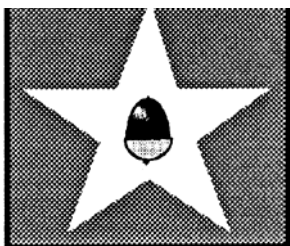


**Conflict Studies Research Centre**

Professor A Kennaway

**The Russian Political  
Economy 1999**

December 1999



**E106**

**Disclaimer**

The views expressed are those of the  
Author and not necessarily those of the  
UK Ministry of Defence





# **The Russian Political Economy 1999**

**Professor A Kennaway**

## **Movements Since 1998 & Current Prognosis**

The real Russian economy has declined each year since 1989; from 1994 it has stagnated at around 58% of the 1989 level, with very small reported variations, according to official estimates. From 1994-1998 the Government, its banks and Ministries were not managing the economy in any real sense. The Federal budget was less of a statement of intent of income and expenditure of the Federal exchequer than a spectacle of juggling with large, growing external and internal debts; finally the jugglers dropped all the balls simultaneously in front of a worldwide audience. The most dramatic effect of this failure was the crash of 17 August 1998, when the ruble was devalued to a fifth of its previous value. Naive foreign "investors" in Russian Treasury bonds, which had been yielding 60-70%, indeed at one time up to 180% pa interest, lost many hundreds of millions of hard currency. This pain forced all but a few foreign financial commentators and macro-economists to admit the truth about the unreformed real economy and the miseries that all but a tiny minority of Russians have endured for the past decade and more.

It has always been difficult to make proper judgements about the Soviet and post-Soviet Russian economy if one works mainly or exclusively from published data and official statements. Some of the problems are set out in Appendix 1. Economists, accountants and anyone accustomed to financial and commercial data know all these issues perfectly well. It is unwise to accept data even from western government figures without probing and explanation. But when it comes to Russia, sober judgements based on training and experience sometimes seem to give way to those based on other, less rational criteria.

It is, however, gratifying to note that nearly all serious western commentators on the Russian economy have recently, if belatedly, come to share the rather more cautious, realistic analyses and judgements that this Centre<sup>1</sup> and one or two others have published over the past decade and which regrettably have been proved correct.

The August 1998 crash has had some beneficial economic consequences since our last published reports, written during 1998. Those few data, glad as one is to note them, are unlikely to constitute an improvement across the economy. This continued failure reflects the lack of political will and business competence to undertake the necessary radical reconstruction; indeed the political climate seems to be going in the opposite direction. Prime Minister Vladimir Putin recognised that the leadership still lacks a clear vision of the country's future and the need to develop a long-term economic and social strategy.<sup>2</sup>

## **Politics Provides the Key to the Economy**

This is perhaps less true in a western country but there is no escape from it in Russia and other CIS countries. It is becoming clear from their actions that the "people of power" have turned significantly against foreign involvement, whether in

direct financial investment (FDI) or in acquiring managerial control which would provide the essential expertise to lead the civilian economy upward.

There is much recent evidence that people in government and those who may aspire to the Presidency or senior office are not going to put into liquidation the loss-making sectors of the economy nor reduce the share of the R&D, design institutes and the production facilities devoted to military and space activities. In the foreseeable future, the old structures and managerial systems and attitudes of the soviet past will continue, coupled with the post-soviet opportunities to amass wealth and power that were made possible by the unregulated rush to "privatise" firms that could be milked by crude or ingenious means. These conditions continue to benefit a small number of people, who operate at every level, federal, regional and city; they may be in positions of political authority or they may own or direct commercial organisations. In the present circumstances there is little point in deciding who controls whom. The outcome of these struggles is yet to be decided: it varies from place to place, industrial sector to sector and between the so-called "power ministries" and between them and the Presidential Administration.<sup>3</sup>

One cannot rationally talk of "market reform" or of a "transition economy" in Russia and only with caution in most of the other countries of the FSU. Other former COMECON countries have fared better; some such as Poland, Hungary and Estonia are well on the way towards genuine improvement.

The absence of the desire, will and ability by industrial leaders to embark on the necessarily long and hard road toward a thriving and profitable economy is closely linked with and indeed produced by political attitudes. Genuine cooperation with foreigners, especially with the West, is probably over and is increasingly being replaced by another era of "cold war" wariness, suspicion and hostility<sup>4</sup>. These are the old, traditional introspective, defensive Russian attitudes which, it has to be said, the West has done not a little to fuel and reinforce through its erroneous and often irrelevant economic and financial recommendations and dealings. Recent military and political events for example in Kosovo, Iraq, attacks by Turkish forces on Kurds in Iran, have had a similar effect as has the West's blatant, from the Russian point of view, exercise of its power in the key industries of gas and oil. The assumptions concerning the expansion of NATO together with the stated intention of the NATO Parliamentary Assembly to redefine as "not illegal within the UN Charter" its self-declared humanitarian, armed crusade have, not unexpectedly, rekindled Russian resistance to and suspicions of the West. Currently, the Russians view the world as "Unipolar", ie one run by and in the interests of the USA. The declared struggle by Russian leaders to provide a counter-weight to this imbalance of forces provides another basis for their decision to strengthen their armed forces and the defence industries, financing the latter by a more vigorous export drive of arms and to form alliances against the USA. Military and defence industrial linkages will grow between Russia, China, India and other countries on the Pacific Rim and in the Islamic belt. These activities as well as the war in Chechnya will once more divert resources from basic investment in the economy.

The nature of the Russian government itself is also significant. Some western commentators believe that the character of individual leaders can radically effect change in policy. They detect in one leader after another a person "with whom one could do business". If by this they mean that they could rely on an understanding of western interests and a convergence towards western democracy and a free market economy in action, history has shown this to be an error. In Soviet Russia, the General Secretary was, as is, perhaps to a lesser extent, his successor, the

President, still *primus inter pares* and has to operate within the consensus of the people of power. It is true that the constitution provides for a super-presidency whose occupant can and does rule on caprice, ignoring the Duma and Federal Council, frequently dismissing and replacing the prime minister and ministers of government. The presidential administration employs 2,500 people; any strategic thinking and decision making that is done at the federal level of government is done there. It is an expensive copy of the old central committee of the communist party, which advised the general secretary and politburo who took the final decisions. The present "government" is similar to the soviet council of ministers, composed of functionaries who are supposed to carry out the instructions of the presidential administration. The Prime Minister is simply the chief administrative officer. Under Putin the government is even more subservient to the president than it has been under previous Prime Ministers. No wonder Russia survives its frequent, abrupt changes. Apart from Primakov, it is doubtful if any presidential candidate will attempt to amend the constitution to reduce the powers of the president. For this reason it is likely that Russia will continue to be governed in ways that have changed little down the centuries.<sup>5</sup>

It would be easy to conclude that there is a monolithic anti-foreign policy and that it will decide Russian actions in every sphere, whether political, military or economic. Since the collapse of the USSR, Russians are free to express their views, which range widely across the spectrum of rational and irrational possibilities. Some of these are as considered, sober and constructive as the best west European commentators, whilst others are closer to some Western crude nationalistic tabloids. The apparently unitary "Party Line" of the old USSR no longer holds, nor does it govern the actions of the leadership, which is riven by internal factions and their self interest. Some senior Russians may abuse the West verbally whilst figuratively holding out the begging bowl with one hand and waving a nuclear weapon with the other. Not only was it often thus in the USSR but it is also not unknown in the West in its own dealings and with its engagement with Russia.

Newton's Law "To each action there is an equal and opposite reaction" also holds in international affairs; we fuel each other's paranoia.<sup>6</sup> For such reasons it is not hard to understand the current return to strident nationalism backed by increased military expenditure and a hardening of Russian's international negotiating stance. Had these policies been supported by reforms of the real economy based on best practice abroad the Russian leaders would have made their international stance more credible, since the defence industry would have been more soundly based on a thriving civilian economy. But Russian leaders seem to have been beguiled by the myths of the "conflict of civilisations" so unfortunately expounded by Samuel Huntington and seized upon to justify extreme nationalist positions. There is no unity of aim, decision or action between the various arms of Government, as there was in the heyday of the USSR. Consequently there is no governing doctrine or consistency of action, except perhaps an instinctive return to old experience mixed with the massive self-interest that was well concealed in the USSR.

The role of foreign oil and gas companies is construed not as a means of providing benefits to the riparian countries, including Russia and therefore to their local populations as well as to the benefit of the investing firms and their overseas customers but, at best, as buying very cheaply the natural resources, the heritage of Russia; at worst foreigners are regarded as engaging in theft through the exercise of their unopposed political-military and industrial strength. Russian leaders see the international petroleum industry as a confrontational battlefield and not cooperation to mutual benefit.

Hardening Russian attitudes, consciously chosen by Russian leaders, prevent significant amelioration of the plight of the Russian people. They are unlikely in practice to produce favourable circumstances for foreign direct investment (FDI) in the real civilian economy. Over the past decade the cumulative FDI in Russia is trivial both in absolute terms and relative to that in other countries such as Hungary and China; estimates vary, but Prime Minister Putin said it was \$11.7Bn by October 1999. The Deputy Economics Minister Vladimir Kosov and EBRD suggested that for the year 1999 alone FDI will total \$3.5Bn, although the rate was lower in the third quarter than in the first two quarters of the year.<sup>7</sup>

The dollar savings of the people are estimated between \$30-50Bn and the cumulative capital flight variously between \$50-120Bn. If a significant part of that money were to be invested properly a start would be made which might produce useful results. Private domestic investment is reported only in isolated cities and projects. One swallow does not make a spring, to use the Russian phrase, more appropriate and cautious than the English term "summer". It is also understandable that foreign investors will continue to hold back if native investors remain reluctant.

### **Financial Loans and Credits**

Apart from FDI the Russians have been receiving credits and loans from international sources such as IMF, World Bank, much of which has simply been recycled to existing foreign creditors. Future IMF loans are intended to go the same way. Almost none of the money has actually benefited the Russian economy. The previous enthusiasm to grant such credits was devoid of economic justification; almost certainly it was based on the erroneous idea of propping up President Yel'tsin who was perceived as being more pro-western than others who might come to power. His endorsement of Vladimir Putin as his successor openly indicates the contrary, as does their joint decision to reopen the war in Chechnya. These facts have evoked some international comment and suspension of financial aid to Russia. Much as the linkage seems to be justified to westerners, the timing only reinforces the Russian view of western hostility to what she perceives as Russia's legal rights, for example in Chechnya, or to Russian demands for a hands-off stance from foreigners in the Caucasus which Russia regards as her historic sphere of influence. The IMF demanded, on 10 November 1999, audits of the Sberbank (the savings bank of Russia) and of the foreign subsidiaries of the Central Bank. The former may be associated with the sequestration in 1998 of the people's deposits by the Government to pay foreign loans and the latter with the well-publicised investigations into irregularities associated with the Yel'tsin Presidential Family. It is typical of Russia's negotiating stance that these prudent steps of exercising due diligence into the affairs of the borrower are castigated by Mikhail Zadornov, the recently replaced envoy to international money-lending organisations and now chief executive of Sberbank and an adviser to Yel'tsin as *"a pretext for delaying the release of the next \$640 million tranche and that... unfortunately, political motives are becoming dominant in the negotiations on the release of the next tranche."*<sup>8</sup>

Simultaneously, however, Victor Khristenko, who replaced Zadornov as well as being first deputy Prime Minister, hopes for an additional \$1.6Bn from the World Bank during 2000-2001.<sup>9</sup> EBRD claims it will have lent 300 million euros (= US dollars) in 1999 and plans to increase that to 400m in 2000, according to Dragica Pilipovic-Chaffey, the EBRD director for Russia.<sup>10</sup>

It is noteworthy that Russia has refused some loan offers from the World Bank and others amounting to \$229.2 million "having analysed the efficiency of the first loan to improve building and maintaining motorways" and other projects aimed at "oil restoration, restructuring agriculture, social and regional infrastructure and urban transport projects". Another \$86.7 million may also be refused.<sup>11</sup> It would be illuminating to learn the facts behind these statements. Is it not strange that lenders press their money on a borrower who sometimes demands more money, accompanied by some hostility and at other times refuses the loans? Especially when the only route for repayment is to borrow more abroad and recycle the new loans to pay off the old?<sup>12</sup>

### **Import/Export Balances, Repayment of Foreign Debts**

By 1 January 1999 these came to \$143.9Bn according to M Zadornov, formerly finance minister; there is also a domestic but dollar denominated debt of \$14.9Bn<sup>13</sup>; by 1 January 2000 this might rise to \$166.2Bn, of which \$103Bn was inherited from the USSR; Russia assumed obligation for all of it as the successor to the USSR. Keith Bush's paper, from which these data are taken,<sup>14</sup> provides detail on the state of negotiations, agreements and promises to pay.

Trade Minister Fradkov stated<sup>15</sup> that "during the first eight months of 1999, foreign trade shrank by 22% from last year, to \$64Bn in total; exports outside the CIS reached \$42,4Bn. Total exports fell by 8% and imports 42% to \$22.6Bn; peddlers accounted for \$5.9Bn of that figure. The net trade balance was positive at \$24Bn. Exports of goods and services accounted for 24.3% of GDP; in 1998 the share was 7.8%. The stability of some sectors depends heavily on exports. For example exports reach 40% in some metallurgical plants, ferrous alloys 60% and 60-70% in the chemical industry." Much of this of course is in raw materials, including fertilisers which as noted below, starved Russian farming.

Finance Minister M Kazyanov on 11 November 1999 said that the Government planned to borrow abroad another \$5.9Bn but did not plan to issue more Eurobonds before 2001. If it is short of money to repay debts it will borrow from domestic sources. Recently the IMF in agreeing to advance further credits, which effectively roll over old debts, bypassed Russian banks and paid the sums directly into the accounts of foreign creditors, thus avoiding the losses due to the notorious sticky fingers of Russian financial institutions.<sup>16</sup>

### **Tax Collection**

The Tax Ministry said on 12 November 1999 that collection was 72% higher in the first 9 months of the year compared with that period of 1998. 36Bn rubles were collected in October alone when the budgeted figure was 20.46Bn. The transport sector provided the biggest share, followed by the fuel and energy sector. The Head of the Tax Service, Pochinok, said that the oil and gas industry had begun paying all of its due taxes in cash in August 1999. This figure has to be seen in a wider context. He stated that the August tax collection totaled 30.35Bn rubles, of which the oil companies paid only 1.8Bn, and their share has reduced from 40-20% of the total collected. However that statement does not seem to have been acted upon, since a new agreement between his ministry and the oil and gas firms was concluded on 31 October 1999 by which the firms would start on 1 November 1999 to pay cash for due taxes plus arrears of R9Bn. Pochinok also observed that

terrorist and criminal acts such as the scandal surrounding the Bank of New York reduce tax collection. "Parlamentskaya Gazeta" on 13 November 1999 said euphoria was unjustified and that budget funded programmes received only 50% of their funding. These statements are of course not necessarily incompatible. The first discusses the inward flow of money, the second its distribution. However the assertions are still disputed; the electricity generating companies, nationally and regionally, for example in Yekaterinburg<sup>17</sup> are reportedly short of cash with which to pay the oil and gas companies.

The picture gathered from odd figures and interviews is not consistent. The complete data must be properly collated and analysed before rushing to judgement.

### **Some Macro-Economic Aspects**

It is essential to take a cool, analytical view of all figures emanating from the fSU, whether from Goskomstat, other Ministries or in interviews, articles and speeches by ministers or other senior figures whether in office or not. Russia's estimated GDP was claimed on 27 October 1999 by Vladimir Kosov, deputy minister of economics, to be \$160Bn for 1999, whereas Victor Khristenko, a first deputy prime minister claimed on 6 November 1999 that it is likely to be \$197Bn<sup>18</sup>. In view of this large discrepancy in official statements it is hard to place any credence on assertions that GDP diminished by (only?) one or two percent between 1997, 98 and 99 or that it will rise by one or two per cent next year. Such predictions are plainly well within the error of reporting and indeed perhaps also of definition and collation. See Appendix 1. Nevertheless it is upon such differential data that claims are made that the Russian economy has turned the corner and is on the road to better things.

Goldman Sachs<sup>19</sup>, in its economics review of the former Comecon States, estimates the real Russian GDP to be around 60% of that of 1989, lower than all other countries of the fSU except the Ukraine, which lies around 35%. Their estimates take into account the published outputs of energy, agriculture and industry, transport, and port statistics. All these suggest that the previous declines have been halted. Whilst all optimistic predictions since 1989 have been wrong, so have the pessimistic prognoses for 1999. The crash of 1998 helped to stabilise the internal economy, which is still muddling along at around the same levels.

Putin claimed recently that industrial output grew by 7-9% in the first 9 months of 1999 over that of the same period of 1998. According to the Purchasing Managers' index published by Moscow Narodny Bank London, on 1 November 1999, the rise in production was backed by an increase in orders in each of the last 12 months. Almost certainly, the devaluation of August 1998 stimulated this rise in manufacturing activity because some imports became far too expensive. We have always advocated a policy of import substitution, maybe this heralds a beginning, even if unplanned. But this should be led by a professional programme aimed at improving the competitiveness of products in an open world market through better and more integrated design, manufacture and service; there is little sign of this. Prior to 1999, industrial output was by all accounts at a very low level. One cannot therefore compare the claimed rise with a similar figure for the economy of a country that is already producing much more. In fact, of course, it may represent an insignificant rise in absolute terms. Who knows, unless the data is published in absolute rather than in comparison with a previous period. Output, even if it translates into sales, as is claimed, furthermore has to be measured consistently

against other data such as demand. The rise in industrial production and sales, apparently true, cannot necessarily be extrapolated into the future, even next year. It would be useful to know which products are represented in this rise, whether industrial or consumer, and who are the buyers, particularly in view of the report of the Ministry of Economics for the years 2000-2002. It came to a remarkable conclusion; that *"the economy stumbles because of the empty purses; the main problem of the government is to increase the real income of the population."*<sup>20</sup> It has taken a long time to find this simple truth - if people can't buy, others can't sell! The report continued *"...But real wages continue to fall; they were 35.9% lower in the first 8 months of this year than in 1998 and continue to fall every month. The backlog of wages owed has reached \$2.2 billion. The state owes only a quarter of this sum, the rest is owed by private firms to their own workers."*

### **Division of Wealth and Income**

In the first quarter of 1999 55.2 million Russians had incomes below the then subsistence level of 787 rubles/month (\$34). This represents 37.7% of the population and 70% of the reported working population. In August the average wage was 1586 rubles (\$61)/month and the subsistence level 960 rubles (\$37)/month. Labour Minister Sergei Kalashnikov commented on 23 November 1999 that wages provided only 42% of the total income of workers. The supplements came from the informal society which the UN report for 1999 noted has "become an element of survival for many". Did the incomes reported include or exclude the (presumably estimated) 58% earned from sources outside wages? Government calculations estimate that in 2000 GDP will reach R5350Bn and the wage bill R1160-1220Bn, about a 21.5% share of GDP.<sup>21</sup>

Current Communist propaganda fuels the nostalgia of many people who believe that the old regime provided an equality of standard of living and that the bosses were hardly better off than the mass. An interesting comment on the present living conditions of the leaders of the Communist Party was published on 9 November 1999.<sup>22</sup> It analyses the share of people whose apartments exceed 100sqm in area. Half live in Moscow, but some Communist Party leaders there and in the provinces have flats in excess of 200 sqm. Huge by London standards, let alone in Russia where some people are still living in communal flats with norms of 11 sqm per person.

The crisis allowed a small number to double their wealth, according to the Ministry of Economics quoted in a recent article.<sup>23</sup> V Bobkov, the director of the Centre for the standard of living, gives the following data:

<b>% of total</b>	<b>Moscow</b>	<b>St Petersburg</b>
Poor	16.5	36.4
Not well off	25.4	39.5
Relatively well off	32.9	21.4
Wealthy	25.2	2.8

The poor are those with incomes not more than subsistence level; currently 1,050.5 rubles/month. It costs 600 to eat, 200 on clothes, the rest on rent and taxes. 57.6% of the population does not even have that.

At the next level are those whose wages lie between 2-2.5 times subsistence level, from 2-3,000 rubles. This comprises 25.6% of the Russian population, down by 5% from 1998.

The third level is the average, with an income undefined in the article. Before the crash such people lived reasonably and could go on holiday. It was a sort of a middle class; but this has shrunk to only 13% of the Russian population. The use of the term "average" in this context is questionable. It is certainly not the average wage, taken as the total wage bill and divided by the number of wage earners. It is not even the median. By inference it probably lies around 5,000 rubles/month.

A wealthy person is defined here as someone earning 7-8 times subsistence level. 7-8,000 rubles a month; this covers 4% of the population. Professionals working for foreign firms, or medical practitioners with some private practice, executives in service industries in Moscow are earning between 25,000-50,000 rubles/month. But state employees in federal ministries, according to an article in the same issue may have a basic wage of R4,200/month plus bonuses etc that would increase that to R9,450/month.

The really rich are excluded from the data. It is not possible to calculate their wealth or share of the population; their business and wealth is mostly abroad.

Note that the Russian income distribution is a pyramid, whereas in Britain the distribution is barrel shaped. Bobkov was surprised with the differences between the two cities. It is not clear if the data comes from tax returns or from public opinion returns which might include a proportion of unofficial earnings. Bobkov comments that the worst off are those living in areas that rely on uncompetitive industry such as textiles and machine building. To those must be added those living in one-company towns, particularly the formerly closed military complexes. We are looking at nearly two thirds of the population. The Economics Ministry estimates that it will take 10 years to return to the real level of pay of 1997.

Inflation is reported from January to September 1999 to have been 31.4% (or 33.2% according to Goskomstat), compared with 56.4% for the same period of 1998 and is predicted to be 40% by the year end. Was the figure for industrial output adjusted for inflation or not? The Budget for 2000 assumes a rate of 18%, whereas OECD thinks it will fall from 40 to 30% in 2000, and that an exchange rate for the ruble will rise from its present 26/dollar to an average of 32/dollar for the year. If the rate continues to be managed on a linear, creeping peg, this implies a year end rate at 1 January 2001 of 38 rubles/dollar. This will turn the terms of trade against Russia and have internal inflationary consequences which suggest the assumption of 18% to be unrealistic, especially if Russia continues to import half of all the food consumed in the country, for example, as well as most of the technical equipment it needs.

## **Employment**

The working population is given as 73 million. Unemployed data are given within wide brackets depending on the source. Figures are claimed to be 1.35 million by the end of 1999, and are estimated to be 1.9% of the working population, which works out as 71 million, again showing a discrepancy in official data. The 1999 figure is claimed in comparison with 1998 to be 30% lower when it was 2.7%. How are the missing two million distributed between people of working age, employed

and unemployed? The data lack credibility. There is a considerable variation in unemployment across the country. Ingushetiya and Koryak AO report the highest, 10.3% and 9.2% respectively.

Pensioners, who form around 30% of the population are still paid late; however pensions due on 1 January 2000 will be paid in December to avoid "the New Year celebrations and possible computer problems."

"It is estimated" that they have been indexed by 28% between 1 November 1999 until 1 February 2000; Putin said on 10 November 1999 that each pensioner will get an extra R50 (under \$2) at some time. How can the Prime Minister merely "estimate", when a pension increase is presumably subject to a government resolution and paid by the State? Does he not know?

### **Is the Russian Economy Transitional?**

The same report from Goldman Sachs introduces an index of transition toward a market economy.<sup>24</sup> The report shows how that index is made up. It compares progress of the Comecon countries in which Russia, Romania and Ukraine occupy the last places, with Russia ostensibly between 25-30% of the way there in 1998, whilst by 2008 it is predicted to rise to 40%. The authors offer a caution: "its simplicity is also its greatest weakness and it should be interpreted as a suggested order of magnitude and not as any kind of precise measure."

Crime and corruption figure large. A 'senior official of the Russian Interior Ministry said on 10 November 1999 that around 50% of private and 60% of state enterprises are controlled by criminal groups and that the latter are an effective way to carry out illegal financial transactions". One wonders how such estimates are made, but it must be true that such firms provide a ready means of tax evasion as well as flight of money abroad. International reviews show that Russia regularly achieves almost the bottom place in the honesty table in the experience of experienced commercial operators.

Keith Bush, whose papers regularly provide an excellent overview of the Russian economy, observes<sup>25</sup> that "the official State statistical authority factors in an additional 25% of the value of the formal economy. To counter this understatement of the size of the economy is the fact that up to 70% of (all) transactions within it are, it is reported, conducted in the form of barter, the value of which is notoriously overstated. So we are looking at an economy in roughly the same ballpark as that of Spain."

Russia for the third year running is rated the riskiest location to do business in, according to several surveys, for example by Merchant International Group. EBRD's annual report highlights corruption in all "transition economies" as a major handicap and recommends that the leaders take political action (sic!). One might legitimately ask EBRD for some specific proposals.

As noted in J Sapir's excellent paper<sup>26</sup>, Michel Camdessus, the outgoing head of the IMF, made a belated but truthful admission of the role of western organisations in creating the conditions for the currently flourishing corruption of the economies in the FSU. His organisation "has contributed to the creation of an institutional waste land in an ocean of lies". Had such a view prevented the IMF and others from making irresponsible recommendations for the move of a soviet economy toward a

legitimate market economy and refused to make loans or credits until those were secure and clearly benefiting the local economy, then Russia's economy ten years later might be in a better state.

However, ten years ago the leadership of the USSR was sliding into corruption and self enrichment and increasing recourse by people at most lower levels to unofficial contacts and means, by-passing the inefficient soviet system of supply. Therefore it was folly for the West to encourage free market activities without first establishing social norms of rejection of such methods with their consequential development into massive self enrichment and to political power of the successful and then to create upon those social norms institutional means of enforcing them. As Sapir carefully notes, such freedoms may work within societies possessing those norms and institutions but are counter-productive in those that lack them. This is the case in post soviet societies, even outside the CIS, for example in Slovakia.<sup>27</sup> In Russia the absence of goods of "merchantable quality and fit for purpose", especially outside the less demanding sections of domestic consumers, together with an economy highly dependent on exports of raw materials and armaments and consequently upon a newly created network of middlemen has provided opportunities to a few people to amass fantastic wealth and power protected by bodyguards against gang warfare.

In these circumstances, as Sapir notes, social prestige and admiration accrue to the really wealthy, simply because of their success, whether wealth is acquired by legal, merely socially unacceptable or criminal means. If the state cannot make it possible to survive by legal means, then people will follow those who succeed by other means. What was once regarded as criminal becomes commonplace. Plainly it is essential to (re) build strong state legitimacy. If a state cannot enforce the use of its own currency across the board of commercial transactions but tolerates widespread dollarisation and the use of alternative money such as barter and vexels, that is another symptom of weak legitimacy in a State. However the current trend in Russia is to concentrate on what is seen as a "strong State", ie one with a highly visible military force.

### **The Russian Economy Continues to Stagnate**

Published data on the basic economy of Russia presents a depressing picture, with little improvement in the structure, changes in governmental or managerial attitudes, competence or performance from the recent Soviet past.

Even if we take the Goldman Sachs index at its face value it demonstrates that stagnation is a more appropriate term than transition. Such reforms that have taken place were not properly devised, carried out or policed; they enabled a small number of people to become enormously rich, by dubious means of acquiring control of assets previously owned by the State. Market reform is an inappropriate term in discussion about the Russian economy. David Woodruff's recent book "Money unmade - barter and the fate of Russian capitalism" provides a useful discussion on some real issues but understandably fails to suggest a way out of them. Aukutsionek, who approves of barter in Russian circumstances<sup>28</sup>, gives the following comparisons: with 1992 as the base, the absolute volume of barter trade grew by 5.6 times, an annual average of 33%, whilst the volume of non-barter trade declined by more than two thirds, an annual decline of 17%. His figure for the contraction of total output over those years of 1/3rd, annualised at 17%, is too low

by comparison with published data. The article analyses barter trade sector by sector.

The people and institutions of power in Russia are hardly directing affairs in the interests of their country. They resemble the small particles suspended in a fluid and which are buffeted by the atoms comprising the surrounding fluid. Let us look briefly at the major sectors and identify those few promising activities and locations.

### **Oil and Gas**

The main firms are partly privatised but retain State shareholding. Their main income stems from exports at world prices. In 1998 export earnings for oil were \$9.46 billion from sales of 126.9 million tonnes of crude from a total output under 300 million tonnes, which has been falling year by year. Boris Yatskevich, the Minister of natural Resources, said, in November 1999 that this "level of extraction was critical and threatening the energy security of Russia". When the world price fell below \$13 bbl the Russian press was full of woe and catastrophe. Plainly they had little faith in the cyclic fluctuations in the world price brought about by OPEC's management of supply relative to demand. Some fields, it was said, worked at a loss since their extraction costs lay between \$2-3 bbl, ten times that of the Saudi fields, transport at \$6-7 bbl, versus \$2-3 from the Gulf to Europe, and they were subject to export taxes, whilst their sales on the home market were not only below world prices but were paid with IOUs or bartered goods. In return they paid most of their taxes by delivering fuel to state enterprises. OPEC reacted in their usual way, restricted output and the price has risen above \$25 bbl, which may nett Russian exporters an annual extra income of over \$14bn. Now that Iraq has stopped export the figure may rise further.

The strategy of Russian oil and gas firms is to extend their exports, building new pipe-lines to bypass Chechnya and to the Baltic, attempting to restrict oil flows of competing former Soviet republics, buying controlling stakes abroad for example in Bulgaria and Ukraine where they took shares in refineries and distribution firms (as well as 11 strategic bombers) to extinguish debts for energy. They try to prevent the construction of the Caspian-Ceyhan line on the Turkish Mediterranean coast and opposed, unsuccessfully so far, the sale to an American oil firm, Williams, of the Mazekai refinery in Lithuania.

Russia could adopt several policies to improve their situation. First to export less, but this would hit the pockets of the firms and more important that of many individuals. Secondly to begin the long, undramatic road to raising the efficiency of using energy, thirdly to use alternative sources such as gas and investing in coal and its efficient and clean use. In the northern regions even wind power may be an attractive alternative to hauling fuel long distances through hostile environments.

There are numerous articles in the Russian press, however, pointing to the need for massive investment in modern technology for raising the amount and the efficiency of extraction as well as in transport and refining. For example, Gurami Avalishvili, the first deputy Fuel and energy Minister said that lack of investment caused 40,000 wells to lie idle. Planned new investments by the Ministry of between \$4-8bn should improve matters.<sup>29</sup> Without major investments, it is argued, in a decade or so Russia will become a net importer of oil. Since the early 1920s Russia has imported such technology and has not yet demonstrated a capability of creating its own.

Nevertheless the legal, financial and administrative atmosphere is unfavourable for participation by foreign firms. The legal position of shareholders is subject to arbitrary actions by the government, State Duma and by regional governors. The leading firms complain about recent proposals to cancel the exemption from tax on expenditure on imported equipment and raw materials used to produce oil subsequently exported. They face opposition from domestic competitors who complain of unfair advantage were this practice to cease. BP-Amoco is reported as "reviewing its operations in Russia". It owns 10% of Sidanko whose subsidiary Chernogorneft could not pay its debts. BP Amoco offered to pay them but the government decided to sell the firm, leaving Sidanko with only a quarter of its previous assets of crude.

Oil reserves in the former USSR are estimated to be smaller than gas deposits; this is true for the Caspian area where the allocation between the riparian states Iran, Russia, Azerbaijan, Kazakstan and Turkmenistan is still under discussion. Nevertheless foreign firms are actively involved in the Azeri and the Tengiz fields in Kazakhstan, with Chinese participation. Russia considers this to be imperialist exploitation and views support by foreign governments as muscle flexing by the "unipolar Power", the USA.

Gazprom occupies a strong position analogous to that of Lukoil but its commercial position is weaker partly because there is, unlike oil, no "futures" market for gas in Europe. In any case the European markets, as far east as Czech Republic, are supplied competitively by others, including Norway. Many countries see alternative suppliers to Russian gas as less potentially threatening to their economic independence. In spite of the foregoing, this sector represents the most promising in the Russian economy; for whom is another matter given present political and financial interests of the quasi-monopolists. Gazprom & ENI, the Italian State Company, has signed an agreement with other international companies to build a gas pipeline under the Black Sea from Russian terminals to Turkey at an estimated cost of \$1.7 Bn. Completion is scheduled during 2002.

The structure of sales of oil and gas is held to be a State secret. But Argumenty I Fakty<sup>30</sup> revealed that "sales to the former Soviet republics are made at prices well below world prices. Oil sold to Kazakhstan went for \$67/Te, to the Ukraine at \$76, ie between 15-25% below world prices. Gazprom, it is claimed, sells gas at \$50/1000 cu.m, about half the world price and Belarus for \$31-32. Not only are these countries who rushed to independence now coming back to us for free lunches, they also steal our gas. The Ukraine taps off as much as 10m cu.m yearly, about 20% of the total supplied."

### **Other Mineral Extraction**

Sakha, Yakutiya and Archangel regions have major diamond deposits. They and the Federal Government have come to terms for the time being with each other and also with de Beers.

Aluminium is processed and exported in various forms but, along with steel, has been subjected to accusations of dumping, first by the USA and more recently by Canada. Widely held in Russia, especially by the chauvinists and communists is the view that this is yet another vicious attempt by the capitalist powers to deny Russia legitimate entry to western markets and to "reduce further Russia to the status of a colony exporting cheap raw materials and to act as a dumping ground

for expensive foreign technology". This totally disregards the fact that Russia still lacks the required capability to create civilian technical products of merchantable quality and continues to rely on its traditional exports. Nor has Russia created the circumstances to attract world class foreign engineering firms to found enterprises in Russia.

Russia has applied to join the WTO, but plainly fails to understand its rules, including those relating to dumping. The political bias against FDI noted above together with proposals to raise tariffs directed against imports also poisons the negotiations.

### **Defence Industry**

The size, number and division of labour between research, development design and production organisations remain as they were in late Soviet times. They are inefficient, unwieldy and in need of drastic slimming and rebuilding if they are ever to be profitable or capable of creating competitive civilian products. They are, however, perfectly capable of producing some imaginative science amongst a mass of mediocrity, items that are well behind those of the west or simply inappropriate to real military needs of today, given that warfare as envisaged during the Cold War is now obsolete. The understandable pride of the designers and researchers in their military output has, unfortunately, led them to denigrate the skills needed to create world class civilian products. This is another handicap for the improvement of a manufacturing sector devoted to civilian needs.

The military-industrial complex (MIC) factories can turn out vast quantities of extremely effective weapons, given the political will to do so and to provide the means, and provided that one disregards the real costs of supply. The factories by our standards are managed purely to drive forward the planned output and mostly poorly laid out. Some of their equipment is good to adequate but the ancillary tooling control systems and drives are often primitive, the work-force and their managers are untrained and indifferent to a regime of high quality, low-reject manufacture. For these reasons the MIC factories are doomed to inefficient production and therefore are even more unsuitable than their western competitors for "conversion", ie to making and selling civilian products that would be competitive on a world market. But the regime sets its face against closure or drastic reorganisation of the bankrupt works with no future.

### **R&D, Design Institutes**

Most of them are outside the organisation of MIC factories which are exactly what their title suggests, purely manufacturing with none of the other functions deemed in the west to be essential to a commercial organisation based on manufacture. The number of R&D and design institutes probably lies between 400-600; this figure may exclude civilian higher educational establishments that accept military research contracts and prepare scientific and technical graduates who may enter the defence field. In 1991 the institutes employed around 2.5 million qualified scientists and engineers (QSE). This figure roughly halved by 1997, according to official figures. The current figure is almost certainly far less, probably below 750,000 following the continued reduction of orders and funding. People are, with the approval of their directors, seeking part-time work elsewhere. Actual funds received for R&D in 1998 were 2.61Bn rubles, according to data derived from two articles<sup>31</sup>. But these data, assuming that the total went to salaries, give 300 rubles/month per QSE; whereas the average wage for such people must be five-ten

times higher. Since the numbers of QSE are almost certainly well above 75-150,000, and there must be some payment for materials, heating lighting etc, the financial allocation figures are therefore suspect.

### **Factories**

The number of factories directly working in military production may be around 1,760, officially employing 2.7 million in 1997. These, of course, are supported by a wide range of sub-contractors whose defence orders may be a small proportion of their activity. The industry was reported in 1996 by *Krasnaya Zvezda*<sup>32</sup>, to be working at 22.9% of their total output in 1991; producing 14.3% of the former level of military equipment and 27.1% of civilian products. Other reports place the total current output even lower, at 16% of the 1991 figure. The best performers, for example in aircraft and personal weaponry, have their own design departments; their market research has relied on their own armed forces and research units who have so far served them well. These items, as are missiles, both tactical and strategic (Topol M), are possibly the best in the world.

The MOD allocation to procurement is given as 5.97Bn rubles.<sup>33</sup> The military income of the MIC factories including arms sales abroad might, post August 1998, reach an annualised value of 50 Bn rubles, deducting an over-modest share for *Rossvooruzheniye*, the State export sales organisation. Ignoring all expenditure except wages and salaries this gives crudely 1500 rubles/manmonth or 750 taking wages at a generous 50% of total costs. But we have to take into account the civilian production of these factories, which is around the same figure, perhaps slightly above their military output. A possible estimate is therefore that the total income of the MIC factories reaches in today's values, 106Bn rubles. On that basis the average wage comes to 1,500 r/month, assuming half the income goes on wages; this is 3-4 times higher than in similar factories of advanced industrial countries. If the MIC factories, the best in the FSU, are increasingly producing and selling civilian goods, as well as sustaining their exports, provided they are for cash, then they can be sustained and preserved for a future expansion of orders from the Russian military. Averages, however, do not represent the realities factory by factory. Obviously those with good export prospects fare the best. Russia also exports a significant amount of nuclear products, material and technology.

Trade Minister Fradkov said that arms exports rose over 80% in January-August 1999 compared with 1998 and now account for about 40% of all exports of machinery.<sup>34</sup>

### **Ambitions**

R Popkovich the chairman of the State Duma's defence committee has put forward a proposal to reorganise the MIC into 5 agencies. These are: aircraft/aerospace; naval; explosive devices; conventional weapons, strategic missiles. In terms of export the first is probably the most lucrative, especially if it includes the air-borne missiles. *"Izvestiya"*<sup>35</sup> reports that the Governmental Commission for Military-Industrial Policy has increased the 2000 defence budget by "1.5 times". All in all, national defence in 2000 will cost Russia 140,853Bn rubles".<sup>36</sup> Prime Minister Putin gave Ilya Klebanov, his deputy, just one week to determine the priorities for weapon development. The MOD announced that money would not be cut for the Strategic Missile Forces (NB the Defence Minister Sergeyev was their chief); manufacture of light weapons, armoured personnel carriers, tanks and aircraft would be increased. Pak, the Director of the Ordnance Agency, stressed the importance of high-precision weapon systems, space reconnaissance and communication systems. *Izvestiya* comments that right now such major

reallocation toward the military is impossible, and from that the intentions put Russia on the threshold of a mobilization economy. Its sub-head states: "The Government has bitten off more than it can chew."

### **Military Expenditure**

These increases in the procurement budget were announced before the scale of the military operations in Chechnya became apparent. The war in Chechnya requires expenditure over that planned in the 1999 budget; Putin stated on 23 November 1999 that 5.5Bn rubles (\$208million) had been re-allocated from the Federal Road Fund for military expenditures; next day he said that 3Bn rubles (\$113Mn) had been earmarked for the offensive in Chechnya. Aleksei Kudrin, deputy Finance Minister said earlier in 1999 that next year the war would cost only an additional 3Bn rubles. Calculations based on revised Russian statements about extra pay for soldiers and officers<sup>37</sup> and the cost of ammunition and flights of aircraft show these figures to be believable, if they relate to military expenditure alone and assuming that the war effectively is ended by 1 April 2000. However the chances are that the Russian Army will then face a continuing guerrilla war as well as Russia having the legal and moral obligation to rebuild the devastated regions in Chechnya, Dagestan and Ingushetiya. As a consequence of the policies noted above, there will be a further increase in planned military expenditure. The Duma budget committee on 15 November 1999 recommended an increase in the general military budget of 8.695Bn rubles (\$330Mn)<sup>38</sup>. As a result the IMF have delayed the payment of the second of seven tranches of a total \$4.5 billion standby loan. As we noted above, the IMF have imposed further conditions before releasing more of that loan; so has the World Bank.

MIC units are, as in the west, combining to survive. For example, 120 factories and institutes are planned to come under the umbrella of a new international financial industrial organisation (FIG) "Granit" involving a known firm, "CIS United anti-aircraft defense systems." Izvestiya<sup>39</sup> notes that most of these barely survive. One closed enterprise assembled up to 1,000 S-300 complexes a year; now only 10-20. A single complex is claimed to cost over \$100 million. The Moscow Radio-Technical Factory which makes locators is practically at a standstill and has debts of 440 billion rubles. It rents space to the defence systems FIG, which is a private company employing 100 people. (In early 1999 I visited this place and some similar institutes. They look like ghost towns but with the chief actors, many attending only for the occasion, of all ages alive, bright, intelligent and hopeful.) Another possible member of the planned association is the well known Almaz design bureau which created the S-300P system. Other mergers are planned; one, between two aircraft firms, MIG-MAPO and Sukhoi, is still unresolved.

The defence industry is learning fast about commerce. It has offered to supply its former Comecon allies, now in or contemplating entry to NATO, with military equipment, such as ammunition, to "NATO standards" as well as modernising old soviet equipment such as their fighter planes. Fitted with modern avionics, engines and missiles these planes would certainly have a respectable second service life. The offers are financially attractive. The MIC is also realistic in accepting different forms of payment, sometimes in kind, on other occasions with joint manufacturing and local assembly, sometimes they are linked with payment of old debts owed to those countries by the USSR.

## **Civilian Manufacturing Industry**

Russian engineering products, except those noted in the military sector, are barely exportable. When restrictions on foreign trade and currency were lifted in 1991, Russian manufactures suffered an immediate slump from which they have only begun to recover after the August 1998 devaluation of the ruble. The mass of the population began to buy increasing amounts of cheap consumer goods from China and other Pacific Rim countries. These goods mostly are carried by the "shuttlers" who may pay bribes but rarely taxes. Some food and other goods enter as official barter trade for sales of Russian military hardware. Expensive consumer goods were bought by the richer and the "new" Russians. The 1998 crash severely reduced the purchasing power of the new, rising professional middle-class who rarely aspired to new foreign cars but did buy imported, often stolen and refurbished second-hand cars carried in from Belgium, Germany via Kaliningrad and Poland. The last twelve months has seen a rise in the fortunes of domestic vehicle manufacturers as well as those making other hardware, ranging from radios, TV sets to tools and household equipment. Whilst their aesthetics, safety and other attributes lag well behind foreign competitive goods they are no worse than they used to be in soviet times and *faute de mieux* they sell once more. Vehicle makers have in the past bought designs, technology and production equipment from the leading foreign makers; they are doing so again. Some are establishing assembly plants in the CIS, including Russia, with the intention of widening their sourcing within these countries. Skoda plans to assemble 80,000 Felicias a year in Izhevsk, but the operation awaits the government's decision to reduce customs duties on imported parts, upon which the profitability was predicated. It will take some years to bring suppliers up to the required standard of culture in quality, delivery and performance.

Production equipment, such as machine tools, are however still in the doldrums; their manufacturers admit frankly that they are not yet designing and making competitive equipment: firms still prefer to buy imported products if they can. Such products are, it is true, very out of date, their control systems, electrical drives and consumable tools are lamentable. Mechanically they are robust enough but this by itself is not a strong selling point. The same is true of mining equipment, road making and resurfacing plant.

The USSR relied heavily on imports from its COMECON partners. The economy was planned as a whole; each country had a specialised niche. For example Russia bought from Hungary trolleybuses and diesel locomotives, ships from Poland and East Germany. Russia did not develop its own equivalent capability; the whole region lagged in electronically based goods, whether for industrial, military or consumer use. On the whole, therefore, these sectors are not doing well.

The criticisms of management, workforce and institutions of the MIC apply to the civilian sector with even more force. Russian leaders complain that massive investment is needed to re-equip the factories, whose plant on average is three times as old as that of the OECD. This is true, but it is the investment in "soft technology" ie attitudes to work and competence that determines the outcome. Russia has down the decades bought a lot of production technology and failed to exploit it properly. A determined professional management on western levels and with the full authority of a western board of directors, could work wonders with the MIC and quite a lot of the firms in the civilian sector. But, even if Russians of equal competence come forward, the circumstances are unfavourable to them just as they are to direct control of those firms by foreigners.

The McKinsey Global Institute recently published a report analysing some aspects of Russian industry.<sup>40</sup> They studied ten representative sectors. Their conclusions are that Russia is in a dire economic situation, labour productivity averages 19% of the US levels, ranging from 7% for cement to 38% for software. Productivity has halved from 30% in 1992 to 15% in 1999 in the old soviet factories. New assets, they say, are surprisingly unproductive. The report, strangely for such a management consulting firm, overlooks many key factors, especially that of poor management, which also bears hard on competitiveness, sales, reject rates and productivity (which nowhere is properly defined in the report). However their assessment of average productivity is confirmed by this author's experience in Russian military factories in the electronic, instrumentation and mechanical engineering fields. Nevertheless some successes are reported.

### **Transport**

Investment in this sector, as in every other part of the infrastructure, has been neglected for decades. This should be high on the list for essential investment but there are no signs of the money forthcoming from foreign or domestic sources. The EBRD, which commissioned some studies by consultants, has not pursued their investment intentions. Transport is in poor condition. In 1999, as in 1998, there is even talk of evacuating the population from the northern territories because they cannot be supplied; the local military garrisons in the last year received only two thirds of their essential supplies of food, fuel, medicine etc.<sup>41</sup> The system is capable of sustaining some military operations but essential commercial traffic would suffer. Not surprisingly the grandiose high-speed train link between St. Petersburg and Moscow has been abandoned. An audit showed that money had been squandered and all there is to show for it is a hole in the ground at the northern end.

One modest success is reported; the Russian Volga-Dnieper air cargo company is using the very large An-124-100 aircraft to transport for international clients high tech aerospace machinery and industrial and oil-extraction and processing equipment.<sup>42</sup> A comprehensive review of the transportation systems in the Russian Federation and CIS was published by CSRC late in 1998.<sup>43</sup>

### **Banking**

After 1991 Russians, with western encouragement, rushed to found banks, but most had no resources or any idea of the proper functions of a bank. About 2,500 came into existence ostensibly monitored by the central authorities, who have recently taken away the licence to trade of several hundred of them. Nevertheless only a tiny minority are reliable and they rarely enter their proper field, that of supporting the competent domestic businesses and providing banking services to the populace, which has learned to stay well clear of them. The banks promoted many fraudulent schemes such as pyramid investment, funding bankrupt firms and regional governors. Some subscribers and depositors who were cheated are now beginning to take an active role in local politics. For example one candidate for Governor of Tver Region has said he will deal with the matter.<sup>44</sup>

## Agriculture

Russia is reported to import 50% of all food and drink consumed in the country. Agriculture was never efficient, its productivity was low. My calculations earlier in the 1990s, based on official data, gave the output of produce per hectare as one fifth of the American states with similar geographical and climatic conditions and the output per person of livestock also at one fifth. Danish and British figures are significantly higher than the American. Russian agriculture still is very labour intensive, in spite of large fields, massive use in the past of mechanical equipment and fertilisers. It was always heavily subsidised but did not produce enough of the main crops in most years. Russian apologists for the subsidies point to those of the EU, but the latter pay farmers not to farm rather than to stimulate production. It is true that the US Government indirectly subsidises farms through roads, dams and electricity but the level is far lower than that of the USSR and Russia.

Russian agriculture is now in a far worse plight than in 1991. In a frank interview<sup>45</sup> Gennadiy Kulik, retiring as Minister for agriculture after a lifetime in those affairs gave a very bleak picture, although he said that enough domestic food was being produced. He offered the following comparisons.

<b>Million</b>	<b>1991</b>	<b>1999</b>
Head of cattle	67	29
Cows	21.8	13.3
Pigs	40	16.7
Sheep	74	16.3

"Not only does the amount of meat and milk on the shelves reduce every year but there is insufficient raw material for clothes and footwear, not just for fashionable shoes but for soldiers' boots. We are, contrary to popular belief, even short of arable land, 0.82 Ha per head of population, 70% of which lies in regions unsuitable for production. In the 1980s 12 fertiliser plants were built, we used 87kg/Ha, now 8kg. In 1998 14 million tonnes were produced but 13 of those were exported. The terms of internal trade have turned sharply against farmers. In 1991 the price of a combine harvester was the equivalent of 20 bullocks, now it costs 300-350. There is no credit bank for farmers to provide the usual bridging funds; one could borrow from a bank at 50-60% interest pa. But farm income would be insufficient even to pay the interest. As a result, over 31 million Ha have gone out of food production. Absence of equipment, fuel and fertilisers has bankrupted the industry where the average income is now below 400 rubles/month, the lowest of any sector. As a result the annual output of tractors fell from 120-130,000 to barely 7,500.

One way out of this vicious circle is to go bankrupt, sell up for pennies to foreigners. As a result many plants processing meat and dairy products now have French and English owners. Producers go out of business while families on low income cannot buy fruit and vegetables which partly explains the poor physical state of 18-year-old men called to the colours. One may add the low quality of alcohol and tobacco now being sold."

Two years ago I asked a rich young Moscow banker why there was no cooperative credit bank for farmers, when after all that system was in place in the Ukraine 100 years ago. He replied with a pitying look "the purpose of banks is to make money and there is no profit in such activities".

The grain harvest for human consumption is barely in balance with requirements, whilst 6 million tonnes have to be imported for animal feedstuffs. America has been approached to supply additionally 5 million tonnes of food for humanitarian aid.

## Conclusions

If oil prices continue to stay high, the profits and taxes remitted to the State should improve. This should provide some funds to repay foreign debts, but the surplus will be reduced by the determination to increase significantly expenditure on the military and on the Chechen war, which may not come to a swift end but may continue as a long term fight against local guerrillas. One or two bright spots are reported but should be checked before concurring with their real existence. These may have come about through the efforts of enlightened and competent city mayors or regional governors. Podolsk and Novgorod report good inflow of FDI, investment bearing useful social and economic results. Some domestic manufacturing sectors are reporting more orders and sales following the devaluation of the ruble which put imports beyond the reach of more people. Otherwise the real economy is apparently no worse than it was this time last year and may even be on an even keel in output terms. Agriculture, transport and the infrastructure are in a very poor state and probably unstable. A few people have got richer. The small middle class has suffered badly as a result of the August 1998 crash. The lot, health and prospects of two thirds of the population living at or below subsistence levels will certainly have worsened. The current rulers federally, regionally and in the cities show every sign of clinging even harder than before to the centralist, soviet ways of doing things provided they are compatible with increasing their personal wealth and power.

One should not look optimistically for sensible economic reforms after the Presidential elections; none of the potential candidates has inclinations that way, nor to do other than respond to what Russian political opinion sees as western determination to reduce her status as a world power, to reduce her foreign trade to that of a third world power supplying raw materials and providing a dumping ground for western technology. These views, fuelled by NATO's eastward expansion and actions in Yugoslavia, are encapsulated as a "Unipolar World" dominated by the USA; Russian responses are seen by the chauvinists, Communists and nationalists as a need to improve her abilities to fight for the survival of her "unique civilisation". In all but name we may be entering Act 2 of the Cold War, with Russian leaders using, in a modified form, the methods of Act 1 from 1954-85, which from their point of view were successful in increasing their self-respect and dealing with the west on more equal terms. A significant change from that period is to be seen in the increased confidence and ability of the major operators in minerals and arms manufacture to perform in world markets.

## Appendix 1

### What is a fact in the former Soviet Union?

#### Basic issues known to western economists but often overlooked in dealing with Russian data.

##### Pertaining to GNP & GDP

\* Even in stable western countries GDP and GNP are not precise measures of the performance and output of an economy, although comparisons between successive years should provide a sensible comparison provided that the basis of definition and reporting is either identical or the changes are known and measurable.

\* It is doubtful if Russia operates and publishes precise definitions, adheres to them or publishes measurable variations in method.

\* It is more likely that such figures, as indeed most others published by Goskomstat or those quoted by the highest and most responsible authorities, are based on different assumptions and calculations and/or are published to suit the purposes of the issuing authority which may well vary from ministry to ministry and from moment to moment.

\* When figures relating to different periods are published, a proper analysis of them requires that they be comparable; it is usually unclear whether published Russian figures take real inflation into account and if so by which definition is used.

\* The current habit, inherited from soviet times, of using percentages and percent changes without providing the data in absolute terms adds to the confusion. One is never quite sure that the authors understand the elementary logic of numbers. Does a rise of 400% mean the figure went from 100 to 400 or, as is rigorously logical to 500, remembering that a rise of 100% requires the figure to double, and 200% to treble? Real mathematicians used to be taught (I was anyway) that it is wiser not to express changes of over 100% in percentage terms but in other ways. For example express the rise as 2.5 times, or best of all, give the absolute figures and let the reader make the comparison. Perhaps the numerically illiterate think that using such technical terms demonstrates their competence!

##### Pertaining to industrial output

\* In Soviet times no one calculated costs of input, manufacture or of stocks; indeed there was no mechanism that allowed accurate calculations to be made. Where is the evidence that current managers, mostly the same people who operated before 1991, have acquired the financial tools to do so and the incentives to use them and report them truthfully and accurately?

Let us remember that in 1964 the incoming British Labour Government set up a Ministry of Economic Affairs in parallel with the Treasury, developed a National Economic Plan and circulated a huge questionnaire to firms. Many directors, including myself, regarded time spent on developing the answers as a total waste of time and irrelevant to their business. Consequently the answers were often simply the invention of the moment. Is it not likely that managers with a Soviet background will similarly invent figures, especially if they affect the ability of the tax and other authorities to harass them?

\* When discussion turns on, say, industrial output, definitions are required. For example does the output of a factory include unsold production lying in stock, work in progress or input stock, the differences in stock figures from one reporting period to another? How are stocks and outputs valued, especially if they are not sold for money but for barter or against IOUs (vexels)? Who provides and who checks the valuations? How are arms sales, whether for domestic use or for export,

valued? Arms sales provide one of the easiest means of hiding payments corruptly made to foreign buyers and also "kick-backs" to the middlemen, sales-people and firms. Since it is commonly admitted that probably half the total of all commercial organisations are making losses but presumably continue to be subsidised, how are these facts treated in the calculations and presentation in financial terms of output?

These valuations are made, if at all, by the directors of the firm. It is incontrovertible that these valuations, especially for those traded for barter and "vexels" are presented to minimise tax liabilities and for other reasons. Those accounts that I have seen audited by even respectable foreign firms often state that the auditors take the valuations presented to them by the directors. These data therefore lack credibility. Since the total of industrial production rationally should be based on the total reported to central authorities by separate organisations it follows that the totals reported by the State authorities must also lack credibility.

\* If one starts from a low level, just a modest increase in output or sales-not the same thing in the fSU - naturally shows quite a large increase. Claims of surge in output have to be set in their proper context. Russian statements rarely are.

### **Pertaining to Employment**

The working population is given as 73 million.

\* Is this the number of people within ages defined as normal for a working paid life? Or is it the number of people actively seeking or in paid work? How many of them are unavailable for work for one reason or another?

Unemployed data are given within wide brackets depending on the source. Figures are claimed to be 1.35 million by the end of this year, and are estimated to be 1.9% of the working population, which works out as 71 million, showing a discrepancy in official data. The 1999 figure is claimed in comparison with 1998 to be 30% lower when it was 2.7%.

\* How is the figure defined and compiled? Is it the number of people registered as unemployed and claiming benefit? Recently, for good reason, the British Government altered the basis of reporting these data, rendering year by year comparison more difficult. One does not know how things are managed in Russia. But the published decrees, often very detailed, usually provide more confusion than enlightenment. Simplicity may be a characteristic of Russian weaponry but hardly of government statistics. How do the data deal with those who are employed, unpaid but moonlighting or with those who work outside the legal economy, pay no taxes yet survive? With the grey and black economy estimated at a significant proportion, perhaps 30-40% of GDP, this affects the issue. Some opinion polls put the figure nearer 50%.

\* Do the published figures relating to the income and subsistence levels relate to the wage earner or to some average family or are they calculated per capita?

\* Confidence in Russian data is not improved when they are so obviously incorrect in matters that are easily measurable and verifiable.

\* In addition to remarks made above let us take as another example the number of people in federal bodies of executive power. According to a detailed article "Argumenti i fakti"<sup>46</sup>, "Russia has 16,000 people of Ministerial Status, in spite of announced job cuts by the President. The Finance Ministry replied - "the number was cut by 20% or by 76,300". But, says the paper, this does not agree with the data from GOSKOMSTAT. "Before the cuts there were 1,108,900 working in those bodies, at the beginning of this year there were 1,102,800. No matter how one deducts one from the other there is no way that one gets 76,300, the maximum is 6,100, not even a 1% cut.

The article details the increase in salaries, perks and allowances of those people. This was supposed to be the response to the IMF's requirement to cut the cost of central administration. There are apparently still 16,000 people of Ministerial rank with only 20 ministries. What do they all do? NB The London Times<sup>47</sup> also suggests that with devolution the number of British Ministers could be reduced and asks the same question - what do they all do?

## Endnotes

---

<sup>1</sup> It does not seem out of place or immodest for a Research Centre located in a military environment to blow its own trumpet.

<sup>2</sup> Speech in Khabarovsk, 27 October 1999, to the Far East and Transbaykal regional Council, during which he announced further orders for the defence industry which would assist the region.

<sup>3</sup> My paper "Continuity and Conflict in the Government of Russia" (CSRC, October 1999) provides a detailed discussion of this theme.

<sup>4</sup> For example, see the typical, sad article "Confrontation or Dialogue" in Nezavisimaya Gazeta 28 September 1999 p8 by Nikolay Rizhkov, former chairman of the Council of Ministers of the USSR 1985-1990 and now a Deputy to the State Duma. This article sets out the current anti-western suspicions and hostility held widely in the offices of power. The NATO actions in Kosovo and eastward expansion plus quoting Toynbee "If Good is to triumph over Evil, we will enter a new phase that of a universal civilisation". Like other leading Communists he quotes also Samuel Huntingdon's conclusion that the world is divided into differentiated, hostile civilisations of which Russia is one. Rizhkov concludes that Russian civilisation can only be saved by Russia becoming once more a great world power capable of standing up to America and preventing her world domination. From such inaccurate pseudo-academic beginnings a whole new Mein Kampf could be constructed..

<sup>5</sup> See paper referred in endnote 3.

<sup>6</sup> Is the statement "NATO-v-Russia" equivalent to "Sinn Fein-v-Orange Order" or to "Russia-v-the North Caucasus"? Discuss in less than one million words. We have less time than one might think to produce a convincing answer.

<sup>7</sup> And yet the same Minister is reported in "Izvestiya", 27 October 1999 p4, as stating that the FDI in 1999 will be about 600Bn rubles (\$22.9Bn at the current exchange rate) or approximately 14.3% of GDP. These figures are ten times too big by comparison with those quoted in the text. Are these just misprints or careless talk?

<sup>8</sup> The continued willingness of the IMF delegations to continue the discussions with a beggar who demonstrates direct as well as general hostility is truly remarkable. Whether is it laudable is another matter.

<sup>9</sup> ITAR-TASS, 10 November 1999.

<sup>10</sup> Interfax, 11 November 1999.

<sup>11</sup> Interfax, 11 November 1999.

<sup>12</sup> Some people think they can suspend the Laws of Gravity. The arguments may be comparable.

<sup>13</sup> Interfax, 7 December 1998.

<sup>14</sup> "The Russian economy in October 1999". Given to the NATO economic colloquium, November 1999. Keith Bush, Russian and Eurasian program, Center for Strategic & International Studies, Washington DC.

<sup>15</sup> RIA Novosti, 30 September 1999.

<sup>16</sup> I advised this step in a letter to the London Times early in 1998.

<sup>17</sup> ATN TV, 28 October 1999.

<sup>18</sup> NB Because 26 rubles buys inside Russia more than its \$1 equivalent does in the USA, some authorities apply a correction factor to provide what is hoped to be a more useful comparison. This is called purchasing power parity, PPP. The World Bank currently multiplies the ruble by 3.8:1 to offer a rule-of-thumb to gauge the internal purchasing power. Such a multiplier must be used with caution. Kosov's figure represents less than 2% of the US economy, which has roughly twice the population. Taking PPP into account, the data

suggests that the average American is 14.2 times better off than the average Russian. But averages hide the distribution, more data is needed to calculate that.

<sup>19</sup> “From Transition to convergence, now a decade of new opportunities” published 9 November 1999, chart 1.1b p6. Permission to quote given orally 22 November 1999 by Erik Nielsen, Director of New European Markets Economic Research.

<sup>20</sup> Rossiyskaya Gazeta, 22 September 1999.

<sup>21</sup> ITAR-TASS, 20 October 1999.

<sup>22</sup> “KPRF – a new trade-mark”, 9 November 1999, website www.gazeta.ru.

<sup>23</sup> “Russian wealthy double after crisis, middle class decline”, Yuliya Tikhonova, Argumenti I frakti, 26 October 1999.

<sup>24</sup> Page 7, charts 1.2a and 1.2b.

<sup>25</sup> “The Russian economy in October 1999”. Given to the NATO economic colloquium, November 1999. Keith Bush, Russian and Eurasian program, Center for Strategic & International Studies, Washington DC.

<sup>26</sup> “Understanding shadow economy & economic criminalisation expansion in transition economies”. Ecoles des etudes en science sociales, Paris, November 1999.

<sup>27</sup> “Transparency & Hidden economy-mutually contradicting phenomena” & “Faces of Corruption in Slovakia – 1”. Emilia Sicokova, President Transparency International, Slovakia, papers to Slovak Seminar at School of Slavonic and East European Studies, 27 November 1999.

<sup>28</sup> The Russian economic barometer, No3 pp3-16, 1999.

<sup>29</sup> RIA News Agency, 28 October 1999. Not much of a plan that puts planned investment within such a wide bracket! More of a casual guess than a plan.

<sup>30</sup> 31 October 1999.

<sup>31</sup> Nezavisimoye voennoye obozreniye, 26 March-1 April 1999, p4 and 22-28 January 1999, pp1,4.

<sup>32</sup> 3 August 1996.

<sup>33</sup> Nezavisimoye voennoye obozreniye, 26 March-1 April 1999, p4 and 22-28 January 1999, pp1, 4.

<sup>34</sup> Interfax, 27 October 1999.

<sup>35</sup> 7 October 1999, p1, “Everything for the front”.

<sup>36</sup> Izvestiya, 4 December 1999, p2.

<sup>37</sup> Initially officers were to get \$1,399 and soldiers \$1,000 per month served in the war. Shortly afterward, the figures were reduced to 500 rubles per month (\$19); mildly disappointing to those naïve enough to believe the former figures.

<sup>38</sup> These extra funds, even if they materialise, are unlikely to solve all the shortcomings in the armed forces. It is indicative that the armed forces still agonise over the supply of food and that many regions and cities not only adopt some units but promise to supply them with food and even clothing. Kaluga region has adopted the newly commissioned cruiser “Petr Velikiy” which they will supply with “domestic items” including food.

<sup>39</sup> 4 December 1999, p2.

<sup>40</sup> “Unlocking economic growth in Russia”, McKinsey, Moscow, October 1999. The ten sectors studied are: steel, cement, oil, dairy, confectionery, residential construction, food retailing, general merchandise retailing, hotels and software.

<sup>41</sup> Lt-Gen Bulgakov, deputy chief of rear services, Krasnaya Zvezda, 7 July 1999, pp1-3.

<sup>42</sup> ITAR-TASS, 29 October 1999.

<sup>43</sup> “Transport in the Russian Federation and CIS - A Review”, A Kennaway, CSRC, Paper E100.

<sup>44</sup> Veche Tveri, 16 November 1999.

<sup>45</sup> Nezavisimaya Gazeta, 3 July 1999, p1.

<sup>46</sup> 26 October 1999.

<sup>47</sup> 2 December 1999.

# **The Conflict Studies Research** **Centre**

Directorate General Development and Doctrine  
Royal Military Academy Sandhurst  
Camberley  
Surrey  
GU15 4PQ  
England

Telephone : (44) 1276 412346  
Or 412375  
Fax : (44) 1276 686880  
E-mail: [csrc.dgd&d@gtnet.gov.uk](mailto:csrc.dgd&d@gtnet.gov.uk)  
<http://www.ppc.pims.org/csrc>