Regional Peculiarities in Russia and Inter-regional Capital Flows

Evgeny Gavrilenkov*

Introduction

As Russia approaches elections and pre-election activities increase, political issues dominate more and more, contributing to an increase in uncertainty over the country's future. Thus, one cannot expect that substantial changes in economic policy will occur until the results of the 2000 presidential elections are announced. It is expected that economic policy in the next century will be shaped and conducted by the new government, which will hopefully be able to restore confidence. Numerous failed attempts to stabilize the economy, along with constant changes in the cabinet throughout the 1990s, have negatively affected the country's economic situation contributing to higher investment risks and uncertainty about Russia's future.

The population's lack of confidence towards the federal leadership has contributed to its falling popularity and allowed regional authorities more opportunities to intervene in decision-making at the federal level. The regions' growing influence was also reflected in that the regional budgets' share (excluding transfers from the federal level) in the federation's consolidated budget increased in 1998 to 54 percent compared to 49.6 percent in 1996 and 51.6 percent in 1997. Regional powers have the potential to increase their strength even more in the near future, which may result in the new Russian president being not only supported, but also promoted or "delegated" by regional ruling elites. Thus, regional aspects of Russia's economy, politics and society are attracting more interest as the country's elections approach.

There is no need to say that Russia's reforms in the 1990s have been incomplete and inconsistent in many senses. In reality, the country's transformation represents a rather peculiar combination of liberal reforms in some areas (although quite regularly with frequent state interventions) and strong administrative regulations in other areas. In fact, throughout the 1990s, Russia's economy suffered from bureaucracy, corruption and monopolies, including so-called regional monopolies. Recent scandals regarding money laundering and the Bank of New York only confirm that the failure of the reforms was to a great extent caused by corruption and capital flight. On the macro level, this was

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* The views expressed in this paper are those of the author and do not necessarily reflect the official position of the institutions he is affiliated with. The author remains responsible for all judgments and possible errors.

indicated by a steady decline in production, decreasing efficiency and extremely poor fiscal performance. In contrast to the views dominant during the early transformation stage, it is now conventional wisdom that the several attempts at macroeconomic stabilization in Russia failed due to the fact that they were not supported by institutional and legal reforms that largely had to be conducted at the regional level. In actuality, while laws and other basic regulations were designed and approved at the federal level, their implementation and day-to-day enforcement were the regional authorities' responsibility. Thus, the response of economic agents to macroeconomic interventions was quite inadequate. So, lacking reforms at the micro level, and due to poor market institution building, fiscal adjustment, unlike in most other transition economies, remains a key issue in the Russian reform agenda even after seven years of economic transformation. The vital need to resume economic growth is another priority for the country. In this context, fiscal adjustment as a part of macroeconomic stabilization is a key step that needs to be taken in order to resume economic growth in the country. Both of these topics will be discussed in this paper, as well, political economic issues will also be examined due to their close relationship with Russia's regional economic problems.

Regional Aspects of Macroeconomic Performance During Transition

For Russia, as well as for other transition economies, it is crucial to keep public finances in order and maintain low fiscal deficits (or even surpluses) due to low monetization, which makes domestic borrowing extremely expensive and pushes interest rates up. This is not a problem for only the federal budget, but also for regional budgets as well. In reality, if the M2 to GDP ratio varies around 15 percent, which is more or less typical for most of the CIS countries, then a fiscal deficit of approximately 5 percent of GDP (relatively normal by international standards), if covered by domestic credit, will increase the money supply by one-third with respective price increases. As indicated by Heymann and Leijonhufvud "high inflation is typically a symptom of a deep-seated crisis in public finances" (see Daniel Heymann and Axel Leijonhufvud, 1995). The 1998 financial crisis obviously affected regional finances. As seen from regular statistics, Russia runs consolidated its regional budget with a permanent deficit. Although it is much smaller than the federal one, it is still significant: 0.4 percent of GDP in 1998. Default on domestic debt negatively affected regional securities' markets. Thus, in fact, in 1998, regional budget deficits were mostly covered by domestic credits with money supply expansion.

There was little change in 1999 with respect to regional budget deficits, despite the fact that between January and August the consolidated regional budget was balanced with a small surplus, which was largely achieved through transfers from the federal level which increased in mid-year substantially relative to the beginning of the year. Still, the issue of new regional securities remains in fact impossible. The federal deficit was partially covered by an increase in domestic credit (from the CBR). Despite an increase in the money supply, there has been little effect on prices so far, as the 1999 federal deficit remains much lower than last year.

Russia's improved fiscal performance was due the government's intention of putting the public finances in order. The shape of the medium-term fiscal strategy is more or less accepted by a wide range of economists and decision-makers in Russia. In fact, in the coming years the country should run budgets with relatively high primary surpluses, equivalent to several percent of GDP,[1] while the total deficit will depend on the results of negotiations on the country's foreign debt. This concerns the federal level only, while the shape of fiscal policy at the regional level has yet to be debated. It was pointed out in Gavrilenkov (1999) that there is a huge potential for increasing revenues from the taxation of individuals. The share of personal income tax throughout the whole reform period remained well below 3 percent of GDP, and as was shown, the bulk of personal income tax evasion comes from the richest 20 percent of the population. Potentially, the GDP's share of personal income tax could be more than doubled. In fact, actual figures show that Russian personal income tax has a flat scale, while legally it is progressive.

It is important to note that according to the Russian tax system, the bulk of personal income is accumulated in the regional budgets. It is also significant that personal income tax is a pure "cash based" tax, while other taxes are largely distorted by offsets, barter, inter-enterprise arrears, and liquidity problems in the corporate sector. It is worth mentioning that over 80 percent of Russia's ruble M2 is household money, and firms in fact are unable to pay taxes without arrears (Gavrilenkov, 1999). Moreover, as will be seen below, the monetization of regional economies is much lower than Russia's average as the bulk of M2 is concentrated in Moscow. Thus, enforcement with respect to better tax collection from individuals could improve regional finances substantially and this should also be the responsibility of local authorities, since the Federal Tax Service at present is more concentrated on federal budget revenues.

It is widely accepted that price stability (more cautiously, low inflation) and currency stability are the main objectives of monetary policy. In Russia's case, however, it is quite often seen that certain top Central Bank officials have publicly expressed their intention to support local producers through money supply expansion. But these intentions were quite far from Friedman-type monetary targeting that assumes a need for stable growth of the money supply in order to maintain stable growth in the real economy. In fact, one could see from regular Russian statistics that during several time periods between 1992-1998, growth in money supply was extremely uneven. Moreover, the real sector could sometimes borrow at negative real interest rates. The most recent example of

1 Although debate in the Duma on the 2000 budget indicated that there was no consensus on the primary surplus' size, there was no disagreement on the need for the surplus itself.

this was seen in the fall of 1998-early 1999 following the August 1998 crisis when monetary authorities did not raise the discount rate, keeping real interest rates negative and allowing a rapid expansion of the money supply. It was said that such a policy was necessary to raise liquidity in the economy to compensate for September 1998's rapid price increases. There is no need to say that such an increase in liquidity contributed to the high inflation and currency depreciation of October 1998-February 1999.

At the same time, these policies stimulated industrial production (it was also done through direct credits to particular industry sectors in order to increase working capital), although it is highly questionable whether this sort of growth is desirable and sustainable. As reported by Goskomstat, industrial growth in the first half of 1999 was extremely uneven across regions with nearly 100 percent growth in tiny Altai Republic and a 25 percent contraction in the Evenki Autonomous Okrug. Devaluation by all means positively affected production in export-oriented sectors, namely chemicals, timber, cellulose-and-paper, and non-ferrous metallurgy, that contributed to higher growth rates in those regions where such industries were located. It also stimulated import substitution, but mainly in sectors producing relatively cheap goods as domestic demand shrank considerably. At the same time the so-called "support of local producers," as it was carried out by the Primakov government, and money supply expansion, resulted in the rapid recovery of industries producing "heavy" machinery, namely locomotives, railroad cars, agricultural machines, specialized trucks, etc. Thus, such support appeared to be rather uneven across regions depending on the allocation of "privileged" enterprises. In this sense, in the fall of 1998 and in the first half of 1999, the Russian economy became closer to a Soviet-type model: rising production of intermediate goods, stable exports and falling consumption.

It should also be pointed out that in fact some of the growth figures might be misleading as in some cases "growth" can be attributed simply to better reporting in 1999 relative to 1998. For example, major growth in the above mentioned Altai Republic occurred due to a more than 9-fold (!) growth in vodka and liquor production.[2] Most likely, such "growth" was detected as a result of the government's campaign against "shadow" alcohol production. The same occurred in other regions, such as the Republic of Ossetia and Rostov Oblast, where alcohol production increased by several times. Such inflated 1999 growth figures might also be the case in some other regions and sectors as well. In reality, decreases in barter, improved tax collection, etc. indicate that the shadow economy's share in 1999 might be lower than that in past years.

Table 1 shows some trends in macroeconomic indicators since 1991. It shows that over the past eight years, consumer prices rose by nearly 12,000

2 According to official Goskomstat figures, production of vodka and liquor for Russia "increased" in January-May 1999 by nearly 70 percent relati ve to the same period of the previous year. This, of course, does not correspond to changes in consumption and net exports of alcohol. Building stocks of vodka does not look realistic as well.

Table 1. Main Economic Indicators in 1991- 1998 (in percent, relative to 1990)

	1991	1992	1993	1994	1995	1996	1997	1998
GDP	- 5.0	- 18.8	- 25.8	- 35.3	- 37.8	- 40.0	- 39.4	- 42.2
Industrial output	- 8.0	- 24.6	- 35.1	- 48.7	- 50.4	- 52.4	- 51.4	- 53.9
Employment	- 2.0	- 4.4	- 6.0	- 9.2	- 12.0	- 12.5	- 14.3	- 14.8
Fixed investment	- 15.0	- 49.0	- 55.1	- 65.9	- 69.3	- 74.8	- 76.1	- 77.7
Retail sales	- 3.0	- 5.9	- 3.9	- 3.9	- 10.7	- 13.2	- 8.8	- 12.8
Foreign debt (in % to GDP)	...	126.3	61.2	43.3	35.7	29.9	30.0	54.7
Fiscal deficit (federal Government, IMF definition in % to GDP)	...	- 44.6	–15.6	–10.6	- 5.5	- 8.1	- 6.7	- 4.9
CPI (times, 1990=1)	2.6	67.9	637.9	2009	4642	5663	6286	11591
M2, end year (times, 1990=1)	2.1	16.2	80.2	263	605	810	1054	1263
Memorandum items:								
Foreign debt (US $ bn)	...	107.7	112.7	119.9	120.4	125.0	130.8	150.8
Exchange rate (rub/$, annual average)*	...	223	932	2203	4562	5126	5484	9.73
Trade balance (US $ bn)	...	...	...	17.7	20.5	22.9	17.4	17.3
Current account (US $ bn)	...	...	...	8.9	7.8	12.0	4.0	2.5

* The 1000 fold redenomination of national currency was carried out in 1998.
Sources: Goskomstat, Central Bank, Ministry of Finance.

times, accompanied by high fiscal deficits. The budget deficit remained relatively high until 1998, when it was reduced as a result of pressure from the International Monetary Fund and post-crisis reality. It is significant that by 1995, the government was able to substantially reduce the fiscal deficit, but was indecisive in further tightening fiscal policy. Instead of cutting expenditures or increasing revenues in order to reduce the deficit, the government expanded borrowing. First, the government borrowed domestically, but after squeezing domestic money markets in 1996 the authorities expanded borrowing from abroad in 1997. Due to the high risks of investing in Russia, the government could only borrow at high prices, issuing short maturity government bonds. Thus, the need for permanent domestic debt repayments forced the government to borrow more and more due to its inability (or unwillingness) to undertake real structural reforms. The well-known 1997 emerging markets' crisis, changes in investors' attitudes towards emerging market economies, and the deterioration of Russia's balance of payments in 1998 only hastened the crisis, but were not its main cause.

Table 1 also demonstrates that there was a ten-fold gap between price increases and growth in the money supply by the end of 1998.[3] In fact, the velocity of money circulation in Russia in 1996-1998 varied between 6.5 to 7.5 times and increased several times relative to the pre-reform period.

3 Ruble M2, national definition.

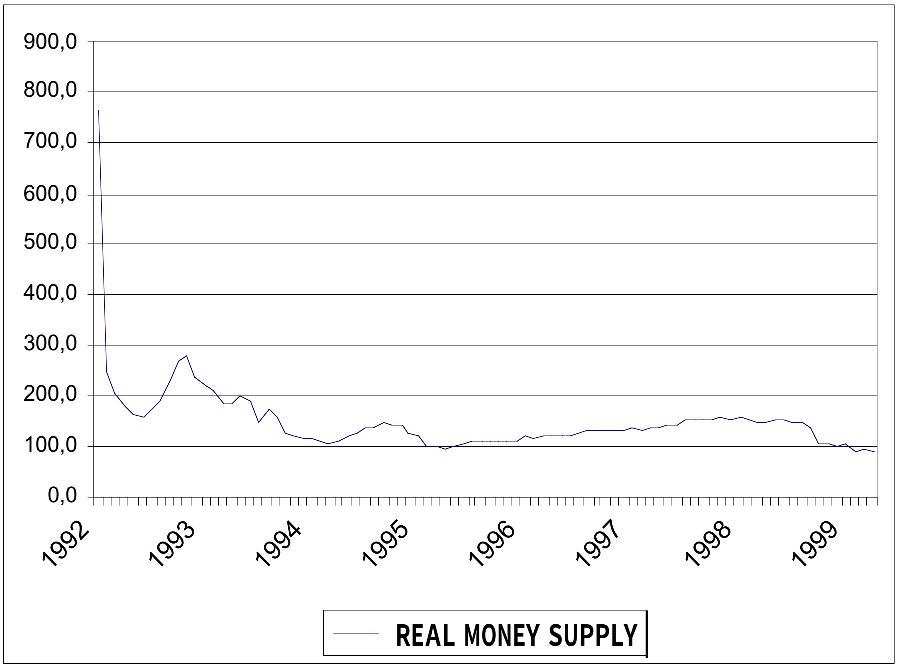

Chart 1. Real Money Supply in 1992- 1999

Chart 1 shows that during the 1990s, the real money[4] supply contracted several times relative to 1991. The real money supply's main contraction could be seen in 1992 during the high inflation period, which was first caused by attempts at price liberalization to eliminate shortages in goods and the monetary overhang inherited from the Soviet era. Inflation at that time was closely linked with fiscal performance.

Chart 1 also shows that in the early 1999, the real money supply dropped essentially to the same level as early 1995, the period when the government rejected direct borrowing from the Central Bank. In actuality, the money supply in real terms was steadily growing in 1995- 1997. This growth, however, was largely caused by the expansion of financial markets, not by an increase in demand for money from the real sector (in fact, remonetization of the economy should be a future macroeconomic policy objective, and should accompany recovery in the real sector). Econometric analysis clearly indicates some correlation between real money supply growth and a two- quarter delayed growth in the real stock of government bonds. Thus, it was quite natural that against a background of falling output, real money supply contracted during and after the 1998 crisis; investors sold Russian assets and government securities, shifting demand to hard currency with the intention of withdrawing their assets from the country. It also proved certain linkages existed between money supply trends and activi-

4 Deflated by the CPI as a proxy of price changes, though it may be not quite accurate.

ties in the assets and securities markets. In this situation, attempts to create some standard type of money demand function (where money demand depends on interest rates and real output, for instance) explain satisfactory results for the period from 1993 to the end of 1997 or the beginning of 1998. Extension of the sample period for one or two quarters more deteriorates the statistical characteristics of the regression, illustrating that demand for money actually collapsed in the crisis period and remained low afterwards. At the same time, monetary authorities oversupplied money by injecting liquidity,[5] thus, fueling inflation in October 1998-February 1999 and depreciating the national currency.

Summarizing the Russian economy's recent results, one could actually say that the ruble's nearly four-fold nominal devaluation, which occurred from mid-1998 to mid-1999, resulted in a contraction of the country's ruble supply (if valued in dollars and market exchange rates are employed). By mid-1999 ruble M2 valued in dollars decreased to some 22.7 billion dollars, which was approximately the same as it was in 1994. If one includes dollar corporate and household accounts with Russian banks (which are not taken into account in the Central Bank's "national definition" of M2) then the entire money supply increases, but not by much, to approximately 30 billion dollars.

Low monetization means that the Russian economy is very sensitive to capital flows. If, prior to devaluation, an outflow of foreign capital equivalent to some 10 billion dollars easily created serious macroeconomic problems and harm the entire financial system, then at present, an outflow of a few billion dollars will be enough to potentially undermine financial stability. Thus, remonetization of the economy is of great importance, but it must be a long-lasting process that should accompany economic growth. As was witnessed by previous developments, an increase in the real money supply could be achieved in a low inflation environment. Low fiscal deficits (or even surpluses) are, in turn, the necessary conditions for achieving price stability or, more conservatively, maintaining a low inflation environment. Sound fiscal policy is most important for Russia given its heavy debt burden. Tightening fiscal policy should also be done at the regional level.

The liquidity problems discussed above are seen even more at the regional level, as some regions became much more demonetized in the 1990s than others. Table 2, for instance, shows the allocation of corporate bank accounts (second column) along with some other indicators by selected regions. It shows that more than 70 percent of firms' money is allocated in the Moscow region, while in the rest of the regions the corporate sector lacks liquidity and regional economies are essentially based on arrears and barter. Thus, mutual offsets and wage arrears are more common in the regions than in Moscow.

The problem of wage arrears was very severe in Krasnoiarsk Oblast or Kemerovo Oblast (a coal mining region), where firms' bank accounts were seen

5 In September to December 1998, the nominal money supply increased by just over 30 percent, while the real money supply shrank by nearly 33 percent over the same period.

Table 2. Selected Economic Indicators by Russia's Major Regions (as of 1998)

	GRP as a percentage of Russian GDP	Regional corporate accounts as a % of total Russian corporate accounts	Population as a % of Russian population
Moscow and Oblast*	14.9	71.1	10.4
Tiumen' Oblast	9.6	3.1	2.2
St. Petersburg and Oblast	4.2	4.2	4.3
Sverdlovsk Oblast	3.7	1.3	3.2
Samara Oblast	3.1	1.5	2.2
Republic of Tatarstan	3.1	1.2	2.6
Krasnoiarsk Oblast	3.0	0.4	2.1
Republic of Bashkortostan	2.9	1.0	2.8
Cheliabinsk Oblast	2.5	0.5	2.5
Perm' Oblast	2.4	0.7	2.0
Kemerovo Oblast	2.4	0.7	2.1
Nizhegorod Oblast	2.4	0.9	2.5
Irkutsk Oblast	2.3	0.5	1.9
Rostov Oblast	1.6	0.6	3.0
Novosibirsk Oblast	1.6	0.6	1.9
TOTAL for 15 regions	59.7	87.3	45.6

* According to Russia's administrative divisions, Moscow and Moscow Oblast as well as St. Petersburg and Leningrad Oblast, unlike other regions, are separate administrative units and subjects of the Russian Federation. To make comparisons with other regions easier they are combined in the table. Such combinations make sense because of labor mobility within the regions, when people from the oblast are employed in Moscow or in St. Petersburg.

Sources: Central Bank of Russia, Goskomstat.

Table 3. Selected Economic Indicators by Russia's Major Regions

	Moscow and Oblast as a percent of Russia (As of April 1, 1999)	(As of July 1, 1999)
Ruble deposits	92,2	91,6
Dollar deposits	91,7	89,1
Corporate ruble accounts	77,7	77,2
Corporate dollar accounts	87,9	87,0
Budgetary accounts	79,8	78,5
Credits in rubles	79,6	81,6
Credits in dollars	92,1	92,2

Source: Central Bank of Russia.

very low relative to the regional GRP[6] or population, although it should be noted that many big regional enterprises have their headquarters in Moscow (like Gazprom or Lukoil), and their bank accounts are also mostly held in the Moscow region. Table 3 indicates that the allocation of cash among the regions became more uneven by mid-1999 as Moscow's share increased substantially, contributing to further regional demonetization. By mid-1999, 90 percent of deposits were held in Moscow banks, most credits were also allocated in the Moscow region, and the share of corporate accounts in Moscow banks also increased relative to 1998 (compare Tables 3 and 2).

In the early 1990s, the real economy reacted to the liquidity squeeze with a rapid growth in arrears and barter, which largely substituted for cash transactions, largely damaging regional economies. Demonetization, in turn, negatively affected tax collection. Monetary policy at the end of 1998 allowed for a reduction in the growth rate of arrears and barter, although the fundamental dilemma remains: if, from the institutional point of view, arrears are in fact "allowed" in the economy, then which type of performance is better - high inflation and a relatively stable stock of arrears, or low inflation and growing arrears?

As also seen from Table 2, 60 percent of Russia's GDP is produced in 15 of the country's 89 regions. At the same time, three regions (Moscow, St. Petersburg along with their oblasts, and Tiumen' Oblast account for nearly one-third of Russia's GDP. According to official statistics, less than 17 percent of Russia's population accounts for this economic activity. In this context, it can be said that the above 15 regions represent the Russian economy's core and most of the major regional problems can be studied on the basis of this limited number of regions. Moreover, these regions' governors (plus some from other republics and oblasts) may in fact dominate the country's future by establishing strong and united political leadership. In this context, it is worthwhile to briefly discuss the fiscal situation and wealth allocation in the above regions. Table 4 shows some of these indicators for Russia's major regions.

As this table shows, the budgets for the bulk of Russia's regions, apart from Moscow, St. Petersburg and the nationally based republics of Tatarstan and Bashkortostan, are relatively low; at least, they are well below Russia's average level. It is also important to note that the share of transfers from the center to local budgets is the highest for Tatarstan and Bashkortostan, i.e. the highest transfers are to the regions with majority native populations. This type of situation is quite common for other regions as well. The share of GRP transfers is highest for all other nationally based republics such as Dagestan (over 27 per cent of GRP), Tyva, Adygeia, Kalmykiia, Ossetia and others where the share

6 Gross regional product statistics officially released by Goskomstat show experimental calculations for Russia's regional breakdown of the GDP, characterizing regional economic activity. Despite the fact that the above data refers to 1996, it can be considered as representative of the current situation.

Table 4. Selected Fiscal and Wealth Indicators of Russia's Major Regions

	Total regional budget revenues (% of GRP)	Budget transfers from the federal level (% of GRP)	Household monthly incomes (US$) 1997	May 1999
Moscow	15.8	0.2	605.9	245.6
Moscow Oblast	18.2	1.5	100.4	43.0
Tiumen' Oblast	2.0	0.2	385.8	140.2
St. Petersburg	18.1	1.4	172.7	58.3
Leningrad Oblast	15.7	3.3	108.6	39.1
Sverdlovsk Oblast	11.5	0.3	146.8	49.1
Samara Oblast	11.3	0.2	163.9	77.7
Republic of Tatarstan	18.5	4.9	116.6	46.0
Krasnoiarsk Oblast	11.4	0.1	179.1	69.5
Republic of Bashkortostan	17.2	4.1	108.3	42.3
Cheliabinsk Oblast	11.1	0.4	119.7	46.5
Perm' Oblast	11.2	0.3	165.1	62.3
Kemerovo Oblast	12.7	2.1	174.6	65.3
Nizhegorod Oblast	13.1	0.9	110.2	37.1
Irkutsk Oblast	9.7	0.7	171.5	70.5
Rostov Oblast	14.0	2.3	110.7	45.6
Novosibirsk Oblast	11.8	0.7	118.4	42.1
Russian average	14.8	2.5	159.5	59.8

Sources: Ministry of Finance, Goskomstat

of transfers from the center vary from 10 to 20 percent of GRP. Such transfer allocations, which are by all means in favor of the above-mentioned regions, resulted from bilateral treaties between federal authorities and the regions. The share of transfers in most Russian provinces with ethnic majority Russians is well below 1 percent of GRP. This means that wealth generated in the main parts of Russia is partially reallocated to nationally based republics. This was the price for political unity in the country. In the case of Tatarstan and Bashkortostan, such transfers largely consist of transfers from social security funds. Thus, their average monthly household income is not that much higher relative to the rest of Russia. Relatively low average household incomes may also indicate that the private sector (where incomes are much higher than in the state sector) is less developed in Tatarstan and Bashkortostan relative to those regions of Russia where incomes are higher (apart from oblasts which produce and export energy).

Regional development was analyzed to determine whether or not subsidies from the federal government contributed to the relative improvement in the regions' economic performance. No such relationship was detected either for 1999 (January-May), or for previous years. According to Goskomstat, Russia's industrial output between January-May increased 1.5 percent relative to the same

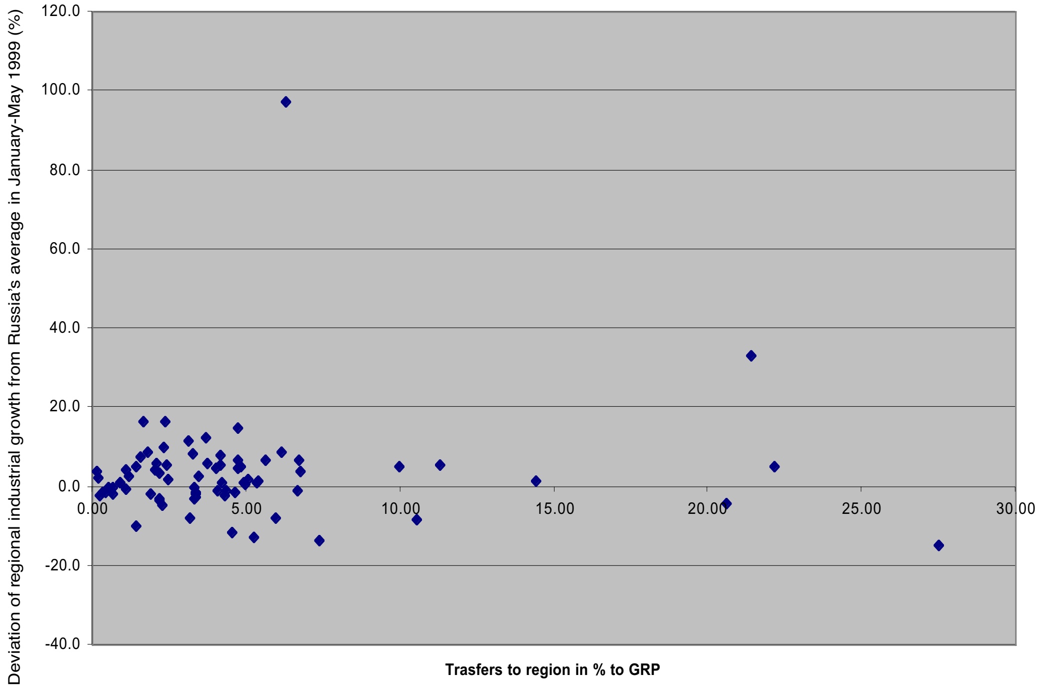

Chart 2. Transfers to Regions and Industrial Growth by Regions

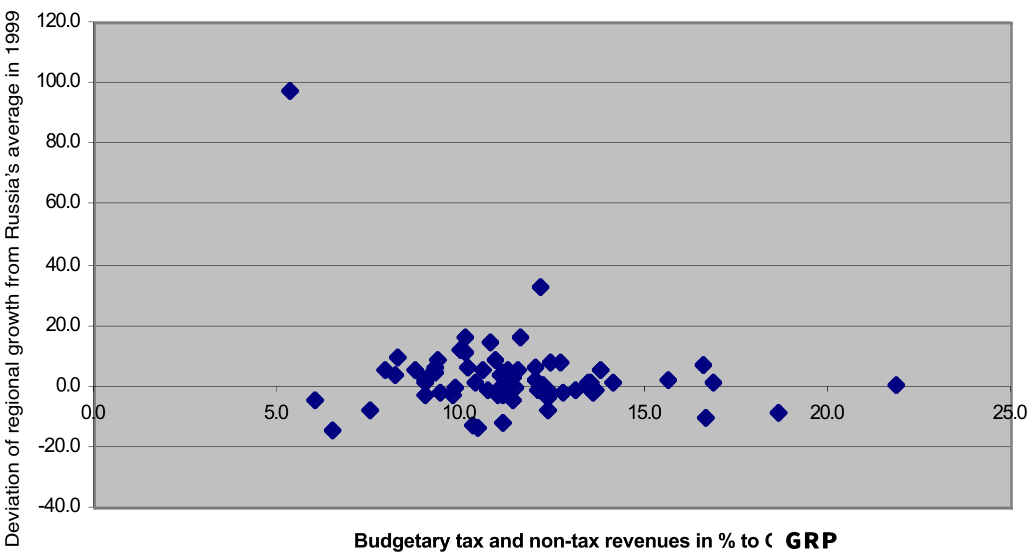

Chart 3. Share of the Budget in GPP and Industrial Growth by Regions

period in 1998. It is possible that these regions, which received more subsidies in 1998, grew faster than the others. Or the opposite could be true; one may assume that subsidies have a negative effect on economic activity.

Chart 2 shows a cross-regional diagram where subsidies as percentages of regional GRP for each region are shown on the X-axis, while residuals between regional and Russia's average growth rates are shown on the Y-axis (the reasons for Altai Republic's abnormal 100 percent growth were previously discussed above). No relationship was found between the share of the budget in GRP (transfers excluded) and growth (Chart 3), although in the future it may appear that growth should be faster in regions where the public sector is smaller.

It can be also seen from other cross-regional studies that subsidies have little effect on consumption and other major indicators. Thus, a future priority should be to reconsider the procedures for allocating subsidies, since they offer negligible impact and low efficiency.

Political Economic Issues and Regional Development

Russian economic performance shows that the efficiency of economic policy was seriously constrained by political economic issues. In reality, Russia's authorities and top decision-makers lacked a clear long-term vision of the country's future. The country's public was never explicitly told what sort of society and what sort of economy it was moving towards. It was never explicitly stated that Russia was going to build a capitalist society. As a result, the country experienced a transition without any clear objectives. General statements that prosperity would be attained through building a market economy or that economic growth would automatically resume right after financial stabilization were in fact no more than Soviet-style slogans.

At the same time, economic agents in Russia were expecting clear and publicly acceptable ideas such as whether Russia would be a part of the European Union in the future (like Poland), or whether it would rely more on autonomous development (like China, for example). Such goals are much more concrete than general intentions to build a market economy.

In reality, if the country seeks to be a part of the European Community in 10, 20 or 50 years, then legislation and market institutions similar to those in developed countries will be needed. Thus, the legislators and the government should cooperate in order to move towards the same direction instead of engaging in permanent confrontation (which is the case in Russia). In contrast, for many years the country has lived with the illusion that Russia will remain a superpower forever, and that the transformation difficulties are only temporary (although, as they say, "there is nothing more permanent, than temporary"). It finally looks as if such illusions vanished after the August 1998 crisis, and Russia can now be considered as a "small open economy" with low GDP per capita and with foreign debt equivalent to its GDP. At the same time, its growth potential remains high. It was very important for Russians to overcome the above illusions given the globalization of asset markets and the permanent threat of destabilization to the country's markets when capital can quickly enter and leave.

The need to resume economic growth in order to begin solving the country's problems is a fundamental task. It is more likely to be achieved in a political environment characterized by a relatively small, but strong, public sector which guarantees easy entry into business, intellectual and property rights protection, and encourages economic agents to take risks in order to develop innovative businesses. It should also be expected that growth, when resumed, might be extremely uneven across the regions due to their rather varying economic structures, natural resources, and cultural roots. History has shown the inefficiency of economic development based on a large public sector and state power which pretended to be strong.

Such political economic issues are of great importance for Russia and its regions as they determine the budget's size and how the tax system should be shaped so that it can supply the budget with the necessary revenues. The long-term vision of the country's development should also shape monetary policy, another key economic policy tool, in the sense that it should be based on particular monetary rules, like exchange rate or inflation targeting, depending on the medium and long-term objectives. Stability in the political economic sense for Russia should allow it to cope with capital outflows (as it did in the past) or take into account the possibility of capital inflows. Investment will be also uneven, depending on regional geographic, political, etc. peculiarities.

The results of transformation indicate that Russia can solve most of its problems in a democratic, liberal economy environment. In actuality, the government's share of the GDP is already below 30 percent (including extra-budgetary funds), which is smaller than most European countries. Most income is earned by the private sector and the division of income across economic sectors and the regions is very uneven, allowing for capital to be accumulated within a rather narrow group of individuals. The allocation of assets after privatization was also concentrated within a small group of owners. This means that potential investment can only come from a minority of society. It does not mean, however, that the rest of society should remain in poverty. Apart from creating jobs in traditional sectors where investment can enter, federal and regional governments should encourage development based on innovation rather than on exploiting existing assets. They should also encourage risk-taking and competition. Microsoft, the world biggest company according to its market value, started two decades ago with no assets (according to Business Week's report, its market value exceeded 407 billion dollars in 1998, surpassing General Electric, the world's second largest company by one-third). Global development shows that future wealth should depend on innovation. Among the world's ten largest companies, apart from Microsoft, one can find Intel, AT&T, IBM, and Cisco Systems representing relatively new sectors of the economy. In this sense, the results of privatization, even though many consider them unjust, are of less importance relative to establishing an appropriate investment climate with low market entry barriers. This is largely the responsibility of regional governments.

In the long run, Russia can hardly afford to rely on exporting energy and semi-finished products, although at present they are the only source of currency revenues and potentially the main source of investment. Thus, the aim of economic policy should be to encourage investment in Russia, as well as reliable guarantees for the protection of private and intellectual property. Given that after devaluation, the outflow of capital is estimated at 10 to 15 percent of GDP, economic growth may resume and remain high if the outflow is reduced and money is invested in Russia (although monetary authorities will face potential problems in sterilizing hard currency inflows).

In conclusion, it should be emphasized once again that the authorities will not be able to conduct more credible economic policies until after presidential elections of 2000. Servicing the foreign debt will remain a key constraint for economic growth, squeezing resources out of the country. At the same time, given the size of Russia's capital outflows, if the government is able to restore confidence, the outflows may revert to inflows and the Russian economy may improve. Investment will come to those regions where institutional reforms are more advanced. Tax collection will also be improved if the government is able to shift the tax burden from the corporate sector to individuals. Remonetization of the economy is another priority, as investment is unlikely in a demonetized economy. Remonetization can be achieved in a low inflation environment; thus, the role of monetary policy should be to increase the money supply in the future given that the government's fiscal strategy is already oriented towards tougher budgets. Monetary policy should also aim to achieve an even monetization of the regional economies.

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