

Russian-European Centre for Economic Policy

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**«EFFICIENT INDUSTRIAL RESTRUCTURING:
PROGRESS AND PROBLEMS »**

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Introduction: micro versus macro-economics

The purpose of this paper is to highlight micro-economic aspects of Russia's reform achievements and reform objectives. The paper may be seen as complementing the recent article by Eric Brunat and Karoly Attila Soos on the Russian Government's Medium-Term Socio-Economic Development Programme 2002-4 (MTP for short).¹ In Russia as in other countries the micro-economic dimension tends to attract less than its proper share of public attention and debate, even when its importance is fully recognised in Government strategy. Headlines tend to focus disproportionately on macro-economic variables such as the GDP and its growth, aggregate unemployment, the price level, the exchange rate and the current balance of payments. Significant as these are, they do not represent the essential mechanism of a market system, nor provide an adequate basis for assessing the progress of reform in a transition economy. Concentration upon them tends to draw attention away from underlying aspects such as the efficiency of resource use and structural policies to promote it.

The post-devaluation episode

The point is especially relevant at the present time. Policymakers and commentators alike are conscious of the successful episode which followed the ruble devaluation of August-September 1998, and are looking for ways to extend it. Mainly thanks to the devaluation itself and its prolongation in real terms (the latter achieved through the containment of domestic inflation by monetary and fiscal restraint), Russia's real GDP expanded at an average annual rate of about 6 percent in the following three years. The process also made good the drop in real earnings of the population which had been caused by the devaluation. Since the third quarter of 2001 output growth has tapered off.

What of the micro-economics of this good growth episode? As regards manufacturing industry, the medium-term gain in Russia's international competitiveness was clearly important, especially on the side of import substitution in such areas as food processing, building materials and furniture. In many such sectors small and medium-sized enterprises play a significant role. At the same time the fixed physical capital requirements for expanding output are modest.

The situation is different in Russia's major export industries. These are to a large extent fuels, minerals and semi-manufactures. In these sectors movements up or down in cost competitiveness of individual countries and regions tend to be swamped by fluctuations in world market prices. The phenomenon reflects the greater short-term volatility of raw-material prices in response to the changing market balance of supply and demand. Russia's recent experience, especially in the oil and gas sector, is a clear case in point.

In addition, technology in the fuel and metals industries tends to be highly capital-intensive. This means that production is typically in the hands of large enterprises. More important, output levels are relatively unresponsive to short-run price fluctuations. Where capacity is fully utilised, its enlargement takes time, so perceived opportunities for expansion can be realised only with a lag. Moreover, even a significant rise in prices is unlikely to stimulate additional investment unless management believes that the higher level of prices will prove reasonably enduring.

If, on the other hand, capacity is not fully utilised, then realisable output prices have to fall a long way, to below short-run marginal cost, before cuts in output appear financially attractive.

¹ Eric Brunat and Karoly Attila Soos, "Some Comments on the Medium-Term Programme for Social and Economic Development of the Russian Federation (2002-4)", RECEP 2002.

The point here is not simply that the favourable performance of Russian exports during 1999-2002, in terms of both volumes and revenue, owed little to devaluation of the ruble. That itself is obvious and has been widely recognised. The further point is that the more favourable trend in Russia's production of crude oil — the long downward movement in volumes levelling off, and signs of recovery in 2000-01 (Table 1) — owes little to price movements of any sort, whether domestically in Russia or on the international oil markets. The turning point reflects rather the completion of a phase of major corporate restructuring in the Russian oil sector. For several years up to 1998-99 top management and controlling proprietors of Russian oil companies focussed primarily on dispossession of minority shareholders and creditors and internecine struggles for the control of valuable oilfields and other assets.² By 1999 the major battles on these fronts had been settled (for the time being at least), and management felt able to turn its attention anew to matters of production and oilfield investment.

Table 1—Russian Federation Production of Crude Oil and Natural Gas, and International Prices, 1990-2001

	1990	91	92	93	94	95	96	97	98	99	2000	01
A. (R.F.) PRODUCTION												
OIL (million tonnes)	516	462	399	355	318	311	303	307	304	305	323	348
NATURAL GAS												
(million t.o.e.)*	539	540	538	519	510	500	505	479	496	496	490	488
B. INTERNATIONAL PRICES												
OIL (Brent, US\$ /barrel)*	23.81	20.05	19.37	17.07	15.98	17.18	20.80	19.30	13.11	18.25	28.98	24.77
NATURAL GAS.												
(European Union cif, US\$/million Btu)*	2.82	3.18	2.76	2.53	2.74	2.37	2.43	2.65	2.26	1.8	3.25	4.19

*toe: tonnes of oil equivalent

Btu: British thermal units

1 tonne of oil = 7.33 barrels

1 million Btu = 0.025 t.o.e.

Source: BP Statistical Review of World Energy, June 2002

It is noteworthy, incidentally, that Russia's natural gas production in the 1990s declined by less than 10 percent, whereas crude oil extraction fell by 40 percent. Various elements help to explain the difference, including weak domestic oil demand throughout the Former Soviet Union plus limitations on export pipeline capacity. But among them one factor was undoubtedly the absence of disruptive corporate governance disputes in the gas sector, where Gazprom retained monopoly control throughout.

In this context one statistical point merits emphasis. A change in real GDP is defined as a change in aggregate physical outputs at constant (base-year or current-year) prices. Provided that Goskomstat has correctly applied the definition in its statistical procedures, it follows that neither

² See Nat Moser and Peter Oppenheimer. "The Oil Industry: Structural Transformation and Corporate Governance" in Brigitte Granville and Peter Oppenheimer Eds., *Russia's Post-Communist Economy* (Oxford, 2001)

crude oil nor natural gas made any direct contribution to Russia's reported 5 percent GDP growth in 1999. Volumes of oil and gas produced in that year were virtually unchanged from 1998. By contrast, in the year 2000, when real GDP growth was 9 percent, crude oil extraction rose 6 percent while natural gas production actually declined by 1 percent; so these parts of the fuel sector together made a positive but less than proportionate contribution to GDP growth in 2000. And in 2001 crude oil extraction was a leading element in total output growth—rising by 7.7 percent against a 5 percent increase in GDP.

A further implication is that, especially in the short run, the change in real GDP is not necessarily a good measure of the change in real national revenues and potential average living standards of the country. Account has to be taken of any significant movement in the terms of trade, i.e. of the relative price level of exports and imports. Russia gained substantially on this front in 1999-2001. Starting from 1998 as the base year, the favourable movement in Russia's terms of trade (essentially higher oil and gas prices) had added almost 10 percent to the country's real national income by 2001. On the other hand, this windfall gain brought no immediate benefit to Russia's population at large. Most of it served to boost capital outflows, legitimate and illegitimate, by the exporters themselves, and to that extent initially added nothing to either consumers' expenditure or domestic capital formation. The potential for adding to them in the future of course remains.

Restructuring hitherto

A contrast between the dynamics of physical output on the one hand and real incomes and living standards on the other was important in Russia long before the 1998 devaluation and debt crisis. Indeed it was at the heart of the restructuring that Russia achieved in the preceding seven years. Its magnitude was particularly striking and has been insufficiently understood. At mid-1998 physical output was perhaps 40 percent lower than in 1990-1991 (or perhaps not quite as much as that, if one thinks the "grey" economy was underestimated). At the same time average living standards had barely declined.

To be sure, the term "average" in these circumstances conceals big variation in several dimensions. Inequality increased—though how substantially is hard to say, because there was little transparency about the privileges accorded previously to Communist Party members. The regional dimension of inequality became more prominent: the Moscow area gained hugely, and some other urban centres more modestly. Remote regions dependent on government outlays, especially military expenditures, lost out.

The time dimension of variation was also important, and particularly blurs the statistical presentation of multi-year trends (Table 2). Year-to-year fluctuations in household purchasing power were far bigger than in earlier decades. This mainly reflected the erratic nature of the inflation process, with prices of goods and services alternately leaping ahead of household earnings and then being restrained while earnings caught up. The phenomenon was especially important at the beginning of the 1990s, when an unsustainable spending spree on consumer durables in 1990-91 was terminated by price decontrol and the resulting "crunch" of 1992.

In addition, money earnings themselves became unreliable, with unpredictable, sometimes lengthy arrears in payment and periodic recourse to barter. Employees felt under pressure to seek additional sources of income to maintain their households. Although the Soviet public had always been accustomed to fluctuating availabilities, the scale of changes and degree of uncertainty experienced in the 1990s were particularly unsettling. This itself detracted from perceived economic well-being, and may be held indirectly responsible for part of the worsening mortality figures from alcohol-related and stress-related conditions among males reported in the earlier 1990s.

Table 2 – Russian Households’ Real Consumption, 1991-2001
(in billion year-2000 rubles)

1991	4820	
92	2834	
93	3159	
94	3485*	3351*
95		3257
96		3104
97		3272
98		3193
99		3053
2000		3337
01		3627

*Discontinuity in series.

Source: *Russian Economic Trends* (various issues)

The fact remains, however, that there was no wholesale collapse of Russian living standards, despite the massive fall in output. How was this possible? Part of the explanation – perhaps between 5 and 10 percent of GDP – lies in the ending of Russian subsidies to other countries of the FSU, whether through direct budgetary transfers or through the sale of fuel and raw materials to them at less than world prices. To that extent these other FSU states have had to bear an additional economic burden in the initial phase of transition.³

The remainder, however, represents economic restructuring, effected through two main channels. One was the reduction in military spending, and the consequent diminished military utilisation of fuel, metals and equipment. The other was the burgeoning of Russia’s external trade, coupled with a shift in the geographical composition of trade towards western industrial countries. This restructuring has meant an enormous gain in the productivity of Russian output in terms of economic welfare (or household living standards).

In the first place, output of purely military goods and services contributed nothing to living standards before – rockets, combat aircraft and tanks do not constitute consumer comforts even for military personnel; so there was no welfare loss from their disappearance. Secondly, international trade has been the crucial means of transformation whereby Russia’s output of primary and semi-manufactured products has been converted into goods that households wish to buy.

The share of imports in Russian consumer expenditure has averaged around 50 percent for most of the past decade. While there was doubtless some “excessive” or “unnecessary” preference for foreign over home goods (especially before 1998), the general magnitude of trade was soundly based. Russian citizens were able to purchase a greater variety of high-quality goods and services than before – including motor vehicles (second-hand as well as new) and holidays abroad. Moreover, external economic relations boosted not only consumption but also the security of cash savings. For the individual citizen freedom to hold foreign currency offered safeguards analogous to the accumulation of liquid assets outside the country by business enterprises.

³ See, among others, International Monetary Fund, *Economic Review: Financial Relations Among Countries of the Former Soviet Union* (Washington DC, 1994)

Limitations on restructuring

What has been achieved so far in terms of restructuring is nonetheless quite limited. To recapitulate: a radical widening of external trade and financial relations enabled consumer well-being to be maintained despite a major contraction of output. But the fall in output still implies that the economy is operating a long way below its physical capacity, and therefore a long way below the level of well-being which it is physically capable of delivering.

In a micro-economic perspective this is visible to the most casual observer of the Russian industrial scene. In many parts of the country large processing and manufacturing plants are working at a fraction of their peak capacity. Yet this seems to be broadly tolerated. There is no move towards downsizing on the one hand and little new investment in more up-to-date production facilities on the other.

Much of the inertia stems from the inadequacies of the markets for labour and for capital. As regards the former, outside the major cities (Moscow in particular) discontented workers seldom have anywhere to go, however poor their pay and conditions. The situation is particularly acute in single-company towns. Even in bigger towns alternative job offers may look insecure, and employees prefer to seek intermittent additional work while remaining on the payroll of their established employer. Unemployment benefit is inadequate or non-existent; bureaucratic disincentives to long-distance labour mobility considerable; and the housing market patchy and nerve-racking. The vast majority of citizens paid little or nothing for their existing homes; and there is no system of mortgage lending to facilitate exchange or acquisition. Ironically, the sum total of these weaknesses shows itself in absurdly low registered unemployment – never more than 3 percent of the labour force, at times less than 2 percent.

As for capital formation, reference was made above to the upturn in oil production now that the major predatory phase of privatisation in that sector has been completed. But this is a narrowly confined phenomenon, despite oil's importance to the overall economy. For the most part there has as yet been little inclination to undertake investment in larger enterprises. Managers and/or controlling shareholders, having developed sufficient market outlets to facilitate profit skimming, asset transfers and other forms of misappropriation, are inclined to shrug their shoulders at the remaining unutilised capacities inherited from the Soviet era. The risk/reward ratio for major investment ventures looks unappealing. Tycoons prefer to husband cash accumulations abroad. Seeking funds from external sources, whether through share issues or borrowings, risks dilution of control over the company – which control was precisely the main objective of corporate strategy in the privatisation process. Declared attempts by major Russian enterprises to solicit investment from foreign rivals are generally a charade. What the Russian side wants is to inveigle foreigners into supplying capital without the prospect of an adequate profit return or a proportionate voice in management. Of course, in a few areas where the partnership is genuine and foreigners are able to insist on their entitlement (such as the Moscow hotel sector), considerable investment has taken place.

Government policy dilemmas

The Russian authorities refuse, quite rightly, to revert to Soviet-style enforcement of industrial investment through direction and subsidisation. It was precisely this approach which bequeathed the existing legacy of idle capacity. As is made abundantly clear in the MTP, the general objective in the micro-economic sphere is not to seek substitutes for inadequately functioning markets, but to get markets to work better.

It cannot be stated too often that this is a long-term process involving repeated iterations between government policy moves and the voluntary behaviour of individual economic agents, both

in response to government measures and spontaneously of their own accord. The government must try to select the modes and targets of its own intervention to achieve the most fruitful outcome.

Two very different domains may be cited to illustrate possible interrelationships. Consider first the housing market and its relevance to geographical mobility of the labour force. The general problem is that of monetising the housing sector. In the Soviet era housing was provided by the state at zero or near-zero charge to householders. Price formation for dwellings is now well advanced in Moscow and other urban centres, but still embryonic in remoter areas, including many single-company towns. As already noted, there is no working system of mortgage finance, nor even of short-term bridging loans for people wishing to re-locate.

Several strategic issues of policy are involved. First, housing, especially at the low-cost end, is a sector where governments play a defined role as both builders and landlords in many market economies (though not in all). How significant should this role be in Russia in the next few decades? Put differently, how many dwellings does the government think should be built in the next 20 or 30 years, and by whom? And how should proper maintenance of the urban housing stock in particular be assured? The MTPs treatment of these questions (in section 3.2.10) is mainly limited to statements of principle. Some are quite detailed (for instance, municipal house building and maintenance contracts to be subject to tender; condominiums to be promoted). But there is no quantification.

Secondly, what net movements of population are envisaged between and within regions of Russia over this period, and how should housing policy take account of them? A whole chapter of the MTP (chapter 4) is devoted to regional issues, but the general tone is one of problem recognition rather than identification of particular solution strategies. The topic is politically very sensitive. To prevent depopulation of some less favoured regions, it may be necessary to bring about a greater concentration of population within such a region. Should there then be concerted efforts to attract new lines of economic activity to single-company towns? At the same time, should some towns be earmarked for shrinkage, and assistance provided for households volunteering to re-locate?

Thirdly, in the pursuit of banking reform housing finance should clearly be a priority. The state Savings Bank (Sberbank) – rather than private institutions – is the obvious starting point. The section in the MTP on banking (in chapter 3.1.8) mentions neither of these items. Should Sberbank retain its present monolithic character, or should it establish divisions specialised by function (e.g. mortgage lending)? If it is desired to involve private institutions, consideration could be given to establishing partnership banks or jointly owned subsidiaries with Sberbank.

The foregoing checklist is obviously not exhaustive. But it serves to illustrate the sort of micro-economic interdependencies that need to be taken into account as the reform process deepens.

My other example is that of the public utilities or “natural monopolies”, especially gas, electricity, rail transport and pipelines. The main inheritance in this domain from the Soviet system was again one of a barely monetized economy, in other words near-zero pricing, especially to persons. There was and remains cross-subsidisation of households with charges to industry, and (now more important) of internal Russian prices from export charges. Significant steps towards economic pricing have been taken over the past decade; but the task is by no means complete, especially in the energy sector. The pace of change here should to some extent be linked with fiscal and social security reforms, so that the low-paid are able to sustain fuel and power charges.

There is also room for debate about the proper “ultimate” or target level of public utility charges, given the desirability of production cost minimization and the difficulty of assessing what is a reasonable level of costs. The Presidential Economic Adviser, Andrei Illarionov, has argued

forcibly (he always argues forcibly) that “natural monopoly” tariff levels as of early 2002 are already generous to producers and should be held down.⁴ One of his reasons is precisely that higher tariffs will mean greater feather-bedding of inefficient industries, whose absorption of both labour and capital inputs is at present grossly excessive relative to their output levels.

Although Illarionov’s statistical evidence is not fully conclusive, this particular argument of his has to be taken seriously. Indeed, the government itself plainly accepts the point: the MTP includes as an important long-term objective structural reform of both the electricity and gas industries and the railways, one purpose of which is to separate out those parts which are intrinsically monopolistic in character (i.e. the network or grid) from those where competition can be introduced so as to lower costs (e.g. power generation; gas exploration and production).

In other respects, however, Illarionov’s position is misguided. For one thing, he dismisses the energy-saving argument, despite the over-whelming international evidence (which he naturally does not cite) of its importance. Admittedly, the absence of individual metering and individual consumption-control in many urban Russian dwellings somewhat weakens the argument for the time being. Admittedly also, one must in the last resort await the outcome of the planned structural reforms to discover what is the correct long-run price level of these goods and services within Russia.

Illarionov’s greater error is his evident belief that concern about feather-bedding is necessary only where public utilities are state-owned and state-managed. Once markets rather than bureaucrats or politicians determine prices, he argues, economic outcomes will be optimised. What is needed, therefore, is structural reform sufficiently radical to permit total deregulation of prices. But deregulation of this order is a pipedream. In the real world the greatest featherbed of all is an unregulated private monopoly. In the public utilities not only must the terms of access to the central network or grid be subject to regulation. Even in the non-monopoly part of the sector competition is unavoidably imperfect. We are not speaking of shirtmakers or urban restaurants. Effective competition in power supply or rail transport simply cannot be guaranteed by any once-for-all act of structural reform. It requires – as Anglo-American experience demonstrates – continuous and alert regulation to prevent collusive pricing, artificial barriers to entry and related monopolistic abuses (such as strategic cross-subsidisation). Although differently named, such regulation is part and parcel of national anti-monopoly or competition policy. In fact it is the most visible and continuous part. However limited the proportion of public utility enterprises retained in the public sector, the government carries a considerable measure of responsibility for the utilities’ economic performance. Partly for this reason, some countries reject the Anglo-Saxon model and prefer to keep the industry as a whole in state hands. France is a leading, and highly effective example.

The Russian authorities should thus beware of expecting too much from “structural reform” of the public utilities. Whatever the ownership regime, the regulatory principle enunciated by Andrei Illarionov will remain valid indefinitely, and not just until some imagined conclusive act of restructuring: “Government approval of public utility tariffs must be founded upon a detailed analysis of their total input budgets, covering current outlays (including numbers employed and wage levels) as well as capital expenses, and not merely upon the financial requirements of their desired investment programmes.”⁵ That is indisputable. The latter alternative would indeed be reminiscent of the military-industrial complex of Soviet times. It is thus reassuring to see explicit recognition of the question in the MTP, which envisages (in sections 3.2.7-9) the development of sophisticated regulatory mechanisms in parallel with structural reform of the industries in question.

⁴ A.N. Illarionov, Should the “natural monopolies’ “ tariffs be raised? (in Russian), Polit.,ru, 23 January 2002.

⁵ From Illarionov, op.it., “Conclusions”, point 9.

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