

Economic and Political Results of 2001 and Prospects for Consolidation of Economic Growth

1. Results of the first decade of post-Communist reform.

The year 2001 concludes the first decade of post-Communist transformation, Russia's development under a market democracy. This period saw difficult and complex processes of the Soviet socialism transformation into a new society. A tortuous and contradictory transformation gave rise to acrimonious debate about the very nature of reform, its effectiveness and appropriateness, about whether there were alternative ways of meeting the challenges that the country was facing.

One of the key points of the debate of the 90s was to what extent the Russian problems were unique to this country, whether they were inherent in the historical experience as well as national and cultural features of Russia's development, and, accordingly, to what extent universal approaches and the experience of other countries were applicable in developing and implementing the program of post-Communist transformation. This is all the more important because an answer to the above questions makes it possible to summarise the results of the first post-Communist decade and formulate some important problems of Russia's further progress towards market and democracy.

At the end of the 80s Russia (rather, the USSR) encountered four formidable challenges associated with four different transformation processes. It was those processes that fully predetermined the country's development throughout the 90s. While not necessarily interrelated per se, those processes proved to be intertwined in Russia, substantially affected each other, and, more importantly, economic and political development of the country.

First, Russia was faced with the challenges of the post-industrial epoch. Transition from an industrial to a postindustrial society is accompanied by severe structural and macroeconomic crises, such as those the Western countries experienced in the 70s. Thanks to the favourable conditions of world markets, the USSR could delay the beginning of structural adjustment, only to make adjustment even more painful when there was no escaping it. The structural crisis of the Soviet economic system, at the height of which came a drastic decline of the now Russian

economy, resulted from the same processes, which with reference to the Western countries of the 70s were described as “stagflation”.¹

Sharp discussions about the nature of structural transformation continued throughout the 90s. Some authors described the output drop in some conventional sectors of the economy as deindustrialization, although a more in-depth analysis of the ongoing processes allows the a nucleus of new, postindustrial structure to be discerned in the structural change that is going on currently (see Table 1). Telecommunications and electronic industries are booming² (after 1998 the latter has been growing by as much as one third annually). Change towards more advanced products is going on in the chemical and metallurgical industries. The number of educational institutions is increasing markedly, so are the numbers of undergraduate and post graduate students. Of course, this trend is not absolutely predominant, and whether it will be sustained or not will greatly depend on the efficiency of economic policy and on the government’s ability to promote favourable change.

Table 1. Some indicators of social and economic development in the 90s (1991 = 100% unless stated otherwise), %

	1992	1998	1999	2000
Education				
Number of universities	103.3	176.1	180.8	183.5
Number of university students	95.5	130.3	147.5	171.7
Number of university graduates	104.4	123	136.3	155.9
Number of faculty members	109.1 (1993)	113.6	116.5	

¹ Description of the Russian crisis as the crisis of an industrial society is found in a number of papers (see: Bauman Z. *A Post-Modern Revolution? // From a One-Prty State to Democracy*. Amsterdam : Rodopi, 1993; Rosser J.B., Rosser M.V. *Schumpeterian Evolutionary Dynamics and the Collapse of Soviet-Block Socialism // Review of Political Economy*. 1997. Vol. 9. № 2).

² In the 90s the electronic industry introduced about 700 new state-of-the-art products and started manufacturing 800 new consumer products. In 1999 output growth was 46%, in 2000 – 37,7%. Exports of electronic products have grown dramatically over the recent years to \$70 mln–\$80 mln annually, mainly to non-CIS countries. (See Smirnov, B. *Bolshiye perspektivy mikrotekhnologiy i skhem // Krasnaya zvezda*. 2001. March 17; Smirnov B. *Rossiyskaya elektronika – bogach i bednyak*. 2001. April 17.

Production				
Video-cassettes	107.7	1157	944	
Share of sophisticated products in the paint and varnish industry	72	82	85	
Share of electric furnace steel and oxygen-converter steel in total steel production, %	50	72	72	72.6
Share of continuous casting steel products, %	28	52	50	49.7
Production of nonferrous metals	99.4	111.4	117	120.6
Transport				
Cars per 1,000 population	107.9	192.1	201.7	
Paved roads per 1,000 square meters of territory	103.3	111.1	111.3	
Tele-communications				
Number of general access telephone lines	101.6	123.8	130.7	135.7
Number of household telephone lines per 100 households	105	137.6	147.6	
Total length of	106.3	252.8	351.1	

long-distance telephone channels				
Share of the length of digital telephone channels in total length of long-distance telephone channels, %	1.5	56.9	69.1	
Number of registered fax-machines	206.2	1706 (1997)		
Number of pagers	100	3838	4118	
Number of cellular phones	100	12695	23600	

Source: Goskomstat

Second: there was post-Communist transformation as such going on in Russian society. This was a truly unique experiment. Never in the world history (including the history of economics) has there been a transition from a totally state-controlled to a market economy. Of course, the most difficult was transformation of ownership, i.e. privatization on a national scale. However, this sort of transition was not only peculiar to Russia. Post-Communist change was simultaneously going on in about 25 countries. What is more, Russia was not a pioneer in this respect: a number of countries had embarked on this kind of transition two or three years earlier, which provided the post-Soviet republics with some, although not very rich, experience.

Third: Russia was faced with a full-blown macroeconomic crisis resulting from populist economic policies (from the second half of the 80s), which led to the breakdown of the fiscal and monetary systems, extremely high inflation and output decline. It has to be mentioned, however, that the phenomenon of macroeconomic crisis and ways of handling it had been thoroughly studied by the end of the twentieth century. In the post-war period many European, Asian and Latin American countries had to grapple with similar problems. Moreover, Russia itself had certain positive experience of pulling out of a macroeconomic crisis in 1922-1923.

And, finally, *fourth*, politico-economic, macroeconomic and structural change that Russia faced at the turn of the 90s was accompanied by a full-scale social revolution. Systemic transformation, which changed the social set-up of the country radically, was being brought about in a situation of a weak state, which in fact is one essential of a revolution.³ By the time post-Communist change began, practically every institutions of the state had been all but destroyed, and their restoration was essentially the central political objective of the first post-Communist decade. Moreover, economic reform advanced only to the extent the institutions of the state were restored, which made the pace of reform much slower than in most of the other post-Communist countries. Among the countries undergoing post-Communist transition revolutionary transformation was a unique Russian feature but it was not entirely new in European history.

Thus, Russia's development in the last decade was indeed quite peculiar. But this specificity was due not so much to cultural and historical factors as to the very fact that the above four processes were simultaneous. There was nothing unique or unknown from the experience of other countries or Russia's own historic experience about each of those processes. What was unique was their combination in the same country at the same time. It is this combination that gave rise to the peculiar processes which predetermined the specificity of Russian transformation and puzzled many scholars dealing with issues of post-Communism.

At the end of the nineties signs emerged that at least three of the four transformation processes had run their course.

First of all *macroeconomic stabilization had been achieved*. The crisis was quite protracted (it lasted about ten years) but not unprecedented in economic history. Stabilization was brought about through an array of standard measures (liberalization, fiscal and monetary stabilization), and its success paved the way for resumption of economic growth.

Of course, stabilization was not achieved once and for all. An economic system is not guaranteed against mistakes of the authorities, against their unsound and populist decisions. In 1999–2000 the government successfully passed its first serious macroeconomic test, i.e., favourable prices for Russian exports.

³ For more detail see Starodubrovskaya I.V., Mau V.A. Velikiye revolutsii ot Kromvelya do Putina. M. Vagrius, pp. 313-317.

The processes of revolutionary transformation have been practically completed. The restoration of state is very much in evidence, macroeconomic stabilization is synchronized with political stabilization. Already the analysis of political parties' pre-election programs of 1999 showed that the reference points of the main political groups, are converging⁴, however important are differences between them. A common system of fundamental political values, which are not subject to political strife, is emerging. Specifically, no one calls into question private property as a basis of economic and political life (although appraisal of the outcome of privatization still arouses controversy); no one calls for renouncing tight monetary and fiscal policies (it is only very recently that inflationary financing of the budget deficit was widely thought to be quite acceptable); all groups (even the left) support the policy of the tax burden alleviation, everyone accepts the need to shift the thrust of action to implementation of deep institutional reform. Of course, practical recommendations of political groups are substantially different but those differences are no longer so deep as to undermine political stability. The ability of the authorities to secure basic macroeconomic stability is the most important politico-economic characteristic suggesting that the crisis has been overcome.⁵

The year 2001 brought new elements to the model of post-revolutionary politico-economic stabilization currently taking shape in Russia. While 2000 saw the emergence of *de facto* domination in the Duma of the executive branch, which could rely on support of either the right or the left (depending on the nature of a bill), now a steady pro-government majority is being formed in the lower house. Now practically every new bill sponsored by the government can rely on support in parliament, which is very important for further operation of the political regime. On the one hand, the role of political haggling over each specific bill is decreasing, which secures stability and consistency of the course chosen by the government. On the other hand, a system of relations between the government (relying on the parliament majority) and the opposition (the parliament minority) is assuming the form typical of stable democratic societies.

One could also claim that *the goals of post-Communist transformation have also been taken off the agenda.* This conclusion tends to provoke especially strong objections and, therefore, needs to be clarified. The Communist system is distinguished by three main political characteristics: a

⁴ IET. Rossiyskaya ekonomika v 1999 godu: Tendentsii i perspektivy. V.: IEPP, 2000, pp. 313–319; Dmitriyev M. Evolutsiya ekonomicheskikh program veduschikh politicheskikh partiy i blokov // Voprosy ekonomiki. 2000. No 1.

⁵ High inflation is not only economic but also a political indicator. Indeed, inability of the authorities to implement a variety of macroeconomic stabilization measures results from their weakness, dependence on the balance of various interest groups seeking soft monetary and fiscal policies. This is exactly why macroeconomic stabilization is feasible on condition of strengthening political institutions, i.e. is one of the most important criteria of political stabilization.

totalitarian political regime, absolute supremacy of state ownership in the economy, and the shortage of goods as an essential of economic and political life.⁶ By the end of the 90s the three main features of Communism had been eliminated in Russia. Of course, this does not at all mean that Russia had fully overcome the crisis that took it into the nineties. However, severe structural and macroeconomic problems which Russia is still facing and which make it very vulnerable to external shocks, are not, strictly speaking, the legacy of the Communist system. They all result from development and crisis of the industrial system, and it is not accidental that practically all countries which had to cope with transition from an industrial to a postindustrial society faced similar problems and challenges.

To sum it up, the dominant socio-economic problem that the present-day Russia is facing is the crisis of the industrial system and establishment of socio-economic basis of a post-industrial society. This process predetermines the nature of current transformation and the main challenges that the country will confront in the coming decade.

2. Politico-economic results of 2001.

Institutional changes have become the focus of the current stage of economic reform, coming to the fore after the task of microeconomic stabilization had been successfully accomplished. Strictly speaking, during the first post-Communist decade issues concerned with establishment of a new system of institutions also played an important role (since privatization is one of the most significant institutional changes).⁷ However, institutional change could not have become more purpose-oriented and consistent before the goals of economic and political stabilization had been achieved. This is only natural, since social instability, sharply increasing instability of economic life, undermines steady operation of economic institutions, primarily the institution of private property.

2001 became the first year which saw the implementation of the Strategic Program, development of which in 2000 was initiated by V. Putin and which has become known as the Gref Program. The program spanning about 10 years was supposed to be detailed in documents covering a

⁶ The essential inseparability of the Communist system and the shortage of goods was shown as early as the first years of practical implementation of the Communist experiment (see Brutskus B.D. Problemy narodnogo khozaystava pri sotsialisticheskom stroye // Ekonomist. 1922. No 1–3; Novozhilov V.V. Nedostatok tovarov // Vestnik finansov. 1926 No 2). Curiously, it was in fact acknowledged by I. Stalin. In “Economic Fundamentals of Socialism in the USSR” “the law of the faster growth of needs compared to ability to meet them” is referred to as one of the fundamental laws of society built under his guidance. (Stalin I. Works. Volume 16.: Pisatel, 1997).

⁷ Incidentally, that is why one cannot help wondering at repeated accusations by the critics of Russian reform that the reformers of the 90s underestimated the importance of institutional change.

shorter period and containing the list of laws to be developed and adopted for the goals of the program to be achieved. Accordingly, in the summer of 2000 a package of measures for 2000–2001 was approved and actually implemented in 2001 (following some revision), and in the spring of 2001 year a program of measures to be implemented in 2002–2004 was approved.⁸

The objectives that the government was to attain in the period that has elapsed boil down to the following key areas: tax reform, fiscal reform, the Land Code, the labour legislation, pension reform, deregulation (streamlining of red tape), reform of natural monopolies, banking reform, reform of the customs legislation, development of financial markets, movement towards the WTO accession. Unification of the legislation across the country (elimination of regional separatism), judicial reform and the government reform were to become important political components of economic reform. All these changes aimed to *establish favourable investment and business climate, thereby providing the basis for sustainable economic growth.*

The sheer scope of this agenda threatened practical implementation of the program, dispersing efforts and preventing concentration on economic and political problems to be addressed. In the meantime, situation with implementation of the program was far from simple.

On the one hand, the fastest possible implementation (or at least the beginning of implementation) of the bulk of planned changes had to be secured, which was necessitated both by some features of the political cycle (considerable “credit of confidence” available to President Putin) and a kind of “revolution of expectations” affecting the public as well as investors. *On the other hand*, institutional reform is much more individualized and country-specific, thus, requiring much more extensive technical (economic and legal) groundwork than the task of financial stabilization (where practically universal international experience is available), hence, it took much longer to prepare. At the same time, identification of priorities and concentration of efforts on their practical (political) translation into at least draft laws turned out to be a problem without theoretical solution.

⁸ To be more specific, the following documents were developed:

- The principal directions of short-term socio-economic policy of the RF Government (approved at the meeting of the RF Government on June 28 2000);
- Plan of the RF Government’s activities in 2000–2001 with regard to social policy and modernization of the economy (approved by the RF Government order No 1072-r of July 26, 2000), amended by the RF Governments order No 933-r of July 14, 2001);
- Strategy of Russia’s socio-economic development for the period up to 2010 (discussed by the RF Government and submitted to the RF President in May 2001);

All this was reflected in quite a peculiar sequence of events around implementation of the 2000-2001 program. Immediately after the appointment of Mr. Putin's new administration and M. Kasyanov's government in May 2000, important steps to restructure federal relations and change the tax system were undertaken. Reform of the Federation Council and establishment of the institution of the President's authorized representatives in the federal *okrugs* (larger regions) were to promote unification of the legal framework across the country. A drastic personal income tax cut and introduction of the regressive payroll tax showed the willingness of the authorities to take resolute steps to improve the economic climate.

However, after these first two steps had been taken, the pace of reform implementation slowed down drastically. What followed was protracted coordination of draft documents between government agencies and interest groups represented in parliament. The above-mentioned technical difficulty of drafting (especially with regard to developing the legal language) laws and regulations, many of which were without precedent in the practices of other countries, also played its role. Deregulation, reform of natural monopolies, banking reform, etc., required not only declaration of general principles of their implementation but also a host of concrete documents explicitly interpreted and built into the Russian legal framework.

All this was not surprising. However, political consequences of such a slow-down of the pace of reform could have been quite detrimental. Investors, although they welcomed the Strategic Program, from the very start doubted the government's ability to put it into practice. Those doubts seemed to have been confirmed. Out of more than one hundred items of the Program planned for implementation in 2000–2001, only slightly more than a dozen were fully implemented.⁹ Many had only just been approved by the government after lengthy coordination and were unlikely to be accepted by the Duma deputies, since some government agencies intended to oppose adoption of those laws at the stage of their passage in the Duma.

The package of deregulation laws was making its way through the Government with difficulty, as it affected the interests of most of the agencies, unwilling to cede any of their powers. The new sections of the Tax Code (primarily the corporate profits tax) were languishing in the Duma

- Program of medium-term socio-economic development: 2002–2004 (approved by the order of the RF Government No 910-r of July 10 2001).

⁹ To be more specific, out of 119 items of the Government action plan 78 items were to have been implemented by March 15, 2001. Actually only 51 measures had been implemented in full or in part by that time. In practice this meant that most of the documents that were to have been put into effect, were still being refined or coordinated within the government itself. At the same time, many of them were draft laws that were subject to passage at the Federal Assembly (Monitoring of the progress of the Program implementation was conducted by the Russian European Centre for Economic Policy (RECEP)).

committees, which launched a practically endless process of reconciling interests of individual industries and sectors of the economy (with a powerful lobbying potential), which sought to secure the biggest possible number of tax breaks by referring to the peculiarities of their respective industries and the need to boost investment there. Taxation of mineral resources hit similar snags, as the wish to take account of all possible subtleties of various deposits made the taxation system too cumbersome and thus susceptible to corruption. The pension and labour legislations were also bogged down in coordination and reconciliation procedures. Three versions of the new Labour Code collided in the Duma. Reform of the electricity monopolist UES stirred up fierce infighting within the executive branch itself, with regional governors involved by the authorities as possible umpires. The new system of customs tariffs developed and approved by the government failed to be put into effect.

True, the concept of railway reform was approved, but the transformation model selected was based on the ideas originally put forward by the Railway Ministry (establishment of a super-monopoly called Russian Joint-Stock Company Railway as the starting point of reform), which raised doubts about the transparency and effectiveness of further steps.

Finally, situation with the repayment of debt to the Paris Club that developed at the beginning of 2001, did not contribute to the enhancement of a good image of the new wave of Russian reform either. Everything bore the signs of ill judgment here: an attempt of unilateral refusal to repay the debt and the bitter debate within the executive branch (between the Government and President Administration) that was conducted publicly, and renunciation of the earlier decision. Even if the final decision to comply with the debt repayment schedule is seen as basically fair and the most reasonable economically, such vacillation of the authorities never benefits their image in the eyes of the public.

Summing up the situation, by the spring of 2001 it had become evident that action should be taken fast to improve things drastically. And before long signs emerged that a new phase of power consolidation was setting in. This consolidation was carried out along two lines.

On the one hand, political consolidation was stepped up, targeting both the legislators and the public. As the Federation Council was transformed into a standing body, a semi-formal association *Federation* was established, made up of the members of the upper house, oriented for hard and fast support for the executive branch initiatives and effectively given a majority stake in

the Federation Council. Thus the tacit rule that the upper house is non-partisan and oriented only towards the interests of the regions was broken.

Important processes were also going on among organizations represented in the State Duma. The consolidation of *Yedinstvo* (Unity), *Otechestvo* (Fatherland) and *Vsya Rossiya* (All Russia) into a national party meant the establishment of the pro-presidential majority in the lower house. Earlier, in 2000, this majority was secured *de facto* – pro-presidential factions could always form alliances with the right or the left, but to secure support for the government initiatives, rapport had to be sought and majority formed for each individual bill introduced. By contrast, in the new situation any initiative by the executive branch automatically gets support. So for the first time in the recent Russian history a majority government holds office in the country.

Of course, this substantially simplifies implementation of the government policy. However, the responsibility of the Cabinet for the quality of bills developed by the government agencies increases drastically, for now their introduction to the Duma is likely to switch on “the voting machine”. The more so because, strictly speaking, the government only gets the parliament majority’s support acting as a proxy for the President. This support is to a large extent personified and free from ideological considerations. Therefore, thorough evaluation of proposed bills in parliament becomes much less likely; the source of the bill will be more important to the parliament majority than its substance. That is why it is the Government where the real decision making as regards economic policy will be focused now.

On the other hand, the refinement and passage in the Duma of socio-economic bills have been stepped up considerably. The government agencies were urged to agree and approve documents speedily. Draft laws on deregulation and pension reform were introduced to the Duma. The executive branch agreed to meet the legislators halfway to a degree. This primarily concerned the Land Code from which the section on the sale of agricultural land was struck off, while with regard to the Labour Code the compromise was formal rather than real – it was based on the draft developed by some Duma deputies but very close to the Government approach.

Finally, there was a breakthrough in the area of tax legislation comparable with the achievements of 2000. After protracted and fruitless coordination of the profit tax rates and a variety of tax breaks the Government and the Duma ventured upon a decisive step: the corporate profits tax was cut drastically to 24% with practically all tax breaks, including investment credits,

abolished,. Similar decisions were made with regard to mineral taxes, which were consolidated in a single tax, with its administration simplified crucially.

Certain progress was also achieved in reform of natural monopolies. The Government approved the concepts of the railway and (electricity monopolist) UES reform and replaced top management of Gazprom. Of course, this is only the beginning, and the concepts themselves draw sharp criticism from various political and economic groups. So far, however, only preliminary stage of reform is being implemented involving drafting of the laws, which will then be submitted to the the Government and introduced to the Duma. One will see what kind of transformation is really intended after the drafts have been produced and presented to legislators for debate.

Thus, work to establish the legal framework of proposed institutional reform is in full swing. While it has made noticeable progress, a real breakthrough has yet to be made. A number of aspects of legislative work, their successful development or, au contraire, protraction, can be regarded as a touchstone of effective advance of reform. Those aspects include:

- adoption of the law on the regulation of sale of agricultural land. The main issue here is, of course, whether the executive branch will be willing to insist that the clause of the Constitution on private ownership of land should be applied to agricultural land;
- prospects for the adoption of the Civil Code. The principal issues in this respect are the approval of the third part of the Civil Code and amendments reducing the limitation period from ten to three years;
- further steps to adopt the Tax Code;
- adoption of the pension legislation, which is now being considered by the Duma. Especially important is the issue concerned with the schemes of private pension funds operation, their competition and stability on the market;
- prospects for further progress of deregulation. Approval of laws on registration, licensing and inspections and audits is only the first step in that direction. These laws should be made effectual by amending laws and regulations governing the operation of police, sanitary inspections and other agencies, and also by adopting another package of laws on regulation of entrepreneurship (certification and standardization, self-regulated organizations).

Achievement of these goals will be an important step in establishment in Russia of an institutional system consistent with the ideas of a market democracy in a post-industrial era. However, important as those goals are, they do not exhaust the list of top priorities, which the country will have to address in 2002 and which will dominate the agenda of the executive authorities in the run-up to the elections.

3 *Strategic priorities of socio-economic policy in the present-day Russia as part of the forthcoming reform*

The focal point of Russia's current and medium-term economic policy is provision of conditions for fast economic growth in parallel with restructuring of the economy in the spirit of post-industrialism. This implies addressing the problems of "catching-up" development. Russia already had to address the problems of the same nature about a century ago but in relation to the challenges of the industrial era. The problem of catching-up development is the subject of a separate study, which is far beyond the scope of this article. Here we will only pay attention to the factors and mechanisms of social policy, which came to the forefront in Russia.

There has been a new turn in the debate on the mechanisms allowing sustainable growth to be achieved. As the Strategic Program was prepared in 2000, three key alternatives of growth consolidation policies took shape: a dirigist one (through enhancement of the regulating and redistributing role of the government, through its direct involvement in investment); a liberal one through the drastic reduction of real budget share in the economy) and an institutional one (development and enforcement of the "rules of the game", encouraging businesses and investors to operate in Russia).¹⁰ In its Strategic Program the Government in fact opted for the third of the above approaches. However, actual developments – as regards economic policy as well as business have placed new issues on the agenda.

The need to choose between the three alternatives of relationships between the authorities and business became evident again. First of those alternatives is active industrial policy by the government; second – enhancement of the role of conglomerates of the biggest companies (financial-industrial groups or vertically integrated companies) in investment (and organization in general), and third – development and strengthening of institutions of a modern market democracy. The above three approaches are genetically related to at least two of the three alternative strategies listed above. However, the main difference is that while the debate of 2000

was somewhat speculative and was mostly based on economists' ideas of the desirable way of development, now the conclusions were based on the analysis of actual trends of the development of Russia's economy.

To be more specific, there are two trends worth discussing. On the one hand, the government is implementing the concepts of institutional transformation more or less consistently, making efforts to establish a favourable business climate. On the other hand, establishment of vertically integrated companies have been stepped up. Such companies, absorbing a mixed assortment of businesses and banks start to pursue active investment policies. A more favourable investment climate is believed to be established within such agglomerations, since investment within a corporation drastically decreases transaction costs that are caused by the government's inability to secure contract enforcement.¹¹ It is only natural that a public debate on the ways of boosting economic growth, overcoming of constraints (or negative trends) of the two policy approaches should have started.

One development alternative is to promote active government industrial policy. It implies identification of structural priorities (primarily sectors) and promotion of investment; substantial expansion of government demand and its use as a major factor of enhancing business activity; real appreciation of the rouble to facilitate the import of machinery and components; possibly support for import substituting industries through measures of tariff policy. Reliance on integrated business groups is inseparable from this model, since those can be regarded as instruments and vehicles of the government industrial policy.¹² The main drawbacks of this model are as follows: under the conditions of a post-industrial society it is impossible in principle to select industries as priority targets for support; the high cost of a mistake in making such a choice, let alone low efficiency of government investment, which has been proved repeatedly in practice. In addition, industrial-financial conglomerates tend to impose their interests on society both by "nationalizing losses" and by getting the authorities to limit competition from foreign companies as much as possible.

¹⁰ For details see: IEPP. *Possiyskaya ekonomika v 2000 godu: tendentsii i prspektivy*. M., IEPP, 2001, p. 18.

¹¹ For details see: Dynkin A.A., Sokolov A.A. *Integririvannyye biznes-gruppy – proryv k modernizatsii strany*. M., 2001, p. 13

¹² A. Belousov offers probably the most accurate and balanced description of such a model; "This approach requires clear economic policy seeking encouragement of consumption and investment, and, of course, it rules out any rouble devaluation. The main constraint here is poor competitiveness of the domestically oriented sector, which is unlikely to be improved rapidly without a consistent government industrial policy". (*Ekonomicheskaya konyunktura v oktyabre-noyabre: Obzor makroekonomicheskikh tendentsiy No 32/ Tsentr makroekonomicheskogo analiza I kratkosrochnogo prognozirovaniya*. M., 2001).

Under the other alternative, the government steps up efforts to attract private investment both to export-oriented and import-substituting industries. This should be secured through macroeconomic, institutional and foreign policies of the government. Unlike the first model, macroeconomic policy seeks to curtail real appreciation of the rouble and lower the share of the budget in the economy (with budget expanding in absolute terms). Efforts are stepped up to provide investor incentives – both general (lowering of the tax burden, removal of bureaucratic barriers to business, improvement of the judicial system efficiency, etc.) and special (free economic zones, production sharing agreements, etc.). Finally, activities are undertaken to expand Russia's involvement in the relevant international organizations and harmonize national business legislation with that of other market economies.

In real life the two economic policy models are not absolutely opposite.¹³ They are, of course, alternative, but political practice can to a certain degree combine them, counterbalancing certain drawbacks and making the most of advantages. For example, under certain circumstances government demand could be used as a tool for economic growth, unless this demand is based on fiscal populism or results from provision by the monetary authorities of credit to the budget. Let alone the fact that real development of events does not only depend on government decisions, which are themselves limited by the trends of the national economy.

Let us say that it could be assumed with a high degree of probability that expansion of vertically integrated companies will be a certain feature of Russia's development within the coming years, and that they will likely play an important role both in investment and on the political scene. This means that the government should match these developments with the measures of macroeconomic and institutional policy to support investment by financial-industrial groups and at the same time to neutralize their monopolization tendencies. The authorities have enough levers to deal with such a problem.

If developments follow this scenario (which seems to be very likely), three areas of policy decisions for the authorities to take are coming to the foreground.

First of all, consistent implementation of liberal foreign trade policy. Its key element is the WTO accession. It is openness of the Russian market to competition from foreign producers that is one

¹³ Incidentally, this is where the current situation mainly differs from most of the 90s. At the first stage of post-Communist change different interest and political groups put forward absolutely incompatible demands with respect to economic policies: inflationary infusion of money into the economy versus stabilization based on a tight monetary

of the principal ways to counteract monopolist tendencies of the biggest domestic companies. It is not accidental that in 2001 some of those companies stepped up their efforts to oppose the WTO accession by Russia. At the same time, progress toward this goal does not mean rejection of any kind of protection of domestic producers, which could be effected, for example, through measures of the exchange rate policy.

Second, what becomes extremely relevant is implementation of deep reforms in the realms which are beyond the scope of the economy as such but have a substantial (sometimes even determinative) impact on economic activity. Those are reform of the judicial system, reform of government (including law enforcement) and military reform. Positive change in those areas affects the overall business climate in the country (first of all, reduction of transaction costs) as well as ability to counteract attempts by the biggest companies to get the government institutes under their control.

Third, implementation of special business encouragement policy. This work should center on anti-trust policy and promotion of competition, where a variety of deregulation issues (lowering of administrative barriers to business), as well as encouragement of the innovation sector and small businesses are especially important. All these are factors of establishing a favourable institutional market environment of the post-industrial society.

These three groups of issues put together determine the priorities of government socio-economic policy within the next few years.

4. European economic institutions as guidelines for medium-term institutional reforms.

2001 saw the event which may become crucial for development of the post-Communist Russia: The EU put forward an idea to establish a Common European Economic Area.

The idea of the EU-RF free trade area was formulated already in the Partnership and Cooperation Agreement (PCA), which was signed in Corfu on June 24, 1994, and became effective on December 1, 1997. One of the stated goals of the partnership was “to create the necessary conditions for the future establishment of a free trade area between the Community and Russia covering substantially all trade in goods between them, as well as conditions for bringing about

policy, a zero-deficit budget versus budget-funded support for domestic producers, liberalization of foreign trade versus tough protectionist measures. This list could be extended by any number of entries.

freedom of establishment of companies, of cross-border trade in services and of capital movements". In 1998 it was planned to study the question of whether the time was ripe for beginning talks on the FTA.

The goal of "Russia's integration into a common European economic and social area" was formulated in the Common Strategy of the EU on Russia (3–4 June 1999), which refers to "the future establishment of an *EU-RF free-trade area*" and subsequently of the *Common European Economic Area* as a result of gradual approximation of legislation and standards.

There are still many points that need to be further detailed and clarified in these proposals.¹⁴ However, despite all vague points and provisions requiring more detail, as well as all the technical and legal problems, which practical implementation of this idea will encounter, the declaration on establishment of a common economic area can hardly be overestimated. In effect, we are talking about development of key institutional guidelines for socio-economic transformation of Russia, a sort of keys-notes of post-Communist reform. For the first time after the collapse of Communism, Russian society may come to recognition and formulation of the long-term path of its development. If that is what eventually happens, then Russia will at the same time receive sufficiently clear set of criteria to appraise politico-economic decisions and results of their implementation.

It is adaptation to the European institutions that the Strategic Program spanning the period until 2010 is in effect oriented to. Now this emphasis can be detailed and presented in an explicit form. In describing the goals of medium-term development, criteria of Russia's accession to the European Union could be regarded as strategic targets. They could also be regarded as institutional objectives, which Russia intends to achieve within the next 10–15 years. These criteria are fairly thoroughly developed and are in line with cultural and economic development of the present-day Russia. The level of economic development and education, GDP structure, the social structure of population, and for that matter, the current political system, make the choice of the European criteria the most natural and appropriate.

The conclusion that the European criteria should be used requires, however, some qualification.

¹⁴ In fact there is a European Economic Area (EEA) already, incorporating the EU countries, as well as Norway, Iceland and Liechtenstein. The last three countries are also part of the European Free Trade Area. The EEA membership implies not only establishment of "the common market" but also substantial progress towards harmonization of legislation. The EEA membership effectively means adoption by the member states of the EU legislation and standards. At the same time, the EEA does not envisage establishment of supranational bodies (except for the dispute settlement mechanism).

First, the use of these parameters as the base ones should not be identified with the goal of the EU accession. The latter is a political issue, and Russian society is not yet prepared to discuss it.

Second, these parameters are still quite vague today. Special work needs to be done to adapt the Maastricht and Copenhagen criteria, as well as special reports by the European Commission (evaluating the degree of preparedness of some countries) for more detailed targets to be developed for Russia.

Third, *all* the criteria should be applied to actual Russian realities and practices. Currently Russia is already ahead of the EU as regards some socio-economic decisions (institutions). First of all, this applies to the tax system, fiscal policy (orientation to a zero-deficit budget), labour legislation. It should be recognized that today Russia's agricultural policy (primarily, the principles of relations between the government and the agricultural sector) is more efficient than that adopted in the EU. There should not be formal approximation of the Russian institutes to the European ones if that impairs Russia's competitive advantages.

Fourth, those should be criteria developed in Russia and for Russia. Those should under no circumstances be parameters developed jointly with the EU or under control of European entities. The idea is that Russia should determine its own targets and goals rather than formalize its desire to join the EU.

Remaining within the economic framework, adaptation of the European criteria should primarily be undertaken along the following lines: 1) existence of a functioning market economy; 2) ability to secure effective competition and operation of market forces (deregulation and establishment of favourable conditions for competition, legislation stability and transparency of fiscal policy); implementation of structural reform with a focus on property rights protection, effectiveness of bankruptcy legislation, efficiency of the tax system, stability of the banking sector, stability of financial markets; 4) monetary and fiscal policies securing sustainable growth; 5) establishment of administrative and government institutions in line with the European standards. Financial standards are specified by the Maastricht agreements: 1) price stability: annual inflation within 1.5% of the three best performing EU countries, 2) Annual government deficit must not exceed 3% of GDP; 3) debt: total outstanding government debt must not exceed 60% of GDP; 4) exchange rate stability, meaning that for at least 2 years the country concerned has kept within the "normal" fluctuation margins of 2.5% envisaged by the European Exchange Rate Mechanism

; 5) average nominal long term interest rate must be within 2% of the average rate in the three countries with the lowest inflation rates.

Based on the above list of issues, of special importance today is compliance with criteria associated with the establishment of a functioning market economy, ability to secure efficient competition and operation of market forces, structural reform and adaptation of standards. Administrative reform is also of interest to the extent it is not concerned with procedures directly related to the EU accession.

The complex of goals which have to do with macroeconomic problems does not, of course, become less important, but they have become much less grave over the recent years. It is easy to see that with respect to some criteria, Russia now looks to much tougher parameters than the EU membership requires.

If developments follow a favourable scenario, Russia's position in Europe could, in a strategic perspective, be similar to the current partnership between the EU and Norway (what is meant is precedent rather than specific forms).

Russia's accession to the WTO and the OECD (formal application to the OECD was filed as early as 1996) are natural stations on the way to the European institutes.

5. Economic challenges of the current developments

The 11 September events and slowdown of the world economy are the two key factors that will determine the development of the Russian economy in 2002. However dramatic are those developments, their impact on the domestic economy should not be regarded as unequivocally negative. For apart from external factors there is a conscious reaction of the authorities, an array of tools for alleviating negative consequences, and sometimes even turning them to the country's advantage.

Let us say that the political circumstances are currently turning to Russia's advantage, as after September 11 its tendency toward rapprochement with the West has been given a strong impulse. A drop in oil prices, although painful from the fiscal perspective, may turn out to be an important

incentive to step up structural reform.¹⁵ Thus, a lot depends on the appropriateness of the government's action, its ability to make effective decisions in responding to the situation.

Given the deterioration of world economic conditions and the resulting drop in prices for the main items of Russian exports, the main problem that the country is facing is not to let the situation develop according to a populist scenario. The more so because the recent developments provoke populist decisions so as to support economic growth.

In our view, under the circumstances, the Russian government will have to take the following principal steps.

In the area of *monetary policy*, it would make sense to allow gradual real depreciation of the rouble following the performance of the forex market. This would be advisable on two grounds. First, this would strengthen the position of domestic producers in the internal market, for the real appreciation of the rouble in 2000–2001 has weakened those positions substantially. Second, it would not allow foreign reserves to decline drastically. Third, the low real exchange rate may become an additional factor of boosting investment inflow (the slowdown of the world economy is not the best possible environment for this but given the amount of capital that fled the country previously, potential for its repatriation remains quite strong. Fourth, such a policy would not provoke speculative attacks on the rouble.

Au contraire, strengthening of the rouble or maintenance of the current exchange rate would be too great a strain on Russia's foreign reserves, requiring toughening of customs control (while resources are more than modest in this area). Besides, this policy would most probably result in undermining confidence of the financial sector in the monetary authorities, since the available foreign reserves and forthcoming debt payments would not allow the Central Bank to defend the strong rouble too long, thus making attacks on the rouble practically inevitable.

In the area of *fiscal policy* the maneuver should be carried out without renouncing the principle of a balanced budget while increasingly using budget resources as a factor of supporting economic activity. This will be feasible only if deep reform of the public sector is implemented.

¹⁵ Recently, economic literature has provided convincing evidence that in the contemporary world economic prosperity is achieved mostly by countries poor in natural resources. Lacking in cheap and readily usable resources, those countries and their governments (whatever they are like) have to put an emphasis on productivity, production efficiency and competitiveness, thereby securing growth on a sound basis (See Gaidar E., *Anomalii ekonomicheskogo rosta*. M. Yevraziya, 1996; Gylafson Th., Zoega G. *Natural Resources and Economic Growth: The Role of Investment*: CEPR, 2001.

The revenue collection breakthrough (as regards taxes) achieved over the last two years should now be supplemented by sound decisions in the budget expenditure area. What is meant is not just expenditure cuts but a variety of organizational, political and structural measures to secure substantial improvement of the effectiveness of budget spending. The role and functions of the principal budget beneficiaries, budgeting procedures, etc., are to be revised. This could provide the basis for using budget resources to support growth through their concentration on the most efficient areas as regards growth.

It should be reiterated that we are not opposed to the idea of using government demand for encouragement of economic activity. We are only saying that this policy cannot be effective with the current structure of budget beneficiaries and the current revenue allocation procedures. That is why budget spending reform becomes an important and even crucial priority of the government. It is this reform that could become the key link in dealing with structural transformation of the country and decreasing its dependence on world energy prices.

Implementation of those reforms increases the importance of changes in the above mentioned extra-economic areas, which, nevertheless, are closely related to the economy: judicial, administrative and military. The first of these reforms secures the main institutional prerequisite for development of stable business activity in Russia, supplementing the measures of fiscal and monetary policies to have the capital that has fled the country repatriated. The second and third ones are extremely important conditions for improving the efficiency of budget spending.

Finally, in the situation of falling oil prices and political rapprochement with the West, all these measures would allow talks on restructuring and possibly a partial write-off of the Soviet debt to be revitalized. This aspect should be borne in mind as decisions on cooperation with the OPEC and oil export cuts are taken.

Overall, the Russian government has successfully passed the test of high oil prices, having refrained from populist decisions, known only too well from the past experience. Now, however, Russia will face a new test, that of low prices for the main Russian export commodities. If we pass it successfully, without substantial economic and political destabilization, it would mean that Russia has completely overcome the crises of transition, that the Russian elite has consolidated and the country is capable of stable operation in the post-industrial world.