

Fiscal Crisis, Monetary Stabilization and Investment in Russia

Starting from 1992, a low level of production investment has been one of the major problems for Russian economy. Investment crisis occurred in spite of the relatively high level of domestic saving exceeding 20% of GDP. During all the years of market transformation, the excess of domestic savings over domestic investment caused the capital flight from Russia. Without changing this tendency, neither the beginning of economic growth nor an active integration of Russia in the global economy is hardly possible. This article concerns the analysis of macroeconomic conditions favoring the rise of investment activity at the post-reform period.

The economic liberalization in 1992 allowed Russia to solve various urgent problems: to liquidate monetary overhang and shortage of goods, create money-based market mechanisms of exchange, improve public finance, solve the problem of over accumulated sovereign debt and raise official foreign reserves, open the economy for international trade. Among important institutional changes are: establishment of the two-level banking system, privatization of a considerable part of state enterprises and the capital market creation.

However, all these steps were necessary for the first stage of reforms, but not sufficient to considerably improve the investment environment and opportunities. In particular, the political situation in Russia in 1992–1995 was the main obstacle for macroeconomic stabilization and reform of public finance.

APPENDIX

Table 1. Macroeconomic performance of Russia in 1995-1996

	Monetary base, (bln roubles)	M2, (bln roubles)	Net domestic assets (bln roubles)	Net foreign reserves (bln roubles)	Official exchange rate of dollar, end of month (roubles./\$)	Average return on government securities (% per annum)	Interbank overnight rate (% per annum)	Monthly inflation (consumer price index)
Jan 1995	44000	93800	40500	3500	4048	256,0%	222,4%	17,8%
Feb 1995	47600	101900	42000	5600	4473	220,6%	124,4%	11,0%
Mar 1995	49900	107300	40800	9100	4897	187,2%	125,2%	8,9%
Apr 1995	57300	123200	46000	11300	5130	145,6%	95,2%	8,5%
May 1995	64000	138200	44200	19800	4995	111,5%	63,7%	7,9%
June 1995	73700	156600	47500	26200	4538	84,2%	67,8%	6,7%
July 1995	81600	165000	55100	26500	4415	124,9%	110,8%	5,4%
Aug 1995	86100	173800	59500	26600	4447	156,7%	103,0%	4,6%
Sen 1995	89300	179700	63800	25500	4508	103,8%	64,5%	4,5%
Oct 1995	90700	184200	62500	28200	4504	93,4%	31,2%	4,7%
Nov 1995	95400	195200	70700	24700	4580	86,9%	30,0%	4,5%
Dec 1995	103800	220800	76500	27300	4640	93,9%	48,8%	3,2%
Jan 1996	100800	216700	75500	25300	4734	84,2%	30,0%	4,1%
Feb 1996	106700	229200	82700	24000	4818	56,9%	26,1%	2,8%
Mar 1996	113700	241800	73500	40200	4856	87,1%	66,3%	2,8%
Apr 1996	120900	251000	89900	31000	4940	130,0%	34,1%	2,2%
May 1996	118800	254200	98800	20000	5031	161,7%	31,3%	1,6%
June 1996	129400	266900	108400	21000	5105	230,2%	52,3%	1,2%
July 1996	131100	271900	111600	19500	5189	94,3%	38,6%	0,7%

Aug 1996	129000	275300	111800	17200	5352	86,6%	30,3%	-0,2%
Sep 1996	125600	276000	110900	14700	5396	72,4%	40,4%	0,3%
Oct 1996	124000	278800	116700	7300	5455	67,8%	32,0%	1,2%
Nov 1996	125000	282300	111200	13800	5510	45,6%	25,7%	1,9%
Dec 1996	130900	292500	121400	9500	5554	43,7%	27,8%	1,4%
Jan 1997	123900	297400	120700	3200	5629	40,3%	21,4%	2,3%

Sources: Goscomstat, The Central Bank of Russia, IMF, Finmarket

Table 2. Consolidated and federal budget of Russia in 1995-1996, % GDP

Consolidated budget													
1995	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	1995*
Tax revenue	21,5	21,5	23,0	25,1	25,6	24,7	23,2	22,9	22,1	21,7	21,7	21,7	30,9
All revenue	23,6	24,6	26,3	28,2	28,3	27,1	26,5	26,8	26,3	25,6	26,1	26,1	34,2
Expenditure and loans net off redemption	25,0	25,2	28,9	30,6	30,2	30,0	29,0	28,6	28,9	28,0	28,8	29,3	39,3
Deficit	1,4	0,6	2,6	2,4	1,9	2,9	2,5	1,8	2,6	2,4	2,7	3,3	5,1
Federal budget													
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	
Tax revenue	10,0	9,6	10,0	11,0	11,2	10,8	10,7	10,5	10,4	10,6	10,6	10,3	
All revenue	11,9	12,6	13,2	13,9									

The Chronic Fiscal Crisis

The dramatic increase of budget deficit in 1991 was predetermined by earlier economic evolution. Fiscal disbalance began mounting in the Soviet Union since about the mid-eighties. There are several reasons for the chronic budget crisis in Russia. The most important reason is the degradation of central planning and hierarchical management of the socialist economy. This in turn was pre-conditioned by weakening a repression mechanism and eliminating the specific incentives of socialism. The attempts to offset these changes by partial reforms of planned economy aimed at utilization of various economic incentives (orientation of state enterprises on profit maximization, improvements of the price system and so on) had an opposite effect and merely speeded up the decay of the planned economy.

The growing share of profit at the disposal of enterprises caused the reduction of budget revenues. Attempts at the late eighties to deregulate wholesale prices occurred while retail prices remained fixed. This automatically reduced the turnover tax and increased price subsidies to enterprises.

Among other important factors of mounting budget distortions at the end of eighties were: the fall of world prices on raw materials, wrong wide-scale economic decisions, such as the attempt to begin a new industrialization, an anti-alcohol campaign which sharply reduced budget revenues, growing military expenses caused by Afghan war. A series of wide scale catastrophes such as Chernobyl explosion, the earthquake in Armenia required unexpected budget expenditures.

In 1991, the loss of price control led to a dramatic fall of turnover tax. This was aggravated by the collapse of the Soviet Union which enforced the degradation of public finance (republics dramatically reduced transfers to the state budget but still received finance from the central budget). As a result, the deficit of the reconstructed state budget of the Soviet Union was 31% in 1991. The budget deficit was actually financed through non-voluntary saving by households and enterprises.

The price liberalization in 1992 allowed to ameliorate the budget situation. This was due to a sharp reduction of price subsidies and introduction of the value-added tax that became possible under free market pricing. Due to the liberalization of foreign exchange policy and introduction of the unique exchange rate of ruble (the internal convertibility) in the summer of 1992, import subsidies to enterprises were also reduced. Defense expenses were sharply cut too, from about 7–8% of GDP in 1991 to 4% in 1992.

As a result, the federal budget deficit made up 5% in 1992, 8% in 1993 (according to the official figures) and 29% and 10% respectively according to our estimates taking into account the quasi-budget operations. Thus, there was a considerable reduction of the budget deficit which was not sufficient, however, for the beginning of financial stabilization at that time. Such a huge deficit could not be financed without money creation. Besides that, the market for government debt did not exist at that time.

Under these circumstances two strategies of reforming the public finance were available. The first strategy was to increase budget revenue by carrying out a tax reform. The second strategy was to reduce and restructure budget expenses. This required a number of institutional transformations, such as reforming the state management and civil administration, military forces, housing and utilities. The latter aims mainly at substituting subsidies to state-owned utilities by subsidies to poor households. The second strategy of reforming could ensure a sustained long-term budget equilibrium necessary for investment-led economic growth, but its implementation required time, social stability and a certain political will. None of these conditions fulfilled till the year 1994 when the political circumstances favored the beginning of financial stabilization.

First, the adoption of the new Russian Constitution in 1993 and the dramatic change of the political system enabled the implementation of unpopular economic measures. Due to the considerable concentration of power under the President, the government was no longer dependent on the populist parliament and stopped the myopic policy of balancing between threat of resignation and continuation of reforms.

Second, the new constitutional and legal conditions imposed barriers for adopting populist budget decisions. The budget process in the new conditions met a strict formal procedure, and any decisions concerning federal budget could be adopted by the State Duma only in case of government resolution. All that made the situation radically different from the chaotic budget discussions in the Supreme Soviet of 1992–1993, when budget amendments could be adopted “by voice” and revised at any time.

Third, the balance of political forces in the State Duma of the 5th convocation elected in December 1993 did not favor the adoption of any budget amendments: the left and right parties automatically blocked each other’s decisions. However, the government had to maneuver between those in order to get approval of the submitted budget proposal.

These political changes were not sufficient to ensure a long-term stabilization of public finance. In fact, there was no restructuring of the expense side of the federal budget, and neither of the above reforms was carried out. Instead of reducing social expenditure with a simultaneous redistribution of social subsidies to poor groups, only total reduction took place. This sharply increased income differentiation and decreased the efficiency of health care, education, science and the cultural sphere. Instead of reducing the army with a sequential cut of defense expenses, these expenses were cut without any attempt to reform the army, and that have had extremely negative consequences for the armed forces. However, the reduction of budget expenses in 1994–1995 made possible the beginning of macroeconomic stabilization in 1995.

Macroeconomic Stabilization in 1995

The rationalization of budget expenses that were necessary for macroeconomic stabilization, could only be accomplished by 1994 by political reasons. The same obstacles prevented tightening of monetary policy. Up to the summer of 1992 each former Union republic could issue money, pursuing unilateral benefits from the uncontrolled emission. The separation of monetary systems began from the introduction of correspondent accounts of the republics' Central Banks in the Central Bank of Russia in 1992 and the sequential introduction of new currencies in the former Union states. However, it took a year to stop the supply of the so-called technical credits, automatically issued by the Central Bank of Russia in case if the republic had a negative trade balance in the bilateral trade with Russia. Actually this emission occurred beyond the government control.

In 1993–1994 this and other channels of money issue were closed. The Central Bank of Russia rejected from the supply of cheap credits to some branches of national economy. According to the new rules adopted in 1993 credits to the industries could be given only through the state budget within the approved limits. Hence, the Central Bank's credits to the government remained the most important source of money issue. It was decided to refuse from those source of money supply only in the fall of 1994.

In fact, the loose monetary policy in 1992–1993 was explained by the dependence of the Central Bank of Russia on the populist Russian parliament. According to the new Constitution of 1993, the Central Bank became an authority completely independent from legislators. However, in 1994-1995, there still remained a considerable informal dependence of the Central Bank on the executive power, as the Central Bank was headed by the deputy chairman and the nomination of a candidature remained a prerogative of the President. Fortunately, Boris Yeltsin's firm support of the stabilization policy neutralized the vulnerable position of the Central Bankers.

The tough monetary policy in 1995 aimed at the reduction of average monthly inflation rate from 10,5% in 1994 to 4% in 1995. The monetary program of the government and the Central Bank planned the average monthly growth of money supply 4,2%. This program was agreed with the International Monetary Fund when Russia received a stand-by credit of 6,4 billion dollars. In order to control money growth, the program imposed monthly limits for the growth of net domestic assets of monetary authorities and monthly upper bounds for net claims to the enlarged government. According to the monetary program the Central Bank committed to reject from providing the government with direct loans. The budget deficit in the ruble part was supposed to be financed through the supply of government securities. The program did not involve explicit pegging the ruble exchange rate and did not impose any binding commitment on the exchange rate dynamics.

Thus, the original choice was made in favor of an orthodox stabilization on the basis of money supply control. Initially the monetary program did not base on a standard nominal anchor mechanism. This approach seemed quite flexible and was justified in the macroeconomic situation of the end of 1994. First, the outbreak of inflation in autumn 1994, provoked a series of speculative attacks on the ruble in September-October. Gross currency reserves of the Central Bank were exhausted up to the lowest level of 1,5 billion dollars in January 1995. By that moment the government was ready to carry out an extreme measure – a sharp devaluation of the rouble. It was quite possible, however, that this step could lead to the immediate resignation of the reformatory government.

Second, pegging the exchange rate at the beginning of stabilization were impossible because of the lack of credibility to the monetary program and to the fiscal policy of the government. This

was a crucial issue at the beginning of 1995, because three previous attempts of financial stabilization in 1992–1994 failed (by the above reasons). Any attempt of the government to return to the inflationary financing of the budget deficit with pegged exchange rate would thus imply the crash of stabilization policy. Therefore, the government and the Central Bank had to begin with a tight policy of money-based stabilization.

However, the exchange rate policy, conducted during the first months of stabilization, played a disorienting role. In order to accumulate foreign exchange reserves the Central Bank continued the policy of rouble depreciation. If in January and February 1995 this policy had serious grounds, in March and April it obviously contradicted to the tight money control. As a result of artificial dollar appreciation, in March and April the Central Bank acquired over 5 billion dollars of foreign reserves. The monetary base growth was 48% in the second quarter instead of the target rate 15% (table 5.3-3). The accumulation of such a volume of international reserves contradicted the monetary program but ensured the stability of foreign exchange market in the second half of 1995 and in 1996.

The introduction of exchange rate corridor 4300–4900 ruble/\$ in July 1995 prevented the fall of dollar rate below 4000 ruble/\$ due to overshooting, and had a positive impact on the further decrease of inflation expectations in autumn. Thus, only in the second half of 1995 the mechanism of nominal anchor could actually work. The exchange rate-based reduction of inflation expectations would be impossible without the tough anti-inflation policy conducted at the beginning of stabilization. Table 1 in Appendix demonstrates macroeconomic performance in 1995.

Assessing the real effect of the anti-inflationary exchange rate policy one should take into account that the real exchange rate of ruble rose by 76,5% in 1995 (in 1994 this rate increased only by 14%, and in the first quarter of 1995 it grew only by 4,4%). Initially, the macroeconomic program assumed a stable or slowly growing real rate of the ruble. But the increase of real returns on rouble assets and the switch of expectations in the second quarter of 1995 caused a vigorous process of dedollarization and a growing currency supply.

Due to the inflation inertia the 1995 budget underestimated inflation rate and the actual federal budget revenue was 1,3 times higher than the planned revenue. The Budget Law for 1995 included a special order for financing the government. This order excluded the Central Bank credits as a source of budget deficit financing, and increased the responsibility of the fiscal authorities for budget expenses. During 1995 total expenses and loans net of redemption from the federal budget were 16,9% of GDP. In real terms, the federal budget expenses were reduced by 34% in 1995 against the previous year. The federal budget deficit in 1995 was 4,7% of GDP against 10,9% of GDP in 1994.

Financial stabilization and the real appreciation of ruble caused the beginning of capital inflow to Russia. This in principle could lead to a decrease of the cost of external finance for industrial firms. Reduction of the bank loan rates and the return on financial speculation increased attractiveness of industrial investment for financial institutions. In the second half of 1995 the largest Russian banks notably amplified activity in the industrial sphere despite the severe liquidity crisis. This change of strategy manifested in the spreading creation of sub-divisions aimed at strategic investment and aggravation of the inter-bank competition for acquisition of share packages of privatized enterprises.

The Sharp Tax Crisis in 1996

Reduction of the budget deficit in 1995 occurred without improvement of the structure of public expenses and tax reform. The government only cut state expenditures according to actual inflation because of the absence of an automatic indexation mechanism. Unlike the period 1992–1993 when it was possible to maintain a relatively high level of tax revenue by partial improvements of the taxation technique, in 1994–1995 an uncontrolled process of decreasing tax revenue began. The dramatic decline of tax revenue was inevitable under the myopic fiscal policy delaying radical tax reforms. Importantly, the structure of tax system, inherited from the socialist economy, played a negative role. The fall in real production under dominating share of corporate taxes in budget revenue explains the decrease of absolute revenue.

The reduction of marginal tax rate in 1995–1996 was caused to a large extent by the decrease of tax discipline of large industrial enterprises. This was aggravated by the structural shifts in Russian economy: a growing share in GDP of private sector and services, initially characterized by a lower tax discipline. The expanding scale of tax evasion is confirmed by a close statistical link between the level of tax collection and the share of cash in the broad money aggregate M_2 . Our estimates show a stable statistically significant negative dependence. Besides that, economic agents learned to make use of tax evasion methods, including legal ways granted due to tax relief.

Development of political mechanisms on the one hand, and the growing influence of financial and industrial groups on the other hand, yielded intensively spreading various lobbying institutions. In 1995–1996 the increased lobbying activity resulted in the variety of new tax privileges granted by all levels of power.

As a result of the peculiarities of the Russian tax system tax pressure is high only for loyal tax payers, obeying tax legislation. At the same time a considerable number of tax payers possesses economically unjustified privileges and (or) evade taxes illegally. This results in an unfair and uneven distribution of tax burden. The major burden is carried by big industrial enterprises, because they have fewer chances of evading taxes (their technological opportunities, production capacities and business connections are relatively transparent to tax authorities). A longer duration of a production cycle and a higher share of physical capital in such firms also matter. Under inflationary environment these raise the efficient tax rate of large enterprises. Among population the main burden lays on groups with average level of income relying on legal salaries. Individuals with high income have had many ways, not only illegal, to evade taxation (for instance, personal expenses can be represented as corporate expenditures and are deducted from the profit tax base; salaries were paid to workers in the form of interest payments that were not taxed etc.).

Unevenly distributed tax burden caused the increase of tax arrears. Of course, the main reason for this phenomenon in the post-communist economy is the lack of an efficient bankruptcy mechanism. However, the volume of tax arrears remained relatively stable up to the beginning of 1996 when it dramatically increased. In particular, the share of tax arrears in GDP rose by over 37% for January 1996. The dynamic of tax arrears in 1996 demonstrates a close connection of this phenomenon with the presidential election in Russia. By clear reasons this election caused a temporal weakening of the federal power and narrowed the bounds for the discretionary fiscal policy.

A considerable growth of tax arrears began in January 1996, which reflected two interrelated circumstances. First, the election campaign of the president in force was inconsistent with tough actions against potential voters and this was rationally anticipated by economic agents. Moreover, the increase of tax arrears served as an alternative mechanism for a pre-election expansionist policy typical for the traditional political business cycle.

Second, enterprises took into account that the communist leaders unambiguously demonstrated support to those who avoided paying taxes “to the government of national betrayal”. Considering a higher chances of communists that all public opinion polls indicated in January-May 1996 enterprises reduced tax transfers. Firms’ directors accounted for the tax amnesty in case of the communists’ victory, and also on a quite possible tax amnesty that could be adopted by the reformatory government with populist aim.

One can suggest a supplementary hypothesis that can to some extent explain the sharpening of tax crisis in 1996. A growing process of barterization of the economy accompanied by a quick spread of sophisticated schemes of non-money settlement was actually enforced by the Ministry of Finance policy in 1996. It implicitly utilized barter exchange by issuing the so called Treasury liabilities, tax discharges, commodity credit etc. These liabilities were widely accepted and circulated in the economy as surrogate money. As a result, many enterprises minimized money balances, and this caused the decrease of tax base and the increase of tax arrears. In many cases enterprises transferred surrogate money to the state budget. Clearly, this did not increase budget revenue. Price distortions, used by surrogate money and barter exchange among enterprises caused the decrease of tax base. Unfortunately, the official statistics is helpless in evaluation the scale of such operations.

Thus, tax crisis in 1996 is a quite complex phenomenon. If it could be explained only by the election campaign, the level of tax revenue would have returned to the initial level after the victory of Boris Yeltsin. But it was not the case. Although the tax crisis mitigated in the middle of the year, it sharpened again in autumn. In our view the dramatic increase of tax evasion in 1996 triggered a transformation of fiscal crisis to a qualitatively new stage. Financial stabilization in 1995–1996 caused the “adverse selection” among tax-payers. Earlier, tax arrears benefited individual enterprises without any notable impact on the market equilibrium. Tax evasion or relief provided excess profit that was a kind of premium for those who took a penalty risk. The increased scale of tax evasion and the wide-scale utilization of numerous individual tax relief put disciplined entrepreneurs under unfavorable conditions and eliminated opportunities for efficient entrepreneurial activity. As tax evasion becomes a common practice, penalty risk becomes negligible and obeying tax legislation does not guarantee profitability any more. This is so because price mechanism accounts for a dominating level of tax evasion. As a result, loyal tax-payers are either forced out of the market, or (this happens more often) have to choose the other strategy, trying to obtain tax relief, tax delay or using illegal ways of tax evasion.

In this situation the government has a choice between tax reform, aimed at increasing tax revenue, and a further accumulation of public debt. The real increase of public debt was a preferable strategy in 1996 by obvious political reasons: certain social expenditures, for instance redemption of pension and wage arrears, were the prior task for the government in the pre-election period. At the same time, expansion of debt was predetermined by political uncertainty and polarisation. Since the successful beginning of monetary stabilization in 1995, there are strong economic and political obstacles preventing an explicit rejection from the tight fiscal and monetary policy. Therefore, political uncertainty and polarization led to the growth of public debt instead of tax reform or at least adoption of an active anti-evasion strategy. Naturally, political uncertainty in 1996 raised risk premium for all government debt instruments. As a result, debt expansion increased the cost of public debt. At the same time the burden of public expenses that were sequestered in the first half of 1996, was delayed to the future.

Note that the political efficiency of debt expansion in the pre-election period was minimal. An empirical analysis of election outcome in different regions of Russia confirms that there is no statistical link between this outcome and the redemption of wage and pension arrears in the region. Actually there is a negative link between the accumulated wage arrears and the share of

Yeltsin's electorate (this share is positively correlated with average wage level and volume of foreign investment in the region. The evidence demonstrates that pre-election attempts of the government to get more votes for Yeltsin did not have any influence on the political preferences of population. However, the share of pre-election social transfers was highest in the regions where the communist party received a stable majority of votes.

The comparison of public finance performance in 1995 and 1996 shows that in 1996 the federal budget revenue further decreased (1,4% of GDP). This resulted in the growth of primary budget deficit (2,4% of GDP for consolidated budget). The federal budget deficit rose in 1996 compared to 1995: it made up 4,7% of GDP (public debt interest payment was 3,2% of GDP) in 1995, while it increased to 7,2% of GDP (public debt interest payment was 5,6% of GDP) in 1996.

Importantly, unlike the prediction of the standard political business cycle models, the government of Russia did not give up the tight monetary policy. In 1996 the monetary program was fulfilled, with annual inflation only 25%. While political uncertainty in 1996 had a notable impact on financial markets, inflation expectations further decreased in that year. The major negative contribution of the election campaign on the macroeconomic performance was a dramatic raise of interest rates and a redollarization of the economy. This, in turn, created barriers to enhancing the supply of bank loans to the real sector. The gap between the money market and the loan rates is explained by high default risks. The default risk premia are still extremely high, because of the lack of an efficient legal system of contract enforcement.

Note that the problem of public debt over accumulation has not become yet so serious that it could significantly influence macroeconomic situation, as it has happened in many developed and developing countries. The total value of debt, as a share of GDP, reduced in 1994–1995 nearly twice, and was 11,4% of GDP at the beginning of 1996. The devaluation of government debt at this period is explained by a relatively quick depreciation of direct loans to the government supplied by the Central Bank before financial stabilization, compared to the growth of real outstanding debt issued in 1995–1996. Nevertheless, the total value of debt began to increase in real terms in 1996 and reached 16,2% of GDP at the beginning of 1997. This is not a small share for the state that has been borrowing on the domestic financial market for only four years. The stabilization of public debt will depend on the political stability and strong incentives of the government to begin the radical reform of taxation.

Fiscal Crisis and Barriers to Production Investment

All the above processes have created necessary pre-requisites for capital formation. During the two years of financial stabilization 1995–1996 the budget deficit was reduced, inflation was suppressed, the exchange rate was stabilized, and the real interest rate moved down. As a result, the credibility problem was softened, and monetary authorities acquired a necessary favorable reputation. At the same time the new financial institutions were created and developed, for example, the markets for government and municipal securities, corporate equities and derivatives. A number of new financial intermediates appeared such as mutual funds, investment banks, stock exchanges and over-the-counter markets for bonds and equities, a private depository system, audit, brokerage and other services. Tightening of monetary policy aggravated competition in banking and accelerated the selection of efficient and reliable banks. After the liquidity crisis in 1995 the Central Bank put special emphasis on the supervision and prudential regulation in banking. Now it is widely recognized that the stability of the banking system is one of the main conditions for the beginning of sustained growth of production investment.

All these processes are necessary for the reanimation of investment activity but not sufficient. The role of the government in the post-stabilization phase of transitory development is still

unclear. The fiscal crisis has already dramatically diminished the state activity which in fact was not very significant after the market transformation started. The sharp fall of government expenditures in 1995-1996 without structural reforms in the public sector had a negative impact on the social and production infrastructure, education, science and medical care. Since private schooling and health care as well as private financing of research are in the infant state, the main sectors for the economy-wide supply of new human capital remain seriously damaged.

Although Russian central bankers remain adherent to the conduct of anti-inflationary monetary policy, the continuing fiscal crisis may have a negative impact on the further credibility of this policy and cause the new wave of inflationary expectations. Reduction of social expenditures has increased social tensions and yielded political benefits to the leftist parties. By this reason there is still a threat of communist or ultra-nationalist counter-reform revenge in the next presidential and parliamentary elections. More important is that the leftist and populist parties have a stable majority of seats in the State Duma and have been persistently creating barriers to the development of market reforms blocking the adoption of crucial laws: the land law, the tax code, the law on production sharing, mortgage legislation etc.

The rate of return on governmental securities notably decreased during a year after presidential election (from 150–180% per annum in June 1996 to 15–20% in May 1997). However, the loan rates are still extremely high (about 100% per annum) because of the high default risks. This evidence very clearly demonstrates that «crowding out» of real investment by government bond issue actually was not as important as many economists and journalists in Russia believed. They repeatedly blamed the Ministry of Finance for non-inflationary financing of budget deficit in 1995–1996 through new debt issue retarding investment in production assets. The continuing stagnation of the loan market in 1997 confirms that the lack of efficient legal mechanism of contract enforcement was and remains the main obstacle to the beginning of wide-scale production investment. Importantly, commercial banks in Russia have become the main domestic financial intermediaries that are in fact able to provide the real sector with a relatively large flow of finance.

Similarly, the anti-inflation policy sharply diminished the variance of inflation and stabilized the relative prices of production factors, resources and goods. This is another necessary but not sufficient condition for the financing of new production projects.

Evidently, the efficient enforcement mechanism requires a sequence of proper measures against corruption and criminality in order to increase the role of legal protection of property rights. Another important factor is the development of an efficient mechanism of bankruptcy. Despite the existence of legislative base, the bankruptcy mechanism works very poorly. There are at least two reasons for this. First, historically there is a high concentration of production in cities and localities due to the badly designed agglomeration and scale economies in the planned system. Now this imposes a binding constraint on the application of the bankruptcy law and procedure in practice, due to the threat of temporary or permanent increase of unemployment. By this reason local and regional authorities would hardly support bankruptcies and takeovers, even if those could increase the number of jobs in the long run. The second obstacle for bankrupting poorly performed firms is that wide-scale privatization in Russia in 1993–1994 resulted in a high concentration of ownership in hands of corporate insiders – managers and workers of firms. It will take quite a long time before redistribution of ownership and control increase skills and competence of managers and improve corporate governance.

From the view of long-run investment, Russia still remains a zone of relatively high political uncertainty and risk. As was mentioned above, the left political forces still have a strong majority in the Russian parliament and adversely affect the legislative process. Another problem is the

negative effect of political business cycle on the stability of financial markets which is taken into account by all potential investors into Russian economy. The new pre-election campaign will start in fact in two years, in 1999, and at that time Russian markets will face the problem of increased political uncertainty similar to the one that had a negative impact on financial stability and investment in 1995–1996. The current political debates about unification of Russia with Belorussia, and the artificial acceleration of this unification by pure political motives may have an adverse effect on the political stability even before 1999.