

Russian Federation's Foreign Economic Relations

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1. Foreign economic relations under the old Soviet system

Under the old Soviet system, all foreign trade activities were controlled by state organizations. This is called “state monopoly of foreign trade.” Soviet enterprises were allowed to conduct export/import activities only through the Foreign Trade Organization (FTO), an umbrella organization of the Soviet Foreign Trade Ministry. Each enterprise was not allowed to directly conclude contracts with foreign enterprises. The Foreign Trade Bank controlled currency with regard to trade settlements. The Soviet government had, in effect, a multiple foreign exchange system, under which the government sets the exchange rate for each goods by using original coefficients. As a result, the Soviet domestic economy had been cut off from the world market. This had worked to protect Soviet enterprises from international price fluctuations but offered no incentives for them to make their production efficient to survive in international competition.

Trade with socialist countries was conducted through COMECON. Under COMECON, trade agreements were concluded among member countries and the kinds, volume and prices of goods to be traded were determined based on such agreements. Trade settlements were made by the transferable ruble. But this was nothing more than an account balance in the COMECON Bank set up in Moscow for calculation purposes. The transferable ruble was not convertible to hard currency and COMECON member countries were not able to offset their claims and debts among themselves¹.

Meanwhile, in the field of international financing, private individuals or juridical persons other than state organizations were not free to hold foreign currencies. And, since all banks were state organizations, international financial activities were completely under the control of the state. Although Russia, as one of the leading gold-mining countries, had a far-reaching impact on the world gold market, the country exported gold only intermittently to settle trade. Russia did not participate positively in the new movement in international financing that emerged in the 1980s, such as **securitization, use of derivatives and establishment of offshore facilities*** (the words with asterisks are explained at the end of this chapter).

Foreign economic relations under the old Soviet system were not a positive component of the state economy no was it a leading force in the world competitive market. The collapse of the Soviet Union and the emergence of the Russian Federation as an independent state have drastically changed this situation. The change was

¹ Up to here, I referred to Gregory & Stuart, 1986 pp. 2191-317.

promoted by eliminating state control on external economic activities, or, in other words, by liberalization. I would like to explain the process of the liberalization by dividing it into trade liberalization and currency/capital liberalization.

2. Trade liberalization

[Independence of Russia and liberalization of trade]

Trade liberalization in Russia began with President Boris Yeltsin's speech at a session of the Congress of People's Deputies on October 28, 1991 and a presidential decree² issued on November 15 the same year. Trade liberalization was critical for the **liberal designers of Russian market economy**^{*}. This was because, under their scenario, promoting inflow of foreign goods into Russia, where there were many monopolistic enterprises, was badly needed in order to eliminate various state controls, create a free market, and promote efficiency of production through price competition, and thereby raising the economic welfare of the people as a whole. They thought that inflow of foreign goods would eliminate monopolistic enterprises that maintain prices at high levels without making any efforts to enhance productivity.

The fact is that such a policy was already in place before the collapse of the Soviet Union. This can be regarded to Yeltsin's declaration of economic dependence designed to topple Gorbachev's Soviet Union from the inside by creating a *fait accompli*. Liberalization of foreign economic relations was a problem that all transition countries faced at the initial stage of transition. But in case of Russia, it is important to note that liberalization of external economic relations was accompanied by other problems: the collapse of the Soviet-bloc economy and formation of a new national economy.

The presidential decree of November 1991 allows all enterprises, regardless of ownership arrangement, to engage in external economic activities, including intermediation, without registration. It has also made it possible for enterprises to conduct foreign currency-related transactions under license. In other words, the presidential decree has made the "state monopoly of foreign trade" ineffectual.

The essence of the presidential decree is to abolish conventional restrictions as much as possible, backed by the free-market scenario. Though specific rules are left to

² Main laws and ordinances of the Russian Federation are published in *Rossiiskaia gazeta*. Important economic laws and ordinances are also published in *Ekonomika i zhizn*. However, it is necessary to refer to *Sobranie aktov prezidentia i pravitel'stva Rossiiskoi Federatsii* or *Sobranie zakonodatel'stva Rossiiskoi Federatsii*.

the central bank and the government, the decree had a strong impact on the Russian people and enterprise owners, who had acquired a semi-independent status, in that it showed a direction toward “liberalization of external economic activities.” An enterprise owner was quoted as saying, “We are now free to conduct any trading activities that have been prohibited so far.” The decree had a stronger impact after the collapse of the Soviet Union, as the authority that enforces rules has collapsed. The most important move that proves this is “peddler trading.”

[Peddler trading]

“Peddler trading (shuttle trading)” emerged shortly after the start of the move toward free market in 1992³. It first began as merchant activities between former Soviet republics and in Russia against the background of price differentials among regions that have resulted from price liberalization, and then spread to foreign trade. Behind the rapid, swelling growth of “peddler trading” was an insufficient tariff system. In the initial stage, there were no restrictions with regard to goods that can transport as “baggage.” The prosperity of “peddler trading” was also attributed to the underdeveloped financial system of Russia. The “peddler trading” easily overcame the problem of the financial system, as it allows Russians going abroad as tourists to settle the trade in cash.

The Russian Federation State Committee for Statistics and the central bank estimate the amount of “peddler trading” in a simple method. According to the estimate, the amount of “peddler imports”⁴ from countries other than CIS already accounted for 18.3% of all imports from such countries in 1993 and the ratio rose to 33.2% in 1996. The estimate is problematic in that it took only consumer goods into account and that it calculated only exports to CIS countries with regard to “peddler exports.” But, there is no question that, as far as imports of consumer goods are concerned, the amount of “peddler imports” was large enough to have a far-reaching impact on the domestic market. Behind this was the fact that people held foreign currencies. Data on Russia’s international balance of payments show that foreign currencies flew out of the country due to “peddler trading.”

The Russian government implemented measures to curb the “peddler trading” that could lead to tax evasion in 1993 and 1996, but to no avail. The government was not strong enough to hold back such an anarchic movement.

³ For “peddler trading,” see Tikhomirov, 2000, pp.138-139 and Kubota/Tabata, 1999b, pp. 368-377.

⁴ The amount is actually estimated as “unregistered imports” by including also some items other than “peddler imports.”

However, the anarchic movement did not necessarily dominate the trading field in and after 1992. The government frequently carried out political intervention in the trading field.

[Order imports by the government]

When Russia began its move toward “market economy” on Jan. 2, 1992, the view held by the international community was that, since the country is in short supply of basic goods, such as foods, the international community must support the country by providing such goods. The Russian Federation government, for its part, was fearful that resources might flow out of the country in disregard of domestic needs. This difference in awareness between Russia and the rest of the world prompted the Russian government to implement strange trade control policies. It took almost no protective measures for imports. On the contrary, the government adopted some measures to encourage imports. But, it implemented various restrictive measures on exports.

First, with regard to imports, there was a “centralized import order” system, under which important goods were imported directly on government orders. Payments for such imports were made by foreign aids and credits, state subsidies, and “centralized exports” (to be described later). Under this system, grains, medicines and some industrial raw materials were imported. Since these products were sold at bargain prices, they drove out domestic goods from the market. According to estimates made by the OECD, etc., the goods imported under the system amounted to nearly \$20 billion in 1992, accounting for about 7% of the total imports (including those for humanitarian assistance) in convertible currency with countries other than CIS countries in the same year. It can be said that the amount is large enough to have an influence on the domestic economy. The “centralized import order” system continued to exist until 1995.

Why did such a thing happen? Of course, it can be said that the Russian government’s uncertain uneasiness that the Russians might face starvation prompted the government to take such a policy. But, a bigger reason would be that the people who suffer from the policy did not have political channels to realize their profits. Of course, there is a parliament in Russia and Yeltsin had to exert great efforts in political negotiations with parliamentarians. But in Russia, some important policies had been implemented by president’s aides and foreign advisers in disregard of the parliament. The interests of persons engaged in farming, commodity industry and light industry were not taken into account. On the other hands, some government officials benefit much from the policy. They had a privilege to exclusively sell foreign goods. The “centralized import order” system became a hotbed of corruption.

[Import duties]

For any capitalist country, imposing import duties is an important policy. The Russian Federation introduced a new tariff system in July 1992. Under the system, a 5% tariff was normally imposed on goods imported from the countries (and their union) to which Russia granted most-favored-nation trade treatment and higher tariffs, ranging from 10% to 25%, were imposed on designated goods, such as beer, wine and automobiles (the tariff was twice as much on imports from countries with which Russia did not have most-favored-nation trade arrangements). Up to worth \$10,000 of goods brought in by private individuals (including those sent separately) were duty free. Government-designated foods and medicines were also duty free. Given the quality of goods produced in Russia in those days, it can be said that the 5% tariff did not have any effect in preventing the inflow of foreign goods. It could have easily imagined that goods brought in by Russian tourists abroad and other imports would result in overwhelming the domestic market. A presidential decree and an order issued by the State Customs Committee in March 1993 further lowered the tariff rates. During 1992 and 1993, the Russian Federation had a very open market in terms of the inflow of imports.

But, there emerged a movement to raise tariff rates in 1994. This movement, after twists and turns, culminated in a new policy in February 1995. The new policy showed a reasonable import tariff regime for a “developing” country. In line with the new policy, import duties on most of the goods, mainly foods, were raised in May 1995.

However, from the viewpoint of protecting domestic industry, the “reasonable” import tariff regime became meaningless in and after the summer of 1995. This is because the system adopted in July the same year to keep the ruble’s exchange value vis-à-vis the U.S. dollar within a target range (corridor: to be described later) in effect resulted in appreciating the value of the ruble and made imports cheaper in the Russian domestic market.

Unlike the case of “centralized import order,” the government’s non-intervention in the initial stage resulted in slackening domestic industry in the case of import duties. And when the government modified its non-intervention policy, then the government’s exchange policy worked against the development of domestic industry.

[State restrictions on exports]

The movement of import duty policies in Russia is very interesting. But, it is not import duties but various state regulations on exports that became the main topic whenever Russian Federation’s trade policy was talked about at home and abroad. The main means of regulations were export licensing, export quotas, and export duties.

With regard to licensing and quotas, the government decided detailed regulations on Dec. 31, 1991. According to the decision, the items subject to import quotas are oil, natural gas, chemicals and steel products, etc., all critical materials for the Russian economy. As to items subject to licensing, items that are economically significant, such as “information concerning locations of fuel energy materials and mineral materials,” are added to the list. The decision made it impossible for Russian enterprises to export those items without obtaining a quota or permit from the government. This clearly runs counter to spirit of the November 1991 presidential decree concerning the “liberalization of foreign economic relations.”

The Russia government was apparently afraid that the commodities that are strategically important for the Russian economy might flow out of the country in an anarchic fashion. In fact, the government order of June 1992 that introduced a system to register enterprises and organization exporting strategic goods clearly states that its purpose is “to protect Russia’s economic interests, to prohibit foreign currency profits from being unlawfully invested in a foreign country, and to prevent Russian enterprises from being exposed to unfair competition in foreign markets.” Among the items designated as “strategic commodities” were oil/liquefied natural gas, oil products, natural gas, electric power, coal/cokes, lumber/cellulose, nonferrous metals, pig iron/steel, chemical fertilizers, inorganic acid, fur, grains, and vegetable oil lees. This system was connected with a supply system of export goods (including goods and services) for national needs. Under the supply system, the government selects items for exports and estimates their export value by taking national needs (including repayment of foreign debts) into account. Then, state organizations (the External Economic Relations Ministry, Gazprom) place production orders to producers and export the products in bulk. This is called “centralized export.”

However, it is highly doubtful whether such export restrictions made it possible for Russia to use the “strategic goods” for the country’s economic recovery “strategically”. Despite the existence of restrictions, a huge amount of Russian resources was exported and the export proceeds came to an enormous amount. Meanwhile, a combination of quotas, the enterprise registration system and the centralized exports provided a source of interests for some organizations.

International organizations called for the abolition of export quotas and centralized exports, etc., terming them as the legacy of the Soviet era that constituted administrative, bureaucratic intervention in export transactions by state organizations. As a result, export quotas, licensing and the enterprise registration system, including those on oil and oil products, were abolished in March 1995.

The export duty system was also introduced as a result of the government decision on Dec. 31, 1991, along with export quotas and export licensing system. According to the decision, the purpose of the introduction of export duty was “to guarantee (the Russian) republic’s sovereignty over economic foundation, protect domestic markets, and to improve its export structure.” In particular, the first purpose, i.e., ensuring fiscal revenue, had the largest meaning. International organizations criticized such export duties as excessive intervention in economic activities by the state. In response to a request from the IMF, the Russian government announced “a program to deepen economic reforms” as early as July 1992. The government said that it would maintain the 20-30% export duties until the end of 1992 but that, thereafter, it would reduce the rates every quarter and totally abolish them by the end of 1994, except those on natural gas. In reality, however, the move to abolish export duties was slow. True that Russia did lower the duties. But, export duties on oil and natural gas continued to exist. It was only after April 1, 1996 that export duties were completely abolished on items other than oil (including liquefied natural gas). And it was only after July 1, 1996 that export duties on oil were abolished. It can be said that the fear about the outflow of strategic goods and the attractiveness of the system as an easy way to boost tax revenues lasted for a fairly long period of time.

[Summary]

In the field of import, the Russian Federation’s liberalization of trade was excessively open in conformity with a free economy scenario. What is important, in particular, is that the government took the initiative in importing consumer goods in the initial stage of the independence of the Russian Federation. In the field of export, on the other hand, the government took the trouble to implement restrictive measures. However, this does not necessarily mean that the Russian Federation’s trade policy was consistent in promoting imports and restricting exports. There were always moves to raise import duties and international organizations put pressure on the government to abolish export duties immediately. In fact, the government did abolish the export duties. As a result, the Russian trade policy looks complicated. However, it is misleading to argue that the Russian trade policy was lacking in free market philosophy. From the standpoint of to what extent government officials could exercise their power to control trade, we have to say that free market philosophy was dominant on the Russian borders in and after 1992. This is evidenced by the enormous amount of resource exports and the prosperity of “peddler trading.”

3. Liberalization of currency and capital

[The presidential decree and currency law of Nov. 15, 1991]

It was also the presidential decree of Nov. 15, 1991 that set forth Russia's first policy concerning liberalization of currency and capital, along with the liberalization of trade. A detailed study of the provisions of the decree shows that the liberalization of currency and capital was initiated more radically than the liberalization of trade. The significance of the presidential decree lies in the fact that it basically allowed the kind of acts that were almost considered as crimes under the old Soviet system. For example, it was possible for Russian juridical and private individuals to hold foreign currencies in cash or in deposit accounts, to carry out economic transactions ("currency transactions") concerning foreign currencies, though under some restrictions such as the requirement to obtain a license, and to make foreign investment such as purchases of securities. Until July 1, 1992, it was also possible to use foreign currency even for the payment to retail transactions and services provided. In and after 1992, Russian citizens were able to use dollars not only as a means to accumulate assets but, in some cases, even for recurring transactions as well (this can be called the "dollarization" of the Russian economy). This resulted in the prosperity of external economic activities beyond the control of the authorities.

It was the "currency regulation and currency control" (hereinafter to be called the "Currency Law") of the Oct. 9, 1992 law of the Russian Federation that, based on the provisions of the above presidential decree, provided comprehensive framework concerning the liberalization of currency and capital. What is most significant about this law is that it provided basic principles about the "currency transactions" that was also referred to in the presidential decree. According to the Currency Law, the "currency transactions" refer to the following:

- [1] Business concerning the transfer of ownership of foreign currency values (*valiutnye tsennosti*) [foreign currencies/foreign currency-denominated securities, precious metals, jewels]
- [2] Business concerning the use of foreign currencies as a mean of payments or the use of the ruble in the implementation of external economic activities
- [3] Business concerning exporting/sending of foreign currency values to Russia (from Russia)
- [4] Business concerning the implementation of international remittance of currency (exchange)

The Currency Law divided these transactions into two categories: “**Current transactions**”* i.e., remittance concerning payments to exports/imports, receipt and provision of short-term credits (less than 180 days), and interest and dividends, and “Currency transactions concerning the transfer of capital,” i.e., direct investment, portfolio investment, other long-term credit, and land transactions. Under the Currency Law, both transactions were supposed to be implemented through “authorized banks. Authorized banks refer to commercial banks that conduct “currency transactions” under license from the central bank and include banks in which foreigners have equity stakes and those owned 100% by foreigners⁵.

The Currency Law sets forth the rights and obligations of residents (including juridical persons) and non-residents (including juridical persons) separately with regard to “currency transactions.” Residents can freely conduct current currency transactions. As for “currency transactions connected with the movement of capital,” residents can such transactions in accordance with the procedure established by the Central Bank of the Russian Federation. Private individuals, who are residents, can transfer, export, and remit from Russia foreign currencies, securities, etc., which have been brought in (remitted) to Russia, with the due observance of the customs rules. Therefore, residents were basically entitled to freely conduct transactions of foreign currencies and securities with non-residents on conditions that they observe provisions set by the central bank and rules set by the customs. Incidentally, one would be surprised if he/she studied how Russian people’s export of capital, i.e., purchases of foreign securities or direct investment in a foreign country, was generally regulated. It has been permitted since the establishment of the Russian Federation. This is because the May 1989 decision of the Soviet Ministerial Council, which remained in effect even after the establishment of the Russian Federation, did not have any restrictive clause concerning residents’ export of capital. A document issued by the first deputy minister of the External Economic Relations on Feb. 3, 1994 approved the basic direction of the 1989 decision⁶. The provision of the Currency Law supported Russian people’s “free export of capital” with respect to currency. This is a significant fact that has to be kept in mind in relation to “capital flight” (to be studied later as “nonproductive capital outflow”).

As to “currency transactions” by non-residents, the Currency Law provides that they are entitled to open accounts in foreign currency and in the currency of the Russian Federation with the authorized banks and freely bring in foreign currency and

⁵ *Shiratori*, 1996, pp.100-101

⁶ *Bulatov*, 1995, pp. 495-500

securities, etc. to Russia. Non-residents are also entitled to buy and sell foreign currency in exchange for the ruble and freely export, transfer and remit from Russia currency values, previously imported, transferred or remitted to Russia. Of course, the conditional terms of “with the due observance of rules established by the Russian government, the central bank, or customs” are attached to these entitlements. But the fact that the direction toward liberalization has been basically set forth by laws and ordinances is more significant. It has become possible for non-residents to come and go to Russia freely with financial assets.

In a nutshell, the Currency Law in effect declared that the door that was opened by the November 1991 presidential decree would be basically kept open.

[Residents' accounts in foreign currency]

It is difficult to fully understand how residents' foreign currency accounts are actually regulated from the November 1991 presidential decree and the provisions of the Currency Law alone. I'd like to explain why. Two laws issued in 1992 have made it possible for enterprises and organizations to open foreign currency accounts at authorized banks. The authorized banks open two different kinds of accounts for enterprises and organizations. One is “transfer account” and the other is “current account.” The former is a foreign currency account with which all income in foreign currency will be registered. Forced sales of foreign currency are made on this account and the remaining amount is transferred to the “current account.” Remittance for export/import transactions to (from) abroad and payments for debts, bank commissions, postal fees, expenses for business trips are made through the “current account.”

In this way, a system under which residents can open both foreign currency and ruble accounts has been established in Russia. This can be interpreted as a measure to guarantee a system for free exchanges of currencies on one hand. The system would help speed up the liberalization of financial system as a whole, as it lets market forces decide the ruble's exchange value. This is in line with the thinking of free-market economy in today's international financing. On the other hand, we cannot overlook the fact that holding a foreign currency account is insuring against a decline in the value of assets. Currency problems in Russia are evolving with two factors – liberalization and inflation – complicatedly intertwined.

The system for forced sales of foreign currency occupies an important place in such a setup. A system to forcibly sell part of foreign currencies acquired through exports, etc. for the ruble was first set forth in the presidential decree of Nov. 15, 1991 and was modified by the presidential decree of June 14, 1992. The modification abolished the conventional system that required forced sales of foreign currencies to the foreign

currency reserves of the Russian Federation at a special exchange rate. Instead, it required all enterprises (including those in which foreigners have equity stakes) to sell in a domestic foreign currency market (regardless of foreign currency reserves) 50% of the foreign currencies acquired at an exchange rate set in negotiations with authorized banks. In December 1998, the ratio of raised to 75%. The forced sale of foreign currencies is designed to get the free-market system under control. Therefore, the change in the ratio reflects the government's policy stance.

[Non-residents' accounts in the ruble]

Non-residents' accounts in the ruble are the other side of the pair with residents' account in foreign currency. According to various laws and documents issued in 1993, non-residents were entitled to open three kinds of accounts with the authorized banks – T-type account, I-type account and an account for non-resident private individuals.

First, non-residents can open a T-type account for their export/import transactions and maintenance of their agencies and branch offices in Russia. What is important here is that, through the account or indirectly based on it, non-residents can conduct ruble transactions not only for their recurring economic activities, such as payment for imports and living expenses, but also for some capital transactions, such as depositing and bond purchases.

Second, non-residents can open an I-type account in the ruble for investment activity. Through the I-type account, they can make all kinds of investment/re-investment* in Russia and convert the ruble in the account into foreign currency for the remittance of proceeds from investments. All transactions are conducted on a non-cash basis. The provisions of the law that sets the outline of I-type account tells that the I-type account was contrived to attract foreign investment, foreign direct investment (FDI) in particular, into Russia. Generally speaking, the most important condition for attracting foreign investment is to guarantee the right to remit proceeds from investment to home country. In this sense, S.M. Borisov points out that the right to purchase foreign currency through the I-type account is the main "attraction" of the law⁷.

Third, non-resident private individuals can open a ruble account for daily expenditure. The ruble in the account can be said to have a high convertibility to foreign currency, because the owner of the currency can convert it to foreign currency on a non-cash basis without any difficulty, or withdraw the currency from the account to purchase foreign bank notes⁸.

⁷ Borisov, 1999a, p. 56

⁸ Platonova, 1996, p. 47; Borisov, 199a, p. 56

With regard to non-residents' ruble accounts, a progress was made as a result of the Central Bank of Russia order issued in July 1996. The order established a new ruble account called S-type account. The S-type account was established for the sole purpose of attracting foreign capital to the government bond (GKO and OFZ) market. S-type is different from T-type account and I-type account in that non-residents can open several S-type accounts with more than one authorized bank. The new account made it possible for non-residents to purchase a huge amount of GKO and OFZs. The active trading on the Russian government bond market in and after 1996 was not possible without the S-type account. The participation of non-residents in the Russian securities market meant the spread of modern financial technology to Russia.

[Currency convertibility]

Now, let's put the process of Russia's liberalization of currency and capital into perspective under the concept of "convertibility of currency." It should bring the peculiarity of Russia's current problems into relief.

John Williamson classified the concept of "currency convertibility" precisely. Williamson⁹ separated "unlimited convertibility" (capital account convertibility) from "current account convertibility" in accordance with the conventional concept in Western Europe. He maintains that currency acquires "unlimited convertibility" only "when conversion restrictions on capital exports are abolished, or when residents have acquired the right to export capital at an official exchange rate without quantitative restrictions." On the other hand, "current account convertibility" is "the concept of convertibility embodied in Article 8, Section 2 of the IMF Agreement." Therefore, under "current account convertibility," any one, domestic importers or foreign exporters and investors, is entitled to convert domestic currency to foreign currency at an official rate in order to conduct all kinds of transactions, including purchases of goods and services from abroad, interest payments, and remittance of profits to home country. "Current account convertibility" is defined as the right of residents and non-residents to convert domestic currency to foreign currency to conduct current transactions. On the other hand, "unlimited convertibility" is defined as the right of residents to export capital. Therefore, under the conventional distinction between unlimited convertibility and current account convertibility, non-residents' right to make domestic capital investment is not explicitly mentioned.

In Eastern Europe, however, "domestic convertibility" and "external convertibility" concepts have been used. Williamson points out that "their characteristic is "who"

⁹ Williamson, 1991, pp. 377-379

should be allowed to convert domestic currency to foreign currency, not the “purpose” of conversion.” Therefore, “domestic convertibility relates to the right of domestic residents to convert currency, while external convertibility relates to a similar right of non-residents (including foreign investors),” he said.

A comparison of the conventional definition of convertibility with the East European definition reveals that East European experts were interested only in external convertibility and had no idea at all as to unlimited convertibility (whose main point is the right to make free capital export). This is because they were enthusiastic about attracting foreign capital and exporting capital from their countries was unthinkable.

To make the problem clear, this writer prepared a simple table (See Table 1), by referring to Borisov’s framework. Figures in the table are the years when convertibility in question was approved by law. The table shows that the liberalization of currency and capital in Russia began with the approval of domestic convertibility of the ruble and moved on to the approval of external convertibility (both in current account convertibility and capital account convertibility).

Table 1) Currency Convertibility

Who \ For what purpose	Current transactions	Capital transactions
Residents	Domestic current account convertibility 1992	Domestic capital account convertibility = Unlimited convertibility 1989, 1992, 1994
Non-residents	External current account convertibility 1993	External capital account convertibility 1993-1996

Note) Modified Borisov’s table (Borisov, 1997, p. 28)

Borisov points out that, in Eastern Europe, the introduction of convertibility began with external convertibility. In Russia, however, residents had free and virtually unlimited access to foreign currency (i.e. domestic convertibility) from the beginning. This, according to Borisov, resulted in a huge loss to Russia’s international balance of payments. Its visible result is the so-called “dollarization” of the Russian economy¹⁰.

With regard to unlimited convertibility, Williamson refers to the fact that France

¹⁰ Borisov, 1999b, pp. 53-64

and Italy abolished their capital control at last in 1990 (therefore, introduced unlimited convertibility – Uegaki). Williamson says, “unlimited convertibility cannot be recommended to Eastern European countries now and not even in the near future.” He goes so far as saying that abolishing capital control is “luxury.”

[Summary]

The liberalization of currency and capital was initiated more radically than the liberalization of trade. Each law (concerning the liberalization) contains various restrictive provisions. This could be view as evidence of the lack of free-market philosophy. But the two facts – the dollarization of the Russian economy and the outflow of non-productive capital (the latter will be described later) – show that the people were actually enjoying freedom in this field. In Russia, the following two systems were established in the initial stage of transition: [1] A system under which residents (private individuals and juridical persons) can own foreign currency, the dollar in particular, in cash or in the form of deposits and use the currency not only for recurring trade transactions but also for other purposes such as depositing with foreign banks and purchasing foreign bonds, and [2] a system under which non-residents can open accounts in the ruble in Russia and, through the accounts, take part in the Russian securities market and convert the interests/dividends thereof to foreign currency for remittance to home country. This resulted in a situation where Russians held a huge amount of dollars without investment purposes and a considerable portion of the dollar flew out of the country. At the same time, it also resulted in a situation where, with the inflow of the latest financial technology, Russians reacted excessively to fluctuations of the international financial market. What is important here is to evaluate the situations from the viewpoint of currency convertibility. According to Borisov and Williamson, Russia is a very unique country in that it introduced domestic current account convertibility from the beginning and residents were entitled to export capital (domestic capital account convertibility).

4. Balance of payments structure

Table 2) Balance of Payments Statement of the Russian Federation
(Vis-à-vis whole world) (In \$ 1 million)

	1993	1994	1995	1996	1997	1998	1999
Current account [1]	12,792	8,870	7,778	12,011	4,049	2,446	24,990
Merchandise trade balance [2]	15,590	17,675	20,476	22,933	17,440	17,306	35,302
Export [3]	59,724	67,826	82,663	90,563	89,038	74,751	74,663
Import [4]	-44,133	-50,152	-62,188	-67,629	-71,599	-57,445	-39,361
Services balance [5]	-1,375	-6,716	-9,402	-5,722	-4,688	-3,150	-3,342
Investment income and compensation of employees [6]	-2,302	-1,782	-3,368	-5,339	-8,411	-11,359	-7,504
Current transfers [7]	879	-307	72	138	-291	-351	534
Capital and financial account [8]	-6,540	-8,538	1	-3,380	3,766	5,469	-18,009
Capital account [9]	-284	2,410	-347	-463	-797	-382	-333
Capital transfers [10]	-284	2,410	-347	-463	-797	-382	-333
Financial account [11]	-6,257	-10,948	348	-2,917	4,562	5,851	-17,676
Direct investment (net) [12]	1,069	538	1,658	1,708	3,640	1,156	746
Portfolio investment (net) [13]	-374	36	-2,408	8,757	45,433	7,779	-562
Other investment (net) [14]	-4,131	-11,574	10,408	-14,739	-42,556	-8,339	-15,907
Reserve assets [15]	-4,354	1,896	-10,386	2,841	-1,936	5,305	-1,778
Errors and omissions [16]	-6,252	-333	-7,780	-8,631	-7,815	-7,914	-6,981

Note) The table was prepared in accordance with the 5th edition of the IMF Formula Manual. Russia began to publish its balance of payments statement in conformity with the 5th edition starting with 1995 statement. Later, the country revised its previous statements retroactively to make them conform to the 5th edition and announced up to the 1993 statement in the 5th formula.

Source) Bank Rossii, *Plachezhnyi balans Rossiiskoi Federantsii*

[Huge surplus in current balance]

The table 2 is a simplified **balance of payments statement*** of the Russian Federation¹¹. The first impression we get from the table is huge current account surpluses in and after 1993. The fact that the country posted a huge surplus in 1999, or after the financial crisis, despite a downturn in 1997 and 1998 shows that a current account surplus is institutionalized in the Russian economy. Let's examine the structure by employing elementary macroeconomics¹².

¹¹ The balance of payments statement of the Russian Federation is published in the homepage of the Central Bank of Russia (<http://www.cbr.ru/dp/statistics.html>). For more detailed data, See *Vestnik Banka Rossii*.

¹² See, for example, Krugman & Obstfeld, 1991, pp. 299-303

$$Y = C + I + G + CA \dots\dots\dots(1)$$

$$Y = C + S + T \dots\dots\dots(2)$$

Therefore,

$$C + I + G + CA = C + S + T \dots\dots(3)$$

That is,

$$CA = (S-I) + (T-G)\dots\dots\dots(4)$$

Y= GNP, C = Consumption, I = Investment, G = Government spending, CA = Current account, S = Private savings, T = Tax

The equation (4) shows that a country's current account balance is the sum of savings surplus (as against investment) [S - I] and fiscal surplus [T - G]. Table 3 shows a comparison of the relationship of current account, savings surplus and fiscal surplus in the U.S., Japan and Russia.

Table 3) Macro-balance of 3 Countries

		CA = Current account	S - I = Savings surplus	T - G = Fiscal surplus
U.S.	1980s	Huge deficit	Sharp contract	Sharp contraction
	Second half of 1990s	Further huge deficit	Further sharp contraction	Close to zero
Russia	Second half of 1990s	Huge surplus	Sharp increase	Sharp contraction
Japan	Second half of 1990s	Huge surplus	Sharp increase	Sharp contraction

As is well know, Japan and Russia posted huge fiscal deficits up to the late 1990s. On the other hand, the United States, though it had huge fiscal deficits in the past, has improved its fiscal balance rapidly in recent years. As to current account, while Japan and Russia recorded huge surpluses, the U.S. suffered deficits consistently and the deficits came to an enormous amount in the late 1990s.

What the equation (4) and the Table 3 mean is as follows: First, Japan and Russia posted current account surpluses thanks to the huge amount of savings surpluses that more than offset fiscal deficits. Consumers are refraining from consumption out of their concern about their future and investors, unable to paint a rosy picture of the future, are not willing to make fresh investments. In this sense, Japan and Russia have the same problems from the macro-economic point of view. Meanwhile, the U.S. suffered current account deficits in the 1980s, as savings shortage and fiscal deficits took place at the same time. The current account deficits of the U.S. worsened in the second half of the 1990s as the savings shortage further increased, despite an improvement in the fiscal balance. The macro-economic structure of the world, as seen in net terms, shows

that the enormous consumption demand in the U.S. has absorbed the savings surpluses in Japan and Russia¹³.

Of course, the cause of consumption shortage (excessive savings) is different between Russia and Japan. In Russia, people's consumption level is still low and there are a lot of things the people want to buy. The problem is that goods are not being supplied at reasonable prices. Japan's consumption structure, on the other hand, is at a turning point. Nevertheless, it is interesting to note that Russia and Japan have very similar macro-economic structures, including insufficient financial systems that connect savings with domestic investment.

[Trade surplus]

The cause of current account surplus in Russia is apparently the surplus in merchandise trade. The Table 2 shows that the merchandise trade surplus always exceeded total current account surplus every year. Even if other current account items posted losses, the surplus in the merchandise trade balance was large enough to offset such losses, resulting in a current account surplus. This forms the basic structure of Russia's current account. What is characteristic of the Russian merchandise trade surplus is that the amount of imports is extremely small compared with exports. Suppose $(\text{exports} - \text{imports}) / (\text{exports} + \text{imports})$ is trade balance ratio, then the ratio in Russia had stood at around 15% since 1993. The merchandise trade under the old Soviet system was not in such a structure (the ratio stood at around 5% in the initial stage of *perestroika* and then turned in the red). In line with the transition of the system, the trade structure underwent big changes.

Now, let's trace the changes in merchandise trade by item. Tables 4 to 7 show the composition of Russian Federation's (up to 1991, the Union of Soviet Socialist Republics') trade with "far foreign countries" (countries other than CIS member countries). First, let's take a look at exports. What is striking is that both the absolute value and weight of "machinery, equipment, transportation" dropped sharply after 1991. This shows that the Russian (Soviet's) heavy industrial goods lost their market due to the collapse of COMECON. In its place, "metals, precious stones, their products" increased their absolute value and weight. This shows the characteristic of Russia blessed with many other underground resources in addition to oil and natural gas. Oil, natural gas and other "mineral products" are the pillar of Russia's exports, but their exports are not necessarily stable in terms of value. Factors such as stagnation in

¹³ This is a view from the standpoint of net balance. If gross capital transfer has to be taken into account, we have to pay attention to the huge amount of capital transfer between the U.S. and the EU.

domestic production and fluctuations of international commodity prices are believed to have had something to do with this. Still, “mineral products” accounted for more than 40% of total exports, because domestic demand was stagnant. Total exports fell sharply at one time, but by 1996-97 they recovered the level of what they were before the collapse of the Soviet Union. This is one of the factors behind the trade surpluses.

Table 4) Composition of Russian exports to countries other than CIS
(Current price, In \$1 billion)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Machinery, equipment, transportation	12.5	5.2	3.8	2.9	3.2	5.3	5.6	5.7	5.8	5.8
Mineral products	32.3	26.3	22.0	20.7	22.8	26.4	32.7	32.5	23.6	26.6
Metals, precious stones, their products	9.2	7.3	7.0	10.3	16.5	19.6	19.0	19.4	18.7	17.8
Others	17.1	12.1	9.6	10.4	10.5	14.3	13.7	12.4	11.0	12.2
Total	71.1	50.9	42.4	44.3	53.0	65.6	71.0	70.0	59.1	62.4

Note) Based on State Customs Commission data (includes data on exports through pipelines, etc. that did not pass through customs houses).

Source) *RSE*, 1995, p. 432 for up to 1993, and *Rossia v tsifrah*, 2000, p. 364 for 1994 and after

Table 5) Composition of Russian exports to countries other than CIS (%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Machinery, equipment, transportation	17.6	10.2	9.0	6.5	6.0	8.1	7.9	8.1	9.8	9.3
Mineral products	45.4	51.7	51.9	46.7	43.0	40.2	46.1	46.4	39.9	42.6
Metals, precious stones, their products	12.9	14.3	16.5	23.3	31.1	29.9	26.8	27.7	31.6	28.5
Others	24.1	23.8	22.6	23.5	19.8	21.8	19.3	17.7	18.6	19.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source) Calculated from Table 3

Table 6) Composition of Russian imports from countries other than CIS
(Current price, In \$1 billion)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Machinery, equipment, transportation	36.3	15.8	13.9	9.1	10.7	12.9	12.3	15.4	13.1	8.2
Textile, textile products	7.6	4.4	4.5	3.7	2.2	1.6	1.4	1.3	0.9	0.7
Foods, agricultural raw materials (except textile)	16.6	12.4	9.6	5.9	8.6	9.7	8.2	10.2	9.1	6.3
Others	21.3	11.9	9.0	8.1	6.9	8.9	10.9	12.4	10.2	7.5
Total	81.8	44.5	37.0	26.8	28.4	33.1	32.8	39.3	33.3	22.7

Source) *RSE*, 1995, p. 432 for up to 1993, and *Rossii v tsifrakh*, 2000, p. 366 for 1994 and after

Table 7) Composition of Russian imports from countries other than CIS (%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Machinery, equipment, transportation	44.4	35.5	37.6	34.0	37.7	39.0	37.5	39.2	39.3	36.1
Textile, textile products	9.3	9.9	12.2	13.8	7.7	4.8	4.3	3.3	2.7	3.1
Foods, agricultural raw materials (except textile)	20.3	27.9	25.9	22.0	30.3	29.3	25.0	26.0	27.3	27.8
Others	26.0	26.7	24.3	30.2	24.3	26.9	33.2	31.6	30.6	33.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source) Calculated from Table 5

Table 8) Estimates of peddlers' imports (In \$1 million, Signs are in line with the balance of payments statement)

	1995	1996	1997	1998
Countries other than CIS	-10,052	-15,446	-15,558	-12,091
CIS	-3,220	-5,128	-3,906	-2,230
Whole world	-13,272	-20,574	-19,464	-14,321

Note) Extracted "other revisions concerning understanding, including peddler trade" from the revisions of data on balance of payments statement by the State Customs Commission

Source) *Vestnik Banka Rossii*, No. 23, 1996, p. 14; No. 29, 1999, p.21, and balance of payments data provided by the Central Bank of Russia

As to imports, although every merchandise group decreased its absolute value, "foods, agricultural raw materials" increased its relative weight. This reflects a change in Russian people's taste and adoration of Western lifestyles after the transition of the system and sluggish agricultural production in the country. The decline of the absolute value of "machinery, equipment, transportation" is striking. In Russia, such policy as importing investment goods from advanced industrial countries to reinforce basic industrial infrastructure has receded rapidly after the transition of the system. Both the absolute value and weight of "textile, textile products" declined. But we need to study it carefully. This is because they are "customs-cleared statistics" compiled by the State Customs Commission and do not include "peddler trading." The Central Bank of

Russia estimates the trade, including peddler trading, that are not covered by the State Customs Commission and adds the estimate to balance of payments statistics. The Table 8 shows the value of items corresponding to “peddler imports” extracted from the central bank’s estimates. Since the central bank estimates cover only consumer goods, the table shows the values of peddler imports, such as textile goods, processed foods and sundries. It shows the actual state of the import structure that cannot be grasped from the tables 6~7 (incidentally, tables 4~7 do not take account of trade with CIS). The figures exceeding an average of \$17 billion a year in the Table 8 illustrate that the goods imported by peddlers overwhelmed the Russian consumer market.

Other current account components – “services trade” consisting of transport, travel, construction, financial, and other services and “investment income and compensation of employees” consisting of interests, dividends, and wages – are omitted here.

[Outflow of non-productive capital]

A current account surplus is always accompanied by an outflow of financial assets. This is generally discussed as “flight of capital” problem. We cannot regard all of such outflow as a factor that disrupts the sound development of national economy. If the outflow returns to the home country with fruits, we should not forcibly hold back such an outflow. On the contrary, forcibly making domestic investments would be harmful to the efficient distribution of resources. But, as far as Russia is concerned, the valuable assets of the Russian people are flowing out of the country through several channels in a way they cannot claim the rights to the assets.

This writer attaches importance to “increase in domestic circulation of cash foreign currency,” “trade receivable and payable,” and “errors and omissions” as such channels and calls their total (always minus on a yearly basis, i.e. net outflow) “outflow of non-productive capital.” Why doesn’t the writer call it “capital flight”? Because none of them include the kind of criminal act that leaves no trace in the balance of payments statement. Normally capital transfer by such a criminal act should be discussed as “capital flight.” However, this writer has given up the idea of doing so in view of the difficulties of obtaining indisputable data. There may be objection to including “increase in domestic circulation of cash foreign currency” to “outflow” capital. Since it actually remains in the country, it is natural that such objection should be raised. However, this writer believes such cash foreign currency is performing the same function as “outflow capital,” as it is being piled up as closet deposits without being used for domestic investment and is reserves of illegal outflow funds.

Table 9) Outflow of non-productive capital (In \$1 million; Signs are in line with the balance of payments statement)

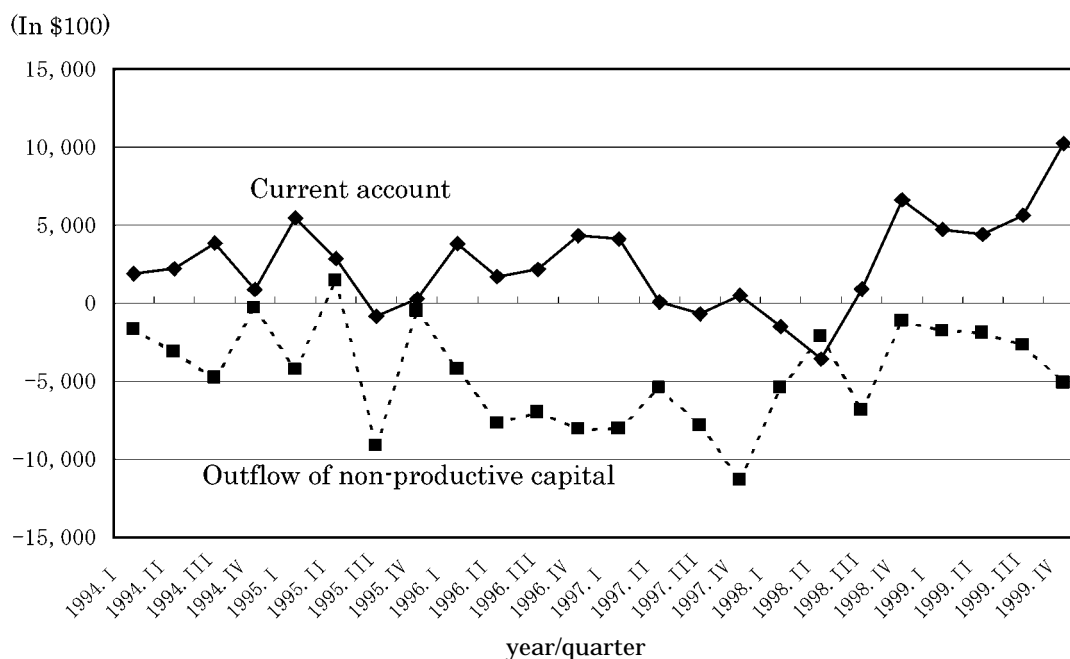
	1993	1994	1995	1996	1997	1998	1999
Domestic circulation of cash foreign currency	-3,619	-5,740	134	-8,669	-13,444	945	848
Trade receivable/payable	0	-3,860	-4,928	-9,773	-11,458	-8,625	-5,384
Errors and omissions	-6,252	-333	-7,780	-8,631	-7,815	-7,914	-6,981
Total	-9,871	-9,933	-12,574	-27,073	-32,717	-15,594	-11,517

Source) Bank Rossii, *Plachezhnyi balans Rossiiskoi Federatsii*

Table 9 shows that “outflow of non-productive capital” increased sharply after 1992 and hit a peak in 1997 and then began to decrease. The figure declined in and after 1998, because “increase in domestic circulation of cash foreign currency” recorded a positive value. According to the entry rules for balance of payments statements, the positive value means that the volume of domestic circulation of foreign currency has decreased. This was brought about by current account movements and various restrictions on foreign currency holdings.

Figure 1 shows the relationship between the total amount of “outflow of non-productive capital” and current account balance on a quarterly basis. The figure shows a strong correlation between the two. That is to say, the bigger the current account surplus is, the larger the outflow is. This writer believes that behind this lies free economic reform of the system that has made it possible for Russian residents to hold foreign currency in cash or in bank deposits. Holding assets in foreign currency means holding internationally recognized valuables. In this case, the locus of the valuables can be easily changed. The figure 1 suggests that profits from exports, etc. are held by Russians in foreign currency and immediately flows out of the country through a non-productive channel.

Figure 1) current account and outflow of non-productive capital



Source) Bank Rosii, Plachezhnyi balans Rossiiskoi Federatsii

5. Currency crisis of 1998

[Influence of the Asian currency crisis on Russia]

The Thai baht crisis that took place in July 1997 spread to Malaysia, Indonesia and the Philippines. Even Hong Kong and South Korea were not immune to the impact of the crisis. A general survey of the East Asian countries hit by the currency/financial crisis leads this writer to believe that they have something common in their economic system and structure.

First, the currencies of these countries (except South Korean won) were pegged to the dollar or a basket of the dollar and other currencies. Capital transactions had been liberalized and the inflow of securities investments had soared to enormous amounts in those countries (The situation in Hong Kong and South Korea, the lenders of capital, was different. The same in the rest of this section). On the other hand, the inflow of direct investment that will reinforce their economic infrastructures was not necessarily active and the countries were suffering from continued current account deficits. Surprisingly, the situations strongly resembled those in Russia, except for the current account problem. In particular, it is important to note that Russia had adopted a kind of target zone system that linked the ruble with the dollar. It was only natural that the

investors who had been vigilantly looking at a globe and seeking the next victim should have targeted Russia whose currency was fixed to an exchange band and whose economic infrastructure was fragile.

Let's trace the influence of the Asian currency/financial crisis on Russia and how the crisis in Russia deepened thereafter, by referring to a report by the Institute of Transition Economic Problem Studies (hereinafter to be called Transition Economies)¹⁴. When the currency crisis occurred in East Asia in the summer of 1997, it appeared that its impact would not reach Russia. However, Russia was plagued with basic economic problems in its finance, international balance of payments, and currency and world investors were downgrading their assessment of Russia. On Oct. 23, 1997, the Hong Kong stock exchange plunged, posting the sharpest decline on record. It spread to New York and Tokyo immediately and pushed Hong Kong stock prices further downward on Oct. 28 and its impact was felt in Russia. In Russia, the impact of the Asia currency/financial crisis was first felt on the stock market.

The impact also began to affect the government bond market. In the first week of the crisis, the weighted-average yield on the government bonds rose to 28% from 22%. Government bond trading nearly doubled in value in the first one week. At the same time, Russian eurobonds soared.

When the East Asian crisis became serious from late 1997 to early 1998, it further worsened the situation of the Russian financial market. When Russia's investment risk increased and giant investment funds that invest in various countries in the world began reconstitute their investment portfolios, stock prices declined one after another and the yields on GOKs and OFZs rose. Reflecting a flight of securities investment from Russia and increased pressures on the ruble, the official exchange rate of the Russian currency vis-a-vis the dollar was lowered drastically in the beginning of the year, pushing futures prices higher. The ruble's fluctuation band against the dollar (corridor; to be described later) was expanded drastically but the Central Bank of Russia failed to take measures to stabilize the currency market, resulting in further expanding the deviation of exchange fluctuations.

At one time after February, the situation appeared headed for stability. But in mid-May, the Russian macro-economic situations began to deteriorate again. Government bond prices nose-dived and RTS-1 stock index lost about 40%. Pressure on the ruble intensified and Russia's foreign reserves decreased \$1.4 billion (10%) in May alone. Moreover, there were signs of banking crisis looming large.

¹⁴ I would like to explain who the crisis deepened by adapting from IEPPP, 1998, pp. 42-58

Following the downgrading of the ratings of Russia, Russian banks and enterprises by an international rating agency in June, investors withdrew their huge amount of funds from the financial markets and this pushed the yields on GKO's higher to 50% in the second half of the month. The stock index lost 20% in June. This put downward pressures on the ruble on the exchange market and prompted the Central Bank of Russia to intervene in the market on a massive scale.

On July 13, the IMF, the World Bank and the Japanese government announced a financial assistance totaling \$22.6 billion. The announcement provided a boost to the market and financial indicators picked up slightly. But this again proved to be a temporary expedient. On July 15, the underwriting auction for GKO's was unsuccessful and interest payments for government bonds were made by using Federation's budget. During June, the Russian government worked out programs to break the deadlock. But the programs were voted down by the parliament. There was a rivalry between the Central Bank of Russia and the Finance Ministry in the final stage. By around August 2, the situation had become uncontrollable.

On August 17, the Russian government announced it would implement the following three economic measures: First, the ruble's exchange band (corridor) is to be widened to 6~9.5 ruble to the dollar. Second, payments of external debts are to be suspended for 90 days. Third, the sale and reimbursement of government bonds are to be suspended temporarily in order to reconstitute the terms of government bonds. The Asian currency crisis spread to Russia and destroyed the basic policies for macro-economic stability implemented under the guidance of Western advisors.

[Corridor]

The biggest cause that plunged Russia into the crisis under the attack of currency speculation was that Russia had adopted a kind of fixed exchange system vis-à-vis the dollar (a target zone system, to be specific) just like Asian countries before the crisis. So, I would like to explain the system that is called corridor.

Corridor literally means passage way, but is used to mean a kind of fixed exchange system. Many developing countries adopted the system as an effective means to stabilize macro-economy (measures to overcome inflation) on recommendation of the IMF. Russia adopted the system in July 1995.

First, the corridor was set at 4,300~4,900 rubles to the dollar for the period from July 6 to Oct. 1 and then the period was extended to the end of December. On Nov. 30, 1995, it was decided to change the corridor to 4,550~5,150 rubles to the dollar for the period from Jan. 1 to June 30, 1996. On May 16, 1996, however, it was decided to adopt a new system, namely, a crawling peg, under which the exchange rates for both ends of

a corridor are set – 5,000~5,600 rubles to the dollar on July 1, 1997 and 5,500~6,100 rubles to the dollar on Dec. 31, 1997 - and adjusted gradually during the 6-month period. A similar method was adopted for the 1997 corridor, with the rates set at 5,500~6,100 rubles to the dollar for Jan. 1 and at 6,350 rubles for Dec. 31. But, a decision dated Nov. 11, 1997 restored the original fixed exchange system and a corridor with an exchange band of 15% upward and downward from the central rate of 6.2 rubles to the dollar (notation after the denomination on Jan. 1, 1998. In older notation, it was 6,200 rubles) was in force for three years starting on Jan. 1, 1998. This last decision was scrapped on Aug. 17, 1998.

True the corridor looked effective in stabilizing prices. The monthly growth rate of consumer prices, which was over 5% until the first half of 1995, dropped to 1~2% in and after 1996 and, at one time, it posted a negative growth from the preceding month. But, what is more important is the fact that the real exchange rate* that shows overall relationship between prices and exchange rates kept rising from the end-of-1994 benchmark after the adoption of the corridor and remained at a high level. In other words, the corridor raised the ruble's real exchange rate, making exports disadvantageous and imports advantageous. As a result, Russian industries began to lose export competitiveness, except for natural resource industries that have strong international competitiveness. Meanwhile, low-priced, high-quality foreign consumer goods were brought in through peddler's imports and devastated the domestic consumer industry.

Another role that the corridor was expected to play, along with stabilizing prices, was creating an environment under which foreigners can invest in Russia without worry by removing exchange instability. As was described earlier, the Russian government implemented measures to attract foreigners to the Russian securities market. GKO and OFZs, ruble-denominated short-term government bonds, formed the core of such measures. Since the bonds were denominated in the ruble, the currency's exchange movement was an important matter of concern for foreign investors.

But, there was a pitfall. Since Russia already had a considerably liberalized currency and capital transfer system, in order for the monetary authorities to keep the exchange rate within a certain fluctuation band, it was necessary to conduct appropriate, timely market intervention. To that end, the monetary authorities had to have a sufficient amount of foreign currency reserves in hand. If people expected that foreign reserves would be depleted and that the authorities would not be able to maintain the fixed exchange band, there would arise a risk of currency speculation. Exactly this happened in Russia. Under the liberalized system in Russia, it was easy to

conduct currency speculation, including the use of the latest financial technology, such as derivatives.

Both the stabilization of the macro-economy by the corridor and the liberalization of currency and capital are the policies that the Russian government adopted on recommendation by the IMF. The currency crisis in August 1998 showed to the world that there was fundamental inconsistency in the IMF recommendation.

6. Recovery from the crisis and the future

The August 1998 currency crisis had a tremendous impact on the Russian economy. The real consumption of goods and services, which stood at 107.4 in August 1998 as against 100 for 1995, declined in and after September to 95.6 and then to 83.6 and tumbled to 75.5 in February 1999¹⁵. The unemployment rate (ILO standard), which hovered between 11.3% and 11.7% until August 1998 (month-end level), rose above 12% in and after October 1998 and hit 14.1% in February 1999. But this plight did not last long. The real consumption began to pick up gradually in the second half of 1999 and recovered the level of 1995 in December 1999 (but began to decline again in 2000). The unemployment rate shows no signs of rising after February 1999. After moving in a range of 11% to 12.5%, it fell below 10% in August 2000. After all, the real GDP for 1999 grew 3.2% over the preceding year.

One of the factors that prompted this development is the currency crisis itself. As a result of the currency crisis, maintaining the corridor became difficult and this led to the depreciation of the ruble. The lower ruble decreased imports. Russian Federation's merchandise imports, which stood at \$73.7 billion in 1997 (including unregistered trade estimated by the State Statistic Bureau), decreased to \$59.1 billion in 1998 and to \$40.2 billion in 1999. This has transformed the structure of Russian consumer goods market that had been overwhelmed by imports, and led to the prosperity of the domestic consumer goods industry.

Another accidental factor backed the recovery of the Russian economy. It was a rise in oil prices worldwide. The Russian exports of oil and oil products stood at \$3.4 billion in May 2000, after hitting a bottom in February 1999. If the exports stayed at that level in the rest of the months, the total exports of oil and oil products in 2000 would exceed \$30 billion. How big the figure is can be understood from the Table 2.

¹⁵ Statistics data from RET, Oct. 11, 2000

Such robust performance of the consumer goods industry and oil-related industries also boosted domestic investment. The real expenditure on new construction/equipment (seasonally adjusted numbers) began to rise gradually after falling to 82 in August 2000 as against 100 for September 1997. It rose above 100 in September 1999 and stood at 114.7 in August 2000. The buoyant economy is also having a good effect on the fiscal deficit problem that had been viewed as an incurable disease of the Russian economy. The continued increase in tax revenues is reducing fiscal deficits. The fiscal deficits of the Russian Federation accounted for 1.7% of GDP in fiscal 1999, the lowest level in many years, and the country produced a fiscal surplus in fiscal 2000.

The question is whether the strong performance of the Russian economy can be sustainable or not. We should avoid making irresponsible forecasts. So, I would like to conclude this chapter by enumerating several issues (limited to those related to external trade) that must be taken into account in making accurate forecasts.

The first issue that must be taken into account is the external debt problem. According to the estimates made by the Russian government and the monetary authorities, Russia has to keep paying an average \$10 billion in interests on its external debts and the principals for 10 years from 2001 to 2010. It is no easy task, even if the country can maintain the present level of current account surplus. Should the payments were suspended due to a decrease of the current account surplus or due to a shortage of the foreign currency that the government can use freely as a result of the outflow of non-productive capital, the reputation of Russia in the international financial market would decline again and foreign countries' investments in Russia would decrease. Of course, judging from the quantitative criteria of Russia's macro-economy, it can be argued that Russia does not need foreign investments because it has a huge current account surplus. But from the micro-economic viewpoint of promoting the rationalization and modernization of each economic unit, Russia badly needs foreign investment.

Second, we have to keep watching currency developments carefully. As was described above, a weaker ruble had a decisive meaning in the economic recovery in and after 1999. If the exchange rate headed for stronger ruble, the foundation of the economic recovery would be tumbled.

Third, we cannot overlook the movement of oil prices as it sways the value of Russian export trade. A decline in oil prices would reduce Russia's current account balance.

Fourth, we have to pay attention to the fact that a huge current account surplus increases the foreign currency reserves held by the Central Bank of Russia. This is

because Russia, which lost the trust of market by implementing a moratorium on government bond redemption at the time of the financial crisis, cannot take a sterilization policy and because an increase in foreign reserves directly increases the domestic circulation of the ruble, resulting in inflation¹⁶. If inflation exceeds its limit, the Russian economy will return to where it was before 1995.

Of course, these things do not happen simultaneously. For example, if the second problem, i.e., a decrease in current account surplus, arises, the fourth problem does not arise. If the third problem, i.e., a decline in oil prices, arises, it will have a downward effect on the ruble's exchange value and the second problem does not arise. Anyway, the existence of these complicated interrelationships show that the Russian economy has already been deeply incorporated, albeit distortedly, into the world market. When we read the future of the Russian economy, we have to disentangle the complicated interrelationships.

Glossary

Securitization, use of derivatives and establishment of offshore facilities: Securitization refers to the tendency of making foreign investment, not through bank loans, but through issuance and acceptance of securities. Following the debt problems of developing countries in the 1980s, many investors began securities investment, seeking safe, short-term profits. The use of derivatives refers to the tendency of newly developed financial technology, such as futures, forwards, swaps, and options, playing a major role in the international financial market. What is important is that derivative is a technology that can move a huge capital with a small amount of fund. The establishment of offshore facilities refers to the tendency of financial institutions moving their head offices to locations other than where they are actually located, such as an island in the Caribbean Sea, for the purpose of tax evasion or concealment of other information. The three tendencies flew into Russia rapidly in and after 1992.

Liberal designers of Russian market economy: It was foreign advisors who played an important role as the designers of Russian market economy. Among them are Anders Aslund, Jeffery Sacks, Andrey Shleifer, Richard Layard, and Stanley Fischer.

Current transactions: They are transactions provided in Article 8, Section 2 of the Articles of Agreement of the International Monetary Fund. The countries that are

¹⁶ This is pointed out by Stoneman *et al.* 2000, p.4

normally required not to put any restrictions on these transactions are so-called IMF Article 8 countries.

Re-investment: Re-investment here means investing in Russia again the profits from investment in Russia, instead of remitting them to home country.

Balance of payments statement: At present, the 5th edition of the IMF Formula Manual (published in 1993) is the latest international standard for balance of payments statements. The balance of payments statement has to be entered strictly in accordance with double entry system and is not a simple cash book.

Real exchange rate: Real exchange rate is a realized nominal exchange rate between two countries by taking prices in the two countries into account. For example, if one U.S. dollar is 120 yen at point 1 and 115 yen at point 2, it means the nominal exchange rate of the dollar vis-à-vis the yen has depreciated about 4.2%. However, if prices rise 30% in the U.S. and 10% in Japan during the period from point 1 to point 2, it means that the real exchange rate of the dollar has depreciated about 13% $[(1 - 0.042) / (1.1/1.3) = 1.132]$. Incidentally, it is important to note that the real exchange rate is different from the “effective exchange rate,” or “the exchange rate of one currency against another currency weight averaged by the value of trade, etc.”

Discussion themes (for study, announcement and discussion)

1. Study the changes of the import tariff system of your country and compare with those of other countries. If possible, calculate average tariff. Study how negotiations with the WTO have been developing.
2. Study through what process has the inflow of foreign capital into your country been liberalized. Study what restrictions exist concerning the outflow of your country's capital into other countries.
3. Study the actual state of the external debts of your country and estimate its impact on the domestic economy.
4. Prepare a balance of payments statement of your country in the same formula as the Table 2. In doing so, confirm if the original table of your country is in conformity with the 5th edition of the IMF Formula Manual.
5. Discuss what exchange system is appropriate for transition countries.

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