that the same picture took place in the years before 1998-year crush. In 1994-97 export was stable, in 1998 it even dropped down, and import grew each year.

<b>Export of goods</b>	<b>75</b>	<b>76</b>	<b>106</b>	<b>102</b>	<b>77</b>
<b>Import of goods</b>	<b>58</b>	<b>40</b>	<b>45</b>	<b>54</b>	<b>54</b>
<b>Current balance of payments<sup>5</sup></b>	<b>0.7</b>	<b>24.7</b>	<b>47.3</b>	<b>34.6</b>	<b>21.1</b>

Negative trend of current balance is aggravated by the payments of the **external debt** by the Russian government (\$11 billions for 9 months of 2002; \$4 billion in the same period of 2001) and by the continuing **capital outflow** from the country (about \$7.5 billion in 9 months of 2002, and \$4.8 billion in the same period of 2001), (source of data [2]).

Banks and government agencies continued to place their assets abroad instead of invest them in the country. As a result **foreign assets** of Russian Federation during the 1<sup>st</sup> half-year of 2002 grew from \$57.6 billion to \$64.6 billion. **Pure international investment position** (assets minus liabilities, PIIP) grew from \$42.5 billion to \$49.4 billion in the same period. Now it equals about 1/2 of monetary aggregate M2. Since 1994 PIIP of the Russian Federation grew three times (source of data [2]).

At the same time the external debt of Russia does not decline. Though the debt of the government decreased from \$150 billions to \$120 billions in the last 3 years the debt of private institutions grew. The total all-national debt (state and private) is still \$150 billion. Let us mention that this figure equals 2.3 times of the federal budget incomes and 1.5 times of the annual export (source of data [2]).

The growth of nominal **wages** significantly outpaces the output. In January-October 2002 it grew on 36 % compared with the same period of 2001. In the same period of 2001 this growth constituted 46 % of the level in 2000 (see Table 4; source of data [1], author's analysis).

<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002<sup>6</sup></b>
<b>Wages, rubles per month</b>	<b>1523</b>	<b>2268</b>	<b>3240</b>	<b>4253</b>
<b>Index of nominal growth,</b>	<b>144.8</b>	<b>147.9</b>	<b>145.7</b>	<b>136.1<sup>7</sup></b>
<b>Index of real growth,</b>	<b>78.0</b>	<b>122.5</b>	<b>119.9</b>	<b>117.4<sup>8</sup></b>

<sup>4</sup>The data relates to 9 months of 2002.

<sup>5</sup> The data reflects export and import of services and some other items.

<sup>6</sup> The data relates to 10 months of 2002.

<sup>7</sup> Index compares wage levels in January-October 2002 with wage levels in January-October 2001.

<sup>8</sup> Index compares wage levels in January-October 2002 with wage levels in January-October 2001.

<b>Rubles per \$1</b>	<b>24.4</b>	<b>28.4</b>	<b>29.3</b>	<b>31.2</b>
<b>Dollar value of average monthly wages</b>	<b>62.55</b>	<b>79.86</b>	<b>110.77</b>	<b>136.31</b>

This data indicates that the share of wages in GDP grows, see Table 5 (source of data [1], author's analysis).

<b>Table 5</b>				
<b>All-national wages as a share of GDP</b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002<sup>9</sup></b>
<b>All-national wages as a share of GDP including social tax, %</b>	<b>34</b>	<b>34</b>	<b>39</b>	<b>48</b>

The increment of Wages/GDP ratio leads to decline of the investment opportunities because Russian companies take more than 50 % of investments from the retained earnings. Let us note, nevertheless, that average wages in Russia is still very low - \$136 per month or about \$1650 annually. It is still lower than in 1998 in real and in dollar terms, and is lower in terms of GDP share.<sup>10</sup>

The producer **price index** (PPI) again began to outpace the consumer price index (CPI), see Table 6 (source of data [1], author's analysis).

<b>Table 6.</b>				
<b>Consumer price index (CPI) and producer price index (PPI)</b>				
<b>in the Russian Federation, 1999-2002</b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b><u>CPI</u></b>	<b>137</b>	<b>120</b>	<b>119</b>	<b>116</b>
<b>PPI</b>	<b>167</b>	<b>132</b>	<b>112</b>	<b>119</b>
<b>Note: The data for 2002 are recalculated in year terms based on the 9 months data</b>				

<sup>9</sup> The data relates to 10 months of 2002.

<sup>10</sup> Let us note that we deal here with the so-called "payroll sheet" wages. The real payment of wages may differ from GOSKOMSTAT figures, both in the "up" direction due to illegal payments "in envelopes" bypassing the accounts departments, and in the "down" direction due to arrears of wages. More over, the wages is statistically calculated only for large and medium-sized companies. This statistical data for wages covers only about 60 % of labor.

Therefore, the cost inflation still takes place in Russia in addition to monetary inflation.

The rate of growth of **bank credits** decreased also (see Table 7; source of data [2], author's analysis).

<b>Table 7.</b>					
<b>Bank credits in the Russian Federation, 1999-2002</b>					
<b>Date/Year</b>	<b>01.01.99</b>	<b>01.01.00</b>	<b>01.01.01</b>	<b>01.01.02</b>	<b>01.09.02</b>
<b>Bank credits,</b>	<b>421.6</b>	<b>596.8</b>	<b>956.3</b>	<b>1467.4</b>	<b>1808.9</b>
<b>billions of rubles</b>					
<b>Annual rates of growth, %</b>		<b>41.6%</b>	<b>60.2%</b>	<b>53.4%</b>	<b>31.0%</b>

**Remark 1.** Table 7 presents credits given both in rubles and in foreign currencies but recalculated in rubles. They include commercial, consumer, interbank credits and loans to government excluding the purchase of government notes.

**Remark 2.** The growth rates in 2002 are recalculated on the year basis.

Among all credits about 1/3 is still given to state agencies and enterprises but not to private sector.

## Counter-trends and Indication of Stabilization

In spite of negative facts Russian economy shows some features of stabilization.

The **investment** growth rate is still positive.<sup>11</sup> **Foreign investments** are growing with accelerating rate though its absolute level is still ridiculously low.<sup>12</sup>

Among all the sectors of economy only **industry** shows the decline of growth rates. The other basic branches are growing with the same rate as in 2001 and the level of **commercial transportation** even accelerates (except railway transport).

**The agricultural sector** gathered a record grain crop in 2002. Thanks to this the Russian government for the first time began to intervene the market to support grain prices. And Russia began to export grain for the first time since 1917.

Some **branches of industry** accelerated their growth amid the general decline. They are (source [1], [2]):

Nonferrous metals production (growth rate on 10 % in January – August of 2002 in comparison with the same period of 2001);

Food industry (8 %);

Oil, gas and coal mining (6 %).<sup>13</sup>

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<sup>11</sup> See Table 2.

<sup>12</sup> The foreign investments reach the level of \$8.4 billion in the first half of 2002. This increment constitutes 25 % of annual growth since in the first half of 2001 they were \$6.7 billion. In comparison, China receives more than \$100 billion of foreign investments in a year.

The **current balance of payments** (source [2], author's analysis) is still large and exceeded \$20 billion in 9 months of 2002. Thanks to this foreign reserves of the Central Bank of Russia rose on \$10 billion during this period in comparison with the same period of 2001. The growth of reserves provide a good support for ruble.<sup>14</sup>

The growth of **real disposal income** continued (see Table 8; source of data [1], author's analysis).

<b>Table 8.</b>				
<b>Real disposal income growth in Russia, 1999-2002</b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002<sup>15</sup></b>
<b>Annual real disposal income index</b>	<b>85.8</b>	<b>109.1</b>	<b>108.5</b>	<b>108.9</b>

After the crisis of 1998 Russian citizens have restored their incomes. **Real wages** also grow (see Table 4).

The **unemployment rate** continues to decrease (see Table 9; source of data [1], [2]).

<b>Table 9</b>				
<b>The rate of unemployment in Russia, 1999-2002</b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002<sup>16</sup></b>
<b>Economically active population, mln.</b>	<b>73.8</b>	<b>72.4</b>	<b>71.4</b>	<b>72.4</b>
<b>Unemployed<sup>17</sup>, mln.</b>	<b>8.7</b>	<b>7.4</b>	<b>6.4</b>	<b>5.1</b>
<b>The unemployment rate, %</b>	<b>11.8</b>	<b>10.2</b>	<b>9.0</b>	<b>7.0</b>

**Inflation** declines though not so quickly as wanted (see Table 6).

**Federal budget** has general profit for already three years (see Table 10; source of data [2], [3], author's analysis) and that helps to pay foreign debts.

<b>Table 10.</b>				
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<sup>13</sup> It is necessary to mention that growth rates of these branches decreased in the last months of 2002 and the rates of other branches began to restore.

<sup>14</sup> In the beginning of December 2002 the monetary base was equal to 1079 billions of rubles. Foreign reserves of the Central Bank of Russia were \$48.2 billion, the rate of conversion of ruble was \$1 = 31.85. So the coverage of the monetary base by foreign reserves was 1.4.

<sup>15</sup> Index compares levels in January-October 2002 with levels in January-October 2001.

<sup>16</sup> The data relates to October of 2002.

<sup>17</sup> Calculated in accordance with methodology of the International Labor Organization (ILO).

<b>Total profit (+) / deficit (-) of the federal budget of Russia, 1998-2002</b>					
<b>Year</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>Profit (+) or deficit (-) as a % to GDP</b>	<b>-4.8</b>	<b>-1.4</b>	<b>2.3</b>	<b>3.3</b>	<b>3.3</b>

Note: The figures for 2002 are calculated on the year basis using the half-year data.

**Bank credits** continue to grow though with lesser rates, and there are signs that their quality improves.<sup>18</sup> At least the share of “long” credits grew, and the same we can say about deposits (see Tables 11-13; source of data [2], author’s analysis). It is interesting that the share of loans nominated in foreign currencies also began to grow after several years of decline. That means the break of the post-1998 tendency when Russians were panicky afraid to take such credits. Russians trust more to their national currency now.

<b>Table 11.</b>					
<b>Bank credits in the Russian Federation, 1999-2002</b>					
<b>Date/Year</b>	<b>01.01.99</b>	<b>01.01.00</b>	<b>01.01.01</b>	<b>01.01.02</b>	<b>01.09.02</b>
<b>Bank credits, billions of rubles, total</b>	<b>421.6</b>	<b>596.8</b>	<b>956.3</b>	<b>1467.4</b>	<b>1808.9</b>
<b>Bank assets, billions of rubles</b>	<b>1047.4</b>	<b>1587</b>	<b>2363</b>	<b>3079</b>	<b>3718</b>
<b>Bank credits as a %, of bank assets</b>	<b>40.3%</b>	<b>37.6%</b>	<b>40.5%</b>	<b>47.7%</b>	<b>48.7%</b>
<b>GDP, billions of rubles, current prices</b>	<b>4757</b>	<b>7063</b>	<b>8727</b>	<b>9684</b>	<b>11426</b>
<b>Bank assets as a % of GDP</b>	<b>22.0%</b>	<b>22.5%</b>	<b>27.1%</b>	<b>31.8%</b>	<b>32.5%</b>
<b>Bank credits as a % of GDP</b>	<b>8.9%</b>	<b>8.4%</b>	<b>11.0%</b>	<b>15.2%</b>	<b>15.8%</b>

Note 1: Table 11 represents credits given both in rubles and in foreign currencies but recalculated in rubles. They include commercial, consumer, interbank credits and loans to government but without purchase of government notes.

<b>Table 12.</b>
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<sup>18</sup> This improvement has strong importance, not only economic but psychological too. Before the crisis in 1998 Russian banks mostly seek for super-easy incomes from GKO (short-term treasury bills) and currency exchange games. Now they began to fulfill their true functions.

<b>Bank deposits in the Russian Federation, 1999-2002</b>					
<b>Date/Year</b>	<b>01.01.99</b>	<b>01.01.00</b>	<b>01.01.01</b>	<b>01.01.02</b>	<b>01.09.02</b>
<b>Bank deposits, billions of rubles, total</b>	<b>304.1</b>	<b>461.7</b>	<b>695.8</b>	<b>971.5</b>	<b>1197.7</b>
<b>GDP</b>	<b>4757</b>	<b>7063</b>	<b>8727</b>	<b>9684</b>	<b>11426</b>
<b>Bank deposits as a % of GDP</b>	<b>6.4%</b>	<b>6.5%</b>	<b>8.0%</b>	<b>10.0%</b>	<b>10.5%</b>

Note 1: Table 12 represents deposits both in rubles and in foreign currencies, but recalculated in rubles.

Note 2: In Tables 11-12 GDP of 2002 is calculated on the year basis using the half-year data.

Note 3: In Tables 11-12 the bank statistics is given on the 1st of January and corresponds to the GDP data of the past year.

Note 4: In Tables 11-12 figures of GDP on 01.09.02 are approximated by interpolation of the rates of growth and the price index during the first 8 months of 2002.

<b>Table 13.</b>					
<b>"Long" credits and "long" deposits in the Russian banking, 1999-2002</b>					
<b>Date/Year</b>	<b>01.01.99</b>	<b>01.01.00</b>	<b>01.01.01</b>	<b>01.01.02</b>	<b>01.09.02</b>
<b>Commercial bank credits, billions of rubles</b>	<b>300.3</b>	<b>445.2</b>	<b>763.4</b>	<b>1191.4</b>	<b>1414.6</b>
<b>among them given for more than 1 year</b>	<b>126.5</b>	<b>157.9</b>	<b>226.6</b>	<b>318.3</b>	<b>426.5</b>
<b>% of total commercial credits</b>	<b>42.1%</b>	<b>35.5%</b>	<b>29.7%</b>	<b>26.7%</b>	<b>30.1%</b>
<b>Bank deposits of citizens, billions of rubles</b>	<b>201.3</b>	<b>300.5</b>	<b>453.2</b>	<b>690</b>	<b>909.3</b>
<b>among them placed for more than 1 year</b>	<b>32</b>	<b>44</b>	<b>83</b>	<b>165.3</b>	<b>282.2</b>
<b>% of total citizen's deposits</b>	<b>15.9%</b>	<b>14.6%</b>	<b>18.3%</b>	<b>24.0%</b>	<b>31.0%</b>

The share of loans given to private sector of economy increases firmly. If in January 1999 it was only 35 % than in October 2002 it was already 71 % (source of data [2], author's analysis).

The **interest rates** continue to decline steadily, especially for ruble credits and deposits (see Table 14; source of data [2], author's analysis).

<b>Table 14</b>				
<i>Annual interest rates in Russia, %</i>				
Year	1999	2000	2001	2002
Deposits (ruble)	13.7	6.5	4.4	4.4
Credits (ruble)	39.7	24.4	18.5	16.1

Note1: Growth rates for 2002 are recalculated on the year basis using the 10 months data.

Note 2. Table 14 presents only private deposits including demand deposits.

The decline of the SBERBANK share in the total amount of deposits can serve as another sign of stabilization.<sup>19</sup> People begin to trust more to private banks.

## Explanatory Arguments

Now let us try to explain the described trends. We divide explanatory factors on the short-term and long-term basis.

### Short-term Factors of Decline of Growth Rates

1. Abolishment of **profit tax privilege**. Until 2002 companies could escape from taxation 50 % of their profits if spent them for the investments. Now though the official tax rate dropped from 35 % to 24 % the effective tax rate for the investing companies increased and the investments dropped down consequently.
2. In 2002 the **prices** for some important factors of production rose significantly. Among them are the following factors:
  - Wages;
  - Electric energy;
  - Oil and oil products;
  - Natural gas;
  - Construction materials;
  - Railway tariffs.

Let us try to explain these price changes.

2a. Wages. The fast growth of wages may be explained by growing demand for labor thanks to contemporary economic growth. In 1991-1998 GDP and real wages dropped drastically. Now the bottom is over and the decline trend changed. The government (federal and local) permanently increases salaries in the state sector (though

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<sup>19</sup> The data shows decline from 73 % in October 2001 to 69 % in October 2002.

from the very low level). It is possible to do this thanks to the budget profit. And this growth trend influences on the growth of wages in the private sector.

2b. Electric energy and railway tariffs are state-controlled. Their increase was a government decision caused partly by active lobbyism of the energy sector administrators.

The economic problems of the power industry are aggravated by the decrease of production that can be explained by the obsolescence of equipment and the subsidized prices for population.

2c. Oil and natural gas. Thanks to instability of the world prices for these products (especially, due to decline of the world prices for gas) Russian companies increased supply of these products on the world market in order not to lose their revenues. These actions consequently created deficit on the domestic market. Besides, the prices on these products are also state-controlled and are lower than the world prices, and industry managers are insisting on their increase.

Thanks to the oil price increase the price for gasoline increased too and it strengthened the total cost rise in the economy.

2d. Finally, the dynamics of prices of construction materials can be explained by growing demand thanks to construction activity (especially in construction of houses).

3. The **real exchange rate** of ruble for dollar (but not for euro!) declined sufficiently. And this can explain partly the worsening of the current balance of payments (see Table 15; source of data [1], author's analysis).

<b>Table 15.</b>				
<b><i>Real rate of exchange of ruble to dollar, 1999-2002</i></b>				
<b>1999 = 1.00</b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>CPI</b>	<b>100</b>	<b>120</b>	<b>119</b>	<b>116</b>
<b>Cumulative CPI</b>		<b>120</b>	<b>143</b>	<b>166</b>
<b>PPI</b>	<b>100</b>	<b>132</b>	<b>112</b>	<b>119</b>
<b>Cumulative PPI</b>		<b>132</b>	<b>148</b>	<b>176</b>
<b>Rubles per \$1 nominal rate</b>	<b>24.4</b>	<b>28.4</b>	<b>29.3</b>	<b>31.2</b>
<b><i>Index of nominal rate</i></b>	<b>100</b>	<b>117</b>	<b>103</b>	<b>107</b>
<b>Cumulative index</b>	<b>100</b>	<b>117</b>	<b>120</b>	<b>128</b>
<b>Real rate of exchange</b>				
<b>cumulative change, %</b>				
<b>to CPI</b>		<b>-3%</b>	<b>-16%</b>	<b>-23%</b>
<b>to PPI</b>		<b>-11%</b>	<b>-19%</b>	<b>-27%</b>

Another reason for the current balance is, of course, the *high quality* of imported goods and services which can not be replaced by domestic products. The *import quotas* that the Western countries inflict on the Russian goods also impede the Russian export. Finally, explaining the situation with the current balance of payments one can mention the well-known problem that the state usually postpones to deduct the **value-added tax** paid by exporters to their contractors.

Since 1999 the Central Bank of Russia pumped the economy with **money**. But in spite of the fact that the money stock grew faster than prices and, consequently, the real cash balance grew, the rate of the GDP growth was less than the former rates. Let us have a look on the Fisher's formula:

$$(M / P)V(i) = Q.$$

Here  $M$  is money,  $P$  is price index,  $V$  is velocity of money,  $i$  is nominal interest rate,  $Q$  is real GDP. The ratio  $M / P$  (real cash balance) grew, but velocity  $V$  decreased. Therefore, real GDP  $Q$  grew less than real cash balance  $M / P$ . In 2002 the rate of money growth has declined (the reasons of this tendency are given below), so the growth rates of real cash balance also declined, and along with the decline of velocity  $V$  it led to decrease of the GDP growth rate (see Table 16, source of data [1], [2], author's analysis).

<b>Table 16.</b>				
<b><i>Real cash balances and velocity of money in the Russian Federation, 1999-2002</i></b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>CPI</b>	<b>137</b>	<b>120</b>	<b>119</b>	<b>116</b>
<b>PPI</b>	<b>167</b>	<b>132</b>	<b>112</b>	<b>119</b>
<b>M2 growth per year, %</b>	<b>57.2</b>	<b>58.1</b>	<b>43.8</b>	<b>20</b>
<b>M3 growth per year, %</b>	<b>56.7</b>	<b>58.4</b>	<b>36.1</b>	<b>23.5</b>
<b>GDP</b>	<b>5.4</b>	<b>8.3</b>	<b>5</b>	<b>3.9</b>
<b>Cumulative GDP</b>	<b>1.054</b>	<b>1.141</b>	<b>1.199</b>	<b>1.245</b>
<b>Cumulative real cash balances dynamics, 1998 = 1.00</b>				
<b>1) M2/CPI</b>	<b>1.15</b>	<b>1.51</b>	<b>1.83</b>	<b>1.89</b>
<b>2) M3/CPI</b>	<b>1.14</b>	<b>1.51</b>	<b>1.73</b>	<b>1.84</b>
<b>3) M2/PPI</b>	<b>0.94</b>	<b>1.13</b>	<b>1.45</b>	<b>1.46</b>
<b>4) M3/PPI</b>	<b>0.94</b>	<b>1.13</b>	<b>1.37</b>	<b>1.42</b>
<b>Velocity of money cumulative index, 1998=1.00</b>				
<b>V1</b>	<b>0.92</b>	<b>0.76</b>	<b>0.66</b>	<b>0.66</b>
<b>V2</b>	<b>0.92</b>	<b>0.76</b>	<b>0.69</b>	<b>0.68</b>

V3	1.12	1.01	0.83	0.85
V4	1.12	1.01	0.88	0.88
<b>Annual interest rates in Russia, %</b>				
Deposits (ruble)	13.7	6.5	4.4	4.4
Credits (ruble)	39.7	24.4	18.5	16.1

Note1: Growth rates for 2002 are recalculated on the year basis using the 10 months data.

Note2: Table 16 presents only private deposits including demand deposits.

There are several indicators of decline of money velocity and factors that can explain this trend. These signals are:

- Large bank balances on their accounts in the Central Bank of Russia.
- Budget profit.

Important explanatory factor is the decline of the interest rate since money velocity depends positively on the value of the interest rate.

One can say, consequently, that in 1999-2001 there was the great deficit of money and its growth stimulated the growth of GDP but caused inflation simultaneously. Now the saturation of economy with money stimulates decline of the interest rate (and this is a good factor) but at the same time it leads to excess of money. And this excess of money is transferred to the foreign assets of the Russian Federation but is not invested to the Russian economy. This tendency indicates presence of disequilibrium on the money market.

### Long-term Factors of Decline of Growth Rates

1. Dependence of the Russian foreign trade on **exports of raw materials and energy**. More than 80 % of the Russian export consists of energy and raw materials (the share of oil, oil products and natural gas is 50 %). In such circumstances the fluctuations of world market prices of these goods influence painfully on the balance of payments, budget, prices and growth rates in Russia.
2. **Obsolete technologies** and high energy intensity and material intensity.
3. **Limits of growth** on old “Soviet” facilities. In 1999 the research of McKinsey group showed that after 1991-1998 years (when GDP fell down for about 50 %) Russian economy had a 25 % reserve of growth on old plants and equipment. Now this limit is exhausted. The 1999-2002 cumulative index of GDP is already near these noticeable 25 % (see Table 1). To grow further Russian economy needs new investments.
4. **Institutional obstacles**. First, the retained earnings still dominates in the sources of **investments**. Its share is 52 % (source of data [2]), the budget money

constitutes (after all the reforms!) 19 %, bank credits provide only 4 %<sup>20</sup>, and “other sources” give 25 %. It is uncommon for Russians investors to find money in banks or on the security market.

5. The other often mentioned problems of investments are:

The fear of businessmen concerning the property protection and uncertainties in the government policy;

Unclear rights of inheritance;

The fear to lose the property because of unfriendly buy-out;

Unclear land property rights;

Lack of guarantees for minority of shareholders;

Irregular and sometimes dishonest depository service;

Currency market limitations.

6. Besides, there are institutional obstacles to **lending**. Among them are:

High credit risk;

Difficulties of withdrawal of money and/or extraction of a pledge from an insolvent borrower;

Lack of bank resources.

Let us say a little bit more about some of these issues. For example, credit risk is strengthened by the absence of a credit bureau. In this situation it is almost impossible to deprive an insolvent borrower from the property rights on a borrowed property. It should be noted that the existence of such bureau is typical for developed countries.

Lack of bank resources can be explained, first of all, by the poverty of Russian citizens. The average year income is about \$1700 per capita and that is dozens of times less than in developed countries. Their saving rate is about 10 % and 2/3 of savings are spent for foreign currency purchases. That is why, Russians spend only 4 % of their disposable income for depositing in bank accounts and for buying securities (source [2], [7], author’s analysis).

The poverty of Russian citizens can explain why interest rates in Russia have the long-term tendency to be very high. Let us remind one classical microeconomic theorem (see [4, P. 76-78], [5, P. 134]). The coefficient of time preference to consume,  $\lambda$ , is determined from the equation

$$1 + \lambda = d(c_2) / d(c_1)$$

Here  $c_2$  is “future” consumption and  $c_1$  is nowadays consumption. In accordance to equilibrium theorem  $\lambda = r$ , where  $r$  is the real interest rate. The coefficient  $\lambda$  is high

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<sup>20</sup> That is one of the reasons why in Russia the discount rate of the Central Bank does not have such influence on economy as it has in the developed countries.

in poor countries. That is why, Russia have a strong tendency to be a country of high interest rates.<sup>21</sup>

7. Another explanation of problems of the Russian nowadays money market is its “dualism”. The lenders of the money market can be divided into two groups: one part is the huge SBERBANK, one of the largest banks in the world, and another part is all other banks. Only SBERBANK is capable to give large credits.

The borrowers can be also divided into three groups. The first group consists of the old style Soviet (governmental or privatized) enterprises which have the permanent losses and only money losers are lending them. The second group are prosperous former state firms that do not need credits because they have a lot of their own resources or prefer to issue bonds or ADRs (depository receipts). Banks allure them to borrow even under the low interest rates because they are “prestigious” borrowers. The third group consists of “new” companies that are mostly small and desperately need credits. Their development can be a serious source for economic reconstruction of Russia. But they are risky borrowers and can get only short-time loans and under high interest rates.

The permanent hesitations of the Russian government in its tax and business policy aggravate the situation on the money market.<sup>22</sup>

## Explanation of Stabilization Facts

We have explained beforehand the reasons of stumbling of Russian economy. Now we should analyze positive factors.

### Short-term Reasons

1. Russian **energy and raw materials** are still welcome (see [6], [9], [11]) in the world markets.<sup>23</sup> The oil prices are still much higher than they were in 1998.

2. The recent decline in **personal income tax** and **profit tax** and liquidation of some turnover taxes supply enterprises with additional working capital.

3. The moderate **monetary policy** of the Central Bank of Russia (see Table 16) leads to the decline tendency of inflation (see [16]).

The reasons for this policy of the Central Bank of Russia are obvious. In 1999-2000 Russian economy suffered from the money deficit and firms had lack of cash. That was one of the reasons of arrears of wages and tax payments. This lack of cash impeded the sustainable growth of firms. Besides, the Central Bank of Russia made an attempt to sterilize the stream of foreign currency that poured on the Russian money market after the drastic ruble devaluation in 1998 and the oil price leap in 2000. That is why, the Central Bank pumped economy with rubles in 1999-2000.

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<sup>21</sup> The history of interest rates in UK and USA shows that real rates decline steadily in accordance with the welfare growth.

<sup>22</sup> This vague policy causes also outflow of domestic capital abroad.

<sup>23</sup> That can explain the accelerated growth of oil and gas industry and non-ferrous metallurgy.

When the monetary stock in Russian economy will reach a sufficient level (see Table 17; source [2], author's analysis) the Central Bank of Russia could alternate the monetary policy in order to diminish the inflation.

<b>Table 17.</b>				
<b><i>Monetization of Russian economy, 1999-2002</i></b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>GDP, billions of rubles,</b>	<b>4757</b>	<b>7063</b>	<b>8727</b>	<b>9684</b>
<b>current prices</b>				
<b>M1 - billions of rubles</b>	<b>342.8</b>	<b>526.8</b>	<b>879.3</b>	<b>1192.6</b>
<b>M2 - billions of rubles</b>	<b>448.3</b>	<b>704.7</b>	<b>1114.3</b>	<b>1602.6</b>
<b>M3 - billions of rubles</b>	<b>628.6</b>	<b>984.9</b>	<b>1560</b>	<b>2122.7</b>
<b>M1/GDP</b>	<b>0.072</b>	<b>0.075</b>	<b>0.101</b>	<b>0.123</b>
<b>M2/GDP</b>	<b>0.094</b>	<b>0.100</b>	<b>0.128</b>	<b>0.165</b>
<b>M3/GDP</b>	<b>0.132</b>	<b>0.139</b>	<b>0.179</b>	<b>0.219</b>

4. The share of aggregate M0 declines in the total money stock (see Table 18; source [2], author's analysis). This factor increases the money multiplier and the capability of banks to accumulate money for crediting.

<b>Table 18.</b>					
<b><i>Dynamics and structure of money aggregates in Russian economy, 1999-2002</i></b>					
<b>Money aggregate/Year</b>	<b>01.01.09</b>	<b>01.01.00</b>	<b>01.01.01</b>	<b>01.01.02</b>	<b>01.11.02</b>
<b>M0 - billions of rubles</b>	<b>187.8</b>	<b>266.6</b>	<b>419.3</b>	<b>584.3</b>	<b>675.8</b>
<b>growth rates per year, %</b>		<b>42.0%</b>	<b>57.3%</b>	<b>39.4%</b>	<b>18.8%</b>
<b>M1 - billions of rubles</b>	<b>342.8</b>	<b>526.8</b>	<b>879.3</b>	<b>1192.6</b>	<b>1313.3</b>
<b>growth rates per year, %</b>		<b>53.7%</b>	<b>66.9%</b>	<b>35.6%</b>	<b>12.1%</b>
<b>M2 - billions of rubles</b>	<b>448.3</b>	<b>704.7</b>	<b>1114.3</b>	<b>1602.6</b>	<b>1884.6</b>
<b>growth rates per year, %</b>		<b>57.2%</b>	<b>58.1%</b>	<b>43.8%</b>	<b>21.1%</b>
<b>M3 - billions of rubles</b>	<b>628.6</b>	<b>984.9</b>	<b>1560</b>	<b>2122.7</b>	<b>2538.6</b>
<b>growth rates per year, %</b>		<b>56.7%</b>	<b>58.4%</b>	<b>36.1%</b>	<b>23.5%</b>
<b>M0/M2</b>	<b>0.42</b>	<b>0.38</b>	<b>0.38</b>	<b>0.36</b>	<b>0.36</b>

<b>M0/M3</b>	<b>0.30</b>	<b>0.27</b>	<b>0.27</b>	<b>0.28</b>	<b>0.27</b>
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Note1: The money aggregate M3 includes deposits in foreign currencies.

Note2: The growth rates for 2002 are recalculated on per year basis using the 10 months data.

5. The **federal budget expenditures** grew on 25 % in 2002 in per year rate (source [3], author's analysis). This growth tendency raised the macroeconomic demand.

### Long-term Factor

The main long-term factors are connected with the total stabilization in Russia - political, social, and economic stabilization (see the related analysis in [8]). The people who were (and are) in opposition to reforms are adjusting to the economic reality. Several important laws liberalizing economy have been enrolled and that made Russian economy more adjusted to market mechanisms. What is also important that step-by-step, not so fast as wanted, but the Russian middle class is growing. It could recover itself after the economic crisis in 1998. The income of the middle class is growing and now this income is the main source of consumer demand and savings.<sup>24</sup>

### What to Do?

At first, we can propose to begin a deep and long-term government policy for **support of investments**. In the recent years such governmental support was absolutely absent. On the contrary, the government resisted private investments.

The policy for support of investments should include several points.

1.1. Recovery of **investments' privileges**.

1.2. Privilege should be introduced for **R&D investments** and **accelerated amortization**.<sup>25</sup>

1.3. Reduction of **tax on issue of securities**. Now it is 0.8 % of the emission volume and should be reduced dozens of times.

1.4. Continuation of legislative and administration work for strengthening **guarantees of private property**. The major efforts should focus not on creating new laws (there are a lot of them already) but rather on creating and supplying the *legal cases*. Only after dozens of successful precedents of protecting private property people will believe that their money, property, and investments are safe.

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<sup>24</sup> The growth of the real income of Russian citizens can explain, for example, the fast growth of food industry. The income growth facilitates also the macroeconomic stabilization.

<sup>25</sup> One may argue that these measures will hurt the state budget. But now the profit tax constitutes only 15 % of the federal budget income. The Russian business avoids profit tax payments with ingenuity which worth the better use. It seems that a country of transition economy with the bottleneck of a good accounting system and lack of the tax discipline should base its state finance system on indirect and property taxes. The first steps in the proper direction have been done already in 2001-2002 when the rates of personal and profit taxes have been reduced.

1.5. The conditions should be created that could help a lender to **extract a collateral** quickly and inexpensively in the case when a borrower is insolvent. For the money market in Russia it is especially important because the data on financial solvency of borrowers are often unreliable and a lender use mostly a collateral as a guarantee.

1.6. The **currency market** law should be liberalized. This liberalization will allow foreign investors to transfer their dividends from Russia easily and this possibility will attract foreign investments. These measures will stimulate also the foreign trade for Russian businessmen. It is necessary to escape mistakes of 1994-98 when the short-run speculative capital was favored.

2. It is desirable to implement measures for steady transfer of **energy markets and markets of raw materials** which are still under the state control to the position of a free market. Without these measures firms do not have incentives to implement energy and material saving technologies.<sup>26</sup>

3. The government should stimulate **exports of products of manufacturing sectors** (see also [10]). As a first and easy step it should eliminate obstacles for returning the value-added tax to exporters.<sup>27</sup> The next step could be introduction of credits on the profit tax not only for direct exporters but also for their creditors and investors.

4. Nowadays Russia householders have a huge unsatisfied **demand for housing**. Millions of families suffer from lack of their own apartments or are not satisfied with their quality. That is why, a hypothec credit may have a great success and the houses construction could become a locomotive of economic growth. But all the previous hypothec programs (some of them have attracted even the foreign capital) failed due to many obstacles. The main obstacle is the sponsors' incapability (the government is among them) to subsidize the interest rates and to elaborate a guaranteeing system for such credits.

5. It is necessary to reset **tax privileges for small business** that have been abolished in 1990s and to introduce additional tax privileges (for example, it is worth to set lesser profit tax rate). It is necessary to remove administrative obstacles for business registration. If Russia will have the share of GDP supplied by small companies equal to the level of USA - 50 %, or (maybe!) even 80 % as in Japan, it can increase its GDP several times (today in Russia this share is around 12 %).

6. Serious sources for investments can be found in **private pension funds**. Now their role is negligible. But if firms will be allowed not to pay a part of the joint social tax in the case when they invest these money in pension funds they can attract "long" money very quickly.

7. It is necessary to invite **foreign banks and other financial institutions** to Russia. Today the Russian financial "industry" is very weak and foreign banks,

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<sup>26</sup> First of all, this concerns electric energy and oil producers. As to rail transport the solving of the problem of liberalizing railway tariffs is likely in splitting the state monopoly to several private competing companies.

<sup>27</sup> This problem has been discussed many times in the Russian press. The last proposals of the Russian Ministry for Economic Development & Trade for diminishing the quantity of documents necessary for such refund seem to be useful.

mutual funds, and life insurance companies can bring contemporary financial products that are absolutely unfamiliar to Russian people. Moreover, potential clients of banks in Russia will trust more to the well-known foreign institutions than to weak domestic financial organizations.

## **Instead of Conclusion: What Economic Advantages of the Russian Economy can attract the outside World?** (see also [12])

1. First, the current situation of Russian economy is characterized by **high rate of return on investments**. Russian businessmen are not satisfied with 8-10 % of return. They work with projects that bring dozens times more.<sup>28</sup> But they often have lack of capital (see, for example, [14]) . Capital from the Western countries can get a share in these revenues.

2. Russian **financial industry** is still the land of “wild bears”. Western financial institutes can bring contemporary financial products to the Russian financial market and get their profits.

3. Geographically Russia has advantages in **transport crossroads** whose construction and exploitation promises good benefits after sound investments. Plans to construct the Paris – Seoul railway and to create joint roots for air companies are good examples of investments into the transport infrastructure of Russia.

4. The present-day Russian **government is more professional** than the previous ones. It guarantees stable political climate, better legal system and greater profits, consequently.

5. The Russian **tax laws** were seriously improved. Since 1998 the new Tax Code is acting. According to this document the personal income tax is ridiculously low – only 13 %. The law of currency market and trade is in the stage of liberalization.

These factors demonstrate that potentially Russia can be not only a source of energy and raw materials but also a lucrative and safe partner for high-tech industrial investments.

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<sup>28</sup> Such high rates may be explained by the following reasons:

- shortage of capital on financial markets;
- combination of growing incomes and rising demands with still existing shortage on commodity markets;
- availability of educated and cheap labor force;
- plenty of natural resources.

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