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The Economy of Russian Regions after the Default of 1998

The default in August 1998, the abrupt rouble devaluation (its exchange rate fell 4 times), the destruction of the national banking system and the halting of loan tranches from the International Monetary Fund caused serious shifts in the economy of Russia and its regions. One of the major causes of the crisis was the deepest disequilibrium in the supply price system, which was emerging since 1992 after the price liberalisation and the foreign trade monopoly abolition.

The price growth for goods and services was uneven in different sectors and regions. The outstripping price growth on energy and transportation caused the self-isolation of local and regional markets, new price gradients on the regional borders and the fragmentation of the Russian economic space.

But the rouble devaluation together with the consequent import price growth created favourable prerequisites for domestic production. Already in March 1999 the import's share in consumption (especially, of food, cars and durable goods) diminished substantially.

After the default crisis the foreign companies faced the dilemma: either to leave the Russian market or to relocate the production to the Russian regions. Now, it is possible to state that the majority of them preferred the second way. This led to the significant dispersion of foreign investments over the Russian regions. This paper reveals how after the default specific inner and outer (international) factors influenced different types of Russian regions and branches of the economy.

The day of April 17, 1998 became one of the most important turning points in the modern history of the Russian economy. The default on the international and domestic obligations, including the state short-term ones, destroyed the Russian banking system and caused the fast fall of the rouble rate – from 6.0 per $1 to 24.0 during one month. Almost all of the experts who tried to explain the default, its roots and outcomes, discussed it in terms of the standard macroeconomic models. Correspondingly, the Russian economy was taken as a one-point structure *without taking into account regional differentiation*. Indeed, some important economic indicators have nation-wide significance and their regional differentiation is comparatively insignificant. Among these are the rouble rate, federal taxes and export/import duties, interest rates, and so on. The federal budget law and current statistical data on the regional exchange rates and the interest rates have supported this argument.

However, the supply prices on goods and services have a strong regional differentiation and the analysis of so-called national or mean prices is very approximate and conditional. Analogue procedures have been used for mean prices on the world markets: the transfer of these prices to the costs accounting for a specific state, region and city will be seriously modified by numerous individual costs.

One of the most important causes of the default of 1998 is *deep disequilibrium* of the transitional prices' systems, which emerged as a result of the collapse of a 'low level' prices` system. The old system had existed for 60 years and was based on the centrally planned economy with foreign trade monopoly and state price regulation. At the initial stage of economic reforms in Russia the liberal prime minister Yegor Gaidar in the framework of his 'shock therapy' program proclaimed the 'freedom of prices' policy simultaneously with the abolition of state trade monopoly. Soon, these measures led to many serious shifts in the macroeconomic and regional structures. At first, all the prices began the impetuous rise up to world market levels. But this growth was extremely uneven for different goods and services irrespective of the demand on the domestic and foreign markets.

The changes turned out most favourable for industries and regions specialising in the extraction of energy resources (oil, natural gas, coal), metallurgy (steel, aluminium, nickel), chemical and timber products; while the main losers were the branches of the military-production complex, metalworking and engineering (excluding automobile industry), textile and other industries orientated towards the domestic markets. The strong dependence on foreign markets made the Russian economy extremely sensitive to the world economic situation. The decline of oil prices and the US restrictions on Russian steel exports were among the chief causes of the default of 1998.

But the macroeconomic factor of controversial exchange dynamics has been ignored during all this 7-year period (1992-1998). In spite of the abrupt fall of the output in Russian agriculture and manufacture, the US dollar purchasing power on the Russian domestic market continued to decline. It diminished approximately 10 times, and the average wages at the same time (02.01.1992-17.08.1998) had also increased tenfold – from US$20 to 200, though average inflation amounted to 250% a year. Simultaneously, the energy prices' growth was determinative compared with other goods groups and this circumstance influenced the transportation costs' growth, which led to the *fragmentation of the Russian economic space.*

As early as in 1992 the signs of closure of the regional markets for consumer goods (especially, food) emerged. The old strong hierarchical distribution system with the privileged points (i.e. the national capital, the oblast administrative centres, the so-called 'closed towns' (connected with top defence secrets), the resort towns on the top) had been substantially destroyed. The regional authorities stopped transporting basic resources outside their region, giving priority to their local consumption. The prices on local goods are lower than in Moscow and other major centres. In spite of the central distribution system's destruction and the default-1998, Moscow has preserved its traditional role of the main distribution centre though not of domestic, but imported goods. The previous role of the state as an importer is played by millions of petty traders and thousands of firms. Huge wholesale markets appeared in Moscow on stadiums (including the Olympic one), from where the imported goods began to be distributed over other regions.

The default-1998 and rouble rate decline caused, first, the spontaneous trend of a new transitional prices' system to the previous traditional low-level type and, second, what is even more important, the growth of economic barriers to imports. Due to the openness of the Russian economy and many-fold rouble devaluation, the country experienced import-substitution on the domestic markets and expansion of exports.

Before the default-1998 the main export-oriented industries located in the inland Ural and Siberian regions became depressive, due to transportation costs growth and lack of correspondence in tariffs and prices between the railways and goods suppliers. The rouble devaluation and price stability or increase on the world markets of oil, gas, steel, aluminium, and fertiliser together with the wages and transportation costs growth by 20-30% (but 400% as the rouble rate) provided the economic growth of the export-oriented regions. They are Volga and Vyatka, the Urals, and West and East Siberia, all notable for concentration of main export industries.

This growth was stimulated by direct economic regulations in production and export activities, e.g. in the Kuzbass area for the enterprises-main donors of the regional budget: two iron and steel plants “Western Siberian” and “Novokuznetskiy”, the nitrogen fertiliser plant and an aluminium works. Also the regional government tried to reduce the number of middlemen who gain a disproportionately high share of the profit from the coal trade both on the domestic market and abroad. The same regulations take place in other Russian regions. For assessment of these regulations we need a much longer period of observations, but the rational combination of private management and government control is very necessary in contemporary Russian reality.

The same can be said about the import-substitution activities, which produce food and durable goods for the domestic regional markets. The share of import in consumption diminished radically and swiftly (see Table 1). This tendency is very important for the Russian economy because all the main centres and industrial regions experience strong dependence on imported foodstuffs.

The same process is typical of durable goods too. The big effect is observed for the most propulsive manufacturing industry – the car production. Before the default the main Russian producer ‘Volzhskiy avtozavod’ (VAZ) in Togliatti had big difficulties with the sale of a significant part of the cars it produced because of competition from imported cars. Since the rouble devaluation, production of Russian cars has been constantly increasing, a circumstance that has had a positive effect on total economic activities in many regions.

Table 1. The changing proportion of import in the consumption of some food items from March 1998 to March 1999 (percent)

Item	March 1998	March 1999
Meat	26	22
Chicken	58	50
Sausage	25	15
Oil	57	45
Butter	32	25
Margarine	44	30
Cheese	57	25
Frozen fish	30	22
Chocolate	30	20

Similar processes of rebirth are observed in the production of other durable goods, even those, whose output earlier fell to almost zero (TV, electronic equipment, etc.).

The sharp average monthly wage decrease from $200 to 60 has promoted domestic production and left the foreign companies engaged in export operations with Russia with a dilemma: either to leave the Russian market or to transfer production there. The initial observations showed that many foreign firms and corporations, including big transnational ones, have selected the second way. Currently, the priority is given to consumer goods with small price flexibility. That transfer has become typical of many Russian regions, though the preferred among them are those with long international production ties and where foreign investments have guarantees by law and customary informal relations (i.e. with regional governments).

This transfer is active in the food industry (brewery and confectionery), in the production of perfumery and cleaners, pulp and paper, in PC assembling. Similar shifts can be observed in the production of agricultural machinery and car industry.

The most important problem is the foreign investment in such principal export-oriented industries as oil and natural gas extraction. As oil and gas fields are located in the Siberian and Polar Regions with harsh natural conditions, their development needs multi-billion dollar investment. The trend towards the oil price increase is favourable for investors, but further co-operation requires *a legislative base* concerning the partitioning of oil production, a reliable means for protecting investments.

The shift in the priorities of foreign investments turned its abnormal hyper-concentration in the Moscow region (83% in 1997) downwards. As the manufacturing output in Moscow diminished in 1991-98 by 70% (in Russia as a whole the figure was lower - by 50%) investment in Moscow was directed mainly in banking and trade activities. The default-1998 and the ensuing events resulted in the stampede retreat of foreign speculative capital and in the numbness or freezing of assets. The exceptions include the productive investments in the food industry, McDonald’s fast food, hotels, some hi-tech branches (oriented to space flights or nuclear safety), the transport and telecommunications networks and equipment.

In Russian regions productive investment dominated total investment, and this tendency has been preserved after the default-1998. Thus, foreign investment acted towards the deconcentration of Russian economic space. For the first time since 1992 the production investment became more profitable than in trade or finance. It depends on the full abolition or collapse of other modes of investment: the state and private obligations, the forward and futures contracts, etc. Of course, the foreign investment volume is very small compared with the real Russian needs because the majority of the productive capacities have obsolete technologies and equipment.

A weak rouble is favourable for the import-substitution in each industry and each Russian region. A typical example is the alcoholic drinks, which always played an important role in the formation of Russian federal and regional budgets. Before the default a big market sector was occupied by foreign producers, including former Soviet Republics – Moldova, Georgia, and Ukraine. In small Moscow kiosks with one salesman you could choose from among one hundred types of beer, half of which originated from the Czech Republic, Germany, Denmark etc. Now, in the same kiosks you can buy about 50 brands, most produced at different Russian breweries but with

Western investment. As for the prices on Western ordinary wines, they are too high for the ordinary Russian consumer.

A new rouble rate continues to impact in a negative way the transportation costs as an important factor in inter-regional links. The low-level prices' system was favourable for the goods and passenger inter-regional turnover, the volume and intensity of which constantly increases. Low transportation tariffs had helped the Russian spatial economic integration as strongly as the State monopoly on foreign trade and hard currency tough restriction, including the free exchange prohibition. That is why before 1992 the Far Eastern fish production could be transported to the European part of Russia with lesser costs than to neighbouring Japan or Korea. These sales were carried out in accordance with the orders of 'Gossnab' (the State Distribution Organisation in the USSR), though in many cases the central planning tried to follow the principles of economic rationality.

The rouble devaluation has stopped the spatial disintegration of Russian economic space. The domestic transportation costs have again become relatively lower than the international ones. Also under the Siberian and Far-Eastern regional authorities' pressure, the federal transportation ministry and the railways came to an agreement on the transport tariff regulation for bulk loads (coal, ores, metals, fertiliser) long-distance operations. The example of such economic-administrative regulation is the agreement between the Kemerovo regional government and the West-Siberian railway. Similar regulations are of great need for the transit container traffic between the Asia-Pacific Region and Western Europe using the Russian Trans-Siberian railway, as this flow dropped ten times. The modernisation of this route has a 2 or 3-year period on hand until China starts the southern alternative to this Trans-Siberian route in co-operation with the new Central Asia countries using the Kazakhstan, Uzbekistan and Turkmenistan railways.

The trans-border financial gradients (wages and prices) between Russia and the CIS-countries, on the one hand, and between Russia and the states of the Baltic region, on the other, differ in a great way. On the borders with Finland and Baltic countries the negative gradients have been stable due to higher rates of their national currencies, but on the borders with Belarus, Ukraine, Georgia etc. the gradient was unstable because the national currencies of these states and the Russian rouble were subjected to inflation processes with different speed.

After so-called ‘technical’ Russian credits to the CIS countries and their en-masse departure from the rouble zone, the CIS states’ currencies were very weak for a long time. The positive gradient on the Russian side of the border made Russian markets very attractive for both exports and labour immigration. These flows cross the border and are directed towards the main Russian centres with high consumption capacity and workplaces. At the top of this list one can find the Moscow area and the export-oriented regions, especially oil and gas extraction centres. For instance, a big number of the Azerbaijan school graduates migrate to Russia because of the lack of jobs in the home country.

The devaluation of the rouble in 1998 led to very important shifts in the economic relations between Russia (especially, its border oblasts) and its CIS partners. The constant factors – the narrowness of the domestic markets in the CIS countries – remained, while the rates of their national currencies against the Russian rouble increased. As a result, the competitiveness of many export goods from the CIS countries came down, whereas that of the Russian goods increased. This circumstance forced the Kazakhstan government to introduce restrictions on Russian export commodities that (in dollar equivalent) became much cheaper than before. A cheap rouble made recreation in the Russian regions – Black Sea coast and others very inexpensive compared with Mediterranean resorts. After the default the flows to the previously preferable Turkey, Spain, Cyprus, and Greece decreased.

Of course, a two-year post-default period is too short for reliable conclusions and serious generalisation. Nevertheless, relative rouble stability at a low level (28 roubles to the dollar) has already helped various Russian regions to transform their socio-economic structures in accordance with the needs of a market social-oriented economy.

[At the presentation the author will demonstrate a number of electronic maps]