



# The Russian Economy in Crisis and Transition

Edited by Pekka Sutela

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in Crisis and Transition

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# Preface

The Bank of Finland's traditions in activities pertaining to the economies of the region comprising the former Soviet Union and the former socialist countries of Central and Eastern Europe are of long standing. The Bank's bilateral trade department administered the clearing payments system and the exchange control measures related to bilateral trade. The monitoring of economic developments in these countries was also the responsibility of the department.

The clearing arrangement between Finland and the Soviet Union was terminated at the end of 1990 and the Bank's operative tasks in this area came to an end. However, the extensive economic and social changes that got under way in the former Soviet Union and in Central and Eastern Europe maintained and even increased the need to continue the economic monitoring and analysis of these countries in the Unit for Eastern European Economies that was established at the Bank in September 1991. Special attention is paid by the Unit to economic and monetary developments and trade policy issues in Russia and the Baltic states and their implications for Finland. In addition to Finnish researchers, experts from abroad work at the Unit as visiting researchers.

This publication consists of selected articles and studies prepared in the Unit. They provide an overview of a number of crucial issues in the Russian economy during the present transition to a market economy. I hope that they will serve to stimulate discussion on topics in this area. Naturally, the opinions expressed here are solely those of the authors.

Kalevi Sorsa  
Member of the Board of Management  
January 1993

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# Overview

Russia emerged as the most important successor state of the USSR in the aftermath of the abortive coup of August 1991. At the end of October, president Yeltsin announced the beginning of a radical policy of transition from a centrally managed economy to a market economy. The Yeltsin–Gaidar administration decided on its basic economic policy by December. It opted for a gradualist strategy of transition. The reform process was initiated on 2 January 1992, when nearly all prices were liberalized. At the same time the government in principle freed domestic trade and imports, while exports remained subject to restrictions of various kinds. In addition to liberalization, another centrepiece of the first phase of transition policy was stabilization. The government set out to reduce the huge budget deficit it had inherited and to restrict money supply. It was decided that the second phase of reform would follow later in the year, when the rouble would be made convertible, privatization would commence and structural change would get under way.

This strategy was made explicit for the first time in a Policy Memorandum submitted to the International Monetary Fund in late February. In summer 1992, the government duly announced that the first phase of reforms had been successfully completed and declared that the country was ready to move on to the second phase, that of privatization and restructuring.

The articles in this volume highlight many of the central aspects of Russian economic policies since the Yeltsin–Gaidar administration came to power. This introductory chapter makes a tentative general appraisal of the path travelled so far. As if to underline the inevitably preliminary character of any appraisal of such recent events, it also risks some general speculation regarding the future of Russia. The approach applied therefore differs from that of the articles that follow. Even if the speculative views advanced below may seem disconnected, they are based on the analyses presented in the articles. If the relatively optimistic scenario to be outlined here turns out to be mistaken, the obvious conclusion to be drawn is that something may have been overlooked in analyzing the past.

All the articles in volume are based upon information available by the end of September 1992.

## Gaidar's glass — half empty or half full?

Policies are seldom total successes or complete failures. More typically, they may be judged to be either half successful or half failures, depending on the policy goals assumed. In the case of the economic policies of the Yeltsin—Gaidar administration, the glass of success is however either one-quarter full or three-quarters empty. There have been successes, and they deserve more credit than it is fashionable to give. Such successes, however, are counterbalanced by failures relative to the goals set early on. Thus, while there has been no dissolution of Russia itself, the powers of the centre (Moscow) relative to many, increasingly assertive, regions have been eroded and this process is continuing. Indeed, the worst in this respect is still to come. The rouble has not lost all its credibility, but there is an imminent danger of hyperinflation. Production has not collapsed totally, but still the decline — at least as recorded in statistics — is unprecedented in peacetime. At present, there is almost no open unemployment, but jobs have been saved at the cost of postponing much needed structural change. The government has made real achievements in liberalizing prices and entrepreneurship, but such changes have increased openly visible income differentials. Not surprisingly, both changes are opposed by important population groups. The government also sought to liberalize foreign trade and payments, but actual trade rules have been inconsistent and unstable. The attitude of the government to foreign investment and international financial organizations has changed completely, but membership of the Bretton Woods institutions has not been matched by large inward resource flows, either public or private. In fact, Russia seems to have become a capital-exporting country.

In this volume, the Russian stabilization programme is discussed by *Alexashenko*, who in another article also addresses the intriguing question of income distribution and redistribution. The foreign sector is analyzed in two articles. That by *Laurila* concentrates on debt problems while *Sutela and Kero* survey the complicated problems of the trade and payments regime.

Overall, the biggest achievement of the Yeltsin—Gaidar administration over the last year must be judged to have been that it has presided over a society undergoing rapid change without having to witness large-scale violent upheavals. Only a year ago many observers thought that either change was impossible in Russia or that it must



always take place through senseless violence, *Russkij bunt*<sup>1</sup> or *Russkaya svoboda*<sup>2</sup>. Such stereotypes now seem to be without foundation, in Russia proper at least. One may, of course, question whether such relative stability should be seen as an achievement of the government, but that will in all probability be the way in which future historians see the matter.

It is worth pointing out that the economic policies of the Gorbachev perestroika period — as well as such early reform proposals as the Shatalin—Yavlinsky 500 Days' Programme — were based on the belief that liberalization of prices would be socially unacceptable. On 2 January 1992, nearly all retail prices were in fact liberalized, as fully as was possible under the given institutions. Still, there were hardly any demonstrations or strikes.

As regards the stabilization of the economy, assessing the performance should be easy, given a monthly inflation rate of at least 20 per cent, a plummeting rouble in currency auctions, a federal budget in almost record deficit after receiving only a fraction of planned-for revenue and the country clearly heading towards debt write-off. All of this is very far indeed from the government goals adopted and agreed with the IMF. Observing the unwritten code of politics, the Yeltsin—Gaidar administration has been remarkably unwilling to concede that its economic stabilization policies have failed. Instead, they optimistically talk about moving on to the second phase of economic transition, that of privatization and structural change. A bold programme of mass privatization has been proposed and various industrial policy programmes are being debated. The privatization programme is discussed in this volume by *Lainela and Sutela*.

Though assessments are bound to differ, one can argue that the overall failure of recent economic policies was inevitable. The distortions inherited from the USSR were huge. Most policy institutions and instruments relevant in a transition to a market environment either never existed or became inoperative with the collapse of the Soviet Union. Nevertheless, economic stabilization had to be the first priority as a total loss of confidence in the rouble and thus in money had to be avoided if at all possible. Prices had increasingly become random numbers beyond anybody's control but

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<sup>1</sup> Literally, "Russian revolt"; more graphically, a senseless outburst of mob violence of the kind seen over past centuries.

<sup>2</sup> Literally, "Russian freedom"; more graphically, violent anarchy.

absorbing more than a tenth of national income in the form of subsidies. They had therefore to be officially decontrolled, though the absence of competition in Russia's typically highly monopolized industries was, of course, well understood.

Below, *Kivilahti*, *Kero and Tekoniemi* address one class of institutional issues, that of banking and the financial system.

Essentially, the Yeltsin–Gaidar government tried to do the right thing in their economic policies; there was no real alternative to putting stabilization first. This has been contested by some observers on what seem to be extremely weak and misguided grounds. Stabilization and liberalization can only be achieved by what amount to shock therapies. There is no practicable way in which privatization and restructuring can be implemented rapidly. Nevertheless, as noted above, the government was bound to fail. It also made its share of avoidable mistakes.

The absence of three supporting factors became the administration's main handicap in 1992. First, there was the political quandrum. The government itself had no direct political mandate from the people, only an indirect one through the popularly elected President. The government lived on borrowed legitimacy. Parliament had been elected in completely different political circumstances and offered much resistance to the government's policies. Its basic weakness, however, was that it lacked strong leaders and an alternative economic programme of any credibility. Second, there was the international environment. The government enjoyed no more than the symbolic support of international institutions in spite of the overwhelmingly positive general attitude of G7 and others. The resources — not only money but primarily human resources — of the Bretton Woods institutions are scarce, and Russia was unable to commit itself to undertaking a proper adjustment programme. Conditionality should always be an essential prerequisite for any programme of financial assistance by the Bretton Woods organizations, regardless of the fact that in this case the country happened to be Russia. Third, the government was unable to regulate its relations with the other successor states of the USSR on a lasting basis. The legacy of the Russian and Soviet imperial past remained unresolved. At the practical level, the absence of a single central bank for a single currency proved catastrophic. In a classic free-rider situation, all the states of the rouble area had an incentive to run budget deficits financed by monetary expansion, as the benefits of budgetary outlays and the costs of inflation would be asymmetrically distributed within the area.

## Who is to blame?

Looking for culprits might be a futile exercise if "who is to blame" were not such a traditional Russian question. Clearly, it will also be of political importance.

Overwhelmingly difficult though the policy environment was, the Yeltsin—Gaidar administration must take its share of the blame for the unnecessary failures of the past year. The first thing to note is that — contrary to popular perceptions — the programme it adopted was not the pure Polish-type shock therapy. To take up one important difference between the Polish and Russian programmes, we cannot say what the consequences of an immediate declaration of convertibility on current account (as in Poland and Czechoslovakia) would have been. What we do know is that the gradualism exercised by the administration in this respect has turned into muddling through and must surely be judged to have failed.

The administration has also been too hesitant for too long about the basic policy to be adopted *vis-à-vis* the other successor states of the USSR. Furthermore, the practical policies of the government have often — foreign trade is a prime example — been inconsistent and even chaotic. Also, the administration has been slow or reluctant to recognize some of the extremely worrisome developments in the economy. Finally, one should ask whether it really was impossible to do more for institutional evolution than the government has done.

Other states of the Commonwealth of Independent States, notably Ukraine, did their share to destabilize the Russian economy, in particular by liberally granting credits in roubles. Finally, the G7 pushed the responsibility for assisting Russia on to a totally unprepared and underqualified IMF. This did not exactly help the mobilization and coordination of international assistance. Future historians will debate whether the advice offered by the international organizations was competent enough.

## Stabilization, recession and growth

In Moscow, the administration has faced much criticism for having pushed the economy into a deep and protracted recession. It was emphasized above that there were no real alternatives to stabilization as the policy goal of the highest priority. There can be no doubt that attempts at implementing stringent policies tend to depress demand and production, but the real depth of the economic crisis is still unclear. There have been losses of production, but so far none of employment. Part of the lost production was socially useless or even dangerous, while many new activities are only very imperfectly recorded in statistics. Official statistics are sometimes almost useless, especially when attempting to measure prices, real incomes or foreign trade and payments. The microeconomic process behind statistical aggregates remains unknown.

For all the hue and cry, one should remember that production losses induced by stabilization in Russia have probably been less than in Poland in 1990. In fact, industrial production and jobs have been maintained by first accumulating inter-enterprise arrears and then by partially monetizing them. The government, perhaps due to its fundamental political weakness explained above, has maintained full employment by allowing high inflation and continued inefficiencies.

One should also ask what might have been the consequences of alternative policies proposed in the Russian debate. Without going into detail, it should be clear that attempting rapid privatization and restructuring prior to economic stabilization would have been impossible. Such attempts could only have spelled even greater chaos than now seen. Abandoning stabilization attempts would have led to the total collapse of the rouble, the ensuing reign of regional substitute currencies, the political dissolution of Russia and an even greater collapse in production.

Still, one should not try to explain away the current crisis. What is more, while the economics of stabilization are relatively well understood, there is really nothing in the standard economics of transition that tell us how a post-Soviet-type economy can be guided from the stabilization-related recession to sustained, investment-based growth. Whether Russian governments pursue consistent stabilization or not, this will be the real challenge to be faced in the years to come.

## Russian peculiarities

In a broad sense, Russian and East European stabilization programmes reflect the "Washington Consensus" in development economics. As is well known, this general view has brought about results which, when incorporated in IMF-sponsored programmes, are rather less than perfect, especially in Latin America. The Washington Consensus is also currently facing mounting academic criticism, in particular regarding its emphasis on rapid liberalization of foreign trade. In Russia itself, the critics of the government programmes often claim that, because of its peculiarities, Russia should not be subjected to the same kind of treatment that might — just might — be appropriate for Chile, Mexico or Poland. Unfortunately, such critics — even when they come from the very highest ranks in Russian academic circles — seldom, if ever, indicate which real or alleged features of the Russian case they have in mind and how exactly these peculiarities might impact upon possible and preferred policies.

It is nevertheless true that Russia has been, is and will remain unique. Let us therefore try to set at least part of this particular record straight. Some of Russia's real peculiarities stem from geography and history. To start with the most obvious and undisputed fact, Russia is a huge country well endowed with resources. Geographically, however, these resources are very unevenly distributed. Put crudely, the European West has qualified labour as well as most of the existing capital stock. The natural resources are in Siberia and the Far North, while net additions to labour force can only come from outside Russia. The basic resources are separated by distances that will always make transportation, migration and other resource flows major concerns. Maintaining the economic integrity of Russia must therefore have high priority for any government. At the same time, there must always be a strong temptation for regional selfishness.

Fortunately, and contrary to many impressions, Russia is ethnically a relatively homogenous country. Almost nine-tenths of the population in Russia today are Russian, and this share will grow with Russian immigration from the other successor states of the USSR. There are few sizable ethnic minorities in Russia, and it should be possible to localize any ensuing conflicts.

Furthermore, the Russian population has, over the decades and centuries, developed a popular psychology characterized by paternalistic dependence, risk aversion, suspicion of change and the

unexpected, as well as egalitarianism *vis-à-vis* end states, not opportunities. Especially in times of change and uncertainty, like today, this helps to give rise to a widely-shared yearning for the past, be it the Stalinist certainties of a few decade ago or a mystified peasant society in the more distant past.

Even at the risk of sounding preposterous it is essential to point out a peculiar feature of the Russian statehood. The state of Russia always seems to have had an illiberal government with a peculiar gap between aspirations and policy resources. It is difficult to say exactly why, but as an empirical fact one can note that the typical Russian government, often assisted by messianistic visions created by intellectuals, attempts to extend the power and involvement of the state throughout society. At the same time the state remains quite incapable as regards its financial, human, bureaucratic and other resources of reaching the chronically overambitious goals that have been set. The capacity of the state is therefore a concern of immense consequence in Russia. Social engineering that comes relatively easily, though at a price, in such otherwise differing countries as the Scandinavian or Far Eastern ones, is simply beyond the practical powers of the Russian state. Corporatism is possible in Russia, but it will be of the weak Latin American type, not of the orderly European type.

What I will call The Russian Chasm between policy aspirations and resources is naturally a sure recipe for an uncivil society and corruption on a large scale. It is and will also remain one determinant of the macro dynamics of politics in Russia. At the same time this fundamental incongruence of means and goals is a phenomenon with even wider implications. In a sense, it entails living and coping with inevitable failure. The czars, Brezhnev and even Stalin shared the same fate. Gorbachev is a recent addition to this list. The implications for the future will be discussed below.

And, of course, Russia is and never can be either a really European or an authentically Asian country. It must remain Russia. Without exaggeration, most Russian literature and social philosophy consists of attempted answers to what being genuinely (and nothing less than the genuine thing is sufficient in such discourses) Russia might actually mean. This was so in Dostoyevsky. Today and for our purposes, this peculiarity of Russia means that there is not and cannot be a fundamental Russian consensus on the projected end state of the transition. This is a huge and all too seldom appreciated difference in relation to the countries of Central and Eastern Europe, where a very wide consensus says that the task ahead is fundamentally a very easy

one: to return to Europe and become an ordinary European state. Doing that in practice is, of course, far from easy, but the real issue here is a different one. Who can even start thinking about Russia as a Holland or even another France?

Another class of Russian peculiarities is a consequence of the long decades of socialist rule. The penetration of the economy and society by the socialist state was both much deeper and more thoroughly rooted over a longer period of time than anywhere else. This has much strengthened the state-centred attitudes already nurtured during the pre-revolutionary regime, when capitalist market-economy relations always remained small pockets in the sea of a paternalistic peasant economy, itself much dependent on the vagaries of the autocratic state. Such a fusion of the economy, society and the polity means that real change in Russia cannot embrace only the economy, but it must — even in the relatively short run — also penetrate politics, culture and even the statehood of Russia. This is a crucial difference both between Russia and Central and Eastern Europe and — even if in a wholly different way — between Russia and China. The much discussed path of authoritarian twentieth century modernization was never open for Russia. In Russia, authoritarianism in politics combined with measured liberalization in the economy becomes an impossible equation. It is somewhat astonishing that this is so rarely understood.

The Russian economy is also highly monopolistic, almost totally protected from foreign competition and exposure as well as structurally anomalous. It also lacks most of the physical, social, legal and institutional infrastructure taken for granted in many developing economies. To take just one example, Russia has never had a body of existing legislation. For many practical purposes, the dividing line between the legal and the illegal simply does not exist.

Finally, there are the peculiarities caused by the recent developments. On one hand, previous socialist economic reforms in Russia were so superficial and incomplete that they failed to give economic agents and decision makers adequate preparation to act in a market environment. In the late 1980s, even the best senior academic economists and policy advisors did not understand the basic logic of markets. Even rudimentary market institutions were missing, and extremely few people had been exposed to a real competitive environment. Therefore, there should be much room for relatively easy improvements in productivity.

But on the other hand, the secular decline in Soviet economic growth and in the technical level and productive capacity of the

resource stock that started in the late 1970s implies that the current Russian economic crisis has a hugely important and poorly understood long-term structural and technological background. The most recent troubles — financial imbalance, the collapse of the rouble, the dissolution of the USSR, separatism within Russia itself, the foreign insolvency of the country and the rapid decline in production — are naturally extremely worrisome in themselves. But they are still only the visible part of the iceberg. Under the surface is an economy that has been in serious decline for almost two decades. This is not the Great Depression or Germany after World War Two. This is a crisis imposed on top of long-term decline. The well-known recipes of stabilization are a necessary part of Russia's recovery. But ultimately, what is really needed is sustainable growth based on investment, innovation, technical progress and structural change. Such growth has been lacking in Russia for a long time. Here is the real challenge, and Russia does not yet seem ready to face it.

To be honest, this lack of readiness is hardly surprising. Other countries also have their long-term problems and we know how difficult it is to tackle them. Just thinking of the list of tasks facing Russian policy-makers is bewildering. It runs, after all, from state-building through democratization to economic stabilization and restructuring to defining one's place *vis-à-vis* new neighbours and the world at large. Basically, the Russian question is topical again: what is Russia and where is it heading?

## Russia at the crossroads

Once again, Russia stands at the crossroads. In current foreign policy debates, the ancient division between the Westernizers — those who see Russia's future in close cooperation and even identification with the developed western countries — and the Eurasians — those who emphasize Russia's non-European peculiarities and Asian orientation — is once again evident, though with new twists brought about by the dissolution of the USSR and its failed search for global parity. The choice has also come to the fore in economic policy, as the failure of the economic policies of the Yeltsin–Gaidar administration is widely accepted. The geostrategic and economic choices are interconnected.

It should be emphasized that the current choice is not about returning to central planning. True, there exists a measure of popular



yearning for the egalitarian and relatively secure past. Still, central planning is no longer an option, for many reasons. First, the large elite and widespread popular support that were available to Stalin and Brezhnev was based on the now-absent prospect of growth, social upward mobility and super-power prestige. Second, the ideological certainties of the past have been demolished by glasnost and the Soviet collapse. Third, a Bolshevik-like movement to implement such a return to the past does not exist. Fourth, those institutions such as the CPSU and Gosplan, the KGB and the Army that used to maintain centralism have been either incapacitated or at least much weakened. Fifth, most new elites as well as (and importantly) segments of the old ones are learning to reap the fruits of economic liberalization. Insider privatization, corruption and misuse of office in fact help to cement the irreversibility of recent change. This may be ironical, but then one should remember what was said above about the uncivil character of the Russian civil society. Finally, it is widely understood that recentralization, even if it were feasible, would solve none of Russia's current problems.

It would be an exaggeration to conclude that such factors make an attempted return to past patterns totally impossible. They do, however, much diminish the probability of such an attempt and in practice doom serious retrograde endeavours to failure.

## Russian corporatism

The real alternative to present economic policies may — for want of a better term — be called corporatist. There are at least five arguments to back up this interpretation. First, Russian society is still dominated by powerful vested interest groups. Among them are the military industrial complex, the energy sector, collectivized agriculture, even the Army and increasingly also organized labour. These interest groups feel threatened by the present administration and they are consequently being organized into political parties. The centrist Civic Union is the best example. Its programme mirrors the aims and worries of industrial managers. At the same time the very heterogeneity of the Civic Union reflects some of the weaknesses of any Russian corporatism.

Second, the policy powers of the central administration continue to weaken as the actual devolution of power to the regional level goes on

in Russia. On one hand, the weakening of central powers is important as such. On the other, the growth of regional power in important cases also tends to recreate the power base of branch-specific interest groups, as many industries are highly concentrated regionally. Also, the emerging new social groups more often than not have a regional basis. In fact, the aspirations of Tyumen or Sakha are less those of the regions themselves than of the energy and precious stone industries present in those regions. If the rouble were to collapse, a dissolution of the monetary system within Russia would seem a highly probable outcome.

Third, while the Russian population accepted price liberalization rather stoically, the government seems to be totally unable to impose cost discipline, competition and structural change upon the major monopolistic industries. In face of threatening bankruptcies, inflationary finance and protectionism are far more preferable to the interest groups. This is a major policy platform for the Civic Union, and there is much sympathy for them both within the government as well as in Parliament and the central bank. Not unexpectedly, the issue of inter-enterprise arrears dominated Russian economic policy debates in mid-1992. Relative to a more consistent policy of restructuring, the corporatist solution will bring about high and continuing inflation, devaluations and foreign trade protectionism. Statistically, there will be a smaller recorded initial loss of production, but also lower long-term productivity and welfare levels.

Fourth, the newly proposed Russian variant of mass privatization will tend to make enterprise insiders in general and managers in particular the active owners of industry. This will not contribute to structural change and efficient corporate control, but it will be acceptable to the crucial interest groups. It will also tend to strengthen the irreversibility of ongoing change.

Fifth and finally, if the Soviet economy had been a command economy, the continuing collapse of the central economic institutions should have brought about an even more drastic decline in production than the one seen so far. In particular, it should have become impossible to maintain trade among the former Soviet republics and Russian regions. But in fact the Soviet-type economy was not, especially during the last few decades, a command economy. Rather, it was a bargaining economy based on long-term horizontal and vertical contacts, where the formal planning agencies mostly distributed net additions to resources. Even in old times, therefore, power resided more at the branch and enterprise level than the command economy

model would lead one to believe. This is a natural background for future Russian corporatism.

Variants of corporatism have contributed to growth and welfare in various countries. The Russian case will be a special one, however.

Though the state will remain an essential institution both as an owner and otherwise, it will be more of a forum for the interest groups than an active implementer of rational development policies. This will partly be a reaction against the overcentralization of the socialist past. It will also reflect the ongoing devolution of policy making powers in Russia discussed above. Furthermore, the successful variants of corporatism have been based on an underlying basic consensus on the fundamental goals of the society. In Russia, as pointed out above, these goals will remain widely contested.

Consensus policies are at their best in distributing net additions to resources among competing uses on the basis of widely shared priority preferences. Consensus can therefore be an effective machine for savings, investment and growth. In Russia, however, a continuing economic crisis will combine with inherited paternalism, conservatism and fear of change to bring about a basically defensive economic outlook. Consensus will turn into a vehicle for conserving existing jobs, structures and privileges. Because there is no reason to believe that existing Russian productive structures would correspond to the long-term relative advantage of the country in the world economy, Russian corporatism will have the roots of future economic weakness embedded in it. Given some optimism about the basic ability of mankind to rationally utilize the scarce resources of the planet, this signifies the ultimate unviability of the corporatist solution.

At the same time as corporatism will seem sovereign, a dual economy will in fact appear. For reasons already outlined, it will be beyond the power of any corporatist solution even to try to control the burgeoning genuinely entrepreneurial sector of the economy. As the savings available for investment will remain relatively small and the net foreign inflow of finance will not grow into a stream of macroeconomic importance, entrepreneurial activities will concentrate on short-term speculative gains rendered possible by market imperfections and government attempts at control. Remember that the government will, by trying to be a highly interventionist one, end up being virtually powerless. To paraphrase Karl Marx, Russian corporatism will, through its own attempt to maintain the status quo, end up by digging its own grave.

Overall, one feels that the Russian corporatism of the future will have more in common with the textbook Latin American case than with the rather orderly corporatism of some small European nations. Experience seems to show that if Russia now loses control over inflation and abandons attempts at structural change, a (near)hyperinflationary cycle of perhaps ten years will ensue. The exact character of attempts to contain hyperinflation will determine the long-term dynamics of economic policies.

## Alternatives to corporatism

A shift to corporatism does not necessarily call for a change of government in Russia. With the possible exception of a few liberals, most current cabinet members might well accommodate themselves to the changes outlined above. Even the liberals may seek solace in the paradox mentioned above: the government, while overextending its resources, will ultimately find itself powerless to control crucial developments in the economy. Finally, in the end, the corporatist state will have to accommodate itself to developments that it was simply unable to prevent.

The corporatist solution presents itself as the only viable path between the Yeltsin–Gaidar economic policies and total uncontrollability. The Yeltsin–Gaidar policies have failed largely because they did not have enough to offer to the powerful vested interests. When enterprises decided to accumulate inter-enterprise arrears and leave taxes unpaid, there was nothing to stop them. This spelled the end of economic stabilization. The inability to force structural change upon the vested interests, on the other hand, will signify the final conversion to corporatism.

The corporatist solution will have to walk uncertain territory between orthodox stabilization and something that can only be characterized as Russian dissolution and chaos. Two criteria offer themselves for distinguishing in which direction, corporatism or chaos, the country is going. Both concern money. First of all, Russia must bring an end to the present practice whereby more than a dozen central banks and banking systems can create roubles. The nationalization of the rouble as the Russian currency under the control of the Russian central bank will help to prevent inflation from getting completely out of hand. At the same time, it will enhance popular

consciousness of being Russian and will help to take some of the wind out of the sails of the Russian nationalists proper.

But to keep Russia one and undivided, the Russian government must also ensure that the rouble does not encounter serious competition from surrogate currencies. Increasing regional and local powers will be inevitable, as stressed above. But because there is no natural way for Russia to further divide itself into sovereign states, the maintenance of Russian statehood and a single currency will be a necessary condition for preventing a lapse into chaos.

These two objectives will, then, be the tests that any future Russian government will have to face.

Pekka Sutela

# The Collapse of the Soviet Fiscal System: What Should Be Done?\*

by Sergei Alexashenko

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\* This is an abridged version of Alexashenko (1992), written in spring 1992.

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# 1 Introduction

The fiscal system played a secondary role during the last sixty years of the planned Soviet economy. The command economy was based on the physical allocation of resources. Money flows in general, and fiscal flows in particular, merely followed behind. Money was used mainly as an accounting tool. Households were the only sector in the economy where money was a limited resource. In the rest of the economy, the financial system was similar to that of the finance department of a huge corporation, where central management is able to reallocate financial resources among corporate divisions.

The Soviet economy exploited huge amounts of natural and human resources. But even this source of economic growth was exhausted by the mid-1980s. The old system lost the ability to sustain itself and economic decline set in. The necessity of change in the economic system became more apparent, with reform of the fiscal system receiving top priority. But in fact reform was postponed until the disintegration of the USSR. The changes that did take place were only cosmetic and did not improve the system. All this added to the severity of the economic crisis in the USSR and virtually led to the bankruptcy of the state, both domestically and externally.

This paper discusses the fiscal legacy of the Soviet Union, the source of many of the problems the former Soviet republics are now having to tackle as they proceed with the transformation of their economic systems.

The second section of the paper examines the primary tool of the old fiscal system, the general financial balance of the state. The third section analyzes the main trends in the revenue and expenditure sides of the Soviet budget over the last 15 years and argues that the financial crisis which took place in 1991 was inevitable. The fourth section summarizes the overall effect of the Soviet fiscal legacy. An appendix is devoted to a brief analysis of the first stage of the Russian economic reform in the first quarter of 1992 and its influence on the fiscal system. This attempt at transformation did not bring about significant changes to the nature of the fiscal system, and the problems that face the government have increased.

The paper draws on extensive statistical data, and it is impossible to indicate all the sources. Much of this information was never published. For this paper, use was made of official information

published by Soviet and Russian authorities, information circulated among members of the Soviet and Russian parliaments, information from officials published in newspapers and magazines (usually after some verification) and the author's own estimates. For a fuller description of the data used, the reader is referred to Alexashenko (1992).

## 2 General financial balance of the state

The general financial balance of the state was for long the principal instrument of financial planning in the Soviet Union. It was tied in with all the physical plans for economic development and formed a basis for the budgetary process. Gosplan of the USSR (State Committee on Planning) was responsible for its formulation and fulfilment, as well as for the whole planning process. The basic idea underlying this document was that the Soviet state was the owner of all state enterprises and, consequently, also of their financial resources. This meant that the state was entitled to reallocate all financial resources in the budget and in the state sector of the economy. The aggregated general financial balances (GFB) of the USSR for 1980 and 1985–1990, as well as its reconstruction by the author for 1991, are presented in Figures 1–4.

This instrument of overall financial planning was in force until the end of 1990. Of course, the real influence of the GFB declined in the second half of the 1980s as a result of attempts at transforming the Soviet economy: enterprises received more freedom in decision making, the basic principles of the command economy were gradually abandoned and the state's ability to force enterprises to implement its decisions diminished. Beginning in 1991, the GFB was no more than a tool of macroeconomic forecasting.

The revenue part of the GFB (Figure 2) comprised all sources of funds available to the state, including the profits and depreciation of state-owned enterprises, cash issues and tax revenue. There were three principal channels for reallocating enterprise finances: the budget, the funds of the industrial ministries, and the financing of centralized investment by enterprises.



Figure 1.

**Redistribution of financial resources through the general financial balance, 1980–1991**

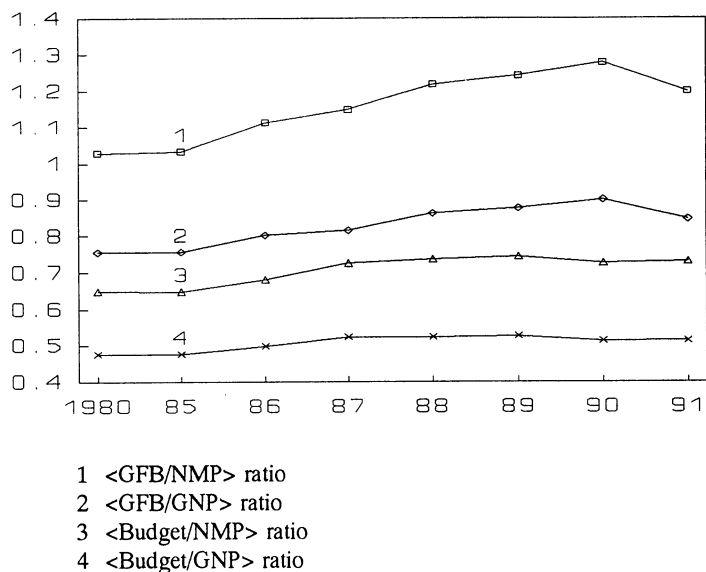
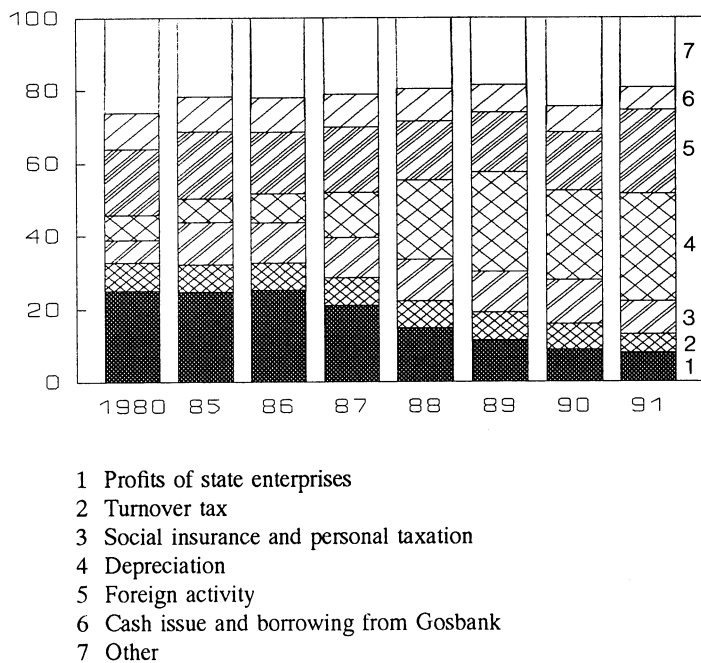


Figure 2.

**Structure of revenue in the GFB, %**

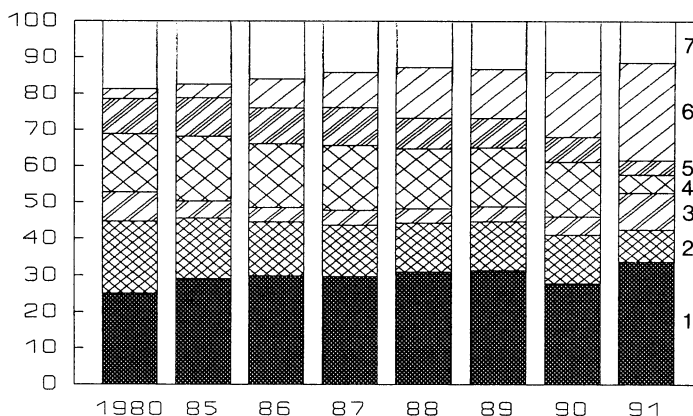


In the classical command economy, which existed until the mid-1960s, enterprises had virtually no access to their profits, and in 1965–1985 they were able to use only a small share of profits (so-called "incentive funds") under the tight control and direction of the state.

The expenditure part of the GFB (Figure 3) included all the outlays of the state and of state-owned enterprises. The structure of this part reflects the inner organization of the planning mechanism: planning by complexes. For example, social investment was included in the "investment" item, together with industrial and military investment, and pensions to the former military were part of social spending.

The 1980s were a critical time for the old system. The financial crisis also became more evident during this period. While state expenditure grew continually, the flow of revenue slowed to the extent that it was no longer sufficient to meet the needs of the state. In 1980–1985, total GFB expenditure accounted for about 75 per cent of GNP. At the end of the 1980s, the total expenditure which the state tried to control amounted to about 88 per cent of GNP. The degree of centralization of the economy continued to increase until the last years of the command system.

Figure 3. Structure of expenditure in the GFB, %

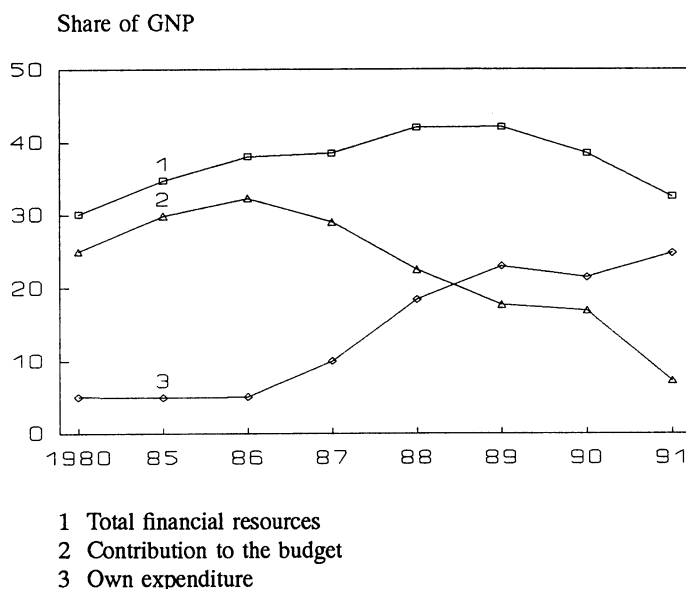


- 1 Centralized investment
- 2 Assets renovation
- 3 Differences in prices
- 4 Funds of enterprises
- 5 Social and cultural activity (excluding investment)
- 6 Defence (excluding pensions and investment)
- 7 Other

It became impossible for the state to finance its expenditure without increasingly resorting to the resources of the banking system. The share of this item in the total revenue of the GFB increased from 3 per cent in 1980 to 17 per cent in 1990 and 27 per cent in 1991. At the same time, the growth of turnover tax proceeds came to a halt and its share in total revenue declined. Foreign trade revenue also fell.

From 1987 onwards, the share of financial resources (profits and depreciation) remaining at the disposal of enterprises began to increase rapidly (Figure 4). In 1980–1986, about 70 per cent of all enterprises' resources went into the budget or ministry funds. In 1988 this share dropped to 42 per cent and in 1991 to a mere 12 per cent. As enterprises received more financial resources they also became responsible for their own spending. At the same time budgetary revenue declined. This would have caused a decline in state outlays had there been a hard budget constraint. But as the state had direct access to the resources of the banking system, the growth of expenditure was financed by domestic credits. Expenditure declined mainly through a reduction in centralized investment. Its share in the GFB declined from 25 per cent in 1980–1987 to 10 per cent in 1989–1990.

Figure 4. **Use of enterprises' financial resources**



The decline in investment contributed to the economic crisis in the former Soviet Union. At the same time, the efficiency of investment fell as less and less new capacity was introduced. Enterprises preferred instead to invest in various social projects. As new resources dwindled, the number of uncompleted construction projects multiplied.

The share of social expenditure — excluding investment but including consumer price subsidies — in total GFB expenditure remained virtually constant. The share of subsidies increased by 1 percentage point in 1985–1990; its fluctuations during this period probably depended on the weather. The share of current social expenditure (other than subsidies) even dropped by 1.5 percentage points in 1988–1990 compared with 1980–1985.

### 3 The Soviet fiscal system

The Soviet budget was usually planned on the basis of expenditure, with revenue raised as needed. The state was able to reallocate virtually all of the country's financial resources. The analysis of the Soviet fiscal legacy therefore begins with the expenditure side.

#### 3.1 Expenditure

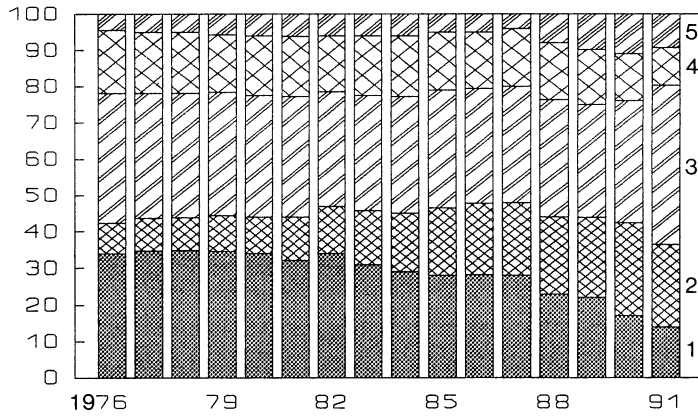
The overall structure of expenditure in the consolidated Soviet budget<sup>1</sup> is presented in Figure 5.

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<sup>1</sup> From 1985 (there are no data on previous years), the real volume of budgetary expenditure was greater than reported officially by the Ministry of Finance. From this time, it became impossible to reimburse the banks completely from the budget for the subsidies which they initially paid to producers. At the end of each year, the current amount of state indebtedness was converted into state debt without any stipulation of the precise obligations on the part of the state. The total amount of this indebtedness increased from SUR 5 billion in 1985 to SUR 132 billion in 1991. Later, we include these hidden outlays in the overall budgetary expenditure.

Figure 5.

**Structure of expenditure in the Soviet budget, %**



- 1 National economy
- 2 Price subsidies
- 3 Social and cultural activities
- 4 Defence
- 5 Other

The socialist state was responsible for the economic development of the entire country. Consequently, the most striking difference between the Soviet budget and a market economy budget was the vast share of expenditure on the item "national economy" (ENE). Until 1990 its share (excluding military outlays) was about 40 per cent of total budgetary expenditure. This item included all outlays going to enterprises, including current expenditure, investment and all types of subsidies. This was traditionally the biggest outlay item in the budget.

During the last fifteen years of the Soviet system the share of ENE (excluding military outlays and subsidies on consumer goods) in total expenditure declined. It was about 34 per cent in 1976–1980 and only 28 per cent in 1985–1987, the time of policies aimed at accelerating the development of basic industries. The downward trend resumed in 1988, and in 1991 the share fell to 13.4 per cent. Relative to GNP, the volume of ENE was relatively stable (14–16 per cent) in 1976–1987. It declined sharply to 11.2 per cent in 1989 and finally to 6.8 per cent in 1991. By this time budgetary financing went solely to the fuel and energy sector and to agriculture. Even the infrastructure sector received virtually no state financing. Instead, it was obliged to finance itself, mainly through under-investment.

The decline in ENE reflected the diminishing role of the state in the economy. But unfortunately, this process was not accompanied by changes in property rights: enterprises remained state-owned. Labour collectives had been given access to current decision making but they were interested mainly in the growth of personal incomes. There was a spontaneous increase in consumption and decline in investment. This slowed the replacement of industrial capacity, led to a significant fall in industrial production in 1991 and will be one of the main obstacles to the future economic recovery of the former Soviet republics.

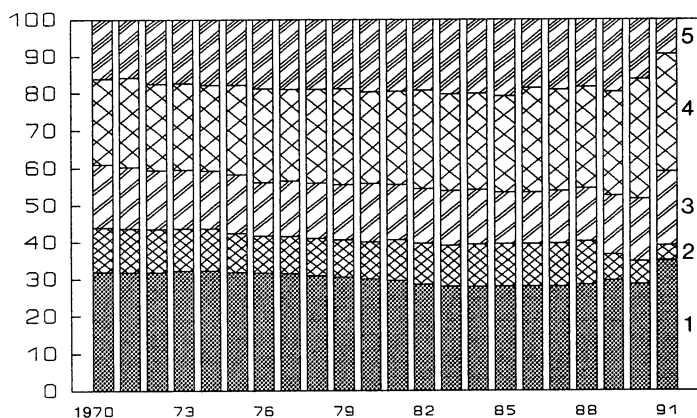
In analyzing expenditure on "social and cultural activity" (SCA) (Figures 6 and 7), one has to bear in mind the peculiar informal social contract between the population and the Soviet state. The state undertook to manage and develop the economy. It guaranteed that certain social needs would be met and most social services would be provided free of charge on an equalitarian basis. The members of society, for their part, "promised" to fulfill their production duties in an appropriate manner. They were not to demand too much by way of remuneration and a high standard of social services. They were also passive with respect to the management of the economy.

SCA expenditure grew continuously in the USSR. As long as economic growth continued, the state was able to fulfil its social obligations at an acceptable price. The ratio of SCA expenditure to GNP did not exceed one-fifth until 1980. When economic growth came to an end, however, the ratio of SCA expenditure to GNP finally rose to 33.9 per cent in 1991.

The highest growth among SCA items was recorded by price subsidies. In absolute terms, they increased six-fold in 1976–1990. Their share in total SCA expenditure (including hidden budget outlays on subsidies) increased from 19 per cent to 44 per cent over the same period and then declined to one-third in 1991. The ratio of consumer subsidies to GNP increased from 4–5 per cent in 1976–1980 to 13 per cent in 1990. In 1991 it declined slightly to 11.4 per cent, but not to 6 per cent as intended by policy makers. This was the price that had to be paid for the illusion of low and stable consumer prices.

Figure 6.

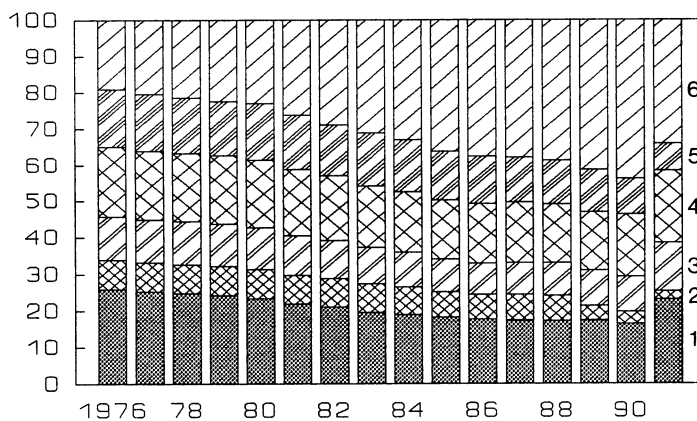
**Structure of Soviet social expenditure, %**



- 1 Education
- 2 Science
- 3 Health care
- 4 Social insurance
- 5 Social safety net

Figure 7.

**Structure of Soviet social expenditure (incl. subsidies), %**



- 1 Education
- 2 Science
- 3 Health care
- 4 Social insurance
- 5 Social safety net
- 6 Subsidies

Subsidies were paid to producers. The incidence of subsidies among the population was therefore determined by the consumption of subsidized goods. As a result, the greater part of these subsidies went to high-income groups, and the poor received the least. At the same time, this price support mechanism caused the continuous growth of subsidies. In fact, all producer costs were paid *ex post* by the state, and there was no incentive to cut costs. Retail and wholesale prices were separated by essentially arbitrary subsidies. If the former were changed, no supply response could be expected because of this buffer.

Social expenditure other than subsidies in the Soviet budget declined from 36 per cent of total expenditure in 1976 to 31 per cent in 1982. Later on, its share remained stable, at about one-third of total expenditure until 1990. The ratio of social welfare expenditure to GNP remained at about 15 per cent in the period 1970–1985, then increased slightly to 17 per cent in 1990. Social transfers of all types<sup>2</sup> grew faster than other SCA expenditure.

At the same time, the share of expenditure on public services in the budget declined. This was the reason for the substantial deterioration in the quality of public services in the last decade.

The volume of Soviet military expenditure (SME) is the biggest mystery in Soviet statistics. The eternal debates on the Soviet military burden are not a subject for this paper. Here we use the data on direct budgetary SME in 1976–1990 presented by Akhromeev (1991). As is seen in Figure 8, it grew without interruption until 1989; Steinberg (1992) draws the same conclusion, though his estimates are higher. The share of direct SME in the consolidated budget was relatively stable (15.5–17 per cent) in 1976–1989. In 1990 its share declined to 13.8 per cent and in 1991 to 10.7 per cent of total budgetary expenditure.

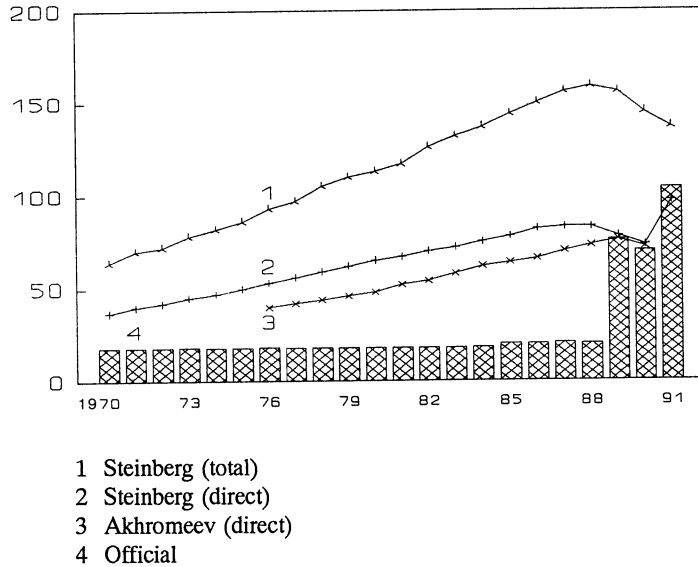
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<sup>2</sup> Until 1990, pensions and social insurance were included in the budgetary system. Beginning in 1991, pension and social insurance funds (in the republics) became independent and presumably self-financed. In this analysis these funds are included in the budgetary system for 1991.



Figure 8.

**Soviet military expenditure, SUR billion**



Total budgetary expenditure increased continually during the last fifteen years the Soviet Union was in existence. In the second half of the 1980s its rate of growth was very impressive compared to the zero growth of NMP. This resulted partly from including in the budget some outlays previously treated as extra-budgetary GFB outlays. As a result, the ratio of budgetary expenditure to NMP increased from about 50 per cent in 1960–1965 to over 70 per cent after 1985. This is equal to about 52 per cent of GNP (Figure 1). Corrected for delays in the repayment of price subsidies, this ratio should actually be 4–5 percentage points higher.

The growth of budgetary expenditure accelerated further in 1990–1991, when the control over expenditure shifted to the newly elected all-union and republican parliaments. Decisions on new budgetary expenditure were made without taking into account the true state of the economy. There was no force to resist the price that had to be paid for the absence of democratic traditions and for the low professional skills of members of parliaments. When all the republican budgets for 1991 had been adopted, the combined planned amount of expenditure exceeded the combined total of planned NMP (80 per cent of GNP).

The old system of budgetary planning helped to avoid the complete collapse of the financial system. All budgetary items were

traditionally planned in fixed nominal figures. The volume of expenditure could not be easily adjusted for the rise in prices. As inflation accelerated far beyond expectations in 1991 (128 per cent vs 60 per cent), the total volume of budgetary expenditure was "only" 54.1 per cent of nominal GNP.

## 3.2 Revenue

The overall revenue structure of the consolidated Soviet budget is shown in Figure 9. According to Soviet statistics, which include not only borrowing from Gosbank but also external borrowing in budget revenue, total budgetary revenue grew steadily over the last decades. Given the secondary role of revenue in budgetary planning mentioned above, this simply reflected the growth of expenditure. Some specialists have argued that the budget was in deficit from the mid-1960s onwards. There are no official data to prove or disprove this claim, and anecdotal evidence is contradictory<sup>3</sup>. There is however no doubt that from 1985 monetary financing of expenditure became increasingly significant.

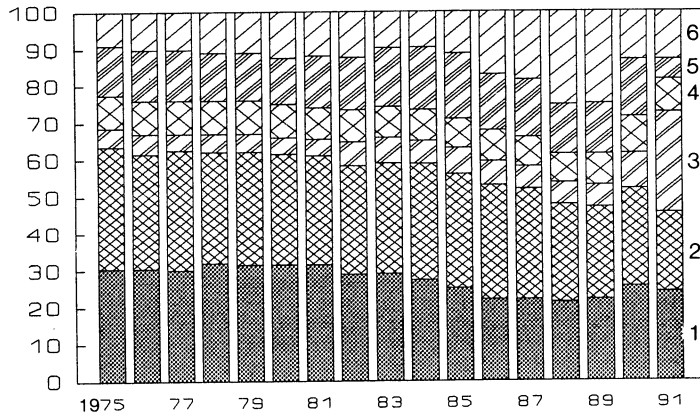
In 1985–1988 total budgetary revenue was virtually constant. In relation to GNP it fell to 43 per cent in 1988–1990 and to 35 per cent in 1991 (Figure 10). Monetary financing accounted for about 20 per cent of total expenditure. There were three main reasons for this. First, the decline in world oil prices in the second half of the 1980s led to a worsening in Soviet terms of trade and declining income from foreign trade. Second, the contributions of state-owned enterprises to the budget decreased. Third, as a result of the anti-alcohol campaign, the proceeds from the turnover tax decreased substantially. According to our estimates, the accumulated decline in budgetary revenue in 1986–1988 due to this campaign was no less than SUR 40 billion, that is one-third of the increase in the internal state debt during the same period.

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<sup>3</sup> There are official figures for the accumulated internal debt since the end of 1974. As these data do not include sales of state bonds to private individuals, this should equal the volume of accumulated borrowing from the banking system. On the other hand, in autumn 1991 it became known that the Ministry of Finance of the USSR made use of secret accounts in Gosbank, where SUR 52 billion had accumulated. According to officials' explanations, budgetary surpluses were accumulated there over a long period.

Figure 9.

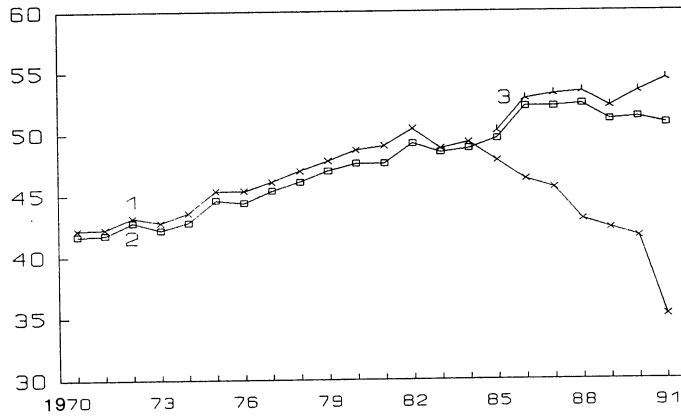
**Structure of revenue of the Soviet budget, %**



- 1 Turnover tax
- 2 From enterprises
- 3 Social insurance
- 4 Personal taxation
- 5 Foreign activity
- 6 Other revenue

Figure 10.

**Soviet budgetary revenue and expenditure as per cent of GNP**



- 1 Revenue minus official deficit
- 2 Official expenditure
- 3 Overall expenditure

A slight increase in revenue occurred in 1989–1990. This was due to an improvement in the terms of trade and an increase in alcohol sales. There was also an increase in the social insurance contribution rate in 1990. The increased revenue was not, however, sufficient to balance the Soviet budget. Deficits became a chronic plague of the budgetary system.

There was no taxation system for state-owned enterprises in the USSR until 1991. The state had the right to appropriate to the budget any part of the enterprises' financial resources (profits plus depreciation). The share left for the enterprise was determined in absolute figures and depended on its needs as perceived by the industrial ministry. This share was subject to bargaining between the enterprise and the ministry and could be changed during the year.

At the end of the 1980s, complex debates took place on the transition to a proper taxation system. Finally, the government's argument for a "one-tax system" for enterprises prevailed in the law on the taxation of enterprises enacted in early summer 1990. However, its revenue-generating potential was reduced significantly. Whereas the first government draft presumed a 60 per cent tax rate, after many parliamentary decisions the final tax rate was cut to 35 per cent in the USSR and to 32 per cent in Russia. The effective average rate of tax on profits in 1991 was about 26 per cent. As a result, though the nominal profits of enterprises more than doubled in 1991, the nominal yield from this tax increased by only 13 per cent.

There is a large literature on the turnover tax in the USSR, but actually this was not a tax at all. Rather, it was one of the constituent parts of the economy's general mechanism of financial reallocation. It allowed the maintenance of relatively low prices for raw materials and industrial goods and higher prices for certain consumer goods as the state established specific gaps (in absolute terms) between wholesale and retail prices for individual goods and producers. Available data show that the continuous rise in retail prices and the maintenance of a fixed absolute turnover tax led to a decline in its share of retail prices. Consequently, the proceeds from this tax grew more slowly than total turnover. With effect from 1992 the turnover tax was replaced in most of the republics by the value added tax (VAT).

Revenue from foreign activity was the third important source of state revenue in 1976–1990, representing 13–19 per cent of total budgetary revenue. The basic source of this revenue was the state's monopoly on foreign trade. On account of the distorted domestic price system and the artificial exchange rate, various gaps between domestic

and world market prices appeared. The prices of exports (raw materials and weapons) were low relative to the prices of imports (consumer goods). In the mid-1980s, external credits emerged as a new source of budgetary revenue. Their share in total foreign sector revenue was 13 per cent in 1986 and more than 35 per cent in 1991. Because virtually all long- and medium-term credits were used for servicing outstanding debt, there is no cogent reason for recording them as budgetary revenue. This, however, is the official convention.

The government tried to increase revenue from trade by introducing import and export taxes in 1991. But as the state-owned foreign trade firms, whose share of trade was 87 per cent, had been granted allowances with regard to these taxes, these taxes were hardly collected at all. The collapse of Comecon trade and the sharp decline in oil exports resulted in a decline of 45 per cent in the volume of Soviet trade in 1991, and the budgetary revenue from foreign activity declined even more.

Personal taxation had never played an important role in the Soviet economy. As virtually the sole employer, the state could directly determine income levels. Personal income tax existed in form but without content. Almost all incomes were taxed at a flat marginal rate of 13 per cent, and the effective income tax rate did not exceed 10 per cent during the last two decades. The share of personal taxation in total budgetary revenue was also small, well below 10 per cent. Only in 1989 and 1990 did the proceeds from personal income tax increase faster than other revenue, and its share rose to 10.5 per cent and 12 per cent, respectively. This was due to the rapid growth of personal incomes combined with stable tax rates.

On 1 July 1990, a new USSR law on personal taxation provided for an increase in the marginal tax rate for high income groups from 13 to 60 per cent. But in fact there was no significant increase in income tax revenue as there were only few people with sufficiently high incomes. At the same time several republics, including Russia, decided to reduce the highest marginal rate to 30 per cent. As a part of the price reform in 1991, income tax deductions were increased and the tax rates of low-income groups were reduced. As a result, the effective personal tax rate declined, and the share of income tax in budgetary revenue fell back to 10 per cent.

Significant changes took place in the social insurance system in 1991. Previously, the system generated total revenue amounting to 40–45 per cent of its total expenditure and the rest was financed from the budget. In 1991, the Pension Fund and the Social Insurance Fund

were separated from the budget. These funds were now supposed to be self-financed. Actually, a surplus was forecast for 1991–1992, and social insurance was supposed to be the largest single source of budgetary revenue in 1991. In the end, a forecast error and additional increases in pensions and other transfers in several republics resulted in a deficit for the consolidated social insurance system.

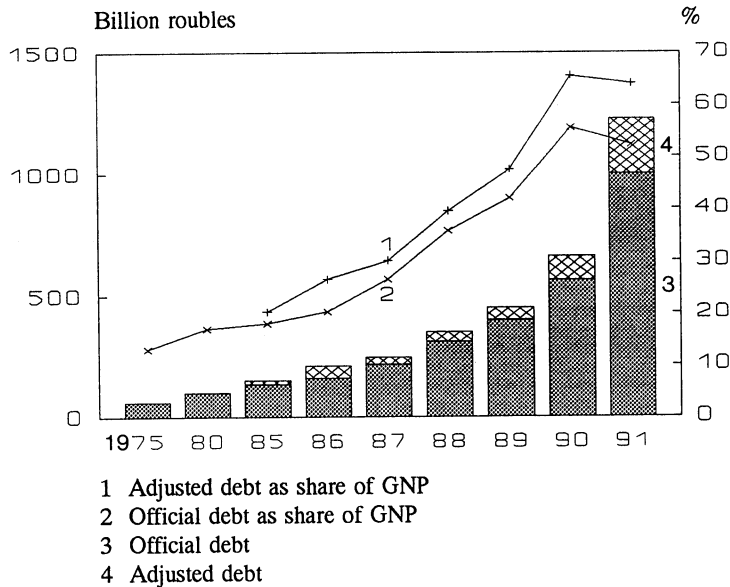
The absence of serious problems with tax collection was a striking feature of the command economy. Virtually all enterprises and the entire banking system belonged to the state, and payments to the budget were made promptly. Furthermore, as the total number of enterprises was relatively small, the financial control network was able to monitor both contributions and payments. The "pay as you earn" system worked perfectly.

Problems arose with the emergence of the large number of non-state enterprises after 1988. There was not sufficient tax collection personnel, and their skills were not up to the task. Tax evasion became very profitable, and loopholes in the laws implied little or no punishment if caught. The propensity to evade taxation grew in 1991 due to the introduction of an improvised 5 per cent sales tax. Moreover the "taxation war" between the central and republican authorities, which took place that year, made it possible even for state-owned enterprises to evade taxation. Total tax evasion may have amounted to 20–25 per cent of collected taxes in 1991.

### 3.3 Internal debt

This part of the Soviet fiscal system is shrouded in secrecy and faces a host of unresolved problems. The first official information on internal debt became available only in 1990. Data are now available from 1975 on (Figure 11), though the information released is still highly problematic. According to Goskomstat, the internal debt of the USSR totalled SUR 990 billion on 1 January 1992, that is 52.5 per cent of GNP. According to our estimates it exceeded SUR 1150 billion, which equals 61 per cent of GNP. Both estimates exclude the internal debts of individual republics.

Figure 11. **Internal debt of the Soviet Union**



The internal debt of the USSR includes the following items:

1) Institutionalized state borrowing from the population and enterprises through the issuance of state bonds. On 1 January 1992, the Soviet population held various state bonds totalling SUR 32.7 billion. In addition, in 1990 the Ministry of Finance issued bonds for enterprises amounting to SUR 49.1 billion, of which only SUR 500 million worth was bought by enterprises; the rest was bought by Gosbank of the USSR.

2) The Soviet state has subsidized the prices of food and certain other goods through Gosbank (and later Agroprombank), which paid subsidies to producers automatically as they sold their products. The bank then charged the state. Since 1985 the budgetary system has been unable to repay these credits as agreed. As a result, credit arrears have been automatically transformed into state debt. Such state debt totalled SUR 132 billion at the end of 1991.

3) Being the owner of both enterprises and banks, the state was able to convert (more or less) legally the debt owed by enterprises to banks into state debt. According to Lushin (1992), the central government wrote off debts totalling SUR 83.9 billion. Moreover, in 1990–1991 several republics decided to follow suit. Russia had the dominant share (SUR 125 billion); the combined share of the other republics was much more modest (SUR 10–15 billion).

4) By the end of 1990, the state had borrowed (or requested, as the owner of the banking system) SUR 18 to 23 billion (according to different sources) from the reserve fund of Gosstrakh (the state insurance company).

5) The government has borrowed directly from Gosbank in order to finance budget expenditure. The total amount of "credits granted to Ministries of Finance of the USSR and the republics" was SUR 462.06 billion on 1 January 1991. The share of this source in debt financing was 73.6 per cent at the end of 1990, and it grew to more than 90 per cent by the end of 1991. Financing of the state debt increasingly siphoned off resources from the banking sector, which meant a shortage of credit for the economy.

6) The implementation of price reform at the beginning of 1991 meant an increase in the average level of consumer prices of 60 per cent. The central government decided to compensate private savings by 40 per cent. The total increase in savings (SUR 160.8 billion) was "financed" by increasing state debt. In spring 1992, several republics – among them Ukraine and Belarus – decided to compensate private savings by another 100 per cent.

7) The disintegration of the USSR in 1991 brought with it the disintegration of the fiscal and monetary systems. As a result, several republics practised inflationary policies by running budget deficits financed by borrowing from their central banks. According to our estimates, the total amount of republican deficits in 1991 was at least SUR 110 billion.

The problem of state debt and current deficits is aggravated by their lack of institutionalization. The share of the debt financed by bond issue is very small. Borrowing from Gosbank was as a rule done without precise maturities and service obligations. After the disintegration of the USSR this debt should be shared by the republics. Until now, all attempts to do this have failed.

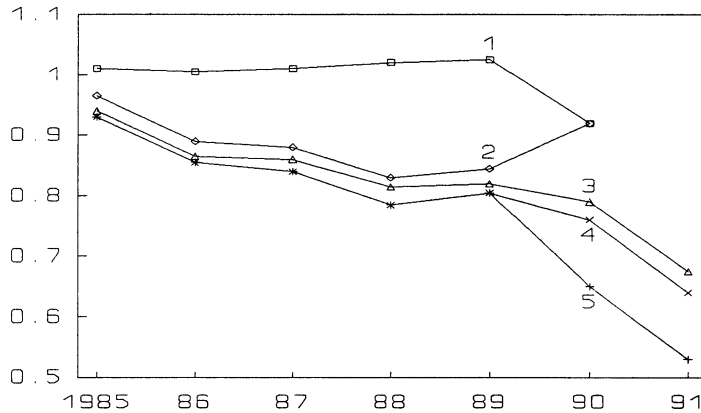
## 4 What is the Soviet fiscal legacy?

Looking at the state of the fiscal system after the disintegration of the USSR, it seems reasonable to discuss four aspects of the legacy of the command economy in the fiscal sphere: fiscal balance and institutional, ideological and technical problems.



Figure 12.

**Adjustment of the Soviet budget  
(revenue/expenditure ratios)**



- 1 Official revenue/ Official expenditure
- 2 (Official revenue minus official deficit)/ Official expenditure
- 3 Adjusted revenue/ Official expenditure
- 4 Adjusted revenue/ (Official expenditure plus indebtedness in procurement prices)
- 5 Adjusted revenue/ (Adjusted expenditure plus total increase in indebtedness to banking sector)

Fiscal balance has virtually disappeared in recent years (Figure 12). The revenue side of the budget eroded as a result of economic crisis and mistakes in economic policy. The ongoing economic crisis has put big enterprises in a very poor financial position, which will cause a further decline in budgetary revenue. The necessity of structural adjustment of the economy, conversion of the military industry and the financing of new social programmes will put pressure on the expenditure side of the budget. Officials estimate that the overall deficit of the budgetary system was 22 per cent of GNP in 1991, but a small adjustment in line with international methodology raises it to some 34 per cent of GNP. Though it can be explained by political developments and by the collapse of the tax collection system, this deficit is a manifestation of the inability of the budgetary system to carry the burden of redistributing more than 50 per cent of GNP.

Institutional problems that were present in the Soviet fiscal system will determine to a large extent what difficulties will confront the republics as they develop their economies. The problems are as follows:

- 1) the need to complete the tax reform,
- 2) the need to establish a new system of budget planning and implementation,
- 3) financing the budget deficit and the accumulated state debt,
- 4) implementation of the principles of fiscal federalism in the republican fiscal systems,
- 5) personalization of the social insurance system and the social safety net,
- 6) partial private financing of public services, and
- 7) the unification of the system of depreciation rates.

The list of problems could be extended, but it is evident that the scale of problems is great and that it will take a long time to resolve them.

Widespread public and political discussions concerning the structure and functioning of the fiscal system took place in the USSR in 1989–1991. But they had a negative overall effect because strong ideological stereotypes appeared in public discussions.

First, the idea that lower tax rates are the only or primary basis for a nation's economic prosperity became widespread.

Second, the ideal of simplicity of the tax system dominates politicians' thinking. They believe that the tax system has to be based on one or two taxes that provide the needed revenue.

Third, the so-called "one-channel" tax system was implemented for the USSR in 1991. All taxes go into the local republican budget. The republics should then contribute to the central budget as agreed. The theoretical disadvantages of this approach are very substantial, but they carried no weight in heated political debates. The idea did not work in practice in 1991. The republics never agreed upon common expenditure, upon the distribution of corresponding contributions, upon their responsibility for the fulfilment of agreements and so on. The one-channel tax system became one of the prime factors in the financial collapse of the USSR in 1991. Now this idea has been implemented in Russia.

Technical problems in the fiscal system also present serious future obstacles to the economy. Soviet financial statistics have always been a state secret. They are characterized by bad methodologies, slow collection and processing of data and by the withdrawal of much information. Literally nobody masters the whole field of financial statistics. Financial and tax documents are not routinely monitored, tax avoidance is popular and tax inspection largely impotent. These problems will take much time to address.

The disintegration of the USSR has created additional problems. The old fiscal system was highly centralized. Now the new independent states have to dismantle this system and reorganize it into fifteen independent systems. In most republics the level of skills of ministry personnel is very low. At the same time, as long as the monetary system is still integrated, there is a need to at least coordinate the fiscal policies of the republics. The significant degree of inter-republican economic and technological interdependence requires substantial coordination of fiscal systems. As populations in all the republics are multinational, the possibility of mass migration into native republics makes a number of agreements very urgent, primarily those concerning social insurance.

Clearly, the existence of these problems will not further economic transformation in the republics, but each of them has to be resolved in the foreseeable future.

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# Russia's Financial and Banking System

by Terhi Kivilahti, Jukka Kero and Merja Tekoniemi

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# 1 Introduction

The financial and banking system is of paramount importance to the functioning of a market-based economy, since it is the channel through which all the resources of the economy are allocated. For the former centrally planned economies in transition to a market economy, the establishment at an early stage of an institutional framework and conducive conditions for banking is essential for economic stabilization and particularly for undertaking structural change. Macroeconomic stabilization measures alone are not sufficient to solve the problems inherited from the period of central planning. Rather, fundamental changes are needed in both the financial sector and the state sector.

As in other planned economies, the main function of the Soviet Union's monobank system was to implement the planning process. Resources were chiefly allocated by the State Planning Commission (Gosplan), not through the banking system. There were no other financial markets. The use of financing was monitored chiefly with regard to its quantity, while no attention was paid to how efficiently financing was used. The special features of central planning are still visible today in the former Soviet republics and they are retarding progress towards a market-oriented banking system. Merely the decentralization of old structures and their development into an efficiently functioning system will take time.

The aim of this article is to survey the current phase in the transformation of Russia's financial and banking system, the goals set for reform and how well the new system is functioning. The article is divided into five sections. Section 2 gives a brief account of the main features inherited from the period of central planning. It also reviews the development of the Soviet banking system. Section 3 describes the structure of Russia's banking system and the principles on which it functions. Section 4 focuses on the prospects for cooperation in monetary and banking affairs among the former republics making up the rouble zone, an issue which is of vital importance to Russia. Section 5 concludes by considering the problems and prospects for Russia's financial and banking system during the transition.

## 2 The legacy of the planned economy

### 2.1 Banking in a planned economy

The role of money and monetary policy in a planned economy was entirely different from that in a market economy. The western concept of the role of money was not relevant to a planned economy, where monetary flows adjusted to mostly physical targets set in state plans.

The passive role of money was also reflected in the way the banking system functioned. Banking was a state monopoly, and therefore all banks operated directly under the control of the central bank. The decisions of the central bank, in turn, rested on the superior state administration. The administrative and practically random price system and the lavish subsidies paid out of the state budget gave rise to extensive structural problems in the banking system, which were, *inter alia*, reflected in the accumulation of state enterprise losses in the banks over the decades. These losses were part of the Soviet internal debt (Alexashenko, 1993).

Moreover, the usefulness of money as a means of payment varied according to whether the user of the money was a household or an enterprise. Households could only use cash money (*nalichnye dengi*), almost all of which was returned to the banking sector through retailers and bank accounts. Enterprises, however, had to use non-cash deposit money (*beznalichnye dengi*) for the most part, ie they could only effect payments through bank accounts. Hence, for them, money was primarily a unit of account. As a rule, cash could only be withdrawn from enterprises' accounts to pay wages. If an enterprise operating at a loss could not make payments, the state would transfer funds to it from profitable enterprises. Hence, in practice, the enterprises had a government guarantee that their financial deficits would be covered. As bankruptcies were impossible, the result was waste of resources and over-investment. Kornai (1986) calls this a soft budget constraint. Lending was also centrally planned, and therefore interest played no role in the allocation of monetary funds and creditworthiness was of no significance to enterprises or banks. A very low, often negative, real rate of interest was paid on household savings and enterprise deposits.

In a planned economy, monetary and fiscal policy were interwoven in such a way that functions which in a market economy fall under fiscal policy and public finance were handled by the banking system. The banking system channelled credits to unprofitable enterprises, which often failed to repay them when they fell due. Budget deficits were traditionally financed by running up internal state debt, mainly in the form of loans which the state raised directly from the state bank (Gosbank). In practice, the loans were financed with deposits made by individuals in the Savings Bank (Sberbank) or through an increase in money supply. The loans raised from Gosbank were either interest-free or bore a very low rate of interest, and their repayment was very uncertain. According to the 1990 law on the central bank of the Soviet Union, Gosbank's lending was restricted to an amount confirmed by the Supreme Soviet. Nonetheless, loans raised from Gosbank did at times account for more than 90 per cent of total debt financing (Alexashenko, 1993).

## 2.2 Development of the Soviet banking system

Throughout the socialist period, the dominant feature of the Soviet Union's banking system was its passiveness and heavy dependence on state plans. In practice, the USSR had only three banks with regional branches and outlets: the state bank (Gosbank), which functioned as a central bank, an all-union construction bank (Stroibank) and a bank for foreign trade (Vneshtorgbank). There was also a network of savings banks, which operated under the direct control of Gosbank; these were later merged to form the Soviet Savings Bank (Sberbank). Monetary and credit policy were based on centrally drafted plans for banks, the implementation of which was strictly controlled by Gosbank.

Perestroika reached the banking sector in autumn 1988, when a process of decentralization got under way. A new system comprising several specialized banks was established. In addition to Gosbank, it comprised five specialized banks: the Bank for Foreign Economic Affairs (Vneshekonombank, VEB), the Industrial and Construction Bank (Promstroibank), the Agro-Industrial Bank (Agroprombank), the Savings Bank (Sberbank) and the Bank for the Housing, Local Government and Social Sectors (Zhilsotsbank).



The basic idea underlying the new banking system was that Gosbank should retain its central banking functions while the commercial banking functions should be transferred to the state's specialized banks. The specialized banks were to focus on serving the needs of a more closely defined circle of customers and on improving their profitability. Thus, the aim was to create a two-tiered banking system.

The reforms did not, however, produce the desired results. There was no improvement in either the quantity or the quality of banking services, and the specialized banks retained their monopoly position; customers had no opportunity to use the bank of their own choice and no competition emerged. In practice, a bank could not refuse to provide services in the sector for which it was responsible, even if the enterprise did not meet its loan obligations.

In March 1989, the specialized banks were reconstituted so as to be financially independent and to strive for profitability. At the same time, customers were for the first time given the opportunity to use the bank of their choice. As the banking business of enterprises in a particular sector would no longer automatically be handled by the specialized bank designated for that sector, interbank competition was expected to increase. VEB was the only bank to remain a truly specialized bank. With the establishment of cooperative and joint stock banks, the ground was laid for commercial banks. At this stage, specialized banks could not yet be regarded as functioning as commercial banks, nor did the setting up of new banks actually make any inroads on their dominant position.

The conversion of the specialized banks into joint stock companies began in summer 1990 when Zhilsotsbank and Agroprombank were reorganized as joint stock banks. The bulk of the shares (at least in the case of Zhilsotsbank) was nevertheless held by the state. At the beginning of the same year, Sberbank had been made part of the Gosbank system.

After lengthy preparations, laws on Gosbank and on banks and banking activity were passed in December 1990. The foundation for the laws was that Gosbank would continue to function as the central bank for the entire union. However, the laws had very little significance in practice, because earlier in the same year some of the republics had enacted laws on their own banking systems which were at odds with the all-union banking law. The so-called bank war had begun. The driving force behind this development was the republics' reluctance to cede the right to issue roubles to Gosbank and to stay in

the rouble zone. The new laws passed in the republics transferred the functions which were previously performed solely by Gosbank to the republics' own central banks. In Lithuania, for example, the central bank was declared subordinate to the Supreme Soviet of the republic and was granted the right to issue currency in Lithuania. Similar rights were also accorded to the central banks of the Russian Federation and Estonia (IMF, 1992a).

At least in principle, completely independent banking systems came into being in the republics in the end of 1991, when the Soviet Union was dissolved. But in fact, the unified banking system had already started to erode before this. Gosbank did not prepare a credit plan for the republican central banks in 1991, thereby allowing them more autonomy in monetary policy. The instructions which Gosbank issued in the second half of 1991 were no longer binding on the republican central banks (IMF, 1992b, p. 15). In practice, however, the interdependence of the banking systems and monetary policy in the former Soviet republics has forced them to cooperate in banking matters. Cooperation has been hampered by different views on fundamental issues concerning the new monetary policy and banking system. Underlying these difficulties is the fear of being linked with structures that prevailed in the former Soviet Union.

### 3 The structure of Russia's financial and banking system

The framework laws governing Russia's banking system were passed in 1990 more or less at the same time as the banking laws of the Soviet Union, which was still in existence at that time. The contents of the laws were fairly similar, but whereas in the Russian laws the entire system was made subordinate to the central bank of the republic, Gosbank was the supreme authority in the union laws. The Central Bank of Russia (CBR) was technically subordinate to Gosbank until late 1991, when Gosbank was merged with the CBR before being officially dissolved a little later.

The framework laws are still in force, but are obviously in need of major revision because of the break-up of the Soviet banking system and the changed conditions in Russia. Under the laws, Russia has a

two-tiered banking system. The central bank and its various subunits — regional offices and payment centres — implement monetary and credit policy and supervise the operations of other banks. The commercial banks — cooperative, joint stock, joint venture and former specialized banks — constitute the second tier. It was estimated in mid-1992 that there were 1 600 commercial banks. Early in 1992, the central bank tightened its procedure for issuing licences to banks operating as commercial banks in an effort to raise the quality of banking.

### 3.1 The functions of the Central Bank of Russia

According to the Law on the Central Bank of Russia, the main functions of the central bank are to maintain money supply, to preserve the stability of the rouble, to pursue a uniform monetary and credit policy, to settle payments, to issue licences to banks for operating as commercial banks and to regulate and supervise the commercial banks' activities and foreign operations. The central bank is accountable to the country's Supreme Soviet, ie Parliament, the decisions of which the bank must in practice adhere to.

The instruments most frequently used by the CBR in the implementation of monetary policy are the central bank lending rate (the discount rate) and reserve requirements. As the securities markets are only just beginning to develop, it is not possible to implement monetary policy through open market operations. The central bank has announced that its goals for monetary and credit policy are to curb inflation and restore the purchasing power of the rouble by restricting the amount of roubles in circulation.

In principle, the CBR has the right to carry out all legal foreign exchange operations both in Russia and abroad. The erratic progress of economic reform has also been reflected in the central bank's exchange rate policy. During perestroika, several other rouble rates emerged alongside the traditional rouble rate, the number and levels of which have been altered at frequent intervals.

The exchange control tasks of the CBR are laid down in the foreign exchange law passed by Parliament on 14 July 1992 (Kommersant, 1992:22). The law states that the central bank is the major exchange control authority in Russia. The powers of the central

bank include the right to issue licences to commercial banks for undertaking foreign exchange operations and to decide on the repatriation of foreign currency. In addition, the central bank conducts certain foreign exchange operations (IMF, 1992b, p. 16).

## 3.2 The role of the commercial banks

The commercial banks can be divided into two categories: the successors of the specialized banks of the Soviet system, and the new joint stock, cooperative and joint venture banks. The establishment of joint stock banks and cooperative banks was made possible by the 1988 law on cooperatives. Provisions on the establishment of joint venture banks were for the first time laid down in the 1990 law governing the banking system in general, in which it was stated that provisions on foreign investments should also apply to joint venture banks. As a group, the former specialized banks are more difficult to define, since they include banks with very different ownership structures and activities. These banks have retained their dominant position.

### 3.2.1 The former specialized banks

For historical reasons, the state's large holdings in them and their preferential treatment, the Russian branches of the specialized banks established in the Soviet Union in 1988 can only be regarded as commercial banks with certain reservations. Several of these banks still exist, although virtually all of them now function in the form of joint stock companies. Most of the specialized banks continue to serve old customers, ie large government enterprises.

Although the Savings Bank is an old institution in Russia, the independent Savings Bank of Russia was established on the foundations of its Soviet predecessor only in 1991, when it was registered as a joint stock bank. At present, the Savings Bank is regarded as a commercial bank which operates under special arrangements. It is exempted from the obligations to which the other commercial banks are subject, for example reserve requirements. The CBR is the major shareholder in the Savings Bank, but in addition, there are more than 1 700 juridical and over 50 000 physical

shareholders. The Savings Bank itself is a shareholder in hundreds of commercial banks (Nezavisimaya Gazeta, 5 June 1992).

The Savings Bank of Russia has to a large extent maintained its former function as a deposit bank for small savers, for which its extensive branch network makes it ideally suited. It has 78 regional banks in the capitals and regional centres of Russia. In addition, the regional banks in Moscow and St Petersburg have over 2 000 divisions and over 40 000 subsidiary offices. The Savings Bank of Russia has more than 160 000 employees (Nezavisimaya Gazeta, 5 June 1992). Its position is further strengthened by the fact that customers' deposits are protected by a government guarantee on customer deposits. On the other hand, a low rate of interest is paid on deposits.

The Savings Bank continues to finance the government budget deficit, but it has also begun to finance commercial banks. This is profitable business for the Savings Bank as it receives a higher rate of interest on lending to commercial banks than it does on its voluntary deposits with the central bank. In 1992, the rate it charged for lending to other commercial banks was 22 per cent. In addition, the bank's activities have expanded to embrace lending to individuals, cooperatives, small enterprises and agricultural units. Up to 70 per cent of the bank's deposits were used to finance state budget deficits via Gosbank (Ibid., IMF, 1992b, pp. 93–94).

The Agricultural Bank (Agroprombank) was officially dissolved on 1 January 1992. It was succeeded by Rosselkhozbank, which took over Agroprombank's branch network in Russia. At the same time, the bank inherited a considerable amount of non-performing loans. As a representative of the Russian government, the bank, like its predecessor, supplies agricultural enterprises with preferential loans and receives funds for this purpose from the budget. In addition, the bank provides normal cash and payments services.

The Bank for Industry and Construction (Promstroibank) was registered as a commercial bank in late 1991, when it was reorganized as a joint stock company. The bank continues the activities of its predecessor in Russia, providing finance for investments and assisting in privatizing enterprises, establishing joint stock companies, reorganizing existing enterprises and acquiring foreign capital. In April 1992, the Russian government approved the bank's proposal to be granted special status. As a representative of the government, Promstroibank provides financing for programmes which have been given priority by the government. The preferred sectors include

agriculture, energy, transport, telecommunications and the armaments industry (Izvestiya, 16 April 1992, and Dubenetski, 1992, pp. 48–49).

The Soviet Bank for the Housing, Local Government and Social Sectors (Zhilsotsbank) was reorganized as a joint stock company in 1990, when the Ministry of Finance was its largest shareholder. Subsequently, new regulations governing banks' shareholders obliged the ministry to dispose of its holding. The name of the bank was changed to Mosbiznesbank. Its major shareholders included the Executive Committee of the City of Moscow, a children's fund and a number of state enterprises and organizations.

The Bank for Foreign Trade of the USSR (Vneshekonombank, VEB) managed payments and financing related to foreign trade during the period before the dissolution of the Soviet Union and was responsible for servicing its foreign debt. In November 1991, most of the former Soviet republics agreed that the bank would continue to manage the debts of the former Soviet Union.

In January 1992, the Russian parliament decided to make Vneshekonombank responsible to the CBR. Part of the VEB's activities were transferred to the CBR and part to the Bank for Foreign Trade of Russia (Rosvneshtorgbank). After much uncertainty, the final fate of VEB still remains undecided.

Rosvneshtorgbank was established at the beginning of 1991 to function alongside the VEB. The CBR is its largest shareholder. The bank manages Russia's foreign exchange reserves and the CBR's stabilization fund for the rouble. It has the sole right to sell gold and precious metals abroad.

### 3.2.2 Joint stock, cooperative and joint venture banks

The establishment of joint stock and cooperative banks got under way in late 1988 and intensified in 1989. By the end of 1991, a total of just under 1 600 joint stock and cooperative banks had been established. Most of them were small — joint stock banks had basic capital of less than SUR 20 billion on average and cooperative banks basic capital of less than SUR 1 million (Ekonomicheskaya Gazeta, 1992:30). The combined basic capital of the ten biggest commercial banks accounted for about 75 per cent of the initial capital of all the commercial banks established by the middle of 1991 (about SUR 4.3 billion). Most of the new banks (90 per cent) were established in the Russian Federation, mainly in Moscow.

On 1 July 1992, Tokobank was the largest commercial bank in terms of basic capital (SUR 11 558 million). The bank was established in late 1989 by the Savings Bank of Russia, the State Insurance Company of the USSR (Gosstrakh), Rosselkhozbank, Ingosstrakh and some of the largest enterprises in various sectors. One of Tokobank's main functions is to provide financing to wholesalers. In spring 1992, the bank bought over 80 per cent of the shares of Ost-West Handelsbank, a Soviet establishment which encountered a liquidity crisis as a result of the collapse of the VEB.

AvtoVAZbank has expanded its branch network rapidly from its headquarters in Togliatti. The bank has more than ten branches in the country's chief car-producing areas. The bank's customers are large enterprises, mainly engaged in the car industry. The bank has shareholdings in several other banks and industrial enterprises in Russia.

Inkcombank, which was established on the initiative of the Plekhanov Economics Institute in Moscow, also includes among its shareholders major industrial companies, both state-owned and cooperatives, in different sectors. Inkcombank was the first of the banks in the former Soviet Union to introduce the international SWIFT payments system. The bank plans to extend its activities to include the financing of research projects and investment programmes. It has set up an exchange, where the students of the Plekhanov Institute work as trainee traders.

The ten banks with the largest basic capital include no less than three descendants of the former specialized banks. Furthermore, the specialized banks sometimes have shareholdings in other big banks. The dominant position of the specialized banks becomes even more apparent from an analysis of their total assets. The Savings Bank of Russia heads the list (with total assets of SUR 874 836 million) by a big margin from the other banks.

Joint venture banks are banks which have been established together with foreign partners. The first joint venture bank in the Soviet Union was the International Moscow Bank, which was set up in 1989 by the VEB, Promstroibank, the Savings Bank and five western banks, including the Finnish Kansallis-Osake-Pankki. Joint venture banks provide services related to payments and lending in foreign trade.

A list of the 50 largest banks in Russia is included as appendix.<sup>1</sup>

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<sup>1</sup> The appendix is based on *Ekonomitsheskaya Gazeta*, 1992:32. Due to limitations in data, the list is incomplete.

### 3.2.3 Regulations on commercial banks

The proliferation of commercial banks is largely a result of legal liberalism and lack of supervision during the initial stage of economic reform. It was obvious from the start, however, that the operational framework would become clearer as more experience was gained. This implies a rapidly changing environment and rapidly changing regulations during the transition phase, thus making banking highly susceptible to risk.

The establishment of a commercial bank requires a licence, which is issued by the central bank after having registered the bank. Prior to this, the central bank ascertains that the bank has adequate capital, who the founding members are and that the bank's executive board is competent. The establishment of a bank does not automatically give the bank the right to engage in all types of banking activity. The right to conduct foreign exchange operations requires a special licence, of which there are different kinds. The holder of an ordinary licence may undertake foreign exchange operations only in Russia. A general licence entitles the holder to conduct foreign exchange operations both within and outside Russia. By late 1991, a general licence had been granted to only 11 banks. Moreover, various technical and administrative problems have arisen in connection with the foreign exchange activities of these banks. Special licences are issued only for foreign exchange transactions of a non-recurrent nature (IMF 1992b, p. 93).

The law on commercial banks in Russia sets capital adequacy criteria for banks. These have been subsequently tightened along with the deterioration in the country's economic situation. The minimum capital requirement was raised to SUR 100 million for all banks in 1992, whereas before it had been SUR 0.5 million for cooperative banks and SUR 10 million for joint stock banks (Delovoi Mir, 20 August 1992). In addition, the reserve requirements and the central bank lending rate have been raised.

The ratio of liabilities to capital has been set at 20:1 for joint stock banks and 12:1 for cooperative banks. However, the regulations are much stricter as far as the banks' commitments to households are concerned. The aim here is that the amount of household deposits in a bank should not diverge widely from the bank's own capital, thus securing the depositors' position in the event of bankruptcy. At the same time, however, the monopoly position of the Savings Bank has



been secured, and free banking competition for deposits between the newly established commercial banks and the state-owned specialized banks has effectively been prevented. In 1991, it was decided that the spread between deposit and loan rates should be 3 percentage points. In January 1992, the CBR cancelled these regulations and announced that the Bank would only monitor developments in spreads.

As no legal framework existed when the first commercial banks commenced operations, they were not liable to pay tax. Provisions on taxation were not issued until summer 1990, when the first commercial banks had already been operating for almost two years. A 60 per cent tax on profits was then introduced and it was charged retroactively from the beginning of the same year. A lower tax rate was applied if the bank had used some of its funds for improving banking technology or increasing its reserves or risk capital. Contrary to accounting practice in the West, funds could be appropriated to reserves before tax. Indeed, building up excessive reserves became the commercial banks' way of evading tax. In 1991, the right to set up reserves was restricted to 25 per cent of the bank's capital, while the tax on profits was successively reduced in accordance with Russian law to 45 per cent of reported profits (Kazmin, 1992).

Before Gosbank was dissolved, the antagonism between Gosbank and the CBR and their conflicting requirements made commercial banks reluctant to observe the regulations of either. Rather, they tried to exploit the confused situation, which forced Gosbank and later the CBR to introduce administrative restrictions. The problem of how to devise regulations that truly support monetary and credit policy and the development of banking supervision remains. An overview of Russian banking regulations in early 1992 is given in Table 1.

Table 1.

**Regulations governing the commercial banks  
subordinate to the Central Bank of Russia<sup>a</sup>**

1	Mimimum capital requirement	100 million roubles <sup>b</sup>
2	Ratio of external capital to equity	12:1 / 20:1 <sup>c</sup>
3	Reserve requirement	0–15 % <sup>d</sup>
4	Loan loss risk/customer	not more than equity
5	Central bank lending rate	80 %
6	Spread between deposit and lending rates	'monitored' <sup>e</sup>
7	Taxation	45 per cent of reported profits <sup>f</sup>

## Notes:

<sup>a</sup> Existing legislation also calls for the application of standards which restrict balance sheet liquidity and exchange rate and interest rate risks. Further information on the eventual application of these standards is not available.

<sup>b</sup> Applies to banks registered after 12 August 1992.

<sup>c</sup> The first ratio indicates the requirement for cooperative banks and the second for joint stock banks.

<sup>d</sup> Requirements according to the term of the deposit (there is no reserve requirement for deposits of more than three years) do not apply to the Savings Bank.

<sup>e</sup> Until January 1992, the central bank decreed that the maximum spread between deposit and lending rates was 3 percentage points.

<sup>f</sup> April 1991; not based on a regulation issued by the CBR, but laid down in the relevant law.

### 3.3 Other financial institutions and exchanges

In Russia, the financial markets are dominated by banks. This is understandable, since during the period of central planning the only financial institution that operated outside the banking system was the state insurance company (Gosstrakh), which was subordinated to the Ministry of Finance and of minor importance. The emergence of financial institutions that are truly independent of banks is taking place only slowly. The process is associated with many peculiar features.

In addition to the banking sector, the financial markets consist of stock exchanges, investment companies and investment funds and insurance companies. Some other financial institutions of very minor significance may also exist. Of the institutions mentioned above, the insurance companies play only a marginal role. Likewise, most of the investment companies and funds operate with a small basic capital. Perhaps the most important source of finance outside the banks is that offered by the slowly evolving securities markets.

In Russia, the concept of an exchange is very broad. It may, for example, denote a stock, commodity, raw material or property exchange or various combinations of these. In many instances, the field of activity of an exchange is so diverse that it is difficult to discern its main line of business. In August 1991, Russia had 110 exchanges, only four of which were specialized in securities trading (*Ekonomika i Zhizn*, 1991:49). A small amount of securities dealing takes place in the trust departments of commercial banks, on commodity exchanges and in the Savings Bank. The scope of and need for stock exchange activities is likely to expand along with privatization.

Mostly, government bonds issued by Russia or the former Soviet Union are traded in the securities markets. Company shares are not traded on exchanges to any significant degree, since most of the joint stock companies founded are closed companies and sell their shares only to employees. By autumn 1991, only 45 of the 800 joint stock companies registered had issued shares. Private persons are not permitted to sell their shareholdings on exchanges; rather, shares must be sold through the issuing company (Berkovich, 1991, pp. 43–44).

The securities markets are dominated by the biggest exchanges: the Central Stock Exchange of Moscow (MTsFB), the International Stock Exchange of Moscow (MMFB), the Stock Exchange of Moscow (RFB), the Stock Exchange of St Petersburg (SPFB) and the Stock

Exchange of Siberia. The exchanges operate irregularly — often just a few times a month. Of these exchanges, the MTsFB, MMFB and SPFB also auction credit resources.

The development of the securities markets currently reflects the difficult transitional phase through which the economy is passing. This is evident, for example, in a tendency to invest assets in goods and real property. Characteristic of the markets is the narrowness of the secondary markets. This is due to the fact that most joint stock companies are closed companies. There are also no clear practical guidelines on securities trading (*Ekonomika i Zhizn*, 1992:7). The law on commodity exchanges and trading on exchanges does not apply to stock and currency exchanges or the equivalent departments of commodity exchanges. The government's decrees on these matters have been criticized as being too general. They are also incomplete. No corresponding law has been passed.

As the markets expand, the spectrum of available instruments is widening. While types of securities known in the West are only gradually becoming more widespread, securities peculiar to Russia have been introduced. Typical of these is that dividends can be paid in goods. In the bond market, all kinds of features are used to attract investors: eg the right to convert bonds into shares, or coupon rates which vary in line with the commercial banks' average deposit rate.

Although, on the one hand, the cash shortage has hampered banking activities in that the amount of cash returned to the banking sector has diminished, on the other hand, it has increased banks' interest in securities trade. Whenever, for example, the CBR has limited banks' access to cash, the commercial banks have increased their issue of certificates of deposit. The banking consortium, Menatep, profited from the rumours in late 1990 of an imminent monetary reform by selling certificates of deposit to the value of SUR 1.2 billion at an interest rate of 12 per cent in a just a few weeks. At present, only a few banks issue certificates of deposit (Kazmin, 1992, p. 120).

## 4 Outlook for financial and banking cooperation in the rouble zone

Under the Soviet banking laws passed in late 1990, the central banks of the Soviet republics were granted more extensive rights than before to operate independently, but Gosbank still remained the supreme body of the banking system. It was responsible for all decisions in principle concerning the system, including decisions on the basic orientation of monetary and credit policy, the commercial banks' reserve requirements and the central banks' foreign exchange regulations. As the laws only granted nominal powers to the republican central banks whilst increasing national self-awareness called for independent systems, the republics began to establish their own national banks by the early part of 1991, before Gosbank was officially dissolved later in that year.

By early 1992 all the CIS states had established their own central banks, which in many cases were set up as successors of the branches of the former Gosbank. The most widely used monetary policy instruments are reserve deposits and the central bank lending rate. The central banks issue licences to commercial banks and supervise the banks' activities. The management of the republics' foreign exchange reserves is normally entrusted to banks specializing in foreign transactions, almost all of which replaced the Soviet VEB. In many CIS states, the central banks have been granted wide monetary and credit policy powers, either on the basis of laws already enacted or draft laws. But in practice, the central banks are in no position to exercise these rights. Central bank decisions normally require the approval of parliament.

The banking model introduced in the USSR in 1988, comprising a central bank and five specialized banks with branches in almost every Soviet republic, is still discernible in all of the CIS states. The branches still operate, but they have been nationalized or re-established as joint stock companies.

In addition, commercial banks have been set up in all of the CIS states. Most commercial banks are only nominally private, since government institutions are often the major shareholders. The largest number of commercial banks is to be found in Russia (about 1 600), while the other states have less than a hundred each.

## 4.1 Monetary policy cooperation between the CIS states

Almost all of the CIS states have at least discussed the possibility of introducing their own quasi-monies or currencies. The discussions have been fuelled by an acute shortage of roubles. Nevertheless, most of the states have announced that they wish to remain within the rouble zone, even though the deepening of the rouble crisis has led to increased speculation about the newly independent states' own currencies and made it necessary to introduce various substitutes for the rouble. In many cases, the arguments for introducing new currencies have been based more on considerations of national identity than on any real need to have independent currencies.

Clearly, it is Russia which has the greatest interest in seeing cooperation in monetary policy between the CIS states. Since the rouble is still used in most of the former republics, liberal credit policies in the other states could ruin Russia's attempts to stabilize the rouble. Since the beginning of July 1992, the CBR has tried to restrict exports to rouble zone states with liabilities to Russia in their correspondent accounts. At the beginning of May, Russia's claims on other rouble zone states amounted to about SUR 100 billion; Ukraine accounted for as much as half of them. According to some estimates, Russia's claims had risen to SUR 300 billion by the beginning of July 1992 (*Rossiiskaya Gazeta*, 24 June 1992).

The situation has been aggravated by the liberal Ukrainian monetary policies, by the introduction of national currencies in Estonia and Latvia, and by the widespread use of substitute monies in other former Soviet republics. The central banks of the CIS states have tried to reach agreement on monetary policy cooperation with the assistance of IMF officials. At a meeting in Tashkent at the end of May, all the central banks within the rouble zone approved in principle a proposal drafted by the IMF. Before these guidelines can be implemented, they must be ratified by the governments of the individual states. Initially, the IMF tried to make the implementation of the principles set out in the proposal a condition for the granting of financial assistance to the CIS states, but it soon had to modify its position on this matter.

The main points of the proposal are:

- monetary policy cooperation between the central banks aimed at curbing inflation;
- coordination of monetary policies (uniform central bank lending rates, reserve requirements, credit limits);
- provision of roubles (up to agreed amounts) by the CBR to the other central banks;
- creation of a uniform payments system;
- creation of a uniform exchange rate system, whereupon all residents of the rouble zone will be permitted to exchange currency in any other country within the rouble zone. The central banks will deal in foreign exchange at market rates;
- if a country within the rouble zone introduces substitute currencies, these must be freely convertible into roubles and their rate of exchange must be the same as that for the rouble; and
- exchange of information between the central banks.

In practice, the IMF proposal has failed because of the stand taken by Russia. Russian representatives have offered just two models for acceptance by the rouble zone states: either to remain within the rouble zone and submit to the monetary policy conducted by the Central Bank of Russia, or to leave the rouble zone and introduce their own currencies.

## 5 Problems and prospects for development

### 5.1 Monetary policy instruments

As reform progresses, the importance of direct central bank lending will diminish and there will be increasing reliance on such instruments as the discount rate, banks' reserve requirements and open market operations by the central bank. However, the necessary conditions for using the new instruments must first exist. Markets must be able to interpret signals from the central bank in the right way and to change their behaviour accordingly. Likewise, enterprises must be able to observe the effects of changes in monetary policy on their own financial position. Successful deregulation of interest rates requires

stable macroeconomic conditions, competition and functioning markets in the banking and business sectors and the availability of instruments which the central bank can use to affect the marginal cost of banks' borrowing from the central bank. Such conditions will not exist in the early stages of reform, and as a result the central bank will often find it necessary to resort to quantitative regulation of the money market.

The discount rate and reserve requirements have been prominent instruments in Russia, because the securities markets are still too underdeveloped to permit open market operations on a large scale. The discount rate and the reserve requirements were for long so low that they had virtually no significance in conditions of accelerating inflation. Only in 1992 did the CBR begin to adjust reserve requirements at frequent intervals. The commercial banks reacted to the situation by raising their interest rates and sharply reducing their long-term lending, thus jeopardizing the prospects for investment in Russia.

The introduction of a fixed exchange rate could function as a nominal anchor during the transitional period. It would help to keep prices in check and introduce inflation expectations, provided that there is sufficient confidence in the anchor. Finding the right equilibrium rate of exchange is difficult, however, and it might be hard to maintain sufficient tightness in both fiscal and incomes policy. Poland, for example, pursued a fixed exchange rate policy in the preliminary stages of its economic reform. Russia, by contrast, introduced a floating rate of exchange at the beginning of July 1992. The exchange rate has fluctuated widely, with potentially major effects on profitability in the export sector.

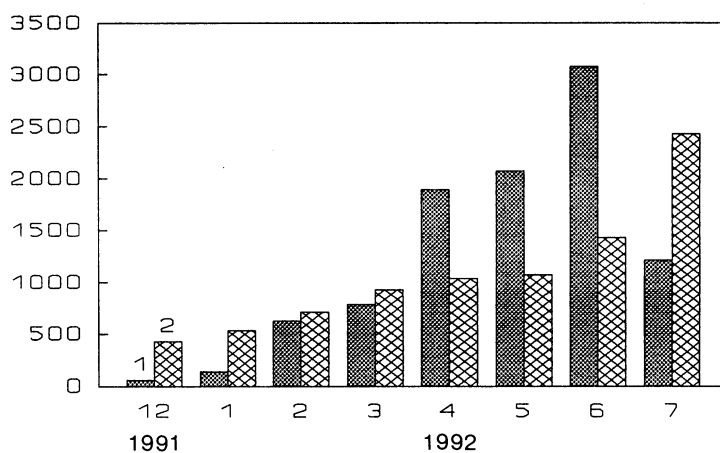
After the deregulation of interest rates, banks have been able to set their lending rates more freely, thus allowing inflation to be reflected more directly in interest rates. In most of the countries of Eastern Europe, interest rates are already largely determined by market forces without any strict ceilings set on interest rates by the central banks. Interest rates are not regulated in Russia either, though the central bank has announced that it will monitor banks' interest rate spreads. Despite the enhanced role of interest rates in the allocation of funds, real exchange rates have remained highly negative. Banks thus provide their customers with loans which are actually heavily subsidized and the repayment of which is, in spite of such subsidies, very uncertain.



## 5.2 Arrears and the payments system

In many economies in transition, inter-enterprise debts have emerged as a problem after the central bank has tightened its credit policy. Russia did not take steps to tackle the problem until the late summer of 1992. The urgency of the matter is shown by the fact that payment arrears rose from about SUR 50 billion at the beginning of the year to nearly SUR 3 000 billion by the summer (Figure). Most new liquidity in the economy consisted of arrears, and as much as 60 per cent of industrial production may at the time have been based on them.

Figure. **Arrears and bank credits of Russian enterprises, billion SUR**



- 1 Inter-enterprise arrears
- 2 Bank credits

Source: Financial Times, 4 September 1992

Note: Bank credits include loans by the central bank to commercial banks and loans by commercial banks to enterprises.

Enterprises' payment difficulties are partly associated with the wider problem of the monetary policy conducted by the CBR and partly with the continued adherence by enterprises to behaviour typical of the planned economy. In early 1992, the central bank was criticized, in particular, for its lack of direction in monetary and credit policy. This had first been reflected in very low central bank lending rates and reserve requirements, which were then abruptly raised. The commercial banks reduced their lending, raised interest rates and shortened credit periods. According to some estimates, one-fifth of all commercial banks ceased lending entirely, with a consequent increase in enterprises' payment difficulties. On the other hand, many enterprises were themselves unwilling to run down their stocks and cut prices in order to remedy the situation.

One explanation for inter-enterprise arrears is simply the rudimentary state and slowness of Russia's payments system. An enterprise is often unable to pay its suppliers because it has not yet received payments from its own customers. Even though the customers may have effected their payments on time, the settlement of payments can take anything between a few days and several months, depending on where the enterprises are located. Payments accumulate at the central bank's clearing centres, through which all payments had to be made until well into the summer of 1992 (Sachs and Lipton, 1992).

The payments crisis may also be partly due to the discrepancy between cash and non-cash money. Most observers agree that enterprises' deposit money grew more than cash in 1991. As a result of the virtually complete liberalization of prices, enterprises raised the prices of their products by more than consumers could afford to pay for them. This led to a huge build-up in arrears between wholesalers and retailers in a short period of time. The expansion of credit to industry as planned and partly implemented by the central bank could actually aggravate the problem rather than provide a solution to it. Prices remain high, but output is being maintained by credit, stocks are accumulating and customers still cannot afford to purchase goods.

The Russian government and the CBR for long disagreed about how to resolve the problem. The CBR recommended that credits be granted automatically to cover net debts between state enterprises. This would have entailed credits amounting to as much as SUR 1 000 billion or the writing off of debts. The central bank argued that the payments crisis had arisen mainly because enterprises had received no compensation for the rise in prices of raw materials and other inputs. Enterprises' expenditure had grown even faster than the additional

income derived from price rises, with the result that enterprises were on the verge of bankruptcy.

The automatic lending system proposed by the central bank does not provide any incentive to enterprises to adopt market-based principles, ie to let prices and output be determined by demand. It would also rule out any chances of sharply reducing lending to enterprises in line with IMF requirements. Financial efficiency can only be enhanced by the introduction of a hard budget constraint covering the entire enterprise sector. The introduction of bankruptcy legislation, the easing of price control and allowing enterprises to use their own profits would help enterprises to reach their budget targets.

### 5.3 Non-performing loans

Many of Russia's specialized banks have extensive non-performing loans inherited from the old system. The amount of such loans is likely to grow further as systemic reforms proceed. These loans have been granted to unprofitable enterprises, which subsequently have not been able to repay them. The literature on transition in the former socialist countries abounds with proposals for solving the problem of bad debts (non-performing loans). Some of the main ones put forward, including those proposed by Brainard (1991), Schmieding (1991) and Begg and Portes (1992), are considered below:

1) Conversion of banks' bad debts or their entire stock of loans into interest-bearing government debt, whereby the banks' bad debts would be replaced by government bonds. This would increase bank profitability, but would further exacerbate the problem of government budget imbalances during the transitional period. On the other hand, financing the losses of state-owned enterprises activities or the payment of unemployment benefits would also require government financing, and so this option would not necessarily give rise to large additional financial requirements in the government sector. Besides, the funds received from the privatization of government enterprises may cover the extra budgetary expenditure involved.

2) A monetary reform involving the netting out of nominal claims and liabilities between banks and enterprises. This solution is only suitable during the initial stages of reform, when the activities of new enterprises would not be disturbed. The advantage of this option is that it would not strain the financial position of the public sector. This was the method applied, for example, in Germany after World War II.

3) Extensive rights for banks to make credit loss provisions. This is not necessarily a feasible course of action, partly because it is not certain whether there would be any profits during the transitional period, when financing through the government budget might be necessary. At the same time, tax revenue would decrease. Hence, options 1 and 2, ie the conversion of loans into government debt or monetary reform would be the most practicable ways to deal with non-performing loans.

A problem common to all the options considered above is that mere knowledge of probable intervention by the public sector in situations where large loan losses have occurred, might lead to lack of prudence in banks and enterprises (moral hazard and adverse selection). The government must be able to convince the banks that they themselves will be responsible for any loan losses incurred after the transitional period. If, however, it is desired to see the emergence of new economic activity, bad debts must first be removed from banks' balance sheets in one way or another. This will have to be supported by structural changes in the economy as a whole. If structures and modes of operation in the economy do not change sufficiently, the benefit will be only temporary and new losses can be expected after some time.

The countries of Central and Eastern Europe where economic reform has advanced most have already taken steps to put their banking systems on to a healthy footing. The choice of measures very much depends on the government's budget and debt situation. In most cases, government financing has been used, but Hungary, for example, has opted for a combination of government financing and loan loss provisions. In East Germany, the entire stock of loans of the old banking system was transferred to a separate unit and a new bank set up by two West German banks which began operating on an entirely new basis.

In the conditions described above McKinnon (1991) recommends the use of moderate regulation which does not unduly stifle the operation of the banking system. Excessive reserve requirements, strict interest rate regulation and low real rates of interest cannot be regarded as optimal policy, if the aim is to achieve a well-functioning market economy. Unstable economic conditions, 'moral hazard' problems etc, may justify limited intervention in the financial markets, however. Among the measures that come into question here are the prevention of excessive concentration and growth of lending, maintenance of sufficient reserve funds and restriction of excessive

foreign currency risks. All these methods require the existence of a supervisory agency equipped with the necessary expertise and capacity to exercise influence.

## 5.4 The capital market and privatization

The development of the capital market would complement the operation of the banking system, although its importance and the extent of its activities are insignificant at the moment and will remain so for a long time to come. As privatization advances, however, the opportunities for the development of the capital market are likely to improve once the technical capabilities have been created.

The most important functions of the capital market are to provide risk capital and spread risk. Enterprises require long-term financing for their investments. Equity financing would enable risk to be spread widely among the public while at the same time individual investors would have the possibility to invest in many different enterprises. This would minimize risk exposures and their potentially destabilizing effect on the economy. The capital market would also perform supervisory functions: shareholders would supervise the activities of enterprises and the threat of takeovers would make management and enterprises more efficient.

However, efficiency in the capital market should not be taken for granted. If, for example, ownership is distributed among a large number of very small units and investors are unaccustomed to acting as shareholders, the supervisory capacity of the owners cannot be very great. It is not yet clear what kind of effects the Russian privatization process based on the distribution of privatization vouchers will have on the structure of ownership. Moreover, the difficulty — or even impossibility — of monitoring and supervising the financial performance of enterprises during the transitional period is likely to weaken the efficiency of the capital market. Besides, the capital market could be extremely vulnerable and sensitive to different kinds of information, whereby long-term economic performance would suffer because of short-term profit-seeking.

The imperfections of the capital market during the transition period have been subject to criticism by, for example, Corbett and Mayer (1991), who argue for bank-dominated financial intermediation and control. They contend that bank-dominated systems along German

and Japanese lines would be better suited to economies in transition than the Anglo-Saxon system in which the capital market plays a greater role in the financing and supervision of enterprises. Still, it is sensible to develop the capital market; the entry of various kinds of investment funds and institutional investors would improve the scope for monitoring and supervising enterprises. This option would require the ability on the part of banks to assess and manage risks.

During the transition period, the banks will play a vital role in the privatization process, *inter alia*, because structures and modes of operation formed at this stage could be very difficult to change later. The banks can finance enterprises either through lending or by functioning as shareholders in enterprises. Since it is difficult to determine the creditworthiness of a firm in economies in transition, it has been suggested that banks should actively participate as investors during the initial stage of privatization. Among the reasons put forward for this are the size of the banks' assets, the advantage they possess as regards access to information and the fact that in many advanced market economies more than half of companies' shares are owned by the financial sector.

One can, however, argue against large-scale company ownership by banks on the grounds that the banks are not yet able to supervise the activities of the entrepreneurial sector of the transition economies owing to a lack of information, expertise and instruments. If the banks were to function as both owners and lenders, this could increase the vulnerability of the economy. In addition, the emergence of a capital market could be impeded.

## 5.5 Assessment of the situation in the banking sector

Russian commercial banking is only in its infancy. Initially, virtually no banking regulations existed, and as a result speculative activity increased. In addition, the deterioration in the economic situation has placed pressures on the banking system. The laws on banks and banking subsequently enacted in the Soviet Union and Russia for the first time created a framework for commercial banking, but they were too general to remove even the worst abuses of the commercial banks.

Although these laws have become hopelessly outdated in the current circumstances, no new legislation has as yet been enacted.

One of the factors preventing the banking system from functioning efficiently is the preferential treatment of the specialized state banks. Most of the regulations governing commercial banks still do not apply to the specialized banks, nor do the latter have to register as commercial banks. The special banks are not, for example, subject to the regulation according to which the loan loss associated with any one customer must not exceed the bank's capital. The deposit rates of commercial banks were for long regulated; they could not exceed the deposit rates paid to customers by the Savings Bank. Even now, deposit accounts held at the Savings Bank enjoy a government guarantee, which, together with the Bank's traditional monopoly position is likely to ensure that it retains its superior position for a long time to come.

As a result of the preferential treatment of the specialized banks, no real competition exists. The commercial banks serve only a narrow circle of customers, while the specialized banks apply commercial banking principles to only a very limited extent in their own business. The specialized banks provide financing primarily for state-owned industry, the infrastructural investments of the social sector and agriculture. In providing finance for these sectors, the specialized banks serve mainly as intermediaries for the government. For the most part, lending has been long term. It is estimated that the government-owned specialized banks account for more than 70 per cent of the total assets and liabilities of the banking sector. The lending of the other commercial banks has focussed on short-term credit to the trade and service sectors and on financing projects where quick profits can be made. Recently, long-term lending has become even more risky than before because of the high rate of inflation. Whereas, in the late 1980s, long-term loans accounted for about one-quarter of all the loans advanced in the economy, their share had fallen to less than 20 per cent by 1990 and to 9 per cent by the end of 1991. Investment in Russia may cease altogether (Khandruyev, 1992, p. 10; Kazmin, 1992).

The dual system described above shows that the government's traditional banking monopoly has still not been eroded. Government ownership still dominates the banking system. Although, in principle, the system has been decentralized, the specialized banks and many of the commercial banks, especially the larger ones, still depend on government capital and are subject to government control. The

specialized banks have the biggest problems with non-performing loans. When the old Soviet specialized banks were reorganized as joint stock banks, their loans were transferred to their successors. The borrowers are state enterprises, collective farms, transport and construction organizations etc, the activities of which have run into difficulties in the new circumstances, and hence it is most unlikely that these loans will be repaid. If capital adequacy requirements were applied to the specialized banks, many of them would go bankrupt (Kazmin, 1992, p. 117).

In addition to the problem of bad debts, the banking sector is hampered by many other problems – including those involving technology and skills. Assessing the creditworthiness of enterprises was not done under the old system. Partly because of bank employees' ignorance of the market economy system and partly because of the underdeveloped state of the environment, banks are either unable or unwilling to develop their activities.

It was noted above that not all the specialized banks necessarily operate according to commercial banking principles. However, one may also ask whether Russian banks in general operate like western banks. In fact, many large banks function as financial departments of monopolies (for example, the Aeroflot Bank) or conglomerates of several enterprises, which together finance a certain sector. In order to reduce possible abuses by banks, the CBR has announced that it will intensify its supervision of banks and tighten its criteria for issuing banking licences. It is important for the development of banks that a clear legal environment for the market economy should emerge. The abolition of the special position of the ex-specialized banks would increase competition and encourage banks to unify their functions. Another important task of monetary reform in the economies in transition will be to reorganize the banks and strengthen their capital base.



# Appendix

## The fifty largest banks in Russia in 1992

		Own capital (mill. SUR)	Total assets (mill. SUR)	
1.	Tokobank	Moscow	11558.0	52241.0
2.	Rosselkhozbank	Moscow	7028.0	270479.0
3.	Imperial	Moscow	4720.0	25000.0
4.	Sberbank RF	Moscow	4520.0	874836.0
5.	Kredobank	Moscow	2180.0	46080.0
6.	AvtoVAZbank	Togliatti	1857.0	28824.0
7.	Inkombank	Moscow	1522.0	35863.0
8.	Promstroibank	Moscow	1333.0	84442.5
9.	Stolitshnyi	Moscow	1100.0	12422.0
10.	MIB	Moscow	960.0	74875.0
11.	Neftekhimbank	Moscow	916.6	13495.0
12.	Vozrozhdenie	Moscow	818.6	21673.9
13.	Mosbiznesbank	Moscow	800.0	137539.0
14.	Edinstvo	Moscow	729.4	5781.3
15.	Zapsibkombank	Tyumen	705.0	40552.0
16.	AKIB NTP	Moscow	672.4	19702.8
17.	Elektrobank	Moscow	665.8	55820.4
18.	Kuzbassotsbank	Kemerovo	647.7	11859.2
19.	Unikombank	Moscow	608.3	65265.1
20.	Mosk. mezhrefion. bank	Moscow	576.6	25877.0
21.	Konversbank	Moscow	545.0	21304.0
22.	Chelindbank	Chelyabinsk	500.0	30763.0
23.	Vostok	Ufa	491.5	11982.0
24.	Mosstroibank	Moscow	476.2	16111.0
25.	Khimbank	Moscow	469.0	2830.7
26.	Rosmedbank	Moscow	451.1	1655.0
27.	Narodnyi KB	Moscow	450.2	20470.0
28.	Kolyma	Magadan	445.0	16776.1
29.	Srednevolzhski KB	Samara	419.5	12795.4
30.	Elbim-bank	Moscow	402.8	4435.1
31.	Kuzbassprombank	Kemerovo	397.0	28545.0
32.	Agrika	Moscow	376.8	2036.3
33.	Effekt-kredit	Moscow	375.0	2970.7
34.	Bashprombank	Ufa	361.0	19801.0
35.	Finistbank	Moscow	357.4	4306.8
36.	Sibirski KB	Novosibirsk	320.4	7739.8
37.	AIKB PSB	Rostov	316.7	20209.6
38.	Khlebobank	Moscow	316.4	1208.6
39.	Komibank	Syktvkar	315.0	13799.7
40.	Permkombank	Perm	311.4	8960.5
41.	Avtobank	Moscow	307.9	7784.5
42.	Aeroflot	Moscow	305.9	3079.3
43.	Mosstroiekonombank	Moskova	304.0	7239.0
44.	Evraziya	Izhevsk	303.0	13010.0
45.	NGS Bank	Moskova	301.0	11421.0
46.	Komagrobank	Rostov	286.0	19990.0
47.	Gazprombank	Moscow	279.0	9755.5
48.	Uralkombank	Ekaterinburg	272.2	1578.5
49.	Assbank	Groznyi	269.0	516.0
50.	Rosinterbank	Moscow	266.2	14557.5

Source: Ekonomicheskaya Gazeta, 1992:31.

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# Russian Privatization Policies

by Seija Lainela and Pekka Sutela

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# 1 Introduction

The legitimacy of private property was only slowly recognized in the USSR (Hanson, 1990). By 1991, however, Russian discussion of privatization had clearly benefitted from the earlier East European experience (Yasin, 1991 and Block, 1991), and actual Russian public opinion (see Aage, 1991, Nelson et al., 1992, and Schiller et al., 1991) far from conformed to the stereotyped anti-market sentiments often taken for granted. On 3 June 1991, the Russian parliament passed a law authorizing the privatization of most state firms and also prescribed the methods to be employed. After August 1991, the new Russian government resumed the work on privatization guidelines. On 27 December, the Supreme Soviet passed an elaboration of the June 1991 law. In January 1992, this document was supplemented by a number of decrees issued by President Yeltsin. In late March 1992, the government submitted the actual Privatization Programme to parliament for approval. This programme was passed in June, and the Russian government proudly declared that the country was leaving the first phase of Russian economic transition, focusing on liberalization and stabilization, and was poised to enter the second phase, that of privatization and restructuring.

This article discusses the state of Russian industrial privatization up to September 1992. In particular, it discusses the prospects and probable outcomes of the privatization methods chosen by the Russian government against the background of earlier East European privatization experience and some of the peculiarities of Russia. The article has benefitted from the earlier interpretative work by McAuley (1992) and Shleifer and Vishny (1992). Tedstrom (1992) provides a progress report on Russian privatization up to early 1992.

## 2 The choices

Like the East Europeans, Russians distinguish between petty and large-scale privatization. Petty (or small-scale) manufacturing firms, shops and other suppliers of services are privatized by local government, while large-scale industrial firms and other large firms are privatized by the Russian government. The exact division into small and large

scale is essentially arbitrary. Small-scale privatization is the relatively easier part. It can in principle be effected speedily through sales, usually to the highest bidder and often to the management and employees of these firms. In Russia small-scale privatization has got under way in many regions. Nevertheless, the relative share of establishments thus privatized remains small. There has been a fair amount of experimentation, as different small-scale privatization methods have been preferred in different regions.

Even small-scale privatization faces such difficult problems as the sales criteria adopted, the acceptability of different bidders, the inevitable existence of insider information, influence and the ensuing corruption, which can be expected to be especially rife at the local level. In the Russian case, two additional problems have emerged. First, current property rights are particularly blurred in the case of small-scale establishments, as the various levels of local government, as well as in some cases different social organizations, compete for legitimate ownership entitlements with insiders, firm management and employees. Occasionally, prior corporatization and commercialization might be needed even in the case of small-scale privatization. Secondly, in contrast to much of Eastern and Central Europe, small-scale plants and service establishments in Russia are often local monopolies. In such cases privatization cannot be expected to produce swift supply responses and there is an obvious danger of a popular backlash.

Large-scale privatization programmes have so far failed to achieve the goals set for them in all Central and East European countries. The search for unorthodox privatization methods continues, and mass privatization by vouchers has gained ground. Russia stands to benefit from earlier experience. At the same time, it faces special problems of its own. The first of these is the unique size of the country. Together with the continuing deterioration of central authority, this means that the fate of many of the tens of thousands of large-scale industrial units to be privatized simply has to be decided at some regional level. This, in turn, means added exposure to corruption and at least great diversity in the privatization process.

Moreover, Russia does not enjoy the same degree of consensus concerning the ultimate goal of the transition process that is generally seen in many other countries in transition. Russia has never been a part of Europe in the narrow sense of the term. Therefore, becoming a "normal European state" cannot be its goal. Russia has to remain Russia, but unfortunately an essential part of this process has always

been to remain unsure as to what this really involves. At a less abstract level, it is interesting to note that the most visible element of current political mobilization has been along the lines of existing *de facto* ownership (Teague, 1992). One might speculate that even the possible dissolution of Russia would be primarily a regional conflict fuelled by the issue of natural and other resource ownership, not an ethnic issue.

Further, in Russia private property rights — even when they have legally existed — have always been overshadowed by a state that has been at the same time intrinsically weak and wide-ranging in its ambitions. This will obviously remain so in the foreseeable future, and the tendency of the official Privatization Programme to plan privatization quotas and schedules for the various regions of the country is just one recent example of this. Inevitably, failed attempts to control too many (and perhaps also the wrong) things by the state will exist alongside corruption, spontaneity and insider arrangements in the uncivil society.

Furthermore, Russia is certainly not free from the general post-socialist problem of fuzzy ownership rights. Industrial ministries and the Communist Party, the closest there was to owners, have been largely dismantled. This has left added room for ownership bids by local government, employees and especially managers (Shleifer and Vishny, 1992). This is a source of much inefficiency and directly unproductive activities, and therefore calls for speedy clarification of the existing situation. At the same time one should remember (contrary to, for instance, Aven, 1992)<sup>1</sup> that what is regarded fair by the population may influence the boundaries of the feasible, and therefore perhaps one cannot solve the tasks of efficient property arrangements without prior consideration of fairness.

Finally, the Russian government is plainly wrong in arguing that the tasks of stabilization and liberalization have already been solved. In fact, the country remains on the brink of hyperinflation, and political involvement in the economy is great and has even been growing recently. Privatization is now emphasized for the perfectly legitimate political reason that it is about the only piece of positive

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<sup>1</sup> In a discussion of the Hungarian case, Aven, before becoming a member of the Russian government, argues that "economic efficiency has nothing to do with fairness" and therefore "the need for rapid privatization means that concerns about fairness are a serious obstacle to reform".

news that the government can offer. Still, privatization under such instability poses a great many serious economic problems.

Russia has naturally faced the already classical problems of privatization. The solutions found so far will be discussed below. The issue of speediness vs careful planning has been resolved in favour of speediness, both because of the need for positive news and because of the prospect of a managerial takeover of "state" property created by the existing blurred property rights. The issue of efficiency vs fairness has been the subject of much debate and political dispute. Apparently, it has been resolved in favour of efficiency. Finally, the issue of insiders vs the general public has been resolved in a way that gives the insiders a notable advantage even though vouchers are intended to secure widely dispersed ownership.

The Russian Privatization Programme is a blend of approaches. It combines insider privatization, privatization by sale and the use of vouchers. Transferring the explicit ownership entitlements of enterprises to their insiders has been a very popular idea in Russia, not surprisingly among enterprise management and trade unions, in particular. It is advocated as a fast and simple method. It also precludes the use of "dirty" money, as the companies are not sold in public. Opponents of insider privatization have naturally pointed out the inherently unjust nature of this method. The value of the property an employee obtains depends on whether one happens to work in a viable company or a company that is ready for closure, to say nothing of the people working in sectors that will presumably not be privatized, such as health care or education.

Employee ownership has also been condemned on the grounds that it provides neither the appropriate incentives nor the strong owners which companies need. Experience from the former Yugoslavia has been cited as showing that companies owned by their employees seem to display excessive opposition to change and tend to prefer short-term benefits to the long-term development needs of the company. This is a strong argument, given the restructuring needs of Russian industries.

Still, earlier experience shows that if the appropriate incentives are lacking, enterprise insiders as well as all others who think that they have legitimate ownership claims can easily complicate, postpone or even prevent privatization. Therefore, under the Russian rules for privatization, enterprise insiders are allowed to acquire shares on advantageous terms.

The main principle applied by the Russian government is to privatize through public sales. This contributes to federal and regional budgetary revenue, restricts the scope for abuse and arguably helps to create efficient corporate control by active owners.

Given the existence of distorted wealth distribution, "dirty" money and insider information, privatization through sales is open to objections related to fairness. The recent high inflation has eaten up most savings, and therefore there is a problem of purchasing power and consequent underpricing of shares.

To effect a fairer division of ownership and involve the whole population in privatization, thereby enhancing its popular support and irreversibility, Russia has chosen to follow a policy that has also been pursued in Poland and Czechoslovakia, ie that of vouchers or investment cheques, as the Russian government prefers to call them. A certain proportion of the shares of the companies being privatized will be sold for the cheques, either directly or through intermediaries. The government intends to encourage the establishment of investment funds and related institutions.

In Russia the privatization cheques will be freely tradable among the population. In Poland and Czechoslovakia this is not allowed because of the fear that it would lead to an acceleration of inflation. In Russia the potential inflationary impact will be curbed by restricting the validity of the cheques. Each voucher will have an expiration date — one year from the issuance of the tranche.

A final peculiarity of the Russian Privatization Programme is regional devolution. A notable share of privatization revenue will be funnelled into local budgets to ensure lower-level support. Still, there remain regions with a basically hostile attitude to privatization. Local decision making powers are not always well defined, and competent personnel are often lacking. Much to the chagrin of Moscow privatizers, some regions, notably Tatarstan, also intend to issue their own vouchers (Anatoly Chubais in BBC Survey of World Broadcasts, SU/1475 C/3, 2 September 1992).



# 3 The legal foundations for privatization

## 3.1 Preparing the way

The privatization process in Russia is guided by several types of regulations, issued at different times and having different legal standing and degree of validity. These include laws (*zakon*) and decrees (*postanovlenie*) issued by parliament, presidential decrees (*ukaz*) and orders (*rasporyazhenie*) as well as decisions (*postanovlenie*) by the government.

Even before the adoption of regulations dealing directly with privatization, several laws were passed that paved the way for private ownership. The most important of these were the Law on Ownership, the Law on Enterprises and Entrepreneurial Activity, and the Joint Stock Company Law. They were all adopted in December 1990. Essentially, these laws reintroduced the concept of private ownership.

Privatization has been debated intensively during the time that the preparations for it have been in progress. The policy decisions taken have of necessity been compromises between the radical and market-oriented principles of the government, on one hand, and the views of the conservatives, on the other.

The actual privatization legislation was initiated in 1991, when in June the parliament passed the Law on Privatization of State-Owned and Municipal Enterprises in the RSFSR (the Privatization Law) and the Law on Personal Privatization Accounts and Deposits. These laws were completed under the then Russian federal government of Ivan Silayev and they were prepared by the State Property Committee headed by Mikhail Malei.

The Privatization Law states the basic principles of privatization, the methods employed and the organizations involved. Like so many other laws in the former Soviet Union and in Russia, the Privatization Law is an indirect law, which means that it does not stipulate the details of its enforcement, but leaves them to be spelled out in other lower-level regulations or subject to the authorities' interpretation. Partly due to the general character of the law, the privatization process did not get under way in 1991 and the deadlines and goals set in the law were not met. Another reason for this was that the regulations

giving the law concrete form were not completed in the heady post-August 1991 days.

The progress of privatization was also hampered by blurred ownership rights inherited from the socialist era. Russia has several administrative levels, which all exert some ownership rights. There is federal property, republican property, property of regions of various levels and finally local property. As already emphasized above, existing property rights must be clearly defined before privatization can commence.

The 1991 legislation included both the principle of employee privileges in the privatization process and the principle of dispersing ownership widely among the population. According to Malei (*Ekonomika i zhizn*, 1991:32), calculations at the time showed that in almost every case employees would be able to buy the enterprise for themselves. The money would come from enterprise incentive funds and also from employee privatization accounts that were to be opened. It was stipulated that a privatization account with a certain sum of money in it should be opened for every citizen. This money could only be used for acquiring property that was due to be privatized. The system of privatization accounts was supposed to be ready by 1992, but the goal was not met. It is unclear if the logistics involved would have been feasible (see Grigoryev and Yasin, 1991).

The Privatization Law is given concrete form on a rolling basis by a State Privatization Programme. According to the Privatization Law the yearly Programme must be approved by parliament each autumn before it starts discussing the state budget for the next year. The Privatization Programme covers the next three years, but contains detailed targets and timetables for the first year only. The programme also spells out in more detail the methods to be applied in privatization. The stipulations of the programme are meant to be binding on the authorities.

As a result of policy disagreements and the general uncertainty created by the post-August 1991 atmosphere, the Privatization Programme for 1992 was not submitted to parliament in the autumn of 1991. Instead, in December 1991 President Yeltsin — using his extraordinary powers — issued a Decree on the Basic Guidelines of the Privatization Programme for State and Municipal Enterprises in the Russian Federation (*Ekonomika i Zhizn*, 1992:2). The aim was to quickly define the methods of privatization in order to set the process in motion. The so-called nomenklatura (or spontaneous) privatization had seemingly proceeded at a rapid pace, and it could not be stopped

or controlled as the necessary regulations were not in place (Rossiiskaya Gazeta, 22 January 1992).

Since December 1991, the architect of Russian privatization policies has been the current Minister of Privatization, Deputy Premier Anatoly Chubais. Chubais was appointed to this position in November 1991, as a key member of the Gaidar cabinet of young economists. Before that Chubais served as an economic advisor to the mayor of the City of St Petersburg. The Chubais approach to privatization was already evident in the presidential decrees of December 1991.

Discussions on the Privatization Programme for 1992 started in various quarters right at the very beginning of 1992. Disputes focused mainly on the right of employees to participate in the privatization of the company where they work. The Russian League for Industrialists and Entrepreneurs — a powerful organization incorporating the managers of big industrial companies — and the Russian trade unions strongly argue for employee ownership (Teague, 1992). They demand that the majority of the shares of companies to be privatized should be given to managers and employees free of charge. They also support the formation of so-called closed joint stock companies. These are companies the shares of which cannot be sold to outsiders without the consent of the majority of the shareholders. The Joint Stock Company Law of 1990 allows for the formation of closed companies.

Closed joint stock companies fall outside the scope of most market-based corporate control. So, it is not really surprising that Russian managers advocate them. Perhaps more surprising is that some radically-minded liberal economists, among them Larisa Piyasheva and Vasily Selyunin, also advocate insider control. They seem to be primarily interested in the speed with which the alleged totalitarian monolith of state property can be destroyed (see, for instance, Piyasheva in Literaturnaya Gazeta, 12 December 1990). According to these radicals the quickest and also the socially fairest method of privatization is to give small firms to their employees free of charge and to sell bigger companies to their employees at a low price. Those who work in sectors that cannot be privatized would receive compensation in the form of financial remuneration or, for instance, land property (Izvestiya, 14 February 1992 and Rossiiskaya Gazeta, 7 April 1992).

To complicate the political debates on privatization even further, another strand of opinion, that representing the new entrepreneurs, strongly criticizes give-away privatization as being socialist-minded

(Getman and Inozemtsev, 1992). Only genuine entrepreneurs, they argue, can be the real "strong" owners.

The policy pursued by the government is basically a compromise. It aims at making the privatization process as transparent as possible, so that in general no transfer of property can take place without a public sale. This principle is seen as a guarantee against excessive nomenklatura privatization. The formation of closed joint stock companies is also forbidden in privatization. In the case of employee ownership, the principle is that ownership should be personal rather than collective. Chubais (Izvestiya, 26 February 1992) argues that this is an important distinction of principle. Privatization cheques will be used to give every citizen a chance of acquiring privatized property.

It took the whole spring for parliament to debate the Privatization Programme and the dispute was quite intensive. The programme was finally adopted in June 1992. Chubais was satisfied that his approach had passed parliament unscathed.

Since the end of 1991, several important decrees have also been passed specifying the methods of privatization. They include regulations on the division of property between different levels of administration and on the commercialization of enterprises (ie about converting them into joint stock companies). A presidential decree of March 1992 made it possible to buy land in connection with privatization. Before that land could only be rented.

Thus, in the autumn of 1992 the privatization process was ready to get under way as far as the legislative framework was concerned. In spite of the political turmoil of 1991, the Russians have been reasonably fast in getting their legislative work done.

## 3.2 Administering privatization

On account of the huge scale of the operation, privatization will be largely decentralized in Russia. Local authorities are expected to base their actions on regulations issued by the central authorities. The city of Moscow has been given special rights to pursue its own privatization policy. The special economic zones which it is planned to set up in the country will also enjoy special treatment. As noted above, other regions, especially those generally aiming at a greater degree of independence, are also trying to widen their prerogatives.

The privatization process in Russia is managed by two official bodies. The State Committee on Management of State Property (the State Property Committee), chaired by Chubais, is in charge of the overall process. It prepares the annual State Privatization Programme as well as laws and other regulations, and also supervises the privatization methods used. In addition, it decides on the privatization of federal property. Corresponding committees exist in the republics, regions and cities for handling the privatization of respective properties. These committees draft local privatization programmes for approval by local governments.

The other organization involved is the Russian Federal Property Fund. It acts as a temporary owner of federal enterprises before their privatization. Corresponding funds exist in republics and also at lower administrative levels. One reason for setting up these funds is to separate the former owners, that is the ministries, from the privatization process, and thus to try to minimize the effects of their possible resistance.

The existence of the two bodies, the committees and the funds, has been criticized on the grounds that it is a waste of resources, as the privatization structure is suffering from a chronic lack of skilled staff. According to some comments (*Rossiiskaya Gazeta*, 10 February 1992), one reason for the dual structure is that it may help to prevent corruption, since not all the decisions are taken by one single body.

### 3.3 Privatization targets

The Privatization Programme for 1992 contains very ambitious targets for this year: an astounding 60 per cent of light industry, 50 per cent of food and construction industries, 60 per cent of retail trade and 50 per cent of wholesale trade are to be privatized in the course of the year. Before that 6000 to 7000 medium- and large-scale enterprises will have to be converted into joint stock companies. It is also planned to privatize 50–60 per cent of all small-scale firms in 1992, and almost all the rest in the following year (Chubais, 1992).

Such ambitious targets will almost certainly not be met. Here the traditional Soviet habit of drawing up the most ambitious of programmes for economic development with strict timetables is demonstrated once again. But Chubais argues that in this case too the method is well suited to Russians, who are used to acting on the basis

of rigid rules (Financial Times, 13 May 1992). Regional governors, appointed by the Russian President, are responsible for seeing that the privatization plan goals set for their region are fulfilled at the risk of losing their jobs.

### 3.4 Privatization methods

Small firms employing less than 200 workers will be sold by tender or by auction. In the former case the buyer commits himself to certain obligations, such as maintaining the number of employees or not altering the business profile of the firm. According to the government, the most likely prospective buyers of small companies are local entrepreneurs and the employees of the companies in question (Chubais, 1992).

Large firms with more than 1000 employees will first be converted into joint stock companies. After that there are three elements in their privatization. A certain part — up to a half, depending on the privatization method chosen — of the company's capital will either be distributed free of charge to the employees or sold to them at a discount, primarily as non-voting shares. An auction, tender or some other competitive method will then be used for finding one big investor, who would acquire the controlling stake in the company. This is how the government intends to prevent excessive diversification of ownership. The rest of the shares — at least one-tenth — will be sold to other investors. Shares of large companies can also be sold in so-called investment tenders, where the buyer is obliged to make investments in the company.

Companies employing between 200 and 1000 workers may be privatized using either the method prescribed for small firms or that prescribed for large companies.

The only limitation concerning buyers in the Privatization Law is the stipulation that enterprises 25 per cent or more of whose capital belongs to state or local authorities cannot be buyers.

According to the Privatization Programme, the privatization process is to be encouraged by granting privatized companies special advantages over state companies. They will, for instance, be given preference in the allocation of foreign financing. The privatization process is also to be speeded up by the introduction of bankruptcy procedures following a June 1992 presidential decree.

The majority of enterprises can be privatized without special permission. Authorization is needed only for enterprises in certain specially listed fields of activity. In the Privatization Programme for 1992, lines of business are divided into five groups according to the opportunities for their privatization.

1) The first group includes objects whose privatization is not allowed, such as natural resources and television and radio stations. 2) The approval of the Russian Federal Government or a republican government is required for privatizing companies in branches such as mining and energy. 3) The State Property Committee authorizes the privatization of transport companies, companies employing more than 10 000 employees and certain other companies. 4) Privatization of, for instance, city transport networks and pharmacies is allowed only if they are included in local privatization programmes. 5) The last group consists of objects whose privatization is obligatory. These include retail and wholesale trade, construction and light industry as well as all unprofitable enterprises and unfinished construction projects.

The initiative for privatization can come either from the authorities, from the company in question, or from an interested outsider. The initiative is handled by the State Property Committee, which is allowed to reject it only in certain specific cases, mainly when the privatization of the company is prohibited.

When the decision on the privatization of a company has been made, a privatization commission is formed. The members of the commission include representatives from federal and local privatization committees. Local governments and the employees of the company concerned are also entitled to nominate their representatives. The commission draws up a privatization plan, in which the method of privatization, the timetable and the initial price are stated. The plan must be approved both by the local authorities and the employees of the company in question. The relevant property committee makes the decision on the form of privatization on the basis of the work of the commission.

The initial (or nominal) price established by the privatization commission is of importance especially for majority insider privatization (see below). It is based on the historical 1991 book-keeping value of the enterprise. Given the high inflation since then, this price will in many instances be exceedingly low.

When the plan for privatization is ready, the company will either be reorganized or in some cases liquidated. The company or its assets are then transferred to the ownership of the relevant property fund, to be finally sold.

### 3.5 Employee ownership

The workers of the companies to be privatized can choose between three models of acquiring shares. The choice must be made during the autumn of 1992. According to the first alternative workers will be given 25 per cent of the company's shares free of charge. In this case the shares will, however, be non-voting. Workers can in addition buy 10 per cent of the voting shares at a discount of 30 per cent of the nominal value. To encourage the interest of the managers in privatization, they will be allowed to buy 5 per cent of ordinary shares at nominal price.

However, the value of the shares given free of charge to workers must not exceed 20 minimum monthly wages per worker, and the value of shares bought by the company management must not exceed 2 000 minimum monthly wages per manager. These restrictions in many cases leave the amount of shares allotted free of charge to the workers below the 25 per cent limit of enterprise equity. For instance, in summer 1992 the maximum amount of shares for a single worker totalled 18 000 roubles (Izvestiya, 13 July 1992).

In the second alternative there is no free distribution of shares to workers. Instead, workers can, without an auction, buy a controlling interest in the company, that is at most 51 per cent of ordinary shares. This is an exception to the general government's principle of open sales of shares. Opting for this alternative requires a 2/3 majority decision by the employees. The price of the shares in this case is the nominal price plus 70 per cent. A further 10 per cent of shares will be auctioned against vouchers and the final 39 per cent will be auctioned against money.

According to the third alternative, a group of workers is entitled to buy 20 per cent of ordinary shares at a 30 per cent discount on the nominal price. Sales at such preferential terms are, however, conditional on the employees having met the goals set for them in one year's time. These goals may include such things as accomplishing the privatization of the company and improving its financial position. The whole staff of the company (including the aforementioned group) can buy a further 20 per cent of the normal shares at a 30 per cent discount.

Employees can sell the shares that they have acquired without any further restrictions.



In Russia, employees of companies being privatized are offered greater opportunities to acquire company shares than employees in other countries in transition. The aim of the Russian government here is to get the privatization process moving with the aid of the company's management and workers. As a result of this policy, the actual active ownership of the companies may be to a great extent shifting into the hands of enterprise management.

In June, when presenting the Privatization Programme for the year 1992, Chubais expected that, because of worker indolence and managerial inertia, the vast majority of the companies would choose the first alternative of employee ownership (Pravda, 30 June 1992). However, by mid-August most enterprises had, according to the State Property Committee, actually chosen the second alternative, that is they had opted for a majority stake (Izvestiya, 25 August 1992).

### 3.6 Privatization cheques

Preparations for mass privatization involving the entire population will start in October 1992, when the first tranche of so-called privatization cheques is due to be distributed. Every Russian citizen, regardless of age, will be given a cheque worth 10 000 roubles. The cheques may be used in several ways. First of all, they may be used for buying company shares in auctions. Employees may use them for buying shares in the companies where they work. The cheques can also be invested in investment companies, which purchase the shares of privatized companies. Finally, investment cheques may be sold freely at the going market price.

The buyer may use the cheques to pay either the full price of the object being privatized or a part of it. In general, when buying entire companies, 35 per cent of the price must, however, be paid with cheques. This amount is equal to the share of privatization proceeds that goes to the federal budget. This ensures that the federal budget does not receive money from large-scale privatization; it only receives vouchers which will then be nullified. In contrast, regional and local budgets will get a 55 per cent share of privatization proceeds in money (for details, see below). The question naturally remains as to what price level will be attained by the huge amount of shares to be issued in a low-income economy where most liquid savings, including the earlier monetary overhang, have been eliminated by high inflation.

The cheques can be used from the beginning of December 1992, and they are valid until the end of next year. The government intends to issue new series of cheques in the coming years in line with the progress made in the privatization process. The State Privatization Committee has estimated that 40-50 per cent of the total value of the property to be privatized in Russia will be sold for privatization cheques (Chubais, 1992).

The aim of the government is that ownership should be concentrated in the hands of "strong" owners. Privatization cheques, however, tend to disperse ownership among the whole population. Consequently, it is intended to facilitate the sale of the cheques by creating effective markets for them. Thus those who wish to sell their cheques would be able to obtain the best possible price for them. The demand for cheques is likely to be enhanced by the requirement noted above that they must be used to pay a certain proportion of the price of privatized property. It is expected that particularly the poorest population groups will sell their cheques.

Investment companies can act as strong owners, and it is hoped that a large number of such companies will soon emerge in Russia. By buying cheques, these companies help to improve their circulation. People can also invest in the shares of investment companies, which, because of asset diversification, should be less risky than the shares of other enterprises. Investment companies should preferably be privately owned, but privatization authorities are also allowed to establish them. Some companies have already been established by the new commercial banks.

The proceeds from privatization are especially important for republic and municipal budgets. The Privatization Programme for 1992 stipulates that the Russian Federation will receive 35 per cent of the revenue from the privatization of federal property and 20 per cent from the privatization of municipal property. The local budgets will receive 10 per cent and 45 per cent of the revenue, respectively. The republic and regional budgets will also receive their own share, and 10 per cent will be given to the privatization organizations to cover expenses.

After privatization cheques have been used as means of payment they will be transferred to the federal budget where they will be invalidated. There should not therefore be any permanent increase in liquidity.

All estimates of the amount of money involved are extremely uncertain, given the structural change and inflation expected and

already going on. According to Chubais, privatization cheques will be issued in the total amount of 1.5 trillion roubles, which is equivalent to 35 per cent of the presumed value of all property to be privatized in the federal programme. Because of inflation, privatization officials estimate that a cheque with the nominal value of 10000 roubles will actually be worth 150 000 – 200 000 current roubles on 1 January 1993 (BBC Survey of World Broadcasts, SU/1475 C3/1). On the other hand, *Kommersant*, the Russian economic weekly, argues that, judging from expected enterprise revenue flows, the official estimate of current capital values just referred to is about 30 times too high (*Kommersant*, 17–24 August 1992).

### 3.7 Foreign ownership

The question of attracting foreign investment to Russia and involving foreigners in the privatization process has been no less problematic than other policy decisions concerning privatization. Conservatives consider that there is a threat that the national wealth will be transferred to foreign owners, and they have called for restrictions on foreign ownership.

The government has also had reservations about foreign investors, as the very low external value of the rouble would enable foreigners to acquire Russian enterprises for a nominal price. The government has considered using a special exchange rate for investment or price coefficients for foreign buyers as well as various other restrictions on foreign ownership, but in the process of drawing up the privatization regulations the restrictions have been eased. The limitations on foreign investment concern mainly small-scale privatization and some industrial sectors considered strategically important. As small firms would be very cheap for foreign buyers, the Privatization Programme for 1992 stipulates that a foreign investor must first obtain the permission of the local government before being able to participate in the privatization of small firms. In the case of the privatization of companies in the energy and mining sectors, foreign enterprises need the authorization of the Russian Federal Government or republican governments.

There are no special obstacles to foreign participation in the conversion of the military sector enterprises. These companies may be quite interesting for western investors, as they offer higher-than-

average technical potential and know-how. Viewed from the Russian perspective, foreign involvement might help to solve three tasks at the same time: resource inflow, conversion and privatization.

The importance of foreign investments for the privatization process in Russia is admitted by the government. It is also understood that in order to make foreign enterprises interested in the Russian economy, investment procedures must be made as simple and non-bureaucratic as possible. According to Deputy Premier Chubais, this is one reason for decentralizing privatization to regions (BBC Summary of World Broadcasts, SU/1467, 24 August 1992). Foreign investors must also obtain information on investment opportunities, and this requires the setting up of data banks with extensive information on privatization procedures and individual companies in Russia.

A fundamental principle of government policy is that foreign and domestic investors should be treated equally, so that the same legal regulations will apply to both of them. Clearly, however, this does not exclude the possible use of corrective coefficients in the pricing of assets to be privatized. There are also plans to arrange special auctions for foreigners only. Thus, market splitting and discrimination would still take place.

Specific regulations concerning foreign investments are still lacking, but the government is currently working on them.

## 4 Privatization in practice

### 4.1 The federal process

So far, privatization has not produced any conspicuous change in the Russian economy. Only small-scale privatization has advanced, and from the ordinary citizen's point of view, the experience gained from it has not been very encouraging, especially in Moscow. This may even affect people's attitudes towards the transition process as a whole, and it may be one of the reasons behind the rapid introduction of the government's mass privatization project.

Although the basic regulations concerning privatization were completed by the autumn of 1992 and although the preparations for

large-scale privatization are under way, a great number of directives vital to practical privatization are still lacking.

The establishment of privatization organizations at different levels of administration started at the beginning of 1992. According to the latest information it has not, however, proceeded satisfactorily (BBC Summary of World Broadcasts, SU/1473, 31 August 1992). These organizations need competent staff, whose training poses problems. The importance of local training is emphasized by the fact that the local committees are increasingly handling the privatization of federal property as well.

Though privatization is not necessarily opposed, the whole process, together with all its concepts, is unfamiliar to the great majority of the Russian people. A massive information campaign is clearly required. The use of privatization cheques and investing in general are entirely new things for the people. They therefore need to be explained thoroughly. Such campaigns require not only much expertise, but also a great deal of money.

Privatization has evidently suffered from various degrees of negligence or even outright sabotage. Central administration officials are often reluctant to carry out privatization, as it inevitably curbs their own power over enterprises. For instance, the Ministry of Industry has been accused of delaying the transfer of federal property for privatization at the lower levels of administration (Kommersant, 1992:21). There has also been intense opposition to privatization in parts of local administration.

The government has tried to secure the progress of privatization by setting detailed targets for privatization during the year in the Privatization Programme. According to Chubais, local governors who fail to reach the targets could even be dismissed (Financial Times, 13 May 1992). This is another example of governmental willingness to use traditional Soviet methods to destroy the Soviet regime. One incentive for local administration to privatize is the relatively high share of proceeds they will receive from the privatization of local property. Widespread corruption might also be seen as an incentive.

Privatization is also opposed by many managers and workers, who are frightened of losing their jobs, if a new owner takes over. To minimize their resistance, managers and workers have been granted considerable benefits in privatization. It is also stipulated that if an enterprise does not initiate the privatization process itself, this will be done by the local privatization committee. Thus, both carrots and sticks are being used.

One reason for speeding up privatization is the already notorious emergence of nomenklatura or spontaneous privatization. This is the process whereby people occupying high posts in enterprises or in the state administration use their position to transfer the property of state companies to themselves or their own firms. In many cases nomenklatura privatization has been made possible by the lack of laws and by shortcomings in existing legislation. Thus, direct infringement of the law is not usually involved. As the necessary laws and government controlling bodies are not in place, it has been impossible to stop such actions.

Nomenklatura privatization can be and has been carried out in various ways. It is encouraged by the general lack of information concerning state property, and by the unclear division of property between different levels of administration. In addition, the evaluation of property is complicated, since normal markets have not yet been created. Recent high rates of inflation are adding to these difficulties. It is very difficult to estimate the extent of nomenklatura privatization.

The Joint Stock Company Law, passed in 1990, allows the establishment of closed joint stock companies. The formation of such companies on the base of state companies is a convenient way of nomenklatura privatization. Although the Privatization Programme for 1992 prohibits the establishment of closed joint stock companies as part of the process of privatization, it may still be done on the strength of the Joint Stock Company Law.

As the nomenklatura privatization procedures are often not a direct violation of any existing law, their cancellation is not always possible, as much as they might be deplored on grounds of fairness or even efficiency.

In order to fight nomenklatura privatization and corruption, a special Security Department is to be founded in the State Property Committee.

## 4.2 Local privatization

The two largest Russian cities, Moscow and St Petersburg, have been the first to start privatization in Russia, and they have done it according to their own rules. Under the privatization legislation, local authorities are responsible for the privatization of local property. They can also decide on the extent of privatization within the general

framework of the State Privatization Programme. In addition, at the beginning of 1992 Moscow was granted extra powers in privatization by a presidential decree.

The privatization policy in Moscow differs markedly from the policy pursued elsewhere in Russia. Even in Moscow the policy has been much disputed among city officials. The policy in Moscow has been greatly influenced by the former city mayor, the economist and long-time management specialist Gavriil Popov. Anxious to remove one of the pillars of the totalitarian state (Popov, 1992), his aim was to privatize, in a very short period of time, all small service-sector firms in Moscow. A well-known radical liberal economist, Larisa Piyasheva, was appointed to manage the privatization. The privatization of small firms started at the end of 1991. The objective was to sell the firms in a couple of months to worker collectives at a favourable price (Thorson, 1992).

The results of privatization were not, however, very promising, as the quality of service rarely improved. This should hardly have come as a surprise, as shops and service establishments in Moscow seldom face real competition. Rather, they tend to be local monopolies. Another reason is that there still does not exist a wholesale network in Russia. Retail shops are dependent on the same suppliers and suffer from the same problems as before. Moreover, the worker collectives that bought the firms were not particularly motivated to act according to the new principles. They tended to take the easiest way out in earning their living. For example, it pays a food shop to let part of the shop premises to a firm selling expensive imported goods. This secures the profitability of the shop, and the sale of basic goods is no longer important. Profits are ensured, but so too is public indignation.

Privatization could be expected to be especially difficult in Moscow. Existing property rights were contested by the USSR, Russia, Moscow and local authorities. The actual balance and division of powers between the four remained unclear in legislature as well as in management. There were open conflicts between the Mayor and the City Council. Moscow is also the home of quite probably the largest bureaucracy in the world. The approach of the Moscow leadership towards privatization differed significantly from that of the Russian government. While the government opted for the primacy of stabilization and even regarded privatization as a means towards that end, Popov and Piyasheva argued for the absolute primacy of property reform as a goal in itself (Piyasheva, 1992). For the Moscow radicals, noncompetitive, low-price privatization was the shortest route. Chubais

saw it as a serious violation of existing law (*Rossiiskaya Gazeta*, 22 January 1992). In June 1992, Popov finally resigned from his post as city mayor amidst allegations of serious corruption (*Nezavisimaya Gazeta*, 8 August 1992). His successor Yuri Luzhkov has altered the privatization policy in Moscow, which is now more in line with government policy.

The privatization strategy followed in St Petersburg has been quite close to government policy, which is due to the fact that the Russian Privatization Minister, Anatoly Chubais, comes from St Petersburg. He took part in the preparation of economic reform in the city, including privatization.

In St Petersburg, small-scale privatization started as early as the beginning of 1990 with the auctioning of shops, or, more accurately, with the auctioning of the right to lease the premises.

In spring 1992, small-scale privatization was launched in the city of Nizhnyi Novgorod (formerly Gorky) and its surrounding districts as a joint experimental project between local authorities and the International Finance Corporation of the World Bank group. Firms were sold by auction and also by tender. Employees could take part in the sales, and they were granted a discount if they bought the firm. The experience has been very successful and it is intended to extend the experiment to other locations as well, but so far this has been slow to take place. In Nizhnyi Novgorod, local trucks are next in line to be privatized.

The experience gained from small-scale privatization in St Petersburg and especially in Nizhnyi Novgorod is very important for the future of Russian privatization policies. Generalizing from this experience the government wishes to demonstrate that employees can also buy the firm they work for in auctions. Those in favour of employee ownership say that firms will be bought by the nomenklatura and the mafia. Of all the shops auctioned in Nizhnyi Novgorod during the spring of this year, almost 40 per cent were actually bought by employees (*Moskovskye Novosti*, 26 July 1992).

By the end of the June 1992, nearly 9 000 enterprises had been privatized in Russia, and applications for privatization had been filed for 50 000 enterprises. The total number of enterprises in Russia at that time amounted to 220 000 (*Rossiiskie vesti*, 6 August 1992). Unfortunately, current information on the progress of privatization is not as complete or as up to date as might be wished (*Ekonomika i zhizn*, 1992:32, p. 13).



## 5 Prospects

Russia was relatively quick in putting its privatization legislation in place. That was partly a consequence of learning from Eastern Europe, partly it reflected the "salad bowl" character of legislation. It attempts to offer something for every conceivable interest group, including Western financial organizations, which are primarily interested in getting things moving, preferably with speed and, if possible, in a way that tends to favour foreign investment.

As announced on 19 August 1992, the Russian mass privatization plan is ambitious and vague enough to have aroused thinly veiled scorn abroad ("More...", 1992).<sup>2</sup> At home, the acting head of the Central Bank has ridiculed the government's "game of Monopoly" with privatization cheques (Gerashchenko in *Izvestiya*, 2 September 1992). Personnel changes at the State Property Fund have been noted with concern (*The Economist*, 11 September 1992), and in general political uncertainty continues to grow in Russia at the same time as the timetables set in the Privatization Programme start ticking away. So far, practical steps towards privatization have taken a long time to finalize (see *Ekonomika i zhizn*, 1992:34, p. 15). Currently, the desired target state of privatization seems to be subject to some strange restrictions.<sup>3</sup> The economy continues to be on the brink of hyperinflation. Far from making the situation somehow hopeless, these circumstances will colour the process and outcomes of privatization, thus making the Russian case even more unique and interesting.

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<sup>2</sup> Perhaps the most worrying questions put forward by Finance Eastern Europe are:  
1) Have the 6000–7000 state enterprises to be turned into joint stock companies by the end of 1992 already been chosen and, if so, on what basis, utilizing which information?  
2) How can these companies come forward with proper privatization plans in six weeks?  
3) Is there an administrative machinery to process these plans? 4) Will the saving bank system be able to distribute the privatization cheques within a few months? 5) What has been done to prevent fraud? 6) What are the plans and regulations for setting up investment funds?

<sup>3</sup> In an interview on 29 August 1992, V.N. Khlystun, the Russian Agriculture Minister, argued that persons producing agricultural raw materials must be the majority shareholders of processing industry, that the government "now" supports this position and that a decision on this will be issued shortly (*BBC Survey of World Broadcasts*, SU/1473 C3/4, 31 August 1992). Such vertical integration of ownership seems to open new doors for subsidies, as food plants owned by primary producers will not be in a position to cut down their purchases even in face of an eventual future excess supply of food.

Such Russian peculiarities as the sheer size of the country, the unclear nature of its statehood and internal political relations, the precarious economic situation and the intended joint use of different privatization methods all combine to make the process now unfolding difficult to forecast.<sup>4</sup> The government assumes, on the basis of surveys, that there will be concentration of ownership, as perhaps one-third of the population will not become share owners (Chubais, 1992). It is also assumed that most employees — between a half and two-thirds — will only acquire shares in the enterprise where they work (Chubais, 1992). As the Czecho-Slovak example shows, popular attitudes towards privatization may, however, change quickly.

Kommersant, the economic weekly, has made an intriguing forecast about the future of Russian privatization (Kommersant, 17–24 August 1992). It is presumed that most original holders of vouchers and shares will want to sell them. As there is no private capital to buy them, even at very low prices, the government will exchange them for bonds. After that, Kommersant argues, the government will sell these shares to domestic and foreign investors. Of course, given appropriate political developments, one could also envisage the state deciding to remain the owner.

Small-scale privatization and probably also spontaneous privatization are proceeding fast. One relatively neglected consequence of these developments is that while the inevitable attempt by the nomenklatura to transform their politically-based elite position into one based on ownership may be ethically unpleasant, socially it tends to make the ongoing transformation irreversible.<sup>5</sup> There is a very high probability that every former CPSU Department Head or KGB general who has landed himself a highly profitable business opportunity inside the uncivil society will be absent when those planning for a return to the olden times convene.

The current Privatization Programme seems to show that the government is exceedingly fond of illusorily exact figures and timetables. Many of them are the consequence of the need and

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<sup>4</sup> Indeed, at least one member of the government's current economic policy team used to think that Soviet peculiarities make rapid privatization, especially one based on vouchers, both impossible and highly undesirable. See Grigoryev (1990) and Grigoryev and Yasin (1991).

<sup>5</sup> For an early Russian endorsement of spontaneous privatization, see Vitaly Naishul in *Izvestiya*, 9 December 1990.

willingness to strike what is regarded as a reasonable balance between divergent interests. The problem may be that once actual developments start to diverge from the course planned by the government, there will be much temptation to get involved, merely to maintain the balance of interests so intricately woven into the programme (see Getman and Inozemtsev, 1992).

## 6 Conclusions

The Russians have opted for a voucher programme for reasons similar to those in Poland and Czechoslovakia. However, the Russian programme differs from earlier ones (Boycko and Shleifer, 1992). It lacks the Polish-style state-sponsored mutual funds run by foreigners because such a high degree of involvement by foreigners has been deemed politically infeasible. The sheer size of the task would have necessitated perhaps hundreds of such funds, in addition to which it was desired to keep government involvement to a minimum. The Russian programme also lacks the single grand auction opted for by Czechoslovakia because of deficient government power and capacity to implement such a scheme and also because of logistical limitations.

Voucher tradability clearly implies a rapid concentration of voucher and share ownership, as many people will not want to own shares and many will have to sell vouchers to meet basic needs. On economic grounds, such concentration is welcome, at least if it does not mean that share ownership will become even more concentrated among enterprise insiders. Its social acceptability — especially if traded shares become concentrated among a fairly small group of enterprise outsiders, many of whom may have initially acquired their wealth by means widely regarded as dubious — remains to be seen, but clearly the government needs to regulate and even organize the market for vouchers. An adequate and readily available supply of shares will be crucial, particularly if vouchers are to be prevented from turning into an inflationary currency. It is difficult to see how the parallel use of money and vouchers in partially prescribed proportions (mainly in the form of various ceilings for the use of vouchers) will actually work under conditions of (virtual) hyperinflation and great uncertainty. Investment funds will be sorely needed for risk diversification. The relevant regulations are, however, lacking for the time being. A special

problem relates to the plans of some regions to issue vouchers of their own. At worst, such plans might disrupt the entire voucher exercise.

At the same time, important privileges have been granted to enterprise insiders. Management and employees may end up owning 40–51 per cent of shares in newly privatized enterprises.<sup>6</sup> In view of East European experience, something like this is probably necessary in order to prevent insider resistance to privatization. Moreover, the Russian government has had to fight against powerful interests that have demanded a solution much worse than the one now planned (see, for instance, A.P. Vladislavlev, 1992).<sup>7</sup> Managerial interests have pressed for insider privatization and closed joint stock companies as the prevalent enterprise form. Still, high insider influence, even in the form currently allowed for, may well give rise to concern about social fairness. It is clearly a problem for the structural change so much needed in the Russian economy. At worst, if the voucher programme for some reason fails or results in a very wide dispersion of ownership, large-scale privatization will end up being little else than a legitimation of actual insider takeover of state property.<sup>8</sup>

In principle at least, a diametrical danger exists as well. If the sale of shares for money and vouchers does not proceed as planned, the state will remain the main owner of almost all Russian industries. This could also be — as pointed out above — the end result of the state first distributing and then deciding to buy back shares. Whatever the sequence, this process would, on the one hand, tend to lengthen the current situation. On the other hand, enterprise governance would still deteriorate, as in spite of the recent enthusiasm shown by the Russian Ministry of Industry for something called 'technological corporations' (Dvortsyn and Yusin, 1992), there is little reason to

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<sup>6</sup> But remember that in privatization option 1, described above, the 25 per cent share of equity given to workers free of charge will be non-voting.

<sup>7</sup> Vladislavlev, a leading light in Volsky's Renewal party, puts forward two arguments. First, without the expert hand of current managers Russian industries would be ruined. Second, that having invested much energy in running state enterprises managers must be seen as having legitimate ownership rights to at least a share of them. Volsky has recently also argued for allowing cross-ownership between enterprises (*Financial Times*, 12–13 September 1992), a measure that would surely increase managerial powers.

<sup>8</sup> According to some information the government plans to limit the maximum share of ownership by one investment fund in any enterprise to 15–20 per cent (*V. Inozemtsev in Rossiiskaya Gazeta*, 8 September 1992). If so, insider control would be given a big boost.

expect any imminent improvement of state capacity in industrial management.<sup>9</sup>

One aspect of the Russian privatization drive that was not discussed above is the government's belief that privatizing will contribute in an important way to stabilization both by changing the ingrained behavioural patterns of enterprises and by creating budgetary revenue. There are, however, good reasons to believe that such expectations will prove unduly optimistic.

Deputy Prime Minister Chubais has repeatedly argued that the government's Privatization Programme is a reasonable compromise between vested interests arguing for pure insider privatization to maintain managerial powers and radicals proposing almost the same thing in the name of smashing totalitarianism. To put it slightly differently: "The problem with Chubais's plan is that it satisfies no one" (Teague, 1992). As a rock lyricist almost put it, politics moves in mysterious ways, but there is anatomy behind all bodily movements.

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<sup>9</sup> The exact relation of the idea of the technological corporation to privatization remains unclear, as the emphasis is both on state industrial policies and on granting more power to industrial managers. See Dvortsyn in *Delovoy mir*, 4 July 1992 and the critical comments of Piyasheva in *Nezavisimaya Gazeta*, 25 April 1992.

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# Russian Trade Policies with the West: 1992 and Beyond

by Pekka Sutela and Jukka Kero

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# 1 Introduction

Though the level of Russia's trade with the West keeps declining and there is much uncertainty about the exact state of Russia's rapidly evolving foreign trade regime, changes in the rules of the game during the last two years have been of unprecedented depth and extent. In fact, though the Russian economy essentially remains a closed one and policy outcomes have fallen far short of the goals set, foreign trade liberalization is one area where the Yeltsin administration can claim some, albeit only partial, success. To illustrate this easily forgotten fact, this article starts by briefly surveying the state of Russia's (or actually the USSR's) trade regime with the West in 1991. Then to illustrate the speed and to some degree even chaotic nature of the transformation, it provides an overview of the ongoing change in trade rules in 1992. Section 3 assesses the state of the trade regime and trade outcomes in the first half of 1992. Section 4 discusses in a more systematic way some of the crucial issues in Russian trade liberalization against the background of packages of measures planned in early 1992 and partially implemented in July 1992. Section 5 surveys the fundamental choices concerning the foreign sector and especially trade with the West in ongoing Russian economic and political debates. After that, some topics in Finnish–Russian trade are briefly surveyed. The article ends with conclusions and some prophecies.

This article focuses on commodity trade and the exchange regime only. Payment systems, capital flows and indebtedness are bypassed; they are dealt with in the article by Laurila in this volume. Furthermore, the emphasis is on Russia's trade with the West, here understood as the traditional hard currency economies.

## 2 Russian Western trade regime in 1991

To put the recent changes in Russia's foreign trade regime into the right perspective, it is useful to restate the basic features of foreign trade in the traditional Soviet economy. 1) Foreign trade was essentially seen as a way of dealing with the residuals of overall planning. Imports were needed to overcome domestic supply bottlenecks and for technological innovation. Imports were not allowed to compete with domestic production. The general emphasis was on import substitution. Exports, on the other hand, were the means of paying for imports. Beyond that, and reflecting the psychology of a shortage economy, exports were considered an outflow of much needed resources and commodities. 2) In order to maintain controls, concentrate expertise and to exploit economies of scale, foreign trade was made the legal monopoly of state-owned foreign trade enterprises. Their activities were closely monitored and directed by foreign trade and planning authorities. Even minor questions were routinely dealt with at a high political level. 3) Domestic enterprises were effectively isolated from the direct effects of trade by separating foreign trade prices from domestic prices by means of a vast set of commodity- and country-specific price coefficients and by applying a highly arbitrary system of rates of exchange. Foreign trade revenue was a major source of income in the general government budget.

Because of arbitrary prices and rates of exchange, it is difficult to estimate the importance of foreign trade for the Soviet economy. From the 1970s onwards, as export revenue increased rapidly on account of higher world market prices of oil, Soviet imports of food and technology became an essential part of the general strategy of maintaining living standards and superpower parity without embarking upon reforms. In dollar terms, however, Soviet exports in 1991 were only three times higher than Finnish exports. Imports had grown faster than export revenue, and the USSR had accumulated foreign debt.

The year 1991 was one of deterioration, uncertainty and upheaval in Russian society, and Western trade was no exception. According to official statistics, total Soviet exports declined by 32 per cent and imports by 44 per cent. Such a drastic drop in imports yielded a trade surplus, but at a reduced level of activity. These figures — as indeed

most official Russian statistics — should, however, be treated with caution. Soviet foreign trade statistics for 1991 leave much to be desired. Underreporting by exporters — largely for the purpose of hiding currency revenue — clearly increased, though nobody knows by how much. Measurement problems as such were exacerbated by fluctuations in prices and rates of exchange. This is partly, though not wholly, connected with the demise of the CMEA. The general standards of producing statistics probably deteriorated as central administration collapsed and began to be transformed from a Soviet to a Russian basis. Also, specific problems arose as foreign trade statistics were put onto a new basis; too little information was released on statistical methodology.<sup>1</sup> Overall, it seems that published Russian statistics tend to exaggerate the decline in actual trade flows. Scrutiny of mirror trade statistics, now under way in different research and trade institutions, should help to resolve this issue.

These caveats notwithstanding, trade can still confidently be said to have fallen sharply. This was basically due to a decline in domestic production together with increasing political, economic and administrative uncertainty. At the same time as domestic producers learned for the first time how to leave export revenue unreported and unrepatriated on a large scale, the resultant drop in the currency income of the central authorities contributed to the liquidity crisis of the USSR. The liquidity crisis had been developing over the last couple of years, and additional foreign trade financing was generally not available by the autumn of 1991. This, through the multiplier effects of missing imports and the expectations of domestic and foreign agents, contributed to turning the payments crisis into a solvency one (see the article by Laurila in this volume). Russia is still to emerge from this misfortune.

The legalization of the market exchange rate has been a long process.<sup>2</sup> Traditionally, market-determined exchange rates were a phenomenon at best tolerated and at worst persecuted in the USSR. There was a huge wedge between market and official rates. Gradually, things started to change. After having introduced a "special rate of exchange" for tourism purposes in late 1989, Gosbank switched over to using a currency exchange-based exchange rate in April 1991. This step was facilitated by the Currency Control Law of 1 March 1991.

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<sup>1</sup> For a discussion of these problems see ECE (1992), p. 114.

<sup>2</sup> For a full discussion see Alexashenko (1992).

For the first time, this law authorized currency exchanges, thus undermining the earlier official monopoly which Vneshekonombank (VEB) auctions had had. The importance of commercial banks in exchange operations relative to the VEB consequently grew rapidly. Moreover, in June 1991, Gosbank started to quote a so-called "tourist rate of exchange", which was set between the earlier official rates and unofficial market rates. Finally, in December of the same year Gosbank stopped quoting the tourist rate and let the rate for cash be determined by banks licensed to undertake foreign currency operations.

At the same time, however, two other exchange rates continued to exist. The "official rate", which economically was quite arbitrary, was still used for statistical purposes and the measurement of foreign receivables. The "commercial rate" had been in existence since November 1990, and though much lower than the "official one", was also far removed from the market rate of exchange. In fact, during 1991, the difference between the fixed and market-based legal exchange rates widened as a rapid increase in domestic liquidity resulted in a depreciation of the market exchange rates. The commercial rate was used for converting foreign trade revenue and outlays into roubles. It should not be forgotten that the introduction of the commercial rate in November 1990, as artificial as it was, was nevertheless an important step in the sense that it abolished the earlier jungle of thousands of commodity- and country-specific currency coefficients.<sup>3</sup>

Even before August 1991, Soviet decision makers were much preoccupied with foreign trade. In a clear break from earlier policy announcements, Prime Minister Pavlov emphasised repeatedly that Soviet integration into the world economy was both a short-run means of overcoming the economic crisis and a crucial long-run key to increasing competition, creating competitiveness and modernizing the economic culture as a whole. True, not all his pronouncements were as rational. The Great Foreign Banking Conspiracy theme of the partial monetary reform of March 1991 was the foremost but not the only example of such continuing xenophobic undercurrents. In spite of this, the Soviet attitude towards trade and economic cooperation with the West was seen, by some circles at least, to have changed fundamentally. A movement by intellectuals of endowing Gorbachev and his colleagues with handsome amounts of dollar support — some

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<sup>3</sup> For a description of these coefficients see IMF et al. (1991), Vol. I, Chapter III.4.

USD 20–30 billion a year, mostly in the form of balance-of-payments support and a stabilization fund — was under way by June 1991 (Allison and Yavlinsky, 1991, and Sachs 1992).

There was considerable legislative activity concerning foreign trade in the USSR in 1991.<sup>4</sup> The Supreme Soviet ratified the investment protection treaties, which in some cases had already been negotiated with partner countries two years earlier. In July 1991, the Supreme Soviet also passed the Law on Foreign Investment, allowing both completely foreign-owned subsidiaries and concessions.<sup>5</sup> The government's crisis programme of spring 1991 already set the goal of making the rouble (seemingly) internally convertible for trade purposes by the beginning of 1992 (*Ekonomika i Zhizn*, 1991:18). A presidential decree of May 1992 authorized all enterprises in basic industry to sell freely at home or to export 10 per cent of their output — but only provided that they had fulfilled the centrally set export plan and were able to secure the relevant licences (*Izvestiya*, 17 May 1991).<sup>6</sup> As part of the general devolution of the USSR, the republics were also formally given more powers in setting quotas and issuing licences for exports. The central authorities, however, tried to cling to the power of allocating the exports of fifteen main energy carriers and raw materials, which accounted for more than half by value of all Soviet exports (*Izvestiya*, 18 May 1991).

But, in spite of all the seemingly liberalizing legislation that can be enumerated, the fact remains that in 1991 the authorities still tried to control foreign trade very closely. Though decision making powers were decentralized from foreign trade enterprises to productive enterprises, all traders still had to obtain registration.<sup>7</sup> Registration now took place at the republic level, but that did not necessarily imply

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<sup>4</sup> For a full listing of changes in the exchange and trade system in 1991 see IMF (1992a), Annex III.

<sup>5</sup> There was already a similar Presidential decree from late 1990; see *Izvestiya*, 26 October 1990.

<sup>6</sup> The latter provisions actually turned the general principle into an empty letter. In truth it should be remembered that exports of produce in excess of the plan had been allowed earlier as well. By spring 1991, there were already some 25 000 enterprises with foreign trade authorization, compared with the few score of foreign trade enterprises under the traditional regime.

<sup>7</sup> Only in November 1991 was foreign trade authorization given to all enterprises registered in the USSR (*Pravitelstvennyi vestnik*, 1991:46, p. 9).

greater liberalism. The same can be said of the 1991 devolution of the authority of setting quotas and issuing licences from the central to the republic level. In practice, exports were licensed only in exceptional cases, while import licences were pervasive (I. Ivanov, *Ekonomika i zhizn*, 1991:1). This graphically illustrates the extent to which the behavioural rules of a deficit economy prevailed. Controls were not only maintained for balance of payments purposes. They were seen as a way of preventing commodity outflows from the country.

Markets could not be trusted to ration import demand and export supply, as the mechanism of allocating currency among prospective importers was still highly distorted in 1991. While the Currency Control Law of March 1991 tried to clarify the situation, the steps it took towards liberalization were extremely timid. A declaration of origins was still demanded every time currency was deposited. Even more importantly, the branch- and commodity-specific system of currency revenue retention quotas was meant to make enterprises active in foreign trade increasingly self-sufficient as concerns their currency income. The allocation of high quotas to manufacturers and oil producers was intended to provide export incentives. At the same time this procedure came nowhere near to guaranteeing an economically desirable distribution of purchasing power in different currencies among all enterprises, not merely those engaged in exporting. The traditional thinking in terms of self-sufficiency, *khosraschet*, still prevailed over market standards.<sup>8</sup>

Furthermore, high retention quotas (up to 70 per cent of the amount remaining after the 40 per cent of currency revenue payable to the central currency fund) seemed calculated to bring business on the newly established currency exchanges to a standstill.<sup>9</sup> In theory one might argue that, since the currency auctions and later exchanges in principle gave all legal entities access to foreign exchange, they implied a limited kind of internal convertibility as from October 1990

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<sup>8</sup> This statement needs to be qualified. First, in some cases prominent export industries may also have been those most in need of importables. Second, the prevalence of the *khosraschet*-principle should mainly be seen as an example of the power of vested interests, not of that of traditional thinking.

<sup>9</sup> Ivan Ivanov, the Deputy Chairman of the Foreign Economic Commission, estimated in late 1990 (*Rabochaya Tribuna*, 16 November 1990) that in 1991 about one-quarter of forecast Soviet currency revenue would be available to enterprises. However, this would, for the reasons just mentioned, be almost totally concentrated among exporting enterprises, not on the basis of economic criteria among all enterprises.

(see *Izvestiya*, 26 October 1990). In fact, however, there existed barriers to entry in these markets<sup>10</sup> and the main problem remained the extremely limited supply of currency in these markets. Basically, both caveats still apply.

In late 1990, the Soviet foreign trade authorities expected that the following year would be critical for Soviet external liquidity. Ivan Ivanov (*Rabochaya Tribuna*, 16 November 1990) estimated that 40 per cent of all prospective currency revenue would be needed for debt servicing. The quota of revenue payable to the central currency fund was set accordingly. Concomitantly, the Soviet authorities tried to ban barter trade, with exceptions for border trade (*Izvestiya*, 3 November 1990). This ban, which was meant to increase the amount of currency available to central authorities, could never be fully implemented, and it was lifted for many countries in mid-1991. In fact, the volume of barter seems to have increased by at least 50 per cent relative to 1990.<sup>11</sup>

## 3 1992: plans and reforms

### 3.1 The original Yeltsin Reform Manifesto

The dissipation of central control in the aftermath of the failed coup of August 1991 made it increasingly difficult to manage the external situation. Enterprises shifted foreign exchange deposits from the VEB to other banks. Capital flight increased, though no reliable quantitative estimates are available. The policies of the financial institutions of the increasingly independent republics varied. There was no agreement between the republics about which governmental body was responsible for new external commitments. The creditworthiness of the VEB declined and finally foreign creditors even held back disbursements of

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<sup>10</sup> For early examples of such barriers see *Izvestiya*, 24 July and 13 August 1991.

<sup>11</sup> According to official statistics, barter made up 5 per cent of all foreign trade turnover in 1991, up from 1.9 per cent in 1990. Barter exports focussed on traditional primary commodities, while imports were overwhelmingly consumer-oriented; see *Gosudarstvennyi* (1992), p. 69. The central authorities did not approve of this commodity composition of barter trade.

credits already committed. In November, the G-7 countries agreed to defer principal payments on debt. To anticipate the main arguments of this article, two interpretative observations can be made. All through late 1991 and into 1992, actual government policies were more determined by attempts to increase the amount of currency available to the central authorities for debt management than by any consistent policy regarding foreign economic liberalization and the opening up of the economy. There was much *de facto* devolution of powers to enterprises, but that was more due to the continuing deterioration of central authority than to any overall design.

Though the legislative and decision-making relations between the republics of the former USSR remained unclarified, Russia became the factual centre of legislative power in late 1991. President Yeltsin first announced his economic reform plans in late October 1991 (Izvestiya, 28 October 1991). The liberalization of foreign trade was to have a central part in launching Russia's transition to the market economy. This was an important statement of principle. Yeltsin also announced that there would be competitive bidding for export and import licences and competitive sales of roubles for hard currency.

In November, Yeltsin issued a decree which came into force at the beginning of 1992 ("O liberalizacii", 1991). In an important move, this decree gave foreign trade rights to all Russian enterprises. This may be regarded as the eclipse of the state monopoly of foreign trade, one of the basic features of the traditional economic system. Foreign trade registration would no longer be needed. Some licensing would remain, but its scope both as regards exports and imports was to be cut. The remaining licences were to be auctioned among prospective traders. Fuels and raw materials would for the most part still require licences, both for exports and imports. Also, there would be certain commodities for which licenses would be needed either for imports or for exports. Barter, for which more room had been allowed in mid-1991, was again restricted. Barter, after all, does not generate any currency revenue for taxation or confiscation by the central authorities.

The exchange regime was also overhauled. All legal and physical persons were required to sell 10 per cent of their currency revenue to the Russian Central Bank (CBR). Sales would be at the CBR market exchange rate,<sup>12</sup> and accumulated reserves would be used to support

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<sup>12</sup> It should be noted that this CBR market exchange rate, which moved from SUR 110 to SUR 90 to SUR 100 to SUR 90 and finally to SUR 85 per USD during the first five months of 1992, is a different rate from the currency exchange market rate.



the rouble exchange rate. In addition, enterprises exporting energy and raw materials were required to sell a further 40 per cent of their currency revenue to boost Russian reserves, this time at a new commercial exchange rate.<sup>13</sup> In a continuing atmosphere of a deficit economy, this requirement was meant to restrict exports of crucial resources. At the same time — given the predominance of energy and raw materials as Russia's currency earners — such taxation was to be the mainstay of currency revenue available to the central authorities. The remaining currency revenue was to be at the disposal of the enterprise involved, but was supposed to be deposited in a Russian bank (*Rossiiskaya Gazeta*, 7 January 1992). The obligation to repatriate currency was formally decreed. Any currency deposits held by Russian enterprises in foreign banks were to be repatriated within three months.

The only explicit restriction on the market exchange rate was that of a maximum bank spread of 10 per cent. Even very late in 1991, there were public references to introducing convertibility for current account transactions by 1 January 1992 (Yegor Gaidar in *Pravda*, 5 December 1991). Later this goal was postponed to March–April 1992 (Gaidar in *Izvestiya*, 24 December 1991) and then to a later date. As somewhat sourly pointed out by the acting CBR Governor Gerashchenko in late August 1992, this can hardly have enhanced the credibility of the Gaidar team (*Sovetskaya Rossiya*, 22 August 1992).

The holding of foreign currencies both by legal and physical persons was liberalized. Both were allowed to open currency accounts freely in (domestic) banks. Holding currency accounts in foreign banks was to be allowed only in exceptional cases. Russian resident enterprises were allowed to use currency freely for current transactions. Investments still needed a licence. Foreign enterprises were allowed to repatriate their profits and dividends in foreign exchange. Retail sales of goods and services to consumers in foreign currency were only to be allowed until July 1992. After that, only "places having extraterritorial status" were to be exempted.

The November decree annulled import taxes until July 1992. On the other hand, new export taxes on energy and raw materials were introduced. They were soon found to be prohibitive, in some cases even higher than the world market price of the commodity in question.

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<sup>13</sup> This rate was set at SUR 55 = USD 1, while the market exchange rate has fluctuated at around SUR 120–150 and even higher. An element of confiscation thus remained.

By February export taxes had to be changed. They were originally meant to be determined as fixed Ecu-denominated amounts per unit of weight. After February, export taxes were in most cases set at 30–50 per cent of the world market price of the commodity in question. Export taxes were to be paid in roubles. This was to be but the first in the series of frequent readjustments of foreign trade rules that foreign partners soon found to be not only irritating but also a real obstacle in trade relations.

### 3.2 The policy memorandum of February 1992

In late February 1992, the Russian government published its first comprehensive economic programme (*Rossiiskaya Gazeta*, 28 February 1992), a Policy Memorandum submitted to the International Monetary Fund as further proof of the consistently reformist credentials of the administration then negotiating membership of the Bretton Woods institutions. The Memorandum was therefore openly directed to a very specific readership, and its contents were for the most part pure IMF orthodoxy.

The Memorandum stated that Russia would switch over to a dual exchange rate system by 20 April 1992. A floating rate would be used for current transactions (including interest payments and dividends), while a separate fixed rate would be used for capital transfers. Later Russia would unify these two exchange rates by pegging the earlier floating rate. Currency taxation would also be overhauled. After the introduction of the dual exchange rate system exporters would be obliged to sell 30 per cent of their currency revenue to the state. In addition, there would be a 20 per cent export tax – payable either in roubles or in currency – on all currency revenue.

The government expected a new law on currency rationing and control to be passed already in March 1992. That was to mark an important step towards current account convertibility. All export quotas with the exception of those for energy carriers and certain commodities of a military and related character would be abolished by 1 July 1992. Export quotas for energy would be abolished stepwise by the end of 1993.

One of the most controversial aspects of the Memorandum were its ideas about foreign trade taxation. The Memorandum outlined a transition to unified export taxation of energy. These taxes were to be

set equal to the difference between the world market and domestic prices of energy. Thus, as the domestic price of energy was to be increased so that by 1 January 1993 it would be two-thirds of and by the end of the year equal to world market prices, this implied that the export tax on energy would be correspondingly lowered and eventually phased out altogether. Also, a flat import tax of 15 per cent was to be introduced by 1 July. At the same time, all remaining quantitative import restrictions would be abolished. Finally, import commodities would, by 1 June 1992, face VAT and excise tax.

In early May, the Russian government caused considerable confusion by announcing that the rouble would be made convertible on 1 July 1992 (*Financial Times*, 6 May 1992). This was — together with the general liberalization of foreign trade — meant to be the centrepiece of the second phase of Russian reform, domestic liberalization and economic stabilization being thought to be tasks that had essentially already been solved.<sup>14</sup> Though it was never made totally clear, it was widely assumed that this would involve current account convertibility for residents. The rouble would float for the month of July and a unified rate of exchange would be fixed on 1 August. Earlier plans for a special exchange rate for investment thus seemed to have been abandoned. The government spokesman (Konstantin Kagalovsky) also cited SUR 80 to USD 1 as the level at which the government wanted the exchange rate to stabilize.<sup>15</sup> It was soon estimated that such a strengthening of the rouble would demand a ten-fold increase in the volume of CBR intervention in the currency exchange. As CBR reserves would only have lasted ten days at that rate, the Russian government was presumably counting on the use of foreign support in creating a suitable exchange rate (*Kommersant*, 1992:19). This, however, is not the way in which currency stabilization funds are usually thought to work. They are used for creating confidence and for defending a feasible rate of exchange against speculative attacks, not for creating an exchange rate regime. No wonder, then, that only a few days after the government announcement, the CBR Governor Matyukhin declared that the

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<sup>14</sup> On such illusions, see the comments of Konstantin Kagalovsky as cited in *Nezavisimaya Gazeta*, 7 May 1992.

<sup>15</sup> Apparently the government had to change its target exchange rate during the spring of 1992. As late as March, they allegedly had an exchange rate of SUR 30 = USD 1 in mind.

pegging of the exchange rate would only be possible sometime in the autumn (Helsingin Sanomat, 14 May 1992).

The long-expected sale of export licences by way of auctions started in June. Immediately, however, there were complaints that the ministries responsible for exporting raw materials only issued a negligible amount of licences for sale because of bureaucratic slowness and attempts to guard the prerogatives of "their" enterprises (Rossiiskie vesti, 1992:13).

In another surprise move, Yeltsin decreed that enterprises located in special economic zones would be granted a 50 per cent discount on export taxes, provided that trade complied with the export quotas set for the region (Rossiiskaya Gazeta, 9 June 1992). This seemed to reverse previous policies on special economic zones. The Russian government had — in the February 1992 Policy Memorandum and elsewhere — tended to argue that all regions and branches should be accorded equally advantageous conditions for production and trade. Furthermore, the February Policy Memorandum had promised to abolish all tax advantages granted to particular regions and industries. This was at the time understood to spell the end of the Soviet and Russian saga of special economic zones. In May, the government's policy guidelines emphasized that special economic zones could only be maintained if they had extraterritorial status ("O strategii...", 1992).

### 3.3 1 July 1992: the second stage of Russian transformation?

In May 1992, the Russian Ministry of Foreign Economic Relations issued a policy paper outlining its plans for the rest of the 1992–1993 period ("O strategii...", 1992). While reaffirming commitment in principle to foreign trade liberalization, to measures such as cutting the number of commodities traded on the basis of quotas and licences and to the auctioning of the remaining export licences and quotas, this policy paper at the same time clearly signalled a willingness to backtrack on foreign trade reform. Citing the towering cause of economic security, the paper wanted to recentralize the exports of "strategically important raw materials", alleging that they were being dumped at too low prices by inexperienced local companies hungry for hard currency. Concentrating such exports — making up an

overwhelming share of all Russian exports — in the hands of experienced foreign trade organizations authorized by the Ministry would assuredly also help end capital flight. Promptly, President Yeltsin signed a decree to just such effect (*Rossiiskaya Gazeta*, 18 June 1992). Strategic raw materials which can only be exported by entities authorized by the Ministry include energy carriers, metals, timber and certain chemical products. At the same time, it is planned to shorten the list of commodities traded on a quota basis so that by the end of 1992 it would only include gas, oil and oil products. Nevertheless, the Russian foreign trade authorities admit that such licensing of exporters implies "a step backwards" (*Petr Aven in Izvestiya*, 29 June 1992).

The policy paper of the Ministry of Foreign Economic Relations argues for the convertibility of the rouble, in particular as a precondition for attracting foreign investment. In practice its main interest again seems to be to increase the share of currency revenue exchanged into roubles on a compulsory basis. On the other hand, such exchange would have to take place at the market exchange rate, towards which all other existing exchange rates were to be made to converge.

The Yeltsin decree recentralizing most Russian exports is part of the changes in the Russian foreign trade regime introduced on 1 July 1992. Other changes include unification of exchange rates. The CBR now only quotes one exchange rate, based on the Moscow interbank currency exchange (MICE). The original intention of pegging this exchange rate after floating the rouble for only one month has had to be dropped, as instead of appreciating the rouble has depreciated further so that in mid-August 1992 the market exchange rate was about half that set as the goal in early summer 1992. Since then, the rouble has depreciated further still. Other plans that had to be abandoned included making the rouble into the only legal tender in the country. In fact, just the opposite occurred: the legal scope of using other currencies in Russia was widened, as enterprises were authorized to pay salaries in foreign currencies (*Helsingin Sanomat*, 15 July 1992). Neither was the rouble declared convertible.

The currency exchange regime was again overhauled, now by unifying exchange rates and funnelling a large share of currency revenue through the domestic currency market. Since 1 July, exporters have had to sell 30 per cent of their currency revenue to the CBR currency reserve. Another 20 per cent must be sold to any buyer on the currency market. The good news for exporters is that sales to the

CBR will no longer be made at an artificially low special exchange rate, but rather at the market rate quoted by the CBR. At the same time compulsory sales through the currency market will enhance the development of this institution.

Taxation of foreign trade was also changed. Export taxes were adjusted and at least in the case of energy carriers increased. The average export tax after these rearrangements was probably around 20 per cent. Barter is subject to higher taxes, and these will be increased further. Instead of the 15 per cent import tax planned earlier, most imports will be subject to a tax of 5 per cent in the second half of 1992. It is planned to raise this rate on average to 10–15 per cent at the beginning of 1993. Importantly, taxation will now be at the market exchange rate. This makes a huge difference for those companies who make most of their sales in hard currency and used to pay taxes at the very favourable "official" exchange rate of SUR 1.8 = USD 1.

The introduction of import taxes will tend to make imports more expensive. At the same time, Russia adopted the value added tax in respect of imported goods, which were previously exempted. The biggest influence, however, on domestic cost levels will come from the abolition of the previously depressed special exchange rate used in pricing centrally managed imports (such as grain, meat, medicines, baby foods, machinery for light industries). This hidden subsidy, which amounted on one calculation to 4–5 per cent of GNP (Alexashenko, 1992), has now been abolished by adopting the CBR market exchange rate for these transactions as well. Evidently, such subsidies must now be made explicit, at least in some cases, such as the price of bread (A. Vavilov cited in *Izvestiya*, 15 June 1992; *Izvestiya*, 29 June 1992). It seems that the system of commodity-specific currency coefficients — one of the cornerstones of the old foreign trade system — will be maintained here.

## 4 Outcomes: Russia's Western trade in the first half of 1992

### 4.1 The trade regime

There is no doubt that the decree of 15 November 1991 on the Liberalization of Foreign Economic Activity was an important step. In particular, it abolished the need for specific foreign trade authorization. Six months later, however, this licensing was reintroduced for the overwhelming part of Russian exports, as new traders were judged to have neglected Russia's economic interests by selling commodities that were in short supply domestically, by setting prices too low, by competing too much with one another and by neglecting to repatriate currency revenue. It is too early to say what the actual consequences of the new licensing procedure will be. Obviously, the June 1992 decree may be open to different implementation policies. At worst the new regulations could be used to restore *de facto* the strictly centralized system of foreign trade via the state-owned foreign trade organizations that existed until the mid-1980s. It is quite unclear, however, whether the authorities will be in a position to implement such policies after all the changes that have already taken place.

Not unexpectedly, Russian foreign trade officials are anxious to reject this interpretation, saying that each branch should have several competing foreign trade organizations. At the same time, however, they maintain that the state should exercise firm control over these organizations, backed up either by a licensing procedure or a controlling package of shares (Aven et al., 1992). In their article, Foreign Trade Minister Aven and his deputies also call for a high-level Council on Competitiveness, with a status similar to the somewhat sinister Security Council. The Council on Competitiveness, Aven and his colleagues argue, should coordinate the interests of exporters, link export policies with general structural policies, support strategic exports and stimulate exports by small business. They seem to have in mind a Russian version of the Japanese MITI.

Secondly, the decree sought to increase the degree of current account convertibility and to expand the role of market forces in the determination of the exchange rate. In particular, banks are now allowed to have open positions in hard currencies, which permits more

active trading. Also, Russian residents are now allowed to trade freely in foreign currencies (Izvestiya, 28 July 1992).

Third, the decree sought to change the expectations of economic agents by emphasizing that the opening up of the Russian economy was a long-term and irreversible policy.

Though access to foreign exchange did in principle improve and the role of market forces in the determination of the exchange rate increased, huge distortions remained. The policies of the central authorities were in fact more influenced by the perceived need to centralize as much currency revenue as possible for debt servicing and centralized imports. Export enterprises, on the other hand, increasingly learned how to circumvent central regulations. This was greatly assisted by the collapse of Soviet controls and the inability – further boosted by the unclarities surrounding relations with the other CIS states – to establish functioning Russian controls, starting with a customs border. The reintroduction of controls over enterprises will be extremely difficult if not impossible.

A large number of different exchange rates for the rouble still existed in the first months of 1992, before the officially proclaimed unification of the rates of exchange (Alexashenko, 1992; IMF, 1992b. 1) The old official rate of about 0.6 rouble to 1 US dollar was still applied for the valuation of external assets. 2) The Central Bank quoted the CBR market exchange rate on a weekly basis. Ten per cent of currency income was to be sold to the CBR at this rate to support official intervention in the currency market. The CBR market exchange rate was to reflect supply and demand on the interbank market, but these exchange rates were not identical. Neither was there a clear rule for the relation between them. 3) A special commercial exchange rate (SUR 55 = USD 1) was set by the CBR. This rate was used for the compulsory sale of 40 per cent of currency revenue by most (energy and raw material) exporters. Because of its low level, the use of this exchange rate amounted to a tax. 4) Importers of necessities were, on the other hand, heavily subsidized by the use of a special exchange rate for centralized imports. It was set at SUR 5.4 = USD 1. 5) An exchange rate of SUR 10 = USD 1 was applied to tax payments by Russian citizens with incomes in hard currency. 6) The interbank market exchange rate was first determined in the weekly currency auctions held by the CBR and later in the MICE. This market remained extremely thin with relatively heavy CBR intervention and increasing restrictions on access. 7) As the MICE was not active all days, banks were also allowed to trade on behalf of



clients on quiet days. The ensuing interenterprise market exchange rate tended to differ from the interbank market exchange rate, though in early 1992 it was administratively linked to the latter. 8) The last two markets were for non-cash money. A separate market — subject to a maximum spread of 10 per cent — existed for cash, mainly for tourism. Cash and non-cash markets thus continued to be segmented, and the exchange rates varied widely, though the difference tended to grow narrower by the summer of 1992. 9)–10) Furthermore, illegal black market exchange rates also continued to exist both for cash and non-cash.

None of the above-mentioned exchange rates was generated by efficient or even well-functioning markets. The MICE has attracted at most about 3 per cent of all Russian currency revenue. Entry restrictions have abounded and the exchange rate has been maintained by CBR intervention. The interenterprise market is almost negligible owing to the notoriously slow interbank system and other reasons. The biggest currency market for cash in the former USSR is probably in Riga, Latvia. The Latvian authorities, however, claim ignorance of the actual volume of this market.

Neither does Russian foreign trade (excluding trade within the CIS) take place totally on a convertible currency and market basis. Trade with the former socialist countries of Eastern Europe was conducted on the basis of lists of commodities to be exchanged and special accounts. Russia has also wanted to conduct part of its trade with Finland on a similar basis. Furthermore, in 1992 Russia still traded with a number of developing countries using bilateral clearing arrangements.

As already noted, exports of energy and raw materials were subject to quotas. During the first half of 1992, quotas seem to have covered at least 70 per cent of all Russian exports. Though certificates carrying the right to licences can be traded, such cases seem to have been exceptional. An even bigger obstacle to free exports were the export duties applied to about 400 products, and especially the fact that their levels seemed to be totally arbitrary. This necessitated further changes in regulations, which only added to uncertainty. Also, many enterprises, regions and industrial branches have received exemptions from the payment of tariffs from the government. Such exemptions were granted on 61 occasions during the first half of 1991 (Aven and Glaz'ev, 1992) and may have covered more than half of the total value of all exports subject to tariffs. Some quota-requirements were abolished in July. Imports, on the other hand, were almost totally

liberalized in January 1992. In most cases they were free of quotas and licences. The customs duty on imports was abolished in January 1992 and a new import duty was introduced in July 1992.

The inability of the authorities to monitor payments was a major problem contributing to capital flight. There was no functional system for comparing customs and banking records, and even relatively simple measures to monitor real export flows were not implemented. Neither, in fact, was the customs border functional. In the first half of 1992, the Customs Committee is estimated to have covered scarcely more than half of Russia's total volume of foreign trade. Commercial banks did not report their foreign exchange positions to the CBR on a regular basis. With strong inflationary and exchange rate expectations, the repatriation of currency revenue did not seem rational. Moreover, the crisis of the VEB certainly contributed to the loss of confidence in the domestic banking system and the ability or even willingness of the authorities to defend deposits held by Russian banks.

## 4.2 Trade

The 1992 foreign trade statistics for Russia pose even greater problems than those for 1991. First of all, with the end of rouble-denominated trade, Russian trade statistics are now reported directly in dollars. Comparisons over time therefore face the more or less arbitrary choice of the rate of exchange to be used for the pre-1992 trade figures. Second, as Russia emerged as a sovereign state without a functioning customs service and as the number of entities involved in trade multiplied, the coverage and availability of statistics deteriorated further. Third, as regulations concerning intra-CIS trade differ from those concerning trade with the West, Russian firms often have an incentive to avoid export tariffs, currency surrender and quota requirements and to leave currency in banks abroad by shipping goods through other former Soviet republics, especially Ukraine and Belarus, with Poland or the Baltic states as other intermediate destinations. Fourth, exports were abnormally low during January–February 1992 owing to delays in establishing quotas and other administrative obstacles.

According to published Russian statistics, during the first half of 1992 total exports declined by 35 per cent from the same period a year earlier and exports to the former CMEA countries by a massive

48 per cent (Golyakov, 1992; "Russian Foreign...", 1992). Raw materials and energy account for 70 per cent of total exports, energy alone for 48 per cent. Exports of oil reportedly dropped by 18 per cent and those of machinery, equipment and vehicles by a half. There is much confusion regarding the actual level of Russia's exports of base metals, partly because of re-export through the Baltic countries mentioned above. Imports, on the other hand, declined by 24 per cent, those from the former CMEA area by more than a half. Thus the drop in imports from the former CMEA area has, not unexpectedly, been steeper than that in exports. Exporters who sell to the former CMEA countries are generally not required to balance their sales with purchases of goods. As overall grain purchases increased by 52 per cent, the decline in other items was even greater. Imports of machinery, equipment and vehicles declined by 40 per cent and accounted for only 23 per cent of total imports. In contrast to the first quarter of the year, the trade balance for the first six months showed a small surplus (USD 0.5 billion). This was nevertheless only one-eighth of the corresponding surplus for 1991.

Despite the statistical uncertainty referred to above, these data seem robust enough to allow for some conclusions. First of all, the shift in regional trade patterns evident over the last few years seems to have accelerated. Both in Russian exports and imports, in particular, the West has gained at the expense of the former CMEA countries and the developing countries. As it is obvious that both of the last-mentioned shares used to be maintained by political means (CMEA and weapons trade, respectively), such change is in principle to be welcomed on grounds of economic rationality (see also Collins and Rodrik, 1991; Wang and Winters, 1991). This, of course, does not imply that the current trade shares are necessarily efficient ones.

Second, the geographical shift has been accompanied by changes in the commodity structure of Russian exports. As manufactures used to account for an above-average share of Russian exports to those markets that are now diminishing, the share of energy and raw materials in total Russian exports has increased. If export liberalization and the ensuing geographical shift continue, further change in the commodity structure also seems inevitable.

It should be emphasized that so far the Russian experience deviates clearly from that of many developing countries undergoing trade liberalization. Often, the most astonishing goods find their way into exports after liberalization and sufficient devaluation. In spite of the collapse of the rouble, such exports have yet to emerge in Russia.

There seem to be three explanations for this. First, the general deterioration of the Russian economy is of such a character that while producers have problems in maintaining existing production, there is no real need to try to avoid bankruptcy by searching for new markets. Second, the traditional problems of product quality remain. Third, all too often the export infrastructure from communications through expertise to servicing is simply lacking.

Finally, though the potential share of the former USSR in world trade may be higher than has been the case so far, the evolving Russian trade pattern together with the payment crisis, political and economic uncertainty, the remaining bureaucratic obstacles and the continuing general decline of the domestic economy imply that neither Russia will become a major player in the world economy nor the world economy in Russia, at least over the medium term.

## 5 Issues and controversies

### 5.1 The relations between domestic reform and the foreign sector

In the literature concerning Soviet economic reforms, the closed nature of the economy was early diagnosed as one of those pillars of the traditional regime that deserved to be transformed (see, for instance, Hough, 1988). As the agenda shifted from reform to systemic transformation, liberalization of foreign trade and payments became a central part of the orthodox prescription of stabilization, liberalization, privatization and restructuring. Opening the economy to foreign trade introduces rational prices, exposes domestic producers to foreign competition and enhances technical progress, though it is admitted in the mainstream that a rapid move to world prices might not be the right strategy for a large, closed economy such as the USSR (Fischer and Gelb, 1991, especially note 29).

Widely shared though this orthodoxy became, there were always doubters, especially as regards a Polish-type of immediate or very early sequencing of trade liberalization and current account convertibility (see, for instance, Nuti, 1991). It is now admitted that the Polish experience shows that, for that country at least, immediate

foreign liberalization and current account convertibility was feasible. Still, the critics hold, free trade also destroys such activities which, though unprofitable at world market prices, still contribute to national income, employment, exports and consumption (Nutti, 1992). Thus, according to this view, gradualism in convertibility and trade opening is not necessarily unfounded until some progress is made in capacity restructuring (see also McKinnon, 1991). Hungary can be cited as a gradualist that has succeeded in maintaining the impetus of reform. The empirical issue of Poland's production level in 1989–1991 continues to be debated. Thus, Berg and Sachs (1992) argue that not only was the decline in Poland's production much smaller than usually estimated, it was also almost totally unconnected with the speedy introduction of convertibility.

The peculiarities of the Russian economy should be well known and they are discussed elsewhere in this volume.

Obviously, transforming Russia has to mean, even more than in Eastern Europe, that "an entire world must be discarded" (Ericson, 1991, p. 25). But does that imply that in the Russian case gradualism must prevail just because of the immensity of the task? Or does it mean that the reformist attack has to be even more radical and determined than elsewhere, just to be able to topple deeply entrenched institutions and powers? Or, perhaps, the peculiarity of Russia means that the transformation, to be at all successful, has — even more than in Eastern Europe — to let economic outcomes arise naturally as the unpredictable consequences of market interaction.

It is seldom understood that in fact the strategy chosen by the Yeltsin administration in late 1991 differed in crucial respects from the Polish-style orthodoxy. Nowhere is this so clearly to be seen as in the liberalization of foreign trade.

The Yeltsin administration worked under great pressure in late 1991. The Soviet Union and its centralized administration collapsed somewhat unexpectedly, the economy deteriorated rapidly resulting in near hyperinflation and plunging production, nobody was in a position to control prices or certain economic activities, and having only partial legitimacy, the government had to act fast. There was no alternative to rapid liberalization and attempted stabilization, even if it was obvious that success would at best be partial, given the existing state of institutions and policy instruments.

Views concerning trade liberalization and convertibility did differ, however. Following the Polish model, influential outside advisors had recommended that the rouble should be made convertible and trade

liberalized "as soon as possible, either simultaneously with or very quickly after most prices are liberalized" (The Soviet..., 1991, p. 16). This was not, however, the route chosen. As chronicled by a Polish advisor to the Russian government, the Russian path was formulated over a number of steps (see Dabrowski, 1992)). The first draft economic programme of the Russian government proposed gradual liberalization and stabilization over a period of one year. After initial liberalization of prices and partial liberalization of the foreign sector, a currency reform would take place after 8 to 9 months. A new Russian currency would be introduced, which would be convertible into hard currencies.

This approach met with much criticism from the foreign advisors to the government. They would have preferred a single complex shock operation, including the immediate introduction of current account convertibility (Dabrowski, 1992). As pointed out above, there were also government pronouncements on introducing convertibility in conjunction with the first phase of the reform at the beginning of January 1992. This did not take place, perhaps also because Russia, not being a member of the Bretton Woods institutions, could not at that time receive foreign support for convertibility. Contrary to the wishes of the advisors, the Russian government stuck to its original phased approach, only abandoning the currency reform idea.

This implied that the Russian government had in fact opted for a phased, even gradualist, reform strategy in preference to any overall shock therapies. It is unclear what the merits of gradualism in the Russian case might be. A politically weak government, surrounded by a disintegrating bureaucracy largely hostile to market reform, facing economic collapse and a population at best indifferent and trying to implement policies without many of the appropriate instruments at its disposal, would seem to be lacking the necessary preconditions for social engineering. In practice the implementation of economic policies tended to turn sequencing into muddling through (Nuti and Pisani-Ferry, 1992; Åslund, 1992). The government, which was originally proud of not having a written programme, soon became entangled in a true orgy of policy improvisation. This has been demonstrated above in some detail.

The medium-term policy programme launched by the government in July 1992 ("Programma uglubleniya...", 1992) could have improved the situation but did not. These latest guidelines for foreign sector liberalization basically restate the policies already aired, especially in the Ministry for Foreign Economic Relations guidelines for 1992–1993

published in the early summer of 1992. The government sets four medium-term goals for the sector: 1) total abolition of quantitative restrictions in foreign trade and the adoption of a unified exchange rate; 2) reducing the gap between domestic and world market prices with ensuing changes in taxation; 3) convertibility of the rouble both for residents and nonresidents, first for current operations and later also for capital transfers; and 4) export promotion and expansion.

When published, the programme was already partly out of date. Thus, it still promises current account convertibility in the summer of 1992. By the end of 1992, the government intends: 1) to further cut the number of export quotas, so that only oil, gas, oil products, "strategically important raw materials" and commodities the import of which is restricted by a partner will remain on the list; 2) to extend the auctioning of quotas; 3) to abolish the current administrative allocation of centralized imports and credits together with the commodity-specific currency coefficients still in use, to use market allocation and, if necessary, direct subsidies instead; and 4) to establish current account convertibility during the summer of 1992 (sic!).

In 1993, the government intends: 1) to restrict products exported on the basis of quotas to oil, oil products and other energy carriers; 2) to continue moving the prices of energy carriers closer to world markets, at the same time gradually phasing out the export taxes on energy by the end of 1994; and 3) to establish a permanent system of import taxation.

Finally, in 1994, the government intends to abolish also the quotas for energy carriers. In addition, and this is given much emphasis in the programme, by this time there should exist a government programme for export promotion. The Gaidar administration leaves no room for doubt here: the future Russian export drive should be forcefully directed by the state. At the same time it is possible that import taxation is meant to be protective. At least the programme states that "in future, import tariffs will change depending on the tasks of restructuring".

## 5.2 At the crossroads: Westernizers and Eurasians Reborn

If this interpretation of the latest government programme is correct, we are witnessing another shift in official Russian economic thinking, now from the liberalism of the early Gaidar team towards government-led development policies. Recently in Russia, many debates on the foreign sector have evolved around the somewhat "straw-man"-like themes of Western-style foreign sector liberalization and Far Eastern-style strong governments. Naturally, such debates have many facets. There is much general discussion on Russian peculiarities, but also several problems with more concrete ramifications.

First, there is the issue of the appropriate geographical distribution of trade. Foreign Trade Minister Aven, among others, shares the view that Russian exporters should try to conquer not so much the difficult Western European markets as those of Africa and Latin America (*Pravitelstvennyi vestnik*, 1992:1). Second, but related, is the issue of export composition, in particular of the advisability of arms export. This may be one of the few competitive areas, but at the same time one where conflicts with the G-7 countries could easily arise. The administration is reportedly divided on the issue. Third, there is the issue of economic self-reliance. First vice-premier Shumeyko argued recently (see BBC SWB, SU/1467 C/3–4), noting the negligible flow of foreign investment into Russia<sup>16</sup>, that the Japanese road of self-sufficient industrial development would also be the appropriate path for Russia. And naturally, both Shumeyko and others, including economists from the Far East, have argued that the standard IMF programmes would be inappropriate for Russia due to its (usually unspecified) peculiarities. Academician Petrakov, who decades ago used to be the most prominent proponent of a market-based economy among Russian economists, is more explicit in his opposition to the IMF than most Russian commentators (Petrakov, 1992). To him the case seems to boil down to Russian pride. Not a single developed country, he writes, has been subjected to the IMF remedies. Though Russia is backward in consumption, to Petrakov it remains a superpower in productive structure. Therefore the "Chilean-Mexican-Polish path" is not the one for Russia.

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<sup>16</sup> Not more than USD 1 billion over the last two years, he stated.



Naturally, the "Washington consensus" in development policies is not beyond criticism. Alternative approaches in development economics have greater academic respectability than usually allowed for by the mainstream (Krugman, 1992), the IMF record in developing countries is less than perfect and the East Asian growth experience has led some of them to be openly critical of the consensus, in particular concerning the standard requirement for trade liberalization (The Overseas..., 1991). Knowledgeable experts have drawn attention to the East Asian lessons that might be relevant to Russia and other countries in transition (Katz, 1991; Fry and Nuti, 1992). Even if the "Washington consensus" is based on the "Monoeconomics" view that economic laws are the same everywhere, few would seriously argue with the proposition that in designing policies one should take into account the history, culture, institutions, economic starting conditions and politics of the country involved.

Disagreements begin when it is asked what taking such peculiarities into account really means. The most disappointing thing about Russian debates — at least as published — is that there is much noise but hardly any cogent and rational argumentation on this.

## 6 Aspects of Finnish—Russian trade

The demise of bilateral clearing in Finnish—Soviet trade relations has been described in some detail elsewhere (Sutela, 1991 and 1992–1993). In short, from the Soviet point of view clearing was a vehicle for maintaining a larger Finnish trade share than purely economic considerations would probably have allowed for. From the point of view of Finnish exporters, bilateral trade arrangements gave rise to economies of scale and, in particular, to what actually amounted to cash-based export finance.

Having switched over to customary currency-based trading arrangements, Finland and the USSR soon saw their trade collapse. Finland's exports to the USSR may actually have declined in 1991 by more than those of any other major partner. From a historical average of 15 to 20 per cent and from a peak of about 25 per cent in the mid-1980s, the Soviet share of Finnish exports declined to 4.9 per cent in 1991 and an estimated 2.5 per cent in 1992. This was a major, though

not the foremost, reason for Finland's current economic crisis. In 1991 Finland lost about half of its share in Soviet imports from the West.

According to the calculations by Collins and Rodrik (1991), the natural Finnish share in Soviet imports would have been just over one per cent. The actual level used to fluctuate between 3 and 4 per cent. Hukkinen (1990) has shown how the structure of Soviet imports from Finland was more rigid than that of Soviet imports overall. The collapse of Finnish exports to the USSR and Russia in 1991–1992 is not unexpected in the light of such findings. It is probable that current trade flows are less than their natural levels. A long-term solution can, however, only be found by improving Finnish competitiveness and enhancing Russian purchasing power.

## 7 Conclusions

Hardly anywhere is the failure of recent Russian economic policies more evident than in foreign sector liberalization. The road selected in November 1991 has led to the collapse of the rouble and to partial reinstatement of foreign trade controls. We do not know what the adoption of a more consistent overall reform strategy would have implied. Neither can we really tell whether the current failure was inevitable, given the starting conditions in the autumn of 1991, or whether it could have been avoided, given better policies, more experienced policy-makers and more foreign assistance. A clear reorientation of Russian foreign trade policies is now under way, and it is possible that the principle of a single market-determined exchange rate will be abandoned. It is difficult to believe, however, that a return to the old days of state monopoly of foreign trade might even be seriously contemplated.

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# The External Debt of the Soviet Union and Russia

by Juhani Laurila

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# 1 Origins of the debt

## 1.1 Introduction

This article examines the causes and development of the external debt of the Soviet Union during the 40-year period since the Second World War. Special attention is focused on why the Soviet Union acquired the debt. One could ask why the Soviet Union, as a command economy striving for self-sufficiency, could not simply decide not to become indebted to foreign countries. Or, were there structural factors present in the Soviet economic system that gave rise to pressure to borrow from abroad? The article describes those generally known mechanisms whereby the inefficiency of investment policy generated pressure to increase the external debt.<sup>1</sup>

In addition, we examine the origins of the debt crisis now facing Russia, having inherited the Soviet debt, and assess the adequacy of the measures that have been planned for handling the crisis. The article takes up the question of to what extent the crisis is one of ability to pay, ie liquidity, which would require additional short-term credit, and to what extent it is a crisis of solvency, which would require a restructuring of the economic system and production, if Russia is to regain the ability to service its external debt.

## 1.2 The development of Soviet debt

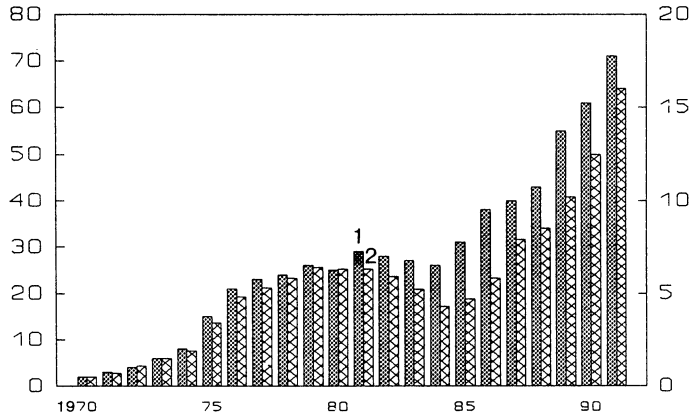
The external debt of the Soviet Union grew relatively slowly, accelerating only in the latter half of the 1980s. In the 1950s and 1960s, the Soviet Union's external debt was small and consisted largely of short-term commercial credits. The Union was not closely tied to the international financial markets. Such ties were developed primarily in the 1960s, when the Soviet Union established Moscow Narodny Bank in London and Eurobank in Paris. Through these banks, the Soviet Union raised primarily short-term Eurodollar loans (Brainard, 1987). The relation between the Soviet Union's external debt and the size and potential currency-earning capacity of its economy can still today be considered reasonably good (Figure 1).

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<sup>1</sup> For more thorough discussions, see Zloch-Christy (1987) and Kornai (1980, 1982, 1992).

Figure 1.

**Gross external debt and debt ratio of the CIS, 1970–1991**



- 1 Gross debt of the CIS (in billion of USD, left scale)
- 2 Gross debt of the CIS relative to GDP (per cent, right scale)

It was only in the 1970s that the Soviet Union began to raise long-term loans abroad; later, it turned to the international financial markets. For a long time, the Soviet Union preferred to borrow from governments at fixed rates of interest rather than from commercial banks at variable rates. Debt financing was usually raised by means of large package deals involving extensive countertrade arrangements. The inclusion of the government was seen as a way of reducing the risk associated with such arrangements and of allowing for the resolution of any technical problems through bilateral negotiations. The inclusion of governments can be further explained by the fact that borrowing was based on political considerations in the context of developing overall relationships rather than on market conditions. For example, in 1977 over half of the USD 23 billion worth of gross external debt was derived from loans granted by western governments. However, as the Euromarkets expanded in the latter half of the 1970s and in the 1980s, the Bank for Foreign Trade of the USSR (VEB) raised several long-term syndicated loans from western commercial banks.

In order to prevent indebtedness from causing excessive dependence on western countries, the Soviet Union decided to limit its imports and borrowing from abroad and to use the savings from the former to service its external debt. Because of this policy, the Soviet



Union's external debt did not grow significantly in the period 1976–1981, and its debt service ratio, ie the ratio of debt service costs to revenue from goods and services exports, remained at an acceptable level, below 30 per cent, throughout the 1970s (Zloch-Christy, 1987).

In the early part of the 1980s, the high level of international interest rates, high oil prices and relatively strong dollar reduced the need of the Soviet economy for financing from abroad. Higher export income due to the rise in world oil prices was sufficient to cover increased imports without necessitating an increase in the external debt during the first half of the 1980s. In 1984–1986, the situation changed: the dollar's exchange rate and international interest rates declined, and the prices of oil and gold fell. The latter was, however, always a minor source of revenue for the USSR.

Reduced export earnings resulting from the decline in oil and gold prices, the attempt to accumulate convertible currency reserves, increased financing needs in connection with the reform process as well as an increase in exports of weapons and equipment to the developing countries caused a sharp upturn in the growth of the Soviet Union's convertible currency debt beginning in 1985. The shortage of convertible currency was already reflected in the debt statistics for 1985. As its net debt began to grow faster than its gross debt, the Soviet Union was forced to use its convertible currency reserves to cover expenditures on imports and debt servicing (Zloch-Christy, 1987, pp. 46–49).

The reform of foreign trade effected in 1986 and 1987 resulted in a significant increase in the demand for imports and a deficit on current account in 1988 and particularly in 1989. At the same time, the Soviet Union changed its borrowing policy: despite the current account deficit in 1987, the Soviet Union raised convertible currency loans in greater volume than was needed to cover the trade deficit, and the practice continued during the deficit years that followed. The vigorous growth of the Soviet Union's foreign currency debt in the latter half of the 1980s resulted from the government's efforts to build up its convertible currency reserves (Dyker, 1992, pp. 183–184).

Overall, the debt of the Soviet Union has grown in a restrained manner in the post-war period. Furthermore, the Soviet Union has attempted to be punctual in servicing its external debt, even after the collapse of the union. The Soviet Union for long maintained a good credit rating, though not the top rating. Interest rates exceeded LIBOR by 5/16 of a basis point, at best 1/4 of a basis point.

### 1.3 Investment policy

After the war, in the 1950s and 1960s, the Soviet Union did not fall behind West Germany, the USA or Japan in terms of economic growth. However, in the 1970s and particularly in the 1980s, the faults in the Soviet Union's investment policy began to surface.

The allocative inefficiency of basic structural investments together with diminishing returns and declining technological change slowed the development of the Soviet economy to an increasing degree. The gestation periods were long, and the yields were either small or perceptible only after the implementation of further investments. Furthermore, large investments in heavy industry and in the weapons industry tied up resources that could otherwise have been used in small investment projects, which would have borne fruit more quickly. The over-commitment of Soviet officials to a programme of excessively large investment projects apparently gained the support of western lenders and thus helped to stifle Soviet economic growth. It also appears that foreign financing freed up resources for use in the weapons industry and gave cause for Soviet officials to postpone economic reform.

Whereas western countries invested in improving productivity, Soviet growth continued to be based on increases only in the quantity, not in the quality of produce and productive inputs. The share of investment in national income was exceptionally high. For this reason, the high employment rate, particularly in the 1980s, together with the slowdown in population growth, began to limit the increases in inputs. At the same time, the high ratio of investment to total output began to limit the increases in investment. According to some estimates, the growth of productivity in the Soviet Union in 1974–1984 was commensurate with that of some of the most heavily indebted Latin American countries. Labour productivity in the production sectors has been estimated at half the labour productivity of the USA and Western Europe. Ultimately, this manifested itself in low efficiency of investments not only in the Soviet Union, but also in all other socialist countries. Kornai (1992, pp. 167–168) points out that in the socialist countries during the period 1950–1979, for output to rise by 4 – 6 per cent a year investment had to grow by around 8 – 10 per cent a year, whereas in the industrialized capitalist countries investment and output grew at more or less the same rate.

Soft budget constraints, together with the absence of economic efficiency criteria, opened the way to oversized investment projects

and led to inefficient use of financial capital. Large state-owned companies generally used bureaucratic means to push for more funds, stressing the need to meet production plans, in the knowledge that there would be no risk of bankruptcy due to poor profitability.

Dyker (1992) summarizes the main features of Soviet investment policy as follows: 1) gigantomania or favouring large-scale projects, 2) "foot-in-the-door" policy or getting as many investment projects under way as possible so as to secure appropriations for the coming years, 3) every sector seeking self-sufficiency and 4) the rejection at all levels of a specific capital-output ratio as an objective and method of valuation, in favour of forecast-based planning.

The primary causes of the debt crisis of the Soviet Union and Russia are to be found in an investment and production policy that was overextended, favoured quantity at the cost of quality and which in the final analysis led to the squandering of productive resources. Resources were allocated badly enough from the point of view of the country's international competitiveness to make it difficult to earn enough revenue to adequately service the external debt. This was the case despite the fact that the debt had been kept within reasonable bounds.

During the first half of the 1980s, the "black gold" that flowed from high oil prices helped to conceal the structural weaknesses of the Soviet economy. After oil prices collapsed in the middle of the decade, the inability of Soviet industrial products to compete with those of the West became apparent. Already in 1986 it was clear that the Soviet Union, though still considered a low-debt nation, was turning into a rather highly indebted nation and, with the onset of the 1990s, into a high-debt nation, as oil prices failed to resume their upward trend.

## 1.4 Policy for a shortage economy

The distorted investment policy also turned the Soviet economy into a shortage economy and in this way fomented the external indebtedness that resulted from a chronic shortage of foreign currency. The one-sided, overextended investment policy, drew productive resources out of the neglected sectors and raised the demand for imports of quality and/or neglected goods. Since poor-quality goods could not be exported to pay for imports, raw materials were exported (primarily

oil, coal and other raw materials, and finally gold and diamonds) and borrowing was stepped up.

The various shortages fed upon each other. The shortages that were most important from the point of view of the nation's susceptibility to external indebtedness were those with respect to investment and imports. The investment shortage resulted from the central authorities' push to forced growth together with the soft budget constraint. The absence of personal responsibility led to the disregard of cost considerations. Any losses on investments could be covered in the budget.

Officials at all levels of the central hierarchy were interested in obtaining as much high-quality western machinery and equipment as possible rather than the poor-quality domestic variety. This led to excess demand for imports, ie the import shortage. Importers were not concerned at all about the prices they had to pay, exchange rates or any other cost factors. Purchasing activities were aimed at countries with whom political relations were good, with little concern about the price-quality relationship. Because importers were not themselves interested in minimizing their import expenditure or earning the foreign currency needed to pay for imports by means of exporting, the shortage of import goods led to a virtually chronic shortage of convertible currency and foreign currency loans. Exporting was considered a necessary evil in the acquisition of convertible currency.

## 1.5 The push for autarky

In the early 1950s, the CMEA countries, under Soviet leadership, aimed at self-sufficiency through the development of domestic and import-substituting industry, rather than focusing on internationally competitive industry. However, the separation of their economies from the division of labour and competitive forces of world trade led to the production of "soft" goods, which could not be readily or profitably sold in world markets and usually ended up in CMEA or developing countries. Since it was not possible to use soft goods to acquire the hard currency needed to pay for western imports, and since, moreover, they did not wish to rely on exchange reserves or to sell gold, other precious metals or diamonds, these countries came to rely increasingly on foreign loans.

There were also other reasons why imported foreign technology was not used to develop the capacity to produce competitive hard goods. Most importantly, with the possible exception of the arms and space industries, the CMEA countries did not have relative advantages with respect to innovation, technological development or markets (Holzman, 1979). Attempts to modernize and accelerate industrial growth by supplementing Soviet technology with Western technology languished because of the Soviet Union's inadequate technical infrastructure (outmoded, ill-maintained) and the inefficiency of the socio-economic system (slow, bureaucratic decision making and low worker morale). Furthermore, the Soviet Union's need to replace its western technology led to bunching in investments and foreign financing.

As the combination of technology purchased from the West and Soviet technology did not improve the Soviet Union's ability to earn convertible exchange reserves nor prevent its productive machinery from becoming outmoded, a widening gap emerged between the Soviet Union and the industrial countries. This, in turn, exacerbated the chronic shortage of convertible currency and increased the need to borrow from abroad (Gomulka and Nove, 1984, pp. 35–37).

## 2 Russia's debt problem and possible solutions

### 2.1 Debt, debtors and creditors

The Soviet Union's gross external debt has almost doubled in five years since 1986, when it stood at some USD 38 billion. Public lending accounts for about half of the total. In the period 1987–1989, commercial banks' share of lending did rise, but it has subsequently declined. Western banks trusted the Soviet Union because of its punctuality in servicing its debt and because of the belief that the government was the "guarantor of last resort" for all Soviet borrowing. The Soviet Union's concern for its credibility as a borrower was evidenced in 1987 by the government's redemption of Tsarist–Russia bonds held by the United Kingdom. This act opened the door to the Eurobond markets. Within a short time — by February 1988 — the

Soviets had made eight Eurobond issues totalling USD 1.5 billion. The doors to the international capital markets were closed, however, in 1990, when the Soviet Union's payment difficulties became common knowledge. In autumn 1984, the Institutional Investor rated the Soviet Union 25th in the country ranking of international creditworthiness (Krayenbuehl, 1985, p. 77). In 1992, Russia was ranked in 73rd place after countries like Sri Lanka and Costa Rica (Shapiro, 1992).

From the point of view of Russia's ability to service its debt, the key figure is the gross convertible-currency external debt, which according to Deputy Prime Minister Shokhin (Izvestiya, 2 October 1992) stood at some USD 71 billion at the end of September 1992. This has been largely inherited from the former Soviet Union. Although the gross debt itself is not large in relative terms (about 17 per cent of Russia's GDP), the Russian economy is no longer able to service it. The following discussion focuses on the situation as at the end of 1991, for which time the data is relatively complete and reliable.

The former Soviet Union's total convertible-currency external debt stood at USD 67 billion at the end of 1991. This figure includes USD 55 billion worth of largely long-term (over one year maturity) commercial loans. The remainder, consisting of bank deposits, letters of credit and unpaid import invoices, is due within one year.

Table 1. **Debts and claims of the former Soviet Union and the CIS at the end of 1991, billion USD**

	Gross debt	Gross claims
Industrial countries	67	10 <sup>a)</sup>
Former CMEA countries <sup>b)</sup>	29	74
Developing countries <sup>b)</sup>		95
– of which African countries <sup>c)</sup>		28
– of which arms sales <sup>c)</sup>		25
Total	96	179

a) Deposits and gold reserves

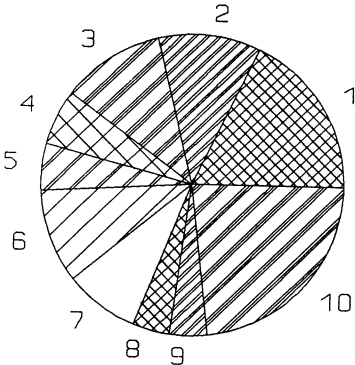
b) 1 USD = 0.55 SUR

c) The source is the VEB according to the Moskovskie novosti, 1 December 1991.

Almost all of the claims on former CMEA countries and more than 60 per cent of claims on developing countries are in non-convertible currencies. All rouble-denominated debts and claims between Russia and the CMEA or developing countries in Table 1 are converted to dollars using the official rate because it served as the relevant base for exchange rate quotation at the time when the contracts were originally signed.

There is another, and perhaps more important, reason why the gross claim of USD 169 billion on the developing and former CMEA countries is only illusory in comparison with the convertible currency gross debt of USD 67 billion. The claims originate from politically unstable, poor and indebted countries with grave payment difficulties and in some cases refusing to repay for political reasons (Figure 2). Moreover, a major part of the financing is connected with arms sales, — for instance, in the case of the African countries, 89 per cent of claims. As a rule, the original loan contracts do not comply with western standards as to legal format and strictness of repayment conditions, but are based on assurances of the maintenance of mutual assistance and friendship. Largely for these reasons interest and principal payments have been suspended on 70 per cent of claims and the rest is subject to considerable uncertainty.

Figure 2. **Soviet external claims by country at the end of 1989**



- |                                   |                                      |
|-----------------------------------|--------------------------------------|
| 1 Cuba (18 %)                     | 6 India (10 %)                       |
| 2 Mongolia (11 %)                 | 7 Syria (8 %)                        |
| 3 Vietnam (11 %)                  | 8 Iraq (4 %)                         |
| 4 Poland (6 %)                    | 9 Afganistan (4 %)                   |
| 5 Other socialist countries (5 %) | 10 Other developing countries (23 %) |

Because of the indebted countries' payments difficulties and political factors, the value in the secondary markets of Russia's combined claim on developing countries is estimated to amount to only a fraction of its nominal value, that is less than USD 10 billion at best. This also applies to the former CMEA countries, many of which have suspended debt service payments because of economic difficulties. Those countries in the best position are repaying their loans largely by supplying goods.

The question of debt service is complicated by the sharing of responsibility for the debt of the former Soviet Union. On 28 October 1991, the G-7 countries, Russia and 12 republics agreed to "joint and several responsibility" for the total debt of the former Soviet Union. Russia assumed responsibility for 61.34 per cent of the debt; Georgia, Kazakhstan, Armenia, Tadzhikistan and Kirgizia signed the agreement without reservations. Ukraine accepted responsibility for 16.7 per cent, Belarus for 4.3 per cent and Kazakhstan for 3.9 per cent. The Baltic countries also expressed their desire to participate in debt repayment but withdrew later. Subsequently, Ukraine also announced its desire to handle its own debts directly. Since then, there has been no agreement of any type regarding responsibility for the debt of the former Soviet Union, based on a listing of the debts and claims of the CIS. Nor is it likely that such an agreement will be forthcoming. Scepticism as to the efficacy of such an arrangement is also motivated by the existence of a number of open issues (see Denchenko in *Izvestiya*, 2 September 1992). Still open are the questions of who will assume responsibility for the share of the Baltic countries, which have dropped out of the arrangement; what are the precise amounts of Soviet debts and claims that are to be shared; is the sharing arrangement to cover debt service itself and how are late payments, failure to pay and possible debt restructuring to be handled? With so many questions still unresolved the only technically feasible solution seems to be that Russia would alone assume the responsibility of servicing the former Soviet debt.

Germany is the leading creditor country. Its combined share of official bilateral and commercial credit claims is some 43 per cent, ie about USD 22 billion or USD 279 per capita. The share increased when East Germany's gross claims on the Soviet Union were transferred to Germany (Gardner, 1992). The shares of principal creditor countries are shown in Figures 3 and 4.



Figure 3.

**The distribution of Soviet bank debt in convertible currencies by country at the end of 1991**

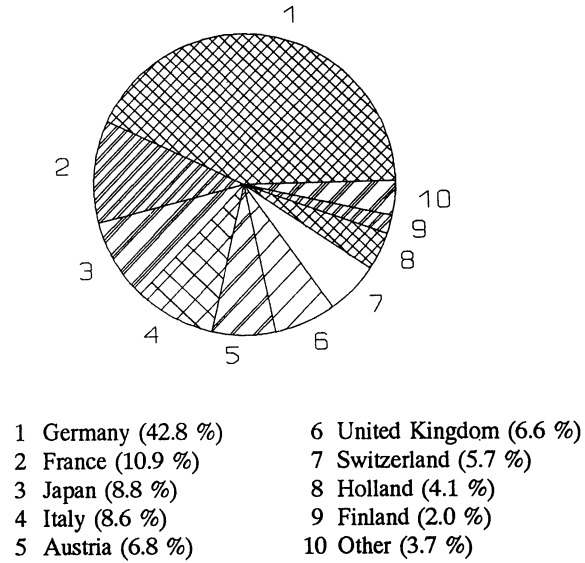
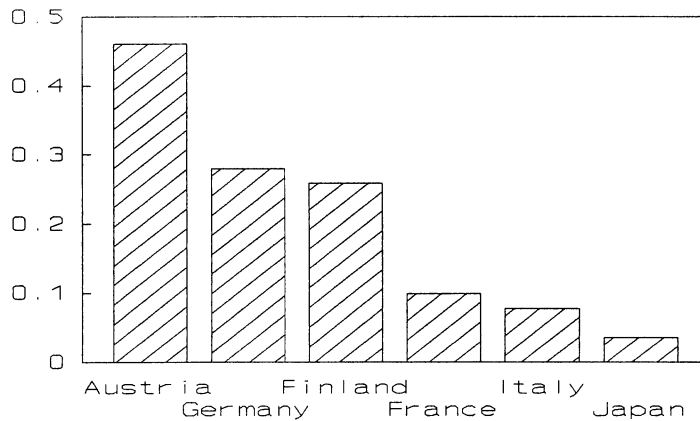


Figure 4.

**Soviet convertible currency debt: creditor countries at the end of 1991, debt per capita (thousand USD)**



Negotiations on an arrangement for the repayment of debts issued or guaranteed by nations are taking place under the auspices of the Paris Club. The negotiations involve 17 lending countries, whose claims on the Soviet Union and its successors amount to USD 32 billion. The Club has decided to defer to the beginning of 1993 USD 3.2 billion worth of loan repayments, due in 1991, on which agreements had been reached prior to 1991.

In regard to commercial loans at lender's risk, an agreement was reached on 16 December 1991 as a result of discussions between an advisory committee set up by 12 commercial banks, the VEB and the Central Bank of Russia. The largest amounts of claims were held by Dresdner Bank, Crédit Lyonnais and the Italian bank, Istituto Bancario San Paolo di Torino. Russia has been given until the end of 1993 to repay a total of USD 3.4 billion of loans which had been agreed prior to 1991.

Cooperation in both groups is based on the principle that a creditor member does not place another member in a better or worse position with respect to the deferral or rescheduling of loan repayments. In practice, however, problems arise from the fact that members often start from widely different positions with respect to the amounts of claims deferred or rescheduled. Thus, for example, the United States, Germany, France and Finland are in quite different positions concerning the rescheduling of Soviet debt. The claims of American banks on Russia are small, less than USD 1 billion. German banks have claims amounting to some USD 22 billion, while the figure for French banks is about USD 6 billion. Over half of the claims of German banks, but just 15 per cent of those of French banks, is state-guaranteed. This has been, and could continue to be, a source of differences concerning the appropriate approach to debt rescheduling.

## 2.2 Debt crisis: collapse of foreign exchange management and credibility

Symptoms of the Soviet Union's liquidity crisis were apparent already in 1990. Thus, the VEB required that a buyer of foreign currency show that it had earned at least as much foreign currency as was needed to pay for imports. Those Soviet importers that did not fulfil this condition were not allowed to purchase currency from the Bank. Trading partners noticed that delays were beginning to occur in

payments for their exports to the Soviet Union. The total of delayed payments reached some USD 4–5 billion in 1990.

The first symptom was the closing of the international financial markets to Russia in the early part of 1990. Yet in 1989, the Soviet Union had raised nearly USD 5 billion in long-term loans from banks and slightly over USD 3 billion from public sources. By early 1990, the Soviet Union had lost its credibility in the international financial markets and had to resort increasingly to borrowing from nations and state-guaranteed credit institutions. Finally, its ability to borrow in the international financial markets expired completely in 1991. In 1990, western banks' lending to the Soviet Union had fallen to less than USD 1 billion, whereas lending by nations and state-guaranteed lending together amounted to almost USD 5 billion (Bond, 1991).

The structure of the convertible-currency debt of the former Soviet Union changed significantly when foreign banks withdrew their short-term convertible-currency deposits. As a result, the USD 18 billion short-term debt to banks (end-1989) shrank to some USD 9 billion in 1991 and is now slightly over USD 5 billion. At the same time, foreign banks also reduced disbursements of credits they had granted at their own risk. Net interest expenditure increased because of the poorer credit rating.

At their meeting in Houston in July 1990, the G–7 countries (USA, Canada, Japan, Germany, France, UK, Italy) noted that the Soviet Union would face a liquidity crisis in 1991. A year later, President Gorbachev sent a letter to the G-7 representatives meeting in London, in which he requested a rescheduling of Soviet debt.

Despite all this, the announcement in November 1991 by the VEB that the currency reserves had been depleted came as a surprise to many western financial experts. The reason why western governments and banks had considered the Soviet Union a good credit risk were the slow growth and reasonable size of its external debt, its punctuality in servicing the debt, the belief that it had abundant reserves of gold and precious metals, the relative scarcity of information concerning the extent of its smouldering problems, particularly its monetary and financial problems, as well as the Soviet authorities' claim that its economy would continue to grow.

The Soviet Union's debt crisis did not develop because of over-indebtedness, as was the case with most Central European countries. Even in 1991, its debt service ratio was still a "tolerable" 41 per cent and the debt amounted to some 10 per cent of GDP, measured at the rouble market rate. The current account deficit was small. Rather, the

crisis resulted from Russia's problems in managing its exchange reserves, currency speculation and the loss of confidence on the part of foreign banks and firms in Russia's banking system and management of exchange reserves.

Up until the mid-1980s, the Soviet Union managed its exchange reserves in the same manner as other command economies. The state's own foreign economic relations bank, having a monopoly on foreign exchange, purchased currency earned from exports at the official exchange rate and used it in turn to pay for essential imports and to service the external debt. In 1986, the gradual breakup of this monopoly was begun with the allocation of a portion of exchange earnings to firms' foreign exchange funds. In addition, as there had already previously been a complicated foreign exchange coefficient system in existence, a system of different market and commercial exchange rates was introduced. In the early years, 1986–1987, the state turned over 5–7 per cent of currency earnings to the firms' foreign exchange funds; but later, in 1989–1991, the figure was 10–15 per cent (estimates which also take into account unofficial export earnings run as high as 40–50 per cent). Although the state still acquires the bulk of foreign exchange assets, these assets no longer cover its currency needs, especially since oil exports as well as world prices of oil and gold have declined.

From the point of view of exchange control, the system changed quickly — probably too quickly to keep the situation under control. In place of the four banks authorized to deal in foreign currency five years ago — State Bank, VEB, International Investment Bank, Bank for International Economic Cooperation — now some 45 000 firms and over 500 banks are involved in different kinds of currency activities. At the same time, there is a need to develop new foreign exchange legislation and a new exchange control arrangement.

The foreign exchange management crisis came to a head in December 1991, when the VEB was dismantled and a reorganization took place. Subsequently, the flow of foreign payments, previously handled by the Bank, was cut off. The new Russian Bank for Foreign Trade was established on 15 December 1991 as a unit of the Central Bank of Russia for the purpose of handling the debts of the former Soviet Union. Three committees were set up to clarify the claims and debts of the new Bank and, at the same time, payment transactions were frozen. Russia's entire financial and banking sector has had to function under the heavy pressure of change, which has led, *inter alia*, to the changing of the Governor of the central bank.

In April 1992, it was decided to split the VEB into several independent banks, one of which would function as a non-commercial state bank and would handle the CIS countries' external debts. In addition, there would be one or two commercial banks formed to keep accounts for firms and individuals. Recently, it has also been suggested that if Russia assumes sole responsibility for handling the debts of the former Soviet Union, a state-managed company should be set up to handle the task. The institutional structure of Russia's foreign sector management remains transient.

## 2.3 Currency flight

The currency flight, ie the attempt of Soviet and Russian residents to transfer (legally or otherwise) their foreign currency holdings to foreign bank accounts, probably did not get into full swing until 1991, when private firms, cooperatives etc were also given the right to engage in foreign trade. Previously, foreign trade had been centralized to a degree that any large-scale flight of foreign currency would probably have been detected. So far, it has been estimated that some USD 10–20 billion worth of foreign currency with which Russia would have been able to continue to manage the foreign debt and preserve its credit rating have slipped out of its hands. Such estimates are extremely uncertain. The position taken in this article is that an increasing amount of export and import activity has taken place through unofficial channels. This implies that the contraction in Russian foreign trade has not been as sharp as the official data would indicate (Sarafanov and Lirov, 1992).

There is reason to believe that the currency flight accelerated in 1992 (Plekina, 1992). Attempts to avoid repatriation requirements, export taxes and the limitations connected with licensing continue to prevent the strengthening of foreign exchange reserves, which have shrunk to practically nothing. Apparently, the Government is unable to force large export-industry organizations to pay, as the repatriation requirement which came into force at the beginning of July is being evaded by means of under-billing and off-the-books trading.

The ultimate reason for the currency flight is the uncertain political and economic outlook. The rouble, in practice, still lacks convertibility and its value (internal and external) is expected to continue falling. Lacking a workable system of exchange control and

repatriation, the authorities limit the availability of foreign exchange by granting rights to engage in foreign trade and export licences, as well as by, in effect, administratively setting the external value of the rouble. Soviet banking services are unreliable or, in many cases, non-existent. Other reasons for the currency flight include the desire to purchase western consumer goods, attempts to avoid official red tape and fear that funds will be frozen and finally confiscated. The fear of being caught is lessened by western bank secrecy and the inadequacy of Soviet customs and other official controls. It is possible that a large portion of export activity is conducted outside the official accounting and statistical framework and that full payments are made in foreign bank accounts.

Even if the tightening of exchange control were successful, it would not remove the basic causes of currency flight. There will not be sufficient incentive to observe the repatriation requirements as long as the rouble is not freely convertible, inflation continues, domestic banking services are not available, export earnings are heavily taxed and there is an underlying fear that foreign currency will be confiscated. If the currency flight should abate in the near future, it is more likely to be the result of a decline in Russian exports than more effective administrative control and regulation<sup>2</sup>.

## 2.4 Liquidity and solvency

Russia's official exchange reserves consist of the foreign currency holdings of the Bank for Foreign Economic Relations of the USSR, including the funds available in the accounts of the Central Bank of Russia and the Soviet ministries. During the latter half of the 1980s, official convertible exchange reserves fluctuated in the range USD 11–14 billion but began to dwindle in the latter half of 1989.

Consequently, the official exchange reserves of both Russia and the former Soviet Union had virtually dried up by the end of 1991. Official convertible reserves amounted to USD 6.7 billion at the end of 1990, USD 5.3 billion at the end of 1991 and USD 0.3 billion in mid-1992.

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<sup>2</sup> According to widely supported western views all kinds of exchange controls should be avoided, given the administratively overburdened and backward situation in the former Soviet Union (see, for example, Dornbusch 1992, p. 419).

The official gold reserves fell from 850 tonnes at the end of 1988 to 485 tonnes at the end of 1990 and probably dried up quickly thereafter, *inter alia*, because the big gold producers, such as Russia, Kazakhstan and Uzbekistan, stopped transferring their gold holdings into the Soviet Union's official gold reserves in 1991.

Both the basic variables that determine a country's ability to pay over the long term (such as GDP, industrial output, exports, imports and the marginal efficiency of investment) and the financial variables that indicate its short-term liquidity (such as external debt, debt service costs and the possibilities for financing the future current account debt either by borrowing abroad or relying on the rapidly diminishing exchange reserves) would seem to indicate that Russia will at some point have to undertake extensive rescheduling of its external debt.

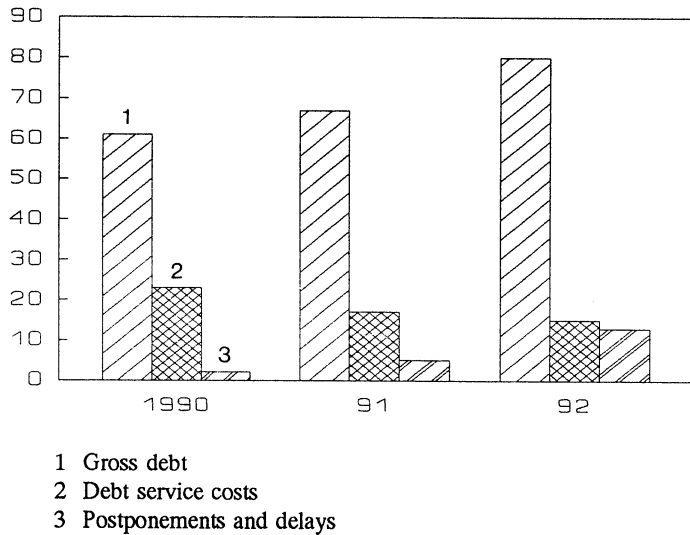
In addition, Russia's position as manager of the debt of the former Soviet Union is made more difficult by numerous special factors, among which are:

- the "deficit-economy mentality", according to which the export of products deemed important to the economy is discouraged by means of licensing schemes, taxation and customs. Importing, on the other hand, being considered beneficial, is treated more leniently;
- evasion of repatriation requirements and the inability of the banking system to effect payments quickly and reliably;
- declining volume of gold sales. Russia is obliged to repurchase some of its prior gold swaps. Independent republics and those in the process of becoming independent use gold output for their own purposes;
- the nonmarketability of claims and, *inter alia*, the drying up of weapons sales abroad as a source of foreign exchange;
- the need to finance critical imports. The purchase abroad of foodstuffs and agricultural products may well increase.

It is understandable that the break-up of the Soviet Union led many foreign lenders to reconsider their commitments to the former Union. At the same time, new loans are not forthcoming and exchange reserves have been depleted. The receipt of aid is uncertain, which poses a threat to the reform process.

Figure 5.

**USSR and Russia: gross external debt and debt service, 1990 to 30 June 1992 (billion USD)**



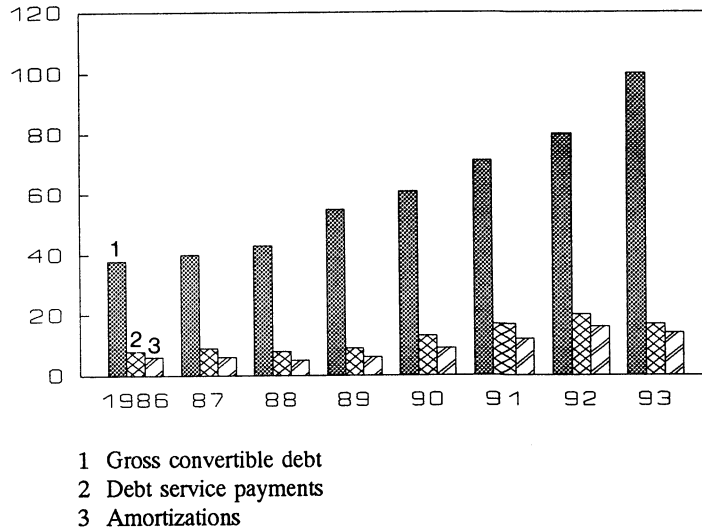
During the first half of 1992, the external convertible-currency debt of the former Soviet Union and Russia grew from USD 67 billion to USD 75 billion, despite the fact that Russia did not raise new loans in any substantial amount (Figure 5). The rapid growth resulted from Russia's failure to fully meet its obligations regarding repayment of principal and interest payments as set out in the original loan agreements. The postponements and delays of some USD 13 billion in 1992 that resulted are included in Russia's gross external debt as short-term debt. This item has grown rapidly because it includes, in addition to postponements and delays of debt service payments *per se*, delays in payments for imports purchased on a cash basis (including unredeemed letters of credit).

As no turn for the better seems likely in the near future, the gross external debt will evidently continue to grow at the current pace and thus exceed USD 80 billion in 1992 and, in the absence of stabilization, approach USD 100 billion at the end of 1993 as shown in Figure 6.



Figure 6.

**Soviet and Russian debt and debt service, 1986–1993, (billion USD) (contractual)**



Replacing the present industrial infrastructure, which has decayed to the point where it is not competitive, will in the absence of massive direct investments from abroad require imports on such a large scale that they can only be financed by running up foreign debt. The debt service problem that this implies is quite clearly a solvency problem, that is one that can only be solved by raising Russia's marginal efficiency of investment. Moreover, this is clearly a question of long-term developments entailing a substantial increase in Russia's debt and debt service burden, regardless of whether success is achieved in handling the debt of the former Soviet Union.

## 3 Finland's claims

### 3.1 Amounts and sources

At the end of September 1992, Finland's claims on the former Soviet Union and the CIS states totalled about FIM 7.4 billion (Table 2). Overdue payments accounted for FIM 3.4 billion. Repayments of credits due to mature between 1993 and 1997 accounted for a further FIM 2.9 billion. Interest is payable on these credits according to the terms agreed on for each credit. Interest payments received, not yet received and to be received in the future are not included in the calculation shown in Table 2.

Table 2. **Finland's claims on the former Soviet Union and the CIS states, 30 September 1992 (billion FIM)**

1. Credit claims	
Credit extended by the state	0.3
Credit guaranteed by the state	2.5
Other credit claims	2.5
<hr/>	
Total credit claims	5.3
(- of which matured by end-September)	(1.3)
2. Arrears on cash and advance payments	
Payments from Russia	1.2
Payments from other CIS states	0.9
<hr/>	
Total payment defaults	2.1
Total overdue credit and payment claims	3.4
<hr/>	
Total credit and payment claims from the former Soviet Union and CIS	7.4

Source: Data collected by the Bank of Finland's Financial Markets Department and Unit for Eastern European Economies

Finland's credit claims on the former Soviet Union arose partly from syndicated loans in which Finnish banks participated and partly from credits advanced to finance clearing export deliveries in the late 1980s.

The state's credit claim of FIM 0.3 billion consists of the outstanding balance on the special clearing account which fell due for payment at the end of 1991. The state's special account claim of FIM 0.3 billion is the outstanding instalment of the SUR 285 million clearing account claim which was transferred to a special account on 6 January 1987. This special account was opened to reduce the imbalance on the clearing account between Finland and the Soviet Union. It was converted from a rouble to a dollar account on 15 April 1992. The outstanding balance is expected to fall due for payment by Vneshekonombank (VEB) on 1 January 1993. Finland's other credit claims on the former Soviet Union mainly comprise long-term export credits, with maturities of 4 to 7 years. Credit repayments amounting to FIM 1.3 billion had fallen due by the end of September 1992. Claims also include FIM 2.1 billion worth of arrears on cash and advance payments related to exports.

A word of explanation concerning the last-mentioned item may be in place. The first group comprises goods or services delivered on cash payment terms but for which the agreed payment has not been received on the due date. Arrears on cash payments amount to FIM 0.9 billion, the major part of which has been run up by Russia. The second group of claims refers to goods manufactured under contracts with advance payment terms but which have not been delivered because no advance payment was received or no letter of credit opened on the agreed due date. Altogether, arrears on advance payments amount to FIM 1.2 billion. Arrears on cash and advance payments have been included in the calculation because their financial burden on the company is the same or even heavier than a deferral of debt repayments on the creditor. Arrears usually need to be refinanced but the company cannot count on recovering the lost interest payments caused by the arrears. The supplier has to bear the costs of storing the non-delivered goods. Last but not least, companies have to try individually to collect their receivables without the help of the kind of "clubs" to which governments and banks have access.

## 3.2 Poor outlook for financing Finland's trade with Russia

In spite of the indisputable importance of trade with Russia to its economy, Finland cannot for the present continue to finance this trade by extending credits. There are several reasons for this.

First, the chances of receiving overdue debt repayments from the Russians seem rather slim. In 1992, the Russians also failed to pay a substantial part of overdue interest. As regards receiving new export credits, the Russians have not been able to offer collateral which could have been converted into foreign currency. This has not, however, prevented potential Russian buyers from asking for new credits from Finnish exporters, usually because they lack the foreign currency needed to pay in cash.

Secondly, the capacity of Finnish financial institutions to finance the trade with Russia by advancing new credits is currently very limited. This reflects the difficulties faced by the financial sector in Finland as well as a sharp increase in Finland's outstanding foreign debt.

Third, as per capita comparisons in particular show (see Figure 3 above), Finland is already among those countries with the relatively highest claims on Russia. Given the country's acute balance of payments problems, the resultant exposure must be judged an evident risk.

Finally, Finland does not expect international negotiations to be of much help in this respect. The repayment of credits advanced or guaranteed by official bilateral creditors are agreed on in the Paris Club, where Finland is represented by the Finnish Guarantee Board. Commercial bank lenders are negotiated under the auspices of the so-called London Club, which, of late, has convened mainly in Frankfurt under the leadership of German banks. The Finnish delegation is coordinated by Kansallis-Osake-Pankki. The problem from Finland's point of view is that the general policy within the G7 and in the Paris and London Clubs is determined by countries who, compared with Finland, have better financing opportunities and relatively smaller claims on the former Soviet Union and Russia. Being heavily indebted to the West, Finland has in principle had to and will continue to have to refinance new credits as well as deferrals and debt write-offs from the western financial markets. In the present difficult economic

conditions, continued financing of trade with Russia with credits, deferrals or rescheduling would place a heavy strain on Finland.

The difficult situation is reflected in the small number of new commitments made by Finland in 1991–1992. The only exception is a credit line of FIM 0.5 billion negotiated in July 1992 when president Yeltsin visited Finland. This credit does not, however, essentially involve any increase in Finland's claims since it includes a substantial part of the arrears, shown in Table 2, that are based on agreements made during the time of the clearing arrangement.

## 4 Concluding remarks

Traditionally, there has not been any shortage of capital in the former Soviet Union. In the 1930s and in the post-war years, the rate of investment in the Soviet Union was higher than in the industrialized market economies without the corresponding growth impact evident in their GDP. The emphasis on increasing the quantity of productive inputs without any regard for the efficiency of the production methods applied, together with a biased allocation of investment mainly to heavy and arms industries, has led to the emergence of bottlenecks and a collapse in the marginal productivity of investment. The USSR's efforts to alleviate the problem through imports from the advanced market economies also largely failed because of the incompatibilities between western and Soviet technologies and were merely reflected in an accumulation of foreign debt, especially in the period of perestroika in the late 1980s.

The present crisis is a liquidity crisis, which could have been avoided had the necessary administrative measures been taken. The right to engage in foreign trade should have been expanded at the same pace as the system of foreign exchange controls was developed. Repatriation of export earnings and payments for imports should have been controlled by introducing a strict reporting obligation as a condition for being allowed to carry on foreign trade. At the same time, the efficiency of the foreign payments system should have been enhanced and payment flows steered through legal channels (that is through the VEB and certain authorized banks capable of using foreign payments techniques). Instead, mistrust in the legal channels was induced by delaying payments for political and other reasons and

finally by freezing them altogether. Those domestic and foreign companies (including some Finnish-Russian joint ventures) as well as individuals who had legally effected their payments lost their foreign currency deposits when the VEB ran out of hard currencies in December 1991. The dissolution of the Soviet Union further weakened cooperation among regional organizations such as customs authorities and banks in the area of foreign exchange controls and administration. Explicit instructions on foreign exchange controls and administration no longer existed. This was because when the republics became independent, a number of unresolved questions arose concerning the republics' new legitimate rights to keep their own export earnings and their responsibility for the Soviet Union's debts.

Combined with the dissolution of the administrative systems, deterioration of the economic situation and efforts to resort to western support, Russia's severe liquidity crisis related to its foreign debt is gradually turning into a solvency crisis. This is because Russia does not have the capacity to meet its debt servicing commitments in the long term without first eliminating the inefficiency and lack of competitiveness inherent in the system. If new borrowing is regarded as a way of remedying the situation, it should be made conditional on measures being taken to increase the profitability of new investment so that the costs of servicing both the outstanding gross foreign debt of almost USD 80 billion and any future foreign debt would be recouped. If this fails, not even skilful foreign exchange management will save Russia, nor indeed any other CIS state, from a severe solvency crisis.

Strict adherence to the terms and conditions attached to support has led to a situation where a major part of the committed support has been made available. Any significant easing in the terms and conditions of support might only result in the postponement of the structural changes necessary for putting these countries on their feet. What is needed here is the CIS states' own political will to carry through the reforms.

Even if sufficient political will and strength is found, western creditors will probably in any case have to accept substantial debt rescheduling and large-scale debt write-offs. Such measures would exacerbate the situation for Finland, which, as a small, capital-importing economy, has had to refinance its trade-related lending to the former Soviet Union from the western capital markets.

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# Distribution of Taxes and Transfers in the Former Soviet Union

by Sergei Alexashenko

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# 1 Introduction

Any study of the economic policy and future development of the former Soviet republics must begin by analyzing the legacy handed down by the command economy and the economic conditions that prevailed before profound changes in the economic system started to take place.

Few studies have been made of personal income in the Soviet Union or of its formation or taxation because income distribution was commonly assumed to be equal in socialist societies. Besides, Soviet statistics were often secret or ambiguous. The level of citizens' personal well-being is, however, one of the most important indicators of economic development. Furthermore, the differentiation of citizens according to standard of living defines the tasks of social policy and sets certain limits to the social reallocation of resources in society.

The aim of this study is, firstly, to analyze the structure and distribution of personal income in the Soviet Union and, secondly, to determine the total amount of budgetary transfers and their contribution to the general standard of living and taxation. Conclusions are then presented on the basis of comparisons of taxation and transfers in different population groups. Finally, comparisons are also made with the distribution of income and transfers in the United States in 1985 (Pechman, 1989).

## 2 Statistical base

This study is based on the statistics produced by the family budget study conducted by Goskomstat, the State Committee on Statistics, in 1989 (Goskomstat, 1989). At this point, it is worth pointing out some of the deficiencies of these data:

- 1) Goskomstat carried out family budget studies at intervals of three years but it was not until 1989 that the results were extended to cover the entire population. In earlier studies, there were two separate groups, one comprising workers and employees and the other collective farm workers. As a consequence, earlier information that would be interesting for this study is missing. So, it is possible to describe the situation prevailing in Soviet society only at a certain

point of time but not the dynamics of change. Officials at Goskomstat also warned beforehand of possible inaccuracies and distortions that might arise in the data because of the newness of the extended budget study.<sup>1</sup>

2) The unit of observation in the statistics is the family. If there are actually three generations in a family, the oldest generation is treated as a separate family according to Goskomstat methodology and is not included in the family budget study. This contradiction between the statistical family and the real family could be important as it has been a common tradition throughout the Soviet Union for three generations to live under the same roof.

3) The research results used in the present study are for the entire Soviet Union. In theory, research results for regions and union republics might be obtainable from Goskomstat but the probability is very small.<sup>2</sup>

4) Unlike other countries, there was a complete lack of taxation statistics in the USSR. Such statistics might, in many cases, have been used to check the budget study results, especially those concerning the income distribution of the population. Even if the collection and processing of this type of data were to start in the near future (at present the tax administration system is only in the process of being introduced), the reliability of the data would clearly not be very high.

5) It is impossible on the basis of available information to draw definite conclusions regarding marginal population groups (according to income) since the data on low-income groups might be distorted while data on high-income groups simply do not exist. According to the methodology used by Goskomstat, the highest-income group comprised families with average monthly incomes of SUR 200 per capita. In 1989, 21.8 per cent of the population belonged to this group. In reality this can hardly be regarded as a high-income group.

Finally, this study uses results from research originally carried out for other purposes. Therefore some of the necessary data were lacking in certain cases and had to be formed using various artificial methods. These methods will be discussed later.

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<sup>1</sup> Particularly regarding low-income groups.

<sup>2</sup> Data were collected and preliminarily processed by regional or republican statistical organizations. Goskomstat only received summaries based on research plans drawn up 12 to 18 months before the study was started. Moreover, Goskomstat's computing centre has limited facilities for storing original information. At the very best, the results of studies made at regular intervals are kept only until the next study is started.

### 3 Income distribution

It was for long considered self-evident that no fully comprehensive indicator of real income existed in the USSR. This was due to the following factors: 1) All social sector services were provided free of charge and their distribution was not taken into account. 2) In the command economy, equality of nominal incomes by no means meant that real incomes were equal. Another noteworthy factor was the possibility to obtain various benefits; no wonder, then, that shop assistants were one of the most well-off groups in Soviet society although their nominal wages were very low. 3) Likewise, the statistics did not cover fringe benefits such as personal official cars, dachas and official visits abroad. These benefits played quite a significant role in the formation of real income. 4) A large part of the income derived from the shadow economy remained outside the statistical system. In the late 1980s, Goskomstat started to publish their own estimates of total income earned in the shadow economy but it was impossible to break this income down by recipients in the budget studies.

All these factors lessen the reliability of the budget study results to the extent that the results do not necessarily reflect the true distribution of income. However, in a general analysis of income distribution attention need not be paid to these factors since their effects are still visible. In other words, if a similar analysis were made today, these factors would probably give an equally distorted picture of the situation at the time. They can, however, be used to make reliable estimates of future changes.

Several income groups were used in the Soviet statistics, which has been one reason why it has been difficult to compare different research results. The following income classification is used in this study:

1) Labour income comprises wage income from enterprises of all forms (state sector, collective farms, cooperatives etc) and money income from personal business activities.

2) Quasi-labour income includes pensions as payment for work *ex post* and grants for studies as payment *ex ante*. Traditionally, these incomes have been included in the concept of social transfers with partial overlapping. This income group is treated as a group of its own because, when analyzing the general income distribution of the population, recipients of these incomes are strongly concentrated in a narrow spectrum. In this analysis, the classification of these incomes is agreed on separately.

3) Monetary transfers are paid in money and they comprise social security benefits, maternity payments and child allowances.

4) Quasi-monetary transfers include admission notes, paid by companies and trade unions, to sanatoria, vacation homes, recreational and similar establishments for children under school-age and food benefits.<sup>3</sup> A special feature of these transfers was the fact that they were specified and their size could be accurately determined in money.

5) Indirect transfers (social services) comprise funds paid from the budget to finance education, health care and similar services. It is difficult and to some extent even impossible to make a detailed breakdown of these funds. Data appearing in Goskomstat's budget studies on the distribution of these funds are used in this study.

6) Price subsidies played an important role in the formation of real incomes although this was not taken into account in Soviet statistics. For this study, price subsidies have deliberately been classified by population group<sup>4</sup>.

This study also includes the following aggregate groups:

Basic income = labour income + quasi-labour income + social transfers + quasi-monetary transfers

Overall income = basic income + indirect transfers

Integral income = overall income + price subsidies

Money income = total of all income paid in money

Social transfers = quasi-monetary labour income + monetary transfers

Overall transfers = Social transfers + quasi-monetary transfers + indirect transfers

Integral transfers = Total transfers + price subsidies

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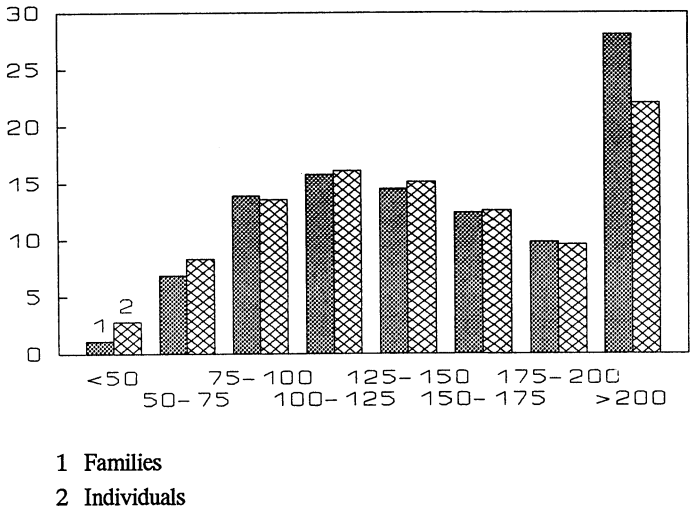
<sup>3</sup> Naturally, these transfers cannot be examined as budgetary ones as they have not been paid out of the budget. Since most enterprises in the USSR were state enterprises and the state in practice controlled this transfer system, this study regards these transfers as equivalent to budgetary transfers.

<sup>4</sup> The breakdown of price subsidies is based on a table showing the consumption of subsidized goods by families with different income levels (Goskomstat, 1989) and data provided by the Ministry of Finance of the Soviet Union on relations between price subsidies and average retail prices. The price subsidies of eg foodstuffs have been broken down in this way. The breakdown of subsidies for housing services provided by local authorities has been made by Goskomstat in the context of the budget studies. Confirmed data are not available on the total amounts of subsidies for goods meant for children, medicine or other goods, nor on the breakdown by recipients. Consequently, these subsidies have not been taken into account in this study either.

Owing to deficient methods employed in the preliminary processing of the statistical data, it is impossible to make an accurate analysis of the income levels of Soviet citizens. The only data available are for a breakdown of the population into income groups on the basis of the average monthly overall income per family member (Figure 1). These data can be found in the research results provided by Goskomstat. On the basis of these results, families have also been classified in the same way.

The average monthly labour, overall and integral income per capita in the USSR were SUR 114.4, 150 and 192.1, respectively, and they accounted for 52.3, 68.7 and 88 per cent, respectively, of average wages in 1989. There has been a slight shift in the income distribution towards groups with below-average incomes, which is what one would expect. Income differences among population groups are small with over 70 per cent of the population classified in the middle-income group, with incomes ranging up to 25 per cent above or below the average for the group. The ratio between the average income of the lowest- and highest-income families is 1:8.8 for labour income, 1:7.8 for overall income and 1:6.8 for integral income. It should, of course, be noted that there are too many high-income families for comparisons of this type. Overall, however, incomes are differentiated in this way.

Figure 1. **Breakdown of families and population according to average income level calculated per capita (%)**



Figures 2, 3 and 4 show the formation of integral income in families with different income levels. Labour income seems to make up most of the integral income (43–70 per cent for different income groups). Price subsidies account for 9.5–20 per cent of families' integral income. On average, these two income sources together make up 75 per cent of families' integral income with a range of 60–80 per cent range for different family groups. If the total amount of labour income increases substantially with an increase in the average income of the family, price subsidies have an increasingly greater effect on the integral income of middle-income families. The largest amount of price subsidies (20 per cent) is then received by families with a monthly income of SUR 50–70 per capita. If the distribution of price subsidies on food is studied using this method, yet another conclusion deviating from the common view can be drawn: for high-income families in the USSR, the share of price subsidies in integral income was the smallest (9.5 per cent with an average of 16.2 per cent) and also the share of subsidies calculated per capita was smaller than the average (89 per cent of the average amount of subsidies per capita).<sup>5</sup>

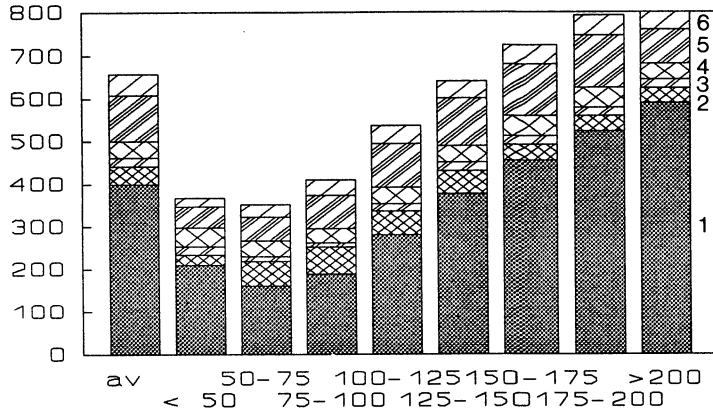
Figure 2. **Labour income and integral transfers for households with different income levels, SUR**



<sup>5</sup> This conclusion applies only to those families with average monthly per capita incomes above SUR 200. The average share of subsidies per capita tends to increase with an increase in the average income. The ratio between subsidies received by families with income below SUR 50 per capita and by families with income of SUR 175–200 per capita is 1:7.55.

Figure 3.

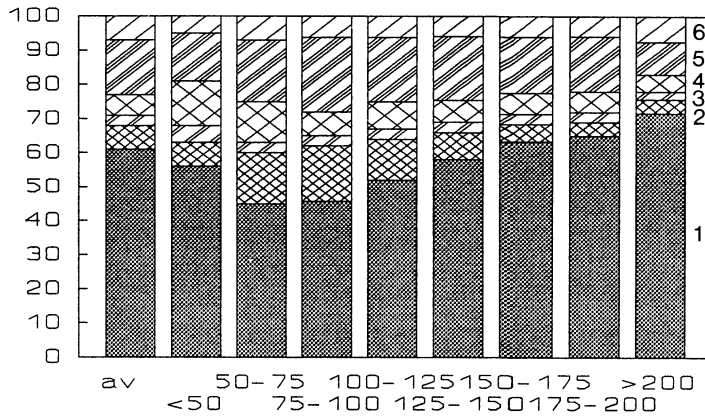
**Amount and structure of integral income in Soviet households (SUR/100 families per year)**



- 1 Labour income
- 2 Quasi-labour income
- 3 Monetary and quasi-monetary transfers
- 4 Indirect transfers
- 5 Price subsidies
- 6 Other

Figure 4.

**Structure of integral income in households with different average income levels (per capita), %**



- 1 Labour income
- 2 Quasi-labour income
- 3 Monetary and quasi-monetary transfers
- 4 Indirect transfers
- 5 Price subsidies
- 6 Other

Quasi-labour income is notably higher for families with average monthly income of SUR 50–100 per capita (14.6–15.7 per cent of the integral income) and families with average monthly income of SUR 100–125 per capita (10.7 per cent). On average, quasi-labour income accounted for 6.8 per cent of the integral income. This clearly reflects the heavy concentration of pensioners' incomes in these income groups (pensions account for 93 to 96 per cent of families' quasi-labour income). The absolute amount of indirect transfers varies only slightly among families in different income groups. The lowest-income families, who receive relatively most indirect transfers, also receive most in absolute terms. Indirect transfers account for nearly 12 per cent of the integral income of families with average monthly incomes below SUR 50 per capita and for 11.6 per cent of the integral income of families with monthly incomes of SUR 50–75 per capita (the average is 5.8 per cent of integral income for this group). This is mainly because budgetary social expenses have been equally distributed or recorded in the budget studies using a particular technique. Thus large families receive the highest absolute incomes from this source.

The Lorenz curve, which describes the formation and concentration of income,<sup>6</sup> can also be applied to the study of income distribution in Soviet society (Figures 5, 6 and 7). The less attention is paid to needs in income distribution, the more equally are incomes distributed among the members of a society. Labour income is the most unequally distributed whereas indirect transfers are more or less equally distributed. Even though high-income families receive more transfers in absolute terms, the total share of transfers in integral income is substantially larger for low-income families. This evens out differences in real incomes among population groups.

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<sup>6</sup> The Lorenz curve shows the relation between the cumulative percentage of income and the cumulative percentage of income recipients. If incomes are equally distributed, the Lorenz curve is a straight line at an angle of 45 degrees (45 degree line). As incomes become more unequally distributed, the Lorenz curve lies downwards to the right away from the 45 degree line. In this study the Lorenz curves have been constructed in a somewhat unorthodox way, which has also affected their shape (eg they run above the 45 degree line), as the population has always been divided according to the average overall income level.



Figure 5.

**Distribution of labour income and quasi-labour income, %**

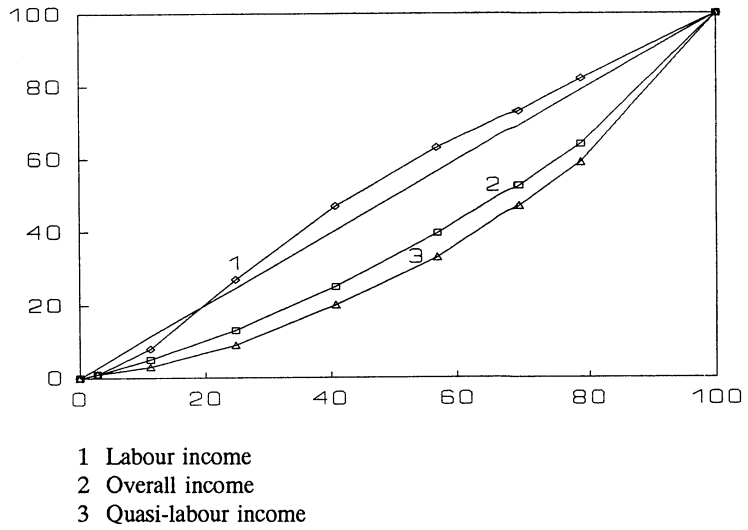


Figure 6.

**Distribution of quasi-labour income and price subsidies, %**

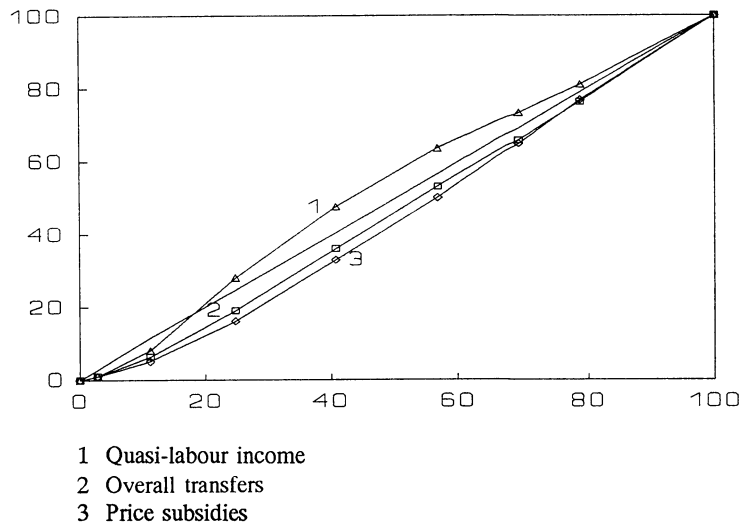
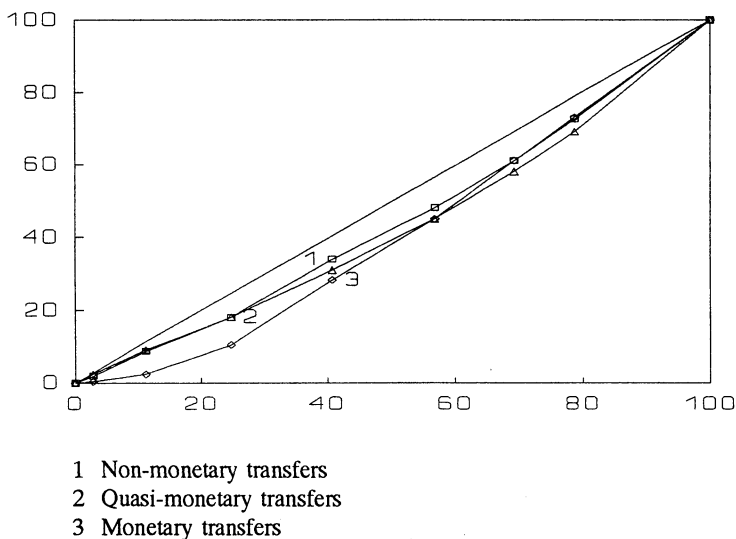


Figure 7.

**Distribution of transfers, %**



The income distribution analysis also shows that incomes are distributed more equally in Soviet society than in the United States. The comparison of basically similar statistics indicates that income is distributed much more unequally in the United States and that transfers do not even out income differences as in the Soviet Union.<sup>7</sup> It is very likely that within the next few years income in the former union republics will be distributed more unequally than before.<sup>8</sup>

<sup>7</sup> The compensating effect of taxes on income distribution is so small in the United States that curves showing the distribution of income and transfers before and after taxation practically merge to form one curve (except for the lowest-income population groups).

<sup>8</sup> Recently many measures have, however, been taken to counteract this process. As a result of the 1991 price reform, price increases were partially compensated for by granting equal compensation to everyone. Thus the equal distribution of compensation offset the unequal distribution of price subsidies. This reduced the dispersion of income among different income groups. Now that the price level and incomes have increased more than tenfold since early 1991, this measure has to a large extent lost its importance in evening out differences. At the same time, an additional allowance system concerning children and mothers was introduced. As this population group has shifted strongly towards the low-income group as regards the general distribution, this measure had a compensating effect. When the reform programme was initiated in Russia in 1992 these allowances were raised from time to time, albeit not in proportion to the price increases. This helped to counteract the process of income differentiation.

## 4 Taxation

In advanced market economies taxation of personal income has traditionally been one of the most important sources of budgetary revenue and therefore also a means of distributing welfare to the benefit of low-income groups.

Up to the dissolution of the Soviet Union in 1991, mainly two taxes were used to tax the population: direct income tax and indirect tax on goods (turnover tax). A few other taxes were also applied but they accounted for only a minimal share of both personal incomes and budgetary revenue (land tax, taxes on motor vehicles and buildings, tax on couples without children etc).<sup>9</sup>

Personal income taxation has always been of minor significance in the Soviet economy. The state was able to determine the wages of all those who worked in state enterprises. Personal income tax was a mere formality.<sup>10</sup> The general tax rate was slightly progressive, varying between 8 and 12 per cent. The marginal tax on low incomes (35 per cent) was notably higher than the basic rate (13 per cent). Overall, Soviet families' personal income was taxed only lightly: in 1989 it totalled 7.45 per cent of the money income of the population, ranging from 3.44 per cent for low-income groups to 8.46 per cent for high-income groups. Similarly, this tax accounted for only a minor share of budgetary revenue (about 9 per cent). Not till 1989–90 did the share of income tax increase somewhat (10.5 and 12 per cent, respectively) as personal incomes grew rapidly while tax rates remained virtually unchanged.

Other direct taxes were even less of a burden on the population. They accounted for 1.25 per cent on average of taxation, with a range of 1 to 1.5 per cent. This indicates that there was some progressiveness in personal income tax rates. All in all, direct taxation was of relatively limited significance in the Soviet Union, accounting for 8.7 per cent on average of money incomes, with a range of 4.5 to 9.9 per cent (the corresponding figures for labour income were 10.9, 5.7 and 11.8 per cent) (Figure 8).

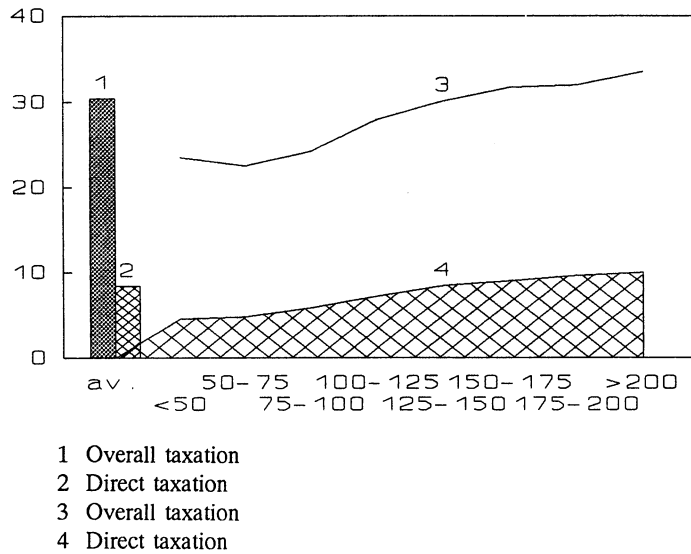
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<sup>9</sup> In this study it is assumed that appropriations for social security and funds collected from enterprises for the budget were not treated as taxation of personal income as they should have been. If a similar study were made today, this assumption would not be entirely correct.

<sup>10</sup> Personal income tax in the USSR remained virtually unchanged after it was adopted in the 1930s. At the time it replaced various personal taxes.

Figure 8.

**Distribution of the tax burden between households with different income levels (per cent of money income)**



Indirect taxation of the population was far more important in the Soviet Union. Turnover tax (nalog s oborota) was traditionally one of the biggest sources of revenue in the budget, although it cannot be called a tax in the true meaning of the word. Turnover tax was one of the basic elements used in seeking to redistribute the economy's monetary resources. It served to keep the prices of investment goods fairly low whereas the prices of some consumer goods could be kept fairly high. The main method for calculating this tax was the difference between wholesale and retail prices (confirmed by the state and applied to certain goods only) and the differentiation of producers and goods within a single group of goods. Of course, tax rates were not stable but subject to annual adjustments.

The amount of turnover tax actually paid by different family groups shows that turnover tax was slightly progressive. Turnover tax accounted on average for 21.9 per cent of the family's money income,

ranging from 18.6 per cent for low-income families to 23.5 per cent for high-income families.<sup>11</sup>

Since direct taxation was fairly progressive and indirect taxation only slightly progressive, the overall taxation of a family increased as its income increased. All in all, low-income families paid just over 23 per cent of their money income in taxes while high-income families paid 33.4 per cent. The average tax rate on money income was 30.6 per cent. Contrary to the general view that personal taxation was of minor importance in the Soviet Union, these figures confirm that personal taxation was in reality heavier and as progressive as, for example, in the United States. According to Pechman, U.S. families in different income groups were taxed at rates between 17 and 25-26 per cent in 1985.<sup>12</sup> On the whole, Soviet taxation was low in terms of progressiveness (Pechman also arrived at a similar conclusion concerning the U.S. taxation system). However, taxation plays a more important role in evening out income distribution in the Soviet Union than in the United States. This is also confirmed by the figures showing personal income distribution before and after taxation in these countries (Figures 9 and 10).

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<sup>11</sup> The distribution of turnover tax was determined by the same principle as the distribution of price subsidies. When turnover tax was determined attention was paid to the fact that about one-third of budgetary revenue was derived from taxation of industrial consumption (oil and oil products, electricity etc). These sums were divided among taxable consumer goods in relation to consumption.

<sup>12</sup> By changing the assumption about the incidence of certain taxes (property tax, tax on the profits of enterprises), we would come to the conclusion that tax burden in the United States is more or less evenly distributed. The tax rate for the lowest decile of income recipients was 24 per cent while it was 20–24 per cent for the second lowest and the second highest deciles of income recipients. The tax rate for the highest decile of income recipients was down to 23 per cent. The general taxation level nevertheless remained practically the same.

Figure 9.

### Equalization of incomes in the Soviet Union, 1989

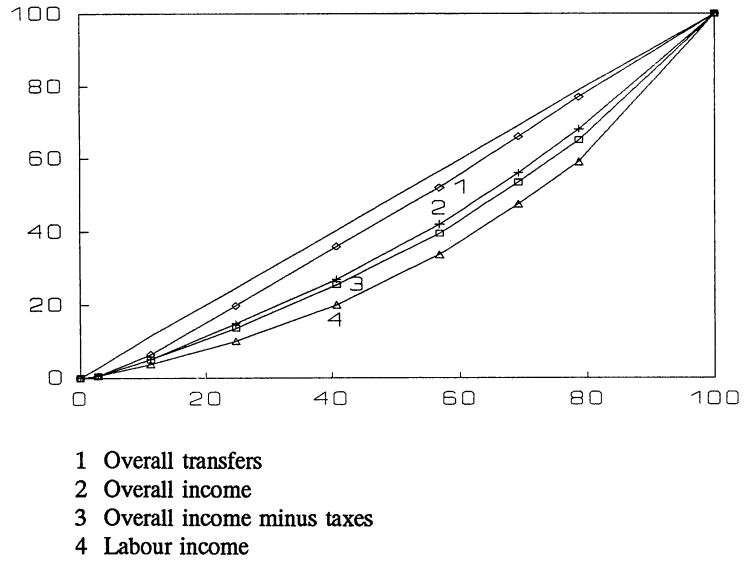
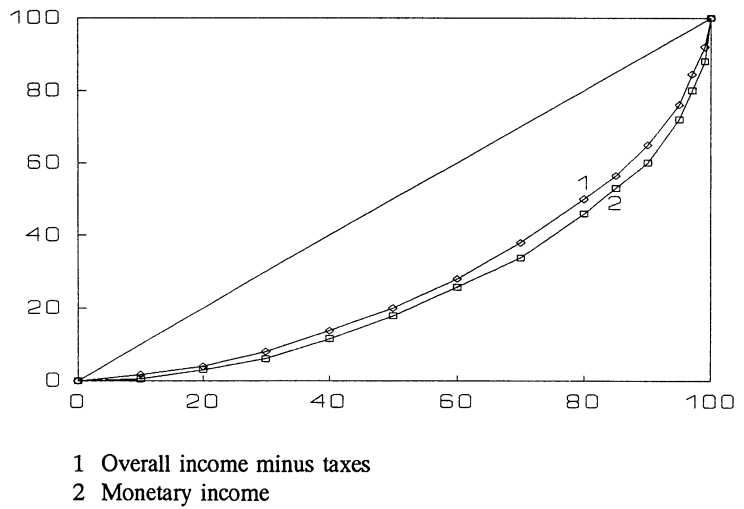


Figure 10.

### Equalization of incomes in the United States, 1985



## 5 Taxes and income transfers

The command economy, which was based on complete state ownership of the economy and on complete state control of all economic agents, led to the disappearance of the incentive effect of the income distribution system. Wages were a mere tool for controlling the economy, and not even a very important one. In addition to planning and distribution based on physical units, the state had financial tools at its disposal, such as prices and price subsidies, state investments and bank loans. In this situation, direct taxation of personal income did not have much significance for income distribution since the state could directly determine the level of incomes. Indirect taxation, on the other hand, served primarily the redistribution of the economy's financial resources and supported the prevailing price system.

A paradoxical (though typical of a command economy) interdependency emerged between the budget and the population. It can be described as follows: 1) social security expenditure exceeded revenue collected for social security<sup>13</sup>, 2) direct and indirect personal taxation yielded less funds for the budget than were needed for various transfers (excl. allowances paid through the social security system). The state had to find the revenue somehow. In the late 1980s, this was done chiefly by running a budget deficit, which was financed by increased borrowing. However, the burden became too heavy for the state, especially after economic growth had come to a complete halt. Bad economic policy led to a financial catastrophe in 1991.

It is interesting to compare the total tax burden and the total amounts of transfers paid to citizens in the Soviet Union and in the United States. (As a country where the government plays a minimal role in the economy, the United States is hardly the best possible country for such a comparison, but perhaps a comparison between two extreme cases is of particular interest.) Figures 11 and 12 show the situation in the Soviet Union in 1989 and in the United States in 1985. The following conclusions can be drawn from these figures:

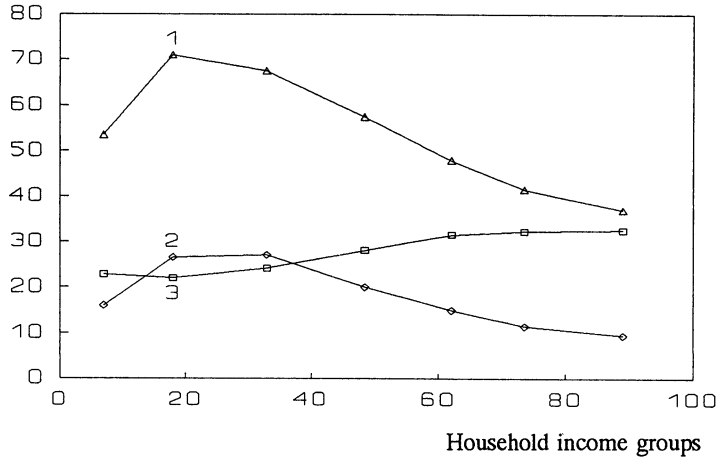
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<sup>13</sup> This situation did not change even after 1990 when a new pension law was enacted and the social security contribution rate was raised from 14 per cent (on average) to 38 per cent.

Figure 11.

### Taxes and transfers: shares in the money incomes of households in the USSR, 1989

Share of taxes and transfers in money income

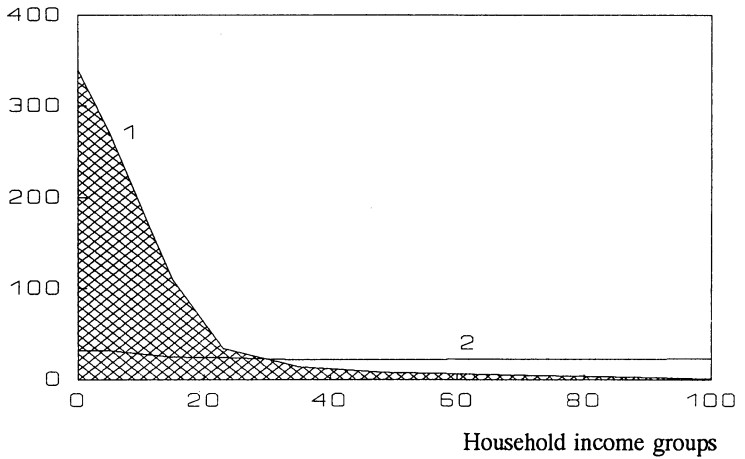


- 1 Overall transfers
- 2 Social transfers
- 3 Taxes

Figure 12.

### Taxes and transfers relative to the incomes of households in the United States, 1985

Ratio at taxes and transfers to income



- 1 Transfers
- 2 Taxes



1) The system of social transfers applied in the Soviet Union was based on the general principle that transfers were distributed equally among all population groups. The U.S. system is based on selection, allocating transfers to those population groups who need them most. The relative importance of social transfers received by low-income groups was much greater than in the USSR.

2) Although the U.S. income taxation system is not much more progressive than the Soviet one, it is a significant source of budgetary revenue. Funds collected through the system are enough to cover not only social transfers but also some other government expenditure. One explanation for this seeming paradox is the quite big income differences among the U.S. population.

## 6 Conclusions

The social security system inherited by the republics of the former Soviet Union is completely paralysed. The system cannot be adapted to conditions of economic slump since it constantly requires more funds for distribution, nor to open inflation conditions since the centralized calculation of all social transfers is based on absolute quantities. There is no indexation system for transfers and the mere calculation of the sums of money to be transferred (after the decision-making) takes four months. Since the social security system is based on the principle of equal distribution it is not possible to allocate benefits selectively to the groups who need them most. Besides, the structure of the system makes it impossible to determine these groups accurately.<sup>14</sup> Clearly, an integral part of a successful reform of the Soviet economy must also be the complete reform of the system of social transfers and services.

Undoubtedly, the transition to a market economy will involve a continuous increase in income differences among the population. This development cannot as such be regarded as favourable or unfavourable but rather as a natural process. However, it should be borne in mind

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<sup>14</sup> In connection with the 1991 price reform, the central government of the USSR tried to apply selection instead of equal distribution in respect of child allowances. However, the attempt failed owing to technical difficulties (according to experts, it would have taken 3–4 months to determine the target families and it would have been necessary to check the data every now and then) and owing to public opinion, which at the time was not willing to accept the idea of abandoning the equal distribution system.

that increasing income differences without a rise in the level of real income of all groups, ie merely dividing the present cake in different proportions, could lead to dramatic changes in the living standard of large population groups and to social unrest. Furthermore, an increase in income differences unquestionably requires a shift from equal distribution to selective social security, which would help to alleviate the unavoidable lowering in the relative living standard of the low-income population groups.

It is imperative for the reform of the Soviet economy to gradually 1) remove the consumption assistance paid to the whole population through state price subsidies (most retail price subsidies have already been abandoned; the remaining ones are transport subsidies and the very large subsidies on housing and municipal services.<sup>15</sup>), 2) remove the equal distribution of social services financed from the budget and 3) adopt a scheme whereby middle- and high-income households will themselves (partly) finance the services they use. These changes will inevitably lead to a redistribution of society's income. Personal incomes will increase and the share of enterprises' profits will decrease. These changes will also be a factor influencing the rise in the wage level in the former Soviet republics in the long term and similarly unavoidable price increases in the medium term.

The economic reforms implemented at the beginning of 1992 in Russia have (so far) done little to help solve the problems inherited. The following effects of the reforms can be mentioned:

1) With the replacement of the former turnover tax (*nalog s oborota*) by a value-added tax and a new turnover tax and the simultaneous removal of retail price subsidies on practically all products, it seems that budgetary revenue raised through personal taxation is greater than social transfer expenditure, including the remaining subsidies on mainly services. However, no change has taken place in the distribution of the tax burden between various population groups.

2) Low-income households and pensioners have been hit hardest by the removal of price subsidies. One of the reasons for this is that subsidies have had a greater weight in these groups' integral income than in that of the high-income groups (Figures 2 and 4).

3) In the first quarter of 1992, when the tax collection system had already become paralysed, efforts were made to drastically reduce the

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<sup>15</sup> It should also be noted that about one-third of the housing and social infrastructure in the area of the former USSR is still maintained by enterprises. This is hardly a situation that can continue for a long time, and most enterprises are bound to try to remove this burden.

budget deficit. The only means to do this was by cutting down on the financing of social services. The state partly abandoned the equal distribution of social services provided free of charge, but did not replace it with a distribution system based on selection. This led to an increase in income differences as the existing cake was only divided up in a new way.

4) The absence of an automatic indexation system linking social transfers (incl. pensions) to price increases results in a situation where the growth of transfers lags behind the average rate of growth of household incomes and the real value of the transfers decreases constantly.<sup>16</sup>

5) The state has not used any form of support to compensate low-income households for the relative decrease in their standard of living. It is, however, the low-income households in particular who have the fewest chances to increase their labour income since the quantitative relation between wage-earners and dependants cannot be changed in families or age imposes restrictions.

## 7 Summary

This analysis of income formation, the system of social transfers and services and personal income taxation in the former Soviet Union shows that the system for distribution of real incomes was based on equal distribution. The principle of equal distribution was emphasized in budgetary social transfers and services. In addition, the personal income taxation system treated all population groups more or less equally and did not play a significant role in equalizing incomes. Furthermore, the generally low income level of the population and the relatively small income differences resulted in a situation where not enough funds accrued to the budget.

The economic reform initiated in Russia in 1992 did not, during the first six months, include measures to reform social security. Moreover, the measures taken by the Russian government have changed the income distribution in favour of the high-income groups. There is a possibility that these changes will lead to increasing social tension.

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<sup>16</sup> It should be noted that the amounts of social transfers (as incidentally also wages in the cultural, educational, social and health sectors) are reviewed every two or three months whereas wages in other sectors of the economy can be raised any time.

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