Comparative Analysis of Russian and Japanese Economic Policy

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I. Summary

For the past six years, since the 1998 economic crisis, stable growth at 4-7% has continued in Russia. The Putin Administration declared in its second term that to maintain this growth trend GDP would have to double by 2010 and attempts to realize a “ Great Russia” would have to be made. This goal cannot be achieved solely by depending on a market economy. Hence, it is necessary for Russia to appropriate an economic policy accommodating its unique circumstances and characteristics.

This report covers the following 4 areas:

1. One factor supporting the recent expansion of the Russian economy is the sudden rise in the international petroleum price. This has without a doubt worked as an advantage for the Russian economy, but on the other hand for the economy to depend solely on high prices will result in very unstable economic growth. While the condition of high oil pricing continues, it is necessary for new economic policies aimed at increasing international competitiveness to be established and the processing industry given the role of leading Russia’s economic growth. .

2. Economic policy under a market economy is fundamentally different from economic policy under former Soviet command. Post-1992 Russian economic policy was based on Radical Laissez-faire Capitalism. Nonetheless, recently it is thought that economic policy is moving in the direction of a Mixed Economy or State Capitalism. It is necessary to investigate in detail how various elements will influence economic policy and hence how they should be reflected in those policies.

3. One example of economic policy can be discovered by tracing post-war Japan’s changing economic policies. Additionally, Japan’s newest policies in the wake of the recovery of the lost decade (the 90s) need to be outlined.

4. An examination of the case of Sberbank (absorbing household deposits) and “Michinoku Bank” (providing housing loans) is included.

II. The Merits and Demerits of High Priced Oil

With the outbreak of the financial crisis in 1998, Russia's economy was on the brink of collapse. World–wide high oil prices reaching more than $42 a barrel were responsible for saving the Russian economy. Due to high oil prices, the Russian Government was able to make its international debt payments, demonstrate impressive economic growth, and set ambitious goals to double its GDP. Doubling its GDP by 2010 means that economic growth rates will have to remain at about 7 percent a year (Note1). For this purpose, there must be a development in new growth-driving sectors outside the natural resource sectors, especially in the manufacturing and service industries.

How does an increase in oil exports influence the manufacturing industry? An increase in oil exports contributes to the expansion of the Russian economy and in doing so, positively effects the manufacturing industry. On the other hand, it is also necessary to take into consideration the following downsides: The accumulation of income from oil exports makes imports cheap and exports expensive by raising the exchange rate of the ruble. This means that the competitiveness of the import substitution manufacturing industry will encounter many difficulties. To avoid such problems, the Central Bank must induce a cheap ruble and increase the money supply. In 2003, the ruble supply went up 58% in comparison with the previous year. Of course, this policy causes inflation and worsens living conditions. Some specialists agree that inflation should stay below 3% a year.

According to a trial calculation conducted by the IMF, the whole Asian real growth rate decreased by 0.8% when the level of crude oil prices rose by 10 dollars a barrel for a long duration of time. Of course, this results in a negative influence on the growth of world economies. Therefore, it is certain to also have a negative effect on Russian exports including industrial goods.

As I mentioned above, the extreme oil prices, even if desirable for the acceleration of investment, are unfavorable for policy makers. From some specialist's viewpoint, the international price of oil for Russia must stay between $24 and $26 a barrel. Excluding oil prices, the impressive economic rebound since 1998 is due to the following factors: Domestic adjustments triggered by the 1998 crises, mostly relative price adjustments such as a massive real exchange rate devaluation and real wage decline. These price adjustments accelerated export and import substitution. Therefore, enterprise profits and investment increased. Also, the underutilized productive capacity of capital and labor played a very important role during the first stage after the crisis, however the effect disappeared by the middle of 2002.

III. Why is Economic Policy Necessary?

Adam Smith said that the market mechanism works efficiently for the distribution of goods and services even in a self-driven society due to the function of the "invisible hand." According to Smith, a state should limit its intervention in such areas as: general administrative services, activities of the army, police, and fire departments etc., which are considered public goods. In the case of these services, the market mechanism does not function and so-called "market failure" occurs. As a result, an economic policy is implemented to compensate for this "failure." .

Market Failure (Causes – Response)

Causes	Government Response
① Externalities	Regulation by "A Pigouvian Tax"(Note2).
②Law of Increasing Returns	To Set Public Utilities Charges
③ Public Goods	Public Investment considered "crowding out" of Private sector
④ Asymmetric information	To ensure "Transparency, Accuracy and Plenty" of Information

Except for the above-mentioned government response for " Market Failure", each country has its own economic policy, the differences of which come from the following elements: differences in the industrial developmental process of that country, in correspondence to globalization, in response to environmental policy, and in national subject, etc. A particularly unique Russian economic policy consists of the following elements: A centrally planned economy covering the state for 74 years and its consequent transition to a market economy in 1992, beginning from step one. In other words, there were no traces of a market system (transitional economy). Other contributing factors include: A surge in the world-wide tide of globalization; Increasing seriousness regarding world-wide environmental problems; a declining birthrate and ageing population; and depopulation and overpopulation are becoming causes of great concern. In the face of such challenges, the Putin Administration is striving to become a "great state".

The Putin administration, in its second term of office, is making great efforts to change Russia's economic policy. In other words, a change from an "Economy Controlled by Oligarchs + Radical laissez-faire Capitalism" to a "Siloviki + Mixed Economy or Social Democracy or State Capitalism" is under way. This policy switch became obvious on October 3, 2003, after the arrest and imprisonment of Mikhail Khodorkovsky (owner and president of the oil giant company Yukos). Oil and natural gas are Russia's most important industries. When CEO M. Khodorkovsky of Yukos Oil company was arrested on suspicion of tax evasion, sources speculated that the Putin administration had begun to take action to politically bury Mr. Khodorkovsky on account of an incident where he fought against the administration in October, 2003.(Note 3)

However, the truth of the matter was not a political dispute, but rather an economic one. A petroleum analyst suggested that through this incident, the Putin administration actually intends to transfer the property of Yukos to national oil company Rosneft, hence initiating a reorganization policy for the oil industry. (re-nationalization) (Nikkei, 04・08・29)(Note 4)

Specialists say that President Putin would like to have a larger role in the control of big business through the appointment of his own administration personal to big company executive positions.(Note 5)

IV. The Case of Japan's Industrial Policy

In the case of Japan, economic policy was changed in order to adapt to various economic situations during the process of development following WWII. First, let us consider The Ministry of International Trade and Industry (MITI, now known as: The Ministry of Economy, Trade and Industry) and its industrial policies. In the period immediately following the war, the government implemented the "Priority Production System" policy. The objective of this policy was to secure a strong base for economic self-sufficiency. In order to meet this objective, MITI concentrated Japanese investment in three basic industries: coal, steel, and electricity. In 1960, the government declared its intention to carry out the "Income Doubling Plan," similar to what the recent Putin administration has been doing. This was considered the beginning of Japan's period of high economic growth.

During this period, the heavy chemical industry became the base for Japan's industrial structure. Japan, imported foreign technology and invested heavily in plants and equipment. Thus, steel, petrochemical, machinery, and other industries achieved remarkable growth. In addition to receiving preferential tax treatment, the government gave the heavy chemical industry priority to borrow capital from the Japan Development Bank. At this time, Japan became a member of the OECD, an organization of advanced nations. After this, trade liberalization of each of the following industries was implemented: color televisions - 1964, passenger cars – 1965. And almost 100% of trade in industrial goods was liberalized by 1972.

In 1971, a former MITI advisory organ "The Industrial Structure Council" announced its "Vision for the 1970s." In the 1970's, as a reflection of the oil crisis and negative effects of high economic growth such as pollution becoming more serious, MITI executed an industrial policy changing from heavy industry to high-tech industry or knowledge-intensive industry. Government policy focused on aid for financing and tax breaks for pioneering technology such as semiconductors and computers. The government also promoted technological development for new forms of energy and energy conservation. In the semiconductor industry, it is often said that public and private cooperation led by MITI was very effective. Japanese government had a close cooperative relationship with industry; it had research laboratories jointly founded by both the public and private sectors. Its achievement was later passed on to private corporations.

Some specialists say that Japan's development was a kind of socialism, more so than that of the Soviet Union. However, the 1980s were a little different. "The Temporary Measures Law for the Structural Adjustment of Specific Industries" was adopted in 1983. Its goal was to assist these industries in disposing of unused facilities and to support technological development for venturing into new fields. For example, although the petrochemical industry had an annual production capacity of 6.2 million tons of ethylene, with the help of this law, through the closing and integrating of plants, the yearly production capacity had fallen to 4.7 million tons from 1983 to 1985. This was not a policy to promote industry, but to streamline it. At present, the industry is putting effort into the deregulation and opening up of the market. A typical example is the electric power industry, which is currently protected as a public business. In the case that deregulation should occur, the electric power industry would become competitive. This move would reflect an effort to reduce the price gap between Japan and other countries through deregulation.

Nowadays, Japan has made a breakthrough from its long-lasting economic downturn and is entering a stage of new growth. This intensive adjustment period was launched under a severe economic environment of negative growth and large amounts of non-performing loans. Nonetheless, in the process of promoting structural reform, the fundamentals for economic recovery have steadily expanded through private demand-led growth without becoming dependent on fiscal stimulus. Prime Minister Koizumi always claims "no growth without structural reform." Some structural reform initiatives include: Disposal of non-performing loans, regulatory reform (deregulation), reorganization and revitalization of corporations, promotion of private demand-led growth, tax reform, deregulation of the nation's postal system, etc. As for the disposal of non-performing loans, the amount carried by major banks has decreased by over 13 trillion yen (about 118 billion US$) in the past two years. The recent principles of reform are moving from the "Public Sector to Private Sector" and from the "State to the Regions".

Here, I would like to demonstrate the total conception of "The Strategy for the Creation of New Industries." The new top seven industrial fields supported by nanotechnology, biotechnology, IT and environmental technology include:

-Group A-

(1) Fuel battery

(2) Information household electric appliances

(3) Robots

(4) Contents: film, animation and game software.

-Group B- New industrial fields to comply with emerging market needs
(1) Health and welfare

(2) Environment and energy friendly machinery and services

(3) Business support services.

V. The Establishment of Russia's Banking System and Bank Policy
(Mainly based on Imai's paper**)**

One important issue to consider is how the establishment of a banking system under Russia's industrial policy will function in a market economy. Although banks existed during the time of the former Soviet Union, they were completely different from the types of banks that are found in market economies. The settlement of accounts among businesses involved in the delivery and receipt of goods produced under the Soviet Union's centrally planned economy were carried out by account transfers between enterprises with bank accounts at the Central Bank. In other words, Real Money did not exchange hands between the enterprises. Real Money existed only in the realm of individual life. Employees received wages in currency from enterprises and used that currency to purchase consumption goods. However, along with money wages, a large portion of employee earnings were paid in kind. In other words, they enjoyed free education, free medical care, free housing, and low transportation charges. An incentive to earn more wages did not exist and labor productivity did not improve. Individuals used banks mainly for the purpose of receiving pensions and to pay small public utility charges. Under such conditions, one of the most fundamental bank functions in a market economy did not work. That is to say, banks did not absorb household saving and funnel that money into industrial funds. One of the biggest challenges necessary for the realization of a market economy is the introduction of the financial mediation function of the bank. Considering this point, let us examine Russia's financial policy below.

V-1. Peculiarities of Russian Banks

The core of Russia's financial policy is not government but rather the Central Bank. Private banks exist under the Central Bank, and these work to expand financial intermediary business. At present, Russia's private banks have the following peculiarities (backwardness) when compared to banks in advanced nations:

＊A very small scale-

Although the total amount of property held by all of Russia's banks is about 35% of the GDP, Japan exceeds 100%.

＊Concentrated in Moscow-

As of January 1, 2004, there were 1,329 banks in Russia of which more than half were located in Moscow.

＊ High oligopoly-

The top 87 banks hold 80% of all bank properties. The top 5 banks share 46% of all bank properties and 35% of corporation deposits.

V-2. High Sberbank Holdings of Individual Deposits

In the beginning of 2003, the total amount of individual deposits reached 68.2% at Sberbank. Hence, Sberbank is maintaining its monopolistic position. The reason it is able to maintain a high market share is because all deposits are protected by the Central Bank (there is no risk). This privilege will be abolished from 2007. Currently, the deposit market share of Sberbank is decreasing by 7% each year, and its shares are expected to fall by 40% after 4 years according to the CB.

In an attempt to increase bank savings, the "Bank Savings Insurance Law" was implemented on December 27, 2003. The highest limit for protection covers a deposit of as much as 10 million rubles (20 months of the average Russian wage is 5000 rubles). This entire amount will be protected in Sberbank until the end 2006 when the privilege will be abolished. Afterwards, fair competition for individual deposit acquisition between Sberbank and the other 1300 private banks 1300 can be expected.

The selection process among medium and small sized banks irequires customer trust as an important prerequisite for banks to acquire individual deposits. When selecting a bank it becomes necessary to examine the reliability of the more than 1300 small banks available to choose from. Examinations will be conducted by the CB at the time a bank joins the deposit insurance system. The screening criterion covers the following:

1. The stability of financial affairs during the past twelve months
2. Risk management know-how
3. Internal management ability
4. Transparency
5. Shareholder configuration

The above are a series of financial policies for the maintenance of deposit acquisition. Bank household deposits are a trend that is on the rise due to such financial policies. Individual bank deposits increased twice in only one year during 2003. As for this reason, some elements include: a series of financial policies to make deposit risks decrease, increase in individual income due to an expanding economy and also an increase in the exchange rate between ruble and the dollar. As a result, individual bank deposits increased two times in 2003.

V–3 Advancement of Japanese Bank Capital: The Case of "The Michinoku Bank"

"The Michinoku Bank" is the only Japanese bank to expand its business by establishing an overseas affiliated company, “The Bank Michinoku,” in Russia. The Japanese International Cooperation Bank and Tokyo Mitsubishi Bank have established representative offices in Moscow but no resident banks.

MB established its first overseas affiliated company in Moscow in July 1999, and continued to open consecutive branches in Iuzhno-Sakhalinsk (August 2002) and Khabarovsk (July 2003). MB is currently planning to open a representative office in Vladivostok in 2004. Since June 2003, the MB Head Office in Moscow and branches in the Far East have started to offer personal loan services, especially home loans.

MB ranks 185th out of Russia’s 1,279 banks for total liabilities and net worth (or aggregate capital). Russia has 126 joint venture banks, of which 29, including MB, are 100% foreign capital ventures and 10 are more than 50% foreign capital ventures. MB ranks No. 29 for equity capital among all joint venture banks, No. 22 for personal loans, No.24 for corporate customer deposit balances, and No.17 for individual deposit balances. As you can see, MB is not so big.

MB is steadily enlarging the number of its client accounts including both corporation and household. For example, it had 800 accounts by the end of 2001 and 2,000 accounts by the end of 2002. Still, by the end of 2003, the number of accounts had reached an impressive 5,672 (2.8 times more than 2002). Its deposit balance is also dramatically increasing: 3.3 times as much in 2002 and 4 times as much in 2003 (1.2 billion rubles, about 43 million dollars). Its loan business is smoothly growing as well (11 million rubles in the end 2001, 300 million rubles in the end of 2002 (2.7 times), 1 billion rubles in the end of 2003 (3.3 times).

From early on "**Michinoku Bank**" shifted its emphasis on business to household dealings. In 1986, MB announced plans to become "a family bank " (a retail bank) and clearly defined the bank's special characteristics. The ratio of loans for smaller enterprises was high. Relations with Russia go back to 1972. From the late 80s when perestroika began thru current cultural exchanges with the Russian Far East, MB has gained Russia's trust. MB also made the following contributions: opening air service between Aomori-city and Khabarovsk, inviting children from Russia Far East to Aomori, Japan, presenting 620 well-maintained secondhand pianos to schools, and contributing secondhand medical instruments to hospitals, etc.

However, MB did not only target family business but also enterprise business. Examples follow: MB participated in JBIC (the Japanese International Cooperation Bank) Blue Stream Project (the black sea submarine pipeline construction business), which was signed into effect in 2000. The project promoters Russian Gazprom and Italian **SNAM** established the joint venture "Bluestream Pipeline Company" (**BSPC**). For this project, a buyer's credit frame was established at a limit of 331,500,000 dollars. JBIC covered 60% of this loan and 10 other private banks provided the rest. This credit was used as an import purchase fund for a submarine pipeline from Japan. MB financed a loan of 20 million dollars in this project. (Imai p. 43)

In addition to this, MB also participated in making bank loans available to **Vneshtorgbank**. Taking the opportunity during the 2001 Economic Mission to Russia, arrangements were made for the establishment of a credit line for **Vneshtorgbank** in the total amount of 8 billion yen (about 88 million dollars). This credit line was set up to support and expand the exports of Japanese machinery and equipment from Japan to Russia. It was decided that **JBIC** would provide 4.8 billion yen and **Tokyo-Mitubishi** (the secretary bank) 1.2 billion yen, MB and "Hokuyo Bank" each provided 1 billion yen. The unique characteristic of this credit arrangement was that it was the first case to establish a credit line based solely on trust with **Vneshtorgbank**. No insurance guarantees were required of the Russian government.

V-4 Obstacles to Business Expansion

MB faced some difficulties at the start of its loan business for individual residences. Specifically, (1) There was no insurance guarantee organization for home loans. (2) During loan examinations, accurate income is difficult to assess, because of the large amount of unofficial income. (3) Another large obstacle was that security claims were not guaranteed. A law on the compulsory execution of loan security was enacted by the end 2002. Still, a civil law giving residency rights priority existed, and in the case of a dispute it was unclear which side would be given priority. Especially in the case that occupants were elderly or children, request for eviction could not be made, nor would loan security be valid, without preparation for alternative living arrangements first.

Despite these obstacles, MB was able to initiate its home loan business due to the following aids: Accompanying post-1999 economic growth, a rush for home loans and housing construction concentrated in Moscow prevailed. At the same time, there was also increased demand for personal loans as individual demand for automobiles and electronic goods increased. In such an environment, the home loan market grew under the plan to have the largest SB cover borrowers. As a condition, more than 3 guarantors were required, as well as alternative housing insurance. In performing this leadership role, SB played a large part in housing loan expansion. A request was made by Japanese overseas affiliated companies (manufacturing, commerce, restaurant and etc.) for MB to shoulder the responsibility of providing home loans to its employees. In this case, because respective companies assured repayment, there was small risk and loan conditions became more lenient. Due to these reasons, both MB and its clients were at an advantage. MB considered that by following in the footsteps of SB and requiring three guarantors and insurance, along with the borrower's signature on a contract indicating that "inability to pay back loans will result in sale of property," would work to minimize the risk of bad debt. In June 2003, loan businesses specializing in the provision of individual home loans and automobile loans commenced at Moscow's head office and 2 branch offices in the Far East. At present, the scale remains small, but there are signs that business will develop steadily.

NOTE

Note 1: "According to Alfa Bank's calculations, every $1 a barrel the world oil price stays above the projected government budget figure for a full year, an additional $1.5 billion will be added to budget revenues and a 0.25 percent increase to GDP growth. Recently the federal government raised its 2004 budget forecast for average Ural oil from $22 to $27.50 a barrel." ("Russian Profile" 2 July 2004, p20)

Note 2: **Pigouvian Tax**

A tax levied upon each unit of pollution in an amount just equal to the marginal damage it inflicts upon society at the efficient level of output. A natural solution, suggested by the British economist A.C. Pigou, is to levy a tax on the polluter that makes up for the low input prices.

Note 3 Mr. **Khodorkovsky** provided a political contribution to a party opposing the Putin Administration and made public his intention to a stand as a candidate for the Federal Presidency in the upcoming 2008 Presidential election.

Note 4: The following Oligarchs, including Mr. Khodorkovsky were targeted by the Putin administration:

(1) Boris Berezovsky (a former Security Council Secretary and businessman with political influence in the Logobus group) → in November, 2000 , he escaped to England.

(2) Vladimir Gusinsky (Chairman of the Most Group and former owner of the biggest private media sector NTV) → in June, 2000, he escaped to Spain.

(3) Former Yukos President Khodorkovsky has been in confinement since October 2003. Who are the next targets? →Potential targets include:

＊Vladimir O. Potanin, Inter-Loss Chairman

＊Mikhail Friedman, Alpha Group Chairman

＊Roman Abramovich, Governor of Chukotka Autonomy and manager of holding company Milhouse (Nikkei 04・08・29).

Note 5: The appointment of Putin Administration personal to big company executive positions:

(The following names have been Romanized from the Japanese.)
(1) The Presidential Executive Office Assistant: SHUKROV → Aeroflot & Transneft Director (after 2004 / 06).
(2) The Presidential Executive Office Chief: MEDVEZHEV→ Gazprom Chairman & NTV Large Share Holder (after 2002 / 06).
(3) The Presidential Executive Office Vice-Chief: SECHIN→National Oil Company Rosneft Chairman (after 2004 / 07).
(4) Former FSB Vice-Chief: ZAOSTOROVTSEV →Foreign Trade Bank Vice President (after 2004 / 03).
(5) First-Deputy Prime Minister; JYUKOV→ Russian Railroad Chairman (after 2004 / 07).(Asahi Newspaper, 2004 / 08 / 04)

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