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**Disproportions in the Investment Sphere and Spatial-Economic Imbalance  
in Russia: a Political-Economic Analysis**

**Abstract**

Since the beginning of the 20<sup>th</sup> century the processes of centralization of the economic and political power in the hands of “nomenklatura” have been taking place in Russia, while in the Western capitalist countries the process of destatization of power has accompanied the economic development. The centralization of power during the Soviet period led to the deformation of horizontal and strengthening of vertical relations, which still determine the imbalanced economic development in Russia nowadays.

One of the characteristics of the deformation processes that have been taking place in the economy is the redistribution of investment resources in favor of the largest economic and political centers in Russia. The aim of this article is to show the main indicators and factors of the imbalance in the investment sphere of Russian economy during the period of economic and political transformation. The centralization of investment resources and the formation of elites from Soviet nomenklatura are interrelated processes. That is why we pay much attention in our research to the phenomena of emergence and development of central (federal) and regional elites. These processes have greatly influenced the deformation of the economic structure, the disturbances in the processes of redistribution of the private property (the so-called process of “nomenklatura privatization”), and in the investment process.

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## Disproportions in the Investment Sphere and Spatial-Economic Imbalance in Russia: a Political-Economic Analysis

### Introduction

In our work we study the investment sphere of Russian economy and its influence on spatial-economic processes. It is argued that **changes in the investment sphere on macro- and microeconomic levels have a strong influence on the emergence and development of different types of imbalances in the socio-economic systems and production locations.** It is highly important to study **the indicators and factors**, which influence the emergence and development of the imbalance in the investment sphere and determine how economic system could develop and transform. The imbalance in the investment sphere means the asymmetrical distribution of investments in different industrial sectors, the distortions between the financial and real investment processes, huge differences in the investment activity in Russian regions, and the imbalance between savings and investments on the macroeconomic level. Of course, there are many other indicators that determine the phenomenon, but the above-mentioned are the basic ones.

In fact, the biggest problem of each country when the transformation of one economic system to another takes place is that many elements and coordination mechanisms inherent in the previous system are in place in the new emerging system, and they (usually negatively) influence the process of economic development for a long period of time. Studying the problem of imbalance in the economy, it is important to examine the legacies of the past: the factors and indicators of imbalance, the main elements and relations of the old economic system, which existed on the previous stages of the development of the state. We might see the problem as a complex where the old and new elements are combined.

The aim of this paper is to study the main indicators and factors of disparities in the investment sphere and the economic system as a whole during transformation. The work consists of two parts. In the first part we study main indicators of imbalance in the investment sphere, which characterize with interrelations between the investment process and general macroeconomic changes, and structural disproportions and the investments; domination of the financial sector over the real sector of the economy; relations between savings and investments; as well as regional disproportions. In the second part four main factors which lead to the imbalance in the investment sphere and the whole economy are examined: 1) mass privatization in the beginning of 1990s and creation of new ownership structures; 2) domination of financial-industrial groups; 3) soft budget constraints syndrome and 4) problems of institution-building.

# 1. The investments and spatial-economic processes: interdependence and interaction

## 1.1. *The investment process and general macroeconomic changes*

The investment processes may lead to highly asymmetrical development of any economic system, if the mechanisms of coordination used in economy are inadequate. There can be a lot of kinds of control mechanisms in an economic system: the mechanisms of bureaucratic coordination (vertical relations between elements and components); mechanisms of market coordination (horizontal relations); ethical relations (also horizontal relations of moral character, like mutual help or observance of legal norms); mechanisms of aggressive coordination (vertical, authoritarian type of relations). What these mechanisms of coordination are supposed to produce are the near-equilibrium fluctuations of the system, they make the development of the system more stable. If the fluctuations are too high, it is an indicator that the system reached the far-from-equilibrium state, some new components or new types of relations emerged.

Since the beginning of 1990s there had to be a transformation from one mechanisms of coordination of economic actors to another (from bureaucratic and authoritarian to market coordination) and accordingly from one investment regime to another: from the Soviet investment regime (high share of investments in GDP but low efficiency) to the market regime (the share of investments in GDP is much lower, but the efficiency is high). But despite these early expectations at the beginning of 21st century we have both low level of investment activity and low efficiency of investments (Bard 1998, Berzon 2001, Yasin 2002). In 1998 the lowest possible level of investment activity for the whole decade of reforms was achieved, i.e. for only six years there was a quintuple decline in the investment activity in Russia (see *table 1*). Huge slump in the investment activity during the decade of reforms led to the disastrous situation in different sectors.

As we can see from *table 1*, only in 1999 and 2000 there was a little growth of investments into the fixed capital of different enterprises. But the tendencies of the whole decade of reforms show that these changes were very small, and the imbalance in the investment sphere as well as the imbalance of the whole economic system remained (see *table 1*). Moreover, in 2001-2002 we can see the process of slowing down of investments in Russian economy.

Table 1. The dynamics of GDP and investments into the fixed capital (in %, 1990 = 100%)

| Years | GDP  | Investments into the fixed capital |
|-------|------|------------------------------------|
| 1991  | 95,0 | 85,0                               |
| 1992  | 81,2 | 51,0                               |
| 1993  | 74,2 | 44,9                               |
| 1994  | 64,7 | 34,1                               |
| 1995  | 62,0 | 30,7                               |
| 1996  | 60,0 | 25,1                               |
| 1997  | 59,5 | 23,9                               |
| 1998  | 56,6 | 22,3                               |
| 1999  | 58,4 | 23,3                               |
| 2000  | 62,5 | 26,5                               |

Source: Berzon 2001: 104

The investment processes are associated with the processes of general economic disequilibrium, and the latter can be also divided in two periods which reflect **the dynamics of systemic development with their inherent indicators of imbalance**:

- 1) **The model of economic development before the financial crisis (1992-1997)** was characterized by:
  - a) the domination of export-oriented fuel industry;
  - b) the depression in branches of industry oriented towards the internal market;
  - c) the imbalance between the demand and supply, when the demand on the consumer goods was satisfied by the import of goods;
  - d) the low level of total savings;
  - e) the low level of monetization of economy (the presence of non-monetary means of payment);
  - f) huge differentiation of the levels of economic development of Russian regions.
- 2) **The model of economic development after the crisis (1998-2002)** was characterized by:
  - a) the development of interconnections between sectors, the spillover of revenues from export-oriented enterprises to the development of internal-oriented industries;
  - b) the understated exchange rate of Ruble which supported the price competitiveness of home products in comparison with the imported goods;
  - c) the increase in the demand for the domestic products;
  - d) the increase in total savings;
  - e) the decline in the use of debt arrears and non-monetary means of payment;
  - f) new tendencies of strengthening of homogeneity of Russian regions.

## 1.2. Structural disproportions and the investments

The increase of the deformations in the investment sphere of Russian economy in 1990s was generally caused by the failed experiment of radical market reforms in Russia. The destruction of the old bureaucratic system of central-planning, the narrowing of the centralized budget subsidies to the enterprises, the elimination of the resource redistribution inside the closed economic system led to the horrifying structural and regional distortions in Russian economy. The ideologists of radical reforms thought that the demand on investment resources had to change automatically (Mikhailova 1991: 62): it had to turn from passive into the active form because the enterprises became free from the state control<sup>1</sup>. But this did not happen, and the situation which emerged at the beginning of the 1990s was much more complex than it had been modeled beforehand.

When the budget constraints became hard, the new system of prices began to emerge, but the enterprises with inflexible pricing could not manage to succeed during that time, they experienced huge losses. At the beginning of 1990s the shortage of goods which was the main feature of socialist economy finally turned into the surplus accompanied by the huge enormous shortage of investment resources for some of these enterprises. In fact, a lot of enterprises were left with huge stocks of produced goods and without capital resources. The first “candidates to future bankrupts” were the enterprises of the Group A (production of the investment goods/means of production): they were highly developed during the socialist times, but there was no demand on their products on the emerging markets, where the consumers were mainly interested in consumer goods. The lack of government contractual work (*goszakaz*) and planning, the elimination of centralized investments led to the stagnation in these sectors which produced the means of production, and, partly for the same reason, the new producers of consumer goods, as well as the old ones, could not develop fast enough. The reduction of the state support at the beginning of the reforms led to the decline of the home production and the increase of the demand on the imported products.

But the situation changed much in a very short period of time: the attempts of the reformers to make the budget constraints **hard for all** economic agents failed for many reasons which I discuss in the second part of the work. During 1993-1997, again, there was a manifest shift in the investment policy to the support of petroleum and gas industry, which was accompanied by the reorientation of these sectors to the external markets. At the same time the development of these “promising” export-oriented sectors of Russian economy was accompanied by the decline in the investments to such important sectors as machine building, hi-tech industry,

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<sup>1</sup> In fact, this assumption was wrong, because the competitiveness of different enterprises and even the whole economic sectors was completely different. For instance, there were a lot of enterprises which could not regulate the prices on their production (i.e. the enterprises with highly inflexible system of pricing).

and the decline in the development of scientific and research centers. In *table 2*.it is shown that from three main sectors of Russian economy (power industry, fuel industry, and machine building) the investments into machine-building were about 7%, and this reflected the investment priorities which were prevalent in Russian economy during that time. And since 1992 there was an increase of investments into the resource-extracting industries, but not the technology-based sectors.

*Table 2. The investments into fixed capital in different sectors of Russian economy in 1991-1999*  
(% to total)

| <b>Investments</b>                          | <b>1991</b> | <b>1992</b> | <b>1993</b> | <b>1994</b> | <b>1995</b> | <b>1996</b> | <b>1997</b> | <b>1998</b> | <b>1999</b> |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Total                                       | 100         | 100         | 100         | 100         | 100         | 100         | 100         | 100         | 100         |
| including branches:                         |             |             |             |             |             |             |             |             |             |
| Industry                                    | 34.7        | 41.3        | 37.0        | 32.3        | 34.4        | 34.8        | 36.4        | 33.3        | 37.2        |
| including:                                  |             |             |             |             |             |             |             |             |             |
| Power industry                              | 2.7         | 4.9         | 5.0         | 4.7         | 5.2         | 6.0         | 6.9         | 6.1         | 4.5         |
| Fuel industry                               | 11.1        | 16.8        | 15.6        | 13.0        | 14.4        | 14.9        | 15.4        | 12.1        | 13.9        |
| Machine-building and metal-working industry | 6.9         | 4.9         | 4.5         | 3.6         | 3.1         | 3.4         | 3.1         | 3.2         | 3.6         |
| Other industrial branches                   | 12.8        | 13.8        | 11.0        | 10.3        | 10.8        | 9.9         | 10.1        | 10.9        | 14.1        |
| Agriculture                                 | 17.8        | 10.8        | 7.9         | 5.0         | 3.5         | 2.9         | 2.5         | 3.0         | 2.9         |
| Construction                                | 4.5         | 2.7         | 2.4         | 3.3         | 2.5         | 4.0         | 4.2         | 4.1         | 3.9         |
| Transport                                   | 8.5         | 8.2         | 10.4        | 11.9        | 13.2        | 13.5        | 15.2        | 14.1        | 18.5        |
| Communications                              | 0.9         | 0.6         | 0.6         | 0.9         | 1.4         | 1.8         | 2.8         | 3.5         | 3.2         |
| Other branches                              | 33,63       | 36,41       | 41,72       | 46,63       | 45          | 43,04       | 38,9        | 42,03       | 34,1        |

Source: Goskomstat 2000: 547

*Table 2* shows that, in fact, the asymmetries in the development of different sectors, which took place in the economy of the Soviet Union, became even more evident after the collapse of the socialist economic system. Some researchers showed that there were (and there still are) huge differences in the patterns of development across different sectors of economy (Perevalov, Gimadii and Dobrodei 2000: 358). We can give a demonstration of this using a very simple example: if the fuel and power industry advanced constantly, than there was a huge decline of production in the machine-building (in 1996 – 69% in comparison to the previous year). The situation changed only after the crisis of 1998 (see *table 3*).

Table 3. The indexes of industrial production in main sectors of industry in 1991-1999 (in %)

|   | In % to the previous year level |      |      |      |      |      |      |      |      |
|---|---------------------------------|------|------|------|------|------|------|------|------|
|   | 1991                            | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
| The whole industry                          | 92                              | 82   | 86   | 79   | 97   | 96   | 102  | 95   | 108  |
| Power industry                              | 100                             | 95   | 95   | 91   | 97   | 98   | 98   | 98   | 100  |
| Fuel industry                               | 94                              | 93   | 88   | 90   | 99   | 99   | 100  | 98   | 102  |
| a) Petroleum production                     | 90                              | 94   | 91   | 93   | 96   | 98   | 101  | 99   | 100  |
| b) Petroleum refining                       | 98                              | 90   | 87   | 86   | 101  | 101  | 99   | 93   | 103  |
| b) Gaz industry                             | 101                             | 97   | 95   | 94   | 100  | 99   | 98   | 101  | 104  |
| c) Coal industry                            | 88                              | 106  | 92   | 88   | 99   | 98   | 95   | 95   | 109  |
| Ferrous metallurgy                          | 93                              | 84   | 83   | 83   | 110  | 98   | 101  | 92   | 114  |
| Non-ferrous metallurgy                      | 91                              | 75   | 86   | 91   | 103  | 96   | 106  | 95   | 109  |
| Machine-building and metal-working industry | 90                              | 85   | 84   | 69   | 91   | 95   | 104  | 93   | 114  |
| Timber industry                             | 91                              | 85   | 81   | 70   | 99   | 83   | 101  | 100  | 117  |
| Construction materials                      | 98                              | 80   | 84   | 73   | 92   | 83   | 96   | 94   | 108  |
| Light industry                              | 91                              | 70   | 77   | 54   | 70   | 78   | 98   | 89   | 120  |
| Food industry                               | 91                              | 84   | 91   | 83   | 92   | 96   | 99   | 98   | 108  |

Source: Goskomstat 2000: 302

There were also some positive changes during the same period of time, but these changes were insignificant. For instance, some restructuring took place: in 1991-1996 there was a fall of production by the large firms (around 50%), and rise of production by the small and medium enterprises (30%). For the period of five years (1990-1995) the number of small and medium enterprises increased by 50% (Goorha 2001: 405).

After the financial crisis of 1998 some very small adjustments took place in the investment into the resource sector of economy, while **the overall output growth was not high** (see tables 2 and 3). In accordance with data issued by Goskomstat (Russian State Committee on Statistics), there was no rash decline in investments into the fuel industry (1997 – 15.4%, 1998 – 12.1%, 1999 – 13.9%), investment growth in the ferrous metallurgy (1997 – 1.6%, 1998 – 1.9%, 1999 – 2.0%), but visible decrease in investment into energy (1997 – 6.9%, 1998 – 6.1%, 1999 – 4.5%), and slight growth in investment into metallurgy and machine-building (1997 – 3.1%, 1998 – 3.2%, 1999 – 3.6%). There was also a positive growth in investments into infrastructure: telecommunications (1997 – 2.8%, 1998 – 3.5%, 1999 – 3.2%) and transport (1997 – 15.2%, 1998 – 14.1%, 1999 – 18.5%) (Goskomstat 2000).

After the financial crisis of 1998 the disproportions in the investment sphere were not surmounted (if we take the distribution of investments into different sectors of Russian economy): in 2000 the investments into fixed capital in the export-oriented branches increased as much as 39.2% compared to 1999 (and approximately the same growth rates of gross profit took place in these branches), and in the branches oriented towards the home market the investment activity was 20% lower than the gross profits (Yasin 2002). The last data on the development of different sectors in 2001-2002 show that there was stabilization of production in raw materials extraction, but production decline in such very important branches as machine-building, machine-tool construction, automobile industry, and stagnation in food industry, light industry and in some other consumer production branches (see CMAKP 2002).

Another constituent of structural imbalance problem of Russian economy is **the share of unprofitable companies in different industrial sectors**. Statistical data show that during 1999-2000 the share of unprofitable companies did not decline, but increased and achieved the level of 40% among all enterprises (World Bank 2001: 75). The companies which had no hope of recovery through restructuring were kept alive “through government encouragement, on what can be called as a ‘second-best’ safety net” (Goorha 2001: 406). The demand on the production of such enterprises is low just because these enterprises are obsolete: their production has low quality and can be substituted by other products of better quality and with lower costs of production. At the same time in most cases the directors of these enterprises are sure that the demand will increase, and thus try to save the production facilities. These enterprises do not feel the need to compete for investments just because the budget constraints are still soft (see **factors of imbalance** below). The situation with these enterprises is even more difficult because they preserve overemployment and they are still an important part of “social safety net”<sup>2</sup>.

### *1.3. Domination of financial sector over the real sector of the economy*

Another indicator of asymmetrical investment activity for the last decade of reforms was the domination of financial sector over the real sector of economy. In the market economy **the real investment process must be the basis for the financial investments**. This statement is based on the following arguments (Bard 1998: 66-67): 1) the financial flows arise from the commodity-money relations taking place in the framework of the production of goods and services; 2) the ultimate goal of “healthy” economy is the consumption of different goods and services, but not the process of accumulation of financial resources; 3) the best criteria of the economic effectiveness is the growth of consumption of goods and services and the constant

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<sup>2</sup> Still many enterprises own a lot of non-productive assets preserved from the Soviet times, like kindergartens for the employees’ children, different holiday homes, sanatoria, etc.

improvement of quality of these commodities and the structure of consumption on the basis of cost reduction.

Theoretically, **if the financial sector dominates**, then the main criteria of effectiveness is the greater enrichment of financial investor, when he or she appropriates the maximum possible sum of money created in the real sector of economy. In this case the economic development of the real sector slows down or even stops because the producers do not have enough investment resources for the extended reproduction. It is obvious that financial sector has to influence the development of the real sector of economy through the redistribution of financial flows, but there must be no total domination of financial sector over the real sector, because in this case the phenomenon “money for the sake of money” emerges, which creates huge disturbances in the investment sphere and destroys the whole economic system.

The Russian practice of domination of the financial sector dominates over the real sector confirmed the correctness of these theoretical statements. During the very first years of transformation in the conditions of high inflation and the economic and political instability during the years of launching the economic reforms the main factor which could influence the choice of the object of investment was **its capability to become profitable in a short-term period**. Despite the fact that the investments into the real sector might have long-term character, the speculative activity became the main investment strategy. The slump of GDP growth in 1992-1998 (GDP decline was about 20-40%) and the increase of activity on the stock market during the same period (the stock index increased nine times!) are the evidence of the increase in speculative activity of investors, which is not connected with the state of affairs in the real sector of Russian economy. Only during 1999-2000 there was simultaneous growth of GDP and the expansion of the stock market, but this still can not be evaluated as a stabilization tendency in view of its temporariness (Berzon 2001: 107).

Of course, the domination of financial sector over the real sector was preserved even after the financial crisis of 1998. Characterizing the investments sources of Russian enterprises, Berzon (2001: 107) writes that “the own assets of Russian enterprises (amortization and profit) form the biggest share in the total investments into the fixed capital”. The enterprises reinvested about 55% of their own assets during 1999-2000, while the other sources of investments were the state budget and off-budget funds (25%), bank credits (4%), securities (4%) and stocks (1%).

In accordance with the data of the empirical research made by A. Batyaeva and other works of the last two years (Batyaeva 2001; Berzon 2001; Yasin 2002), there was the industrial growth connected with the growth of the demand on the goods produced by Russian enterprises during 1999-2002. This growth of solvent demand led to some positive changes in Russian economy after the financial crisis of 1998:

- 1) There was a tendency of **simultaneous growth of GDP and development of the stock market** (the similar patterns of development of financial and real sectors of economy) (Berzon 2001: 107).
- 2) Although the changes had different character in different sectors and for different enterprises (some of these enterprises had the increase in the demand, for some of them demand did not change at all or even fell down), but the tendency was such that the level of the fullness of the received orders increased from 67% in 1998 to 78% in 2000 (Batyaeva 2001: 126).
- 3) The banks decreased their interest rates and became more interested in investments into the real sector of economy (see *table 4*).

*Table 4. The cooperation activities between the industrial enterprises and banks<sup>3</sup>*

| The groups of enterprises with different dynamics of the orders received | The share of enterprises which have debts to the banks, % |    | Changes in p.i. | The share of enterprises which want to get new credits, % |    | Changes in p.i. | Bank interest per annum |    |
|--|---|----|-----------------|---|----|-----------------|-------------------------|----|
|  |   |    |                 |   |    |                 |                         |    |
| Demand decreased   | 57  | 58 | +1              | 60  | 73 | +13             | 47                      | 20 |
| Demand was constant  | 44  | 57 | +13             | 62  | 81 | +19             | 30                      | 18 |
| Demand decreased   | 49  | 46 | -3              | 50  | 71 | +21             | 34                      | 19 |
| As a whole   | 50  | 52 | +2              | 58  | 73 | +15             | 37                      | 19 |

Source: Batyaeva 2001: 132

Here we may ask the question: did these more or less positive changes in Russian economic situation lead to more cooperation between the real and financial sectors? In fact, it did not happen for the following reasons:

*First*, the top managers and bankers still worry about the political and economic instability and, in this situation they are not interested in high cooperation with each other (Batyaeva 2001).

*Second*, while the orientation of enterprises towards the bank credits increased, the top managers are still afraid of high bank interests. That is why more than 55% of investments now come from their own reserves (see *table 4*). “Despite the significant improvement of their financial position, relatively inadequate planning of investments, huge isolation from the banking sector and orientation towards the help of the state are still typical for these enterprises” (Batyaeva 2001: 136).

<sup>3</sup> The data in table 4 are the evaluation of possible future activities by the top managers of enterprises

*Third*, despite the fact that there was a decline in bank interests, the banks are now much more interested to make short-term investments rather than long-term, and still the investment projects can not be financed by the banks (Berzon 2001: 107).

As the result, during the last three years of small economic growth the credit investments into the real sector made by commercial banks were about 12-15% of GDP, i.e. five times less than the normal level of investments. At the same time the capitalization of the whole banking system in Russia in 2001 was also insignificant – less than USD 13 billion (and  $\frac{1}{4}$  of this sum was achieved through the capitalization of “Sberbank” and state-owned banks).

#### 1.4. *Savings and investments*

Here we study the relations between savings and investments as the indicator of imbalance in the investment sphere for the reason that savings, i.e. the part of income which is not used for current consumption, are the basis of capital formation in any economic system. Before the financial crisis, there was the imbalance between the rate of savings and the level of investments into the fixed capital: for the period of 1995-1997 the rate of savings was 22-28% of GDP, while the investments amounted 23-25% of GDP, and the total savings were not enough to provide investments (see *table 6*).

After the crisis the total savings grew sharply and achieved the level of 27.5% in 1998, 33.2% in 2000 (in comparison with 21.6% in 1997). This growth was connected with the growth of savings in the non-financial sector, and (at a lesser degree) with the decline of consumption as the result of devaluation of Ruble and huge increase of prices on consumer goods. But, according to data of the Centre of Macroeconomic Analysis and Short-Term Forecasting (CMAKP) (Belousov 2002: 17, 20), the economic situation in Russia for the last three years was characterized by the high rate of savings and, at the same time, low amount of investments into the fixed capital. Now the problem is that savings are used only partly for the investments (only about  $\frac{2}{3}$  of savings were used for the investments in 2001) (see *table 5*).

Table 5. The usage of gross savings for the investments and other financial operations (% to GDP)

|   | 1997         | 1998        | 1999        | 2000        | 2001        |
|---|--------------|-------------|-------------|-------------|-------------|
| <b>Resources:</b>                                     |              |             |             |             |             |
| Gross savings   | 21.6         | 19.0        | 27.5        | 35.9        | 33.2        |
| <b>Usage:</b>   |              |             |             |             |             |
| Gross investments                                     | 22.8         | 16.2        | 14.7        | 18.6        | 22.1        |
| Outflow of capital                                    | 4.5          | 6.3         | 6.6         | 5.6         | 4.9         |
| Net offset of state debt                              | -4.8         | -5.7        | 2.0         | 2.3         | 2.7         |
| Accumulation of currency reserves                     | 0.4          | -1.9        | 0.9         | 6.2         | 2.7         |
| Other   | -1.4         | 4.1         | 3.3         | 3.2         | 0.9         |
| <i>Share of gross investments in gross savings, %</i> | <i>105.6</i> | <i>85.0</i> | <i>53.4</i> | <i>51.9</i> | <i>66.4</i> |

Source: Belousov 2002: 20

During the first stage of development (until 1998) the investment were financed by the foreign debt, but on the second stage of Russian economic development foreign borrowings cannot be used anymore. Moreover, the ruble became more stable, and, at the same time, the outflow of capital increased much. In these conditions the only way to increase investments is to use savings for that. However savings are badly transformed into investments nowadays. As a result, the economic growth is based on the “eating away” of the fixed capital created during the Soviet time, and the productivity growth slows down constantly. It means that, though since 2001 the growth has been based on the expansion of domestic demand, it will finish very soon because there will be productivity decline and, as a result, the income decrease or stagnation. The only possible alternative is the sharp rise of effectiveness of transformation of savings into investments, and the investments themselves.

### 1.5. Regional disproportions

The disproportions in the investment sphere, the development of contradictory tendencies in the investment activity of the economic agents, as well as the destruction of the economic networks which were highly developed during the Soviet times, led to the imbalance in the regional socio-economic development. There are huge differences in the effectiveness of use of capital and human resources, the investment opportunities and investment climate in different regions of Russia. Table 6 illustrates that in 1998 fifteen major Russian regions (among eighty-nine) with the population of 45.6% produced about 60% of Russian GDP. As Gavrilentov rightly stated, these fifteen regions are the core of Russian economy, and their governors “may in

fact dominate the country's future by establishing strong and united political leadership" (Gavrilenkov 2000: 50).

*Table 6. Selected Economic Indicators by Russia's Major Regions (as of 1998)*

|                             | <b>GRP as a % of Russian GDP</b> | <b>Regional corporate accounts as a % of total corporate accounts</b> | <b>Population as a % of Russian population</b> |
|-----------------------------|----------------------------------|---|--|
| Moscow and Oblast           | 14.9                             | 71.1  | 10.4   |
| Tiumen' Oblast              | 9.2                              | 3.1   | 2.2  |
| St. Petersburg and Oblast   | 4.2                              | 4.2   | 4.3  |
| Sverdlovsk Oblast           | 3.7                              | 1.3   | 3.2  |
| Samara Oblast               | 3.1                              | 1.5   | 2.2  |
| Republic of Tatarstan       | 3.1                              | 1.2   | 2.6  |
| Krasnoyarsk Oblast          | 3.0                              | 0.4   | 2.1  |
| Republic of Bashkortostan   | 2.9                              | 1.0   | 2.8  |
| Cheliabinsk Oblast          | 2.5                              | 0.5   | 2.5  |
| Perm' Oblast                | 2.4                              | 0.7   | 2.0  |
| Kemerovo Oblast             | 2.4                              | 0.7   | 2.1  |
| Nizhegorod Oblast           | 2.4                              | 0.9   | 2.5  |
| Irkutsk Oblast              | 2.3                              | 0.5   | 1.9  |
| Rostov Oblast               | 1.6                              | 0.6   | 3.0  |
| Novosibirsk Oblast          | 1.6                              | 0.6   | 1.9  |
| <b>TOTAL for 15 regions</b> | <b>59.7</b>                      | <b>87.3</b>   | <b>45.6</b>                                    |

Source: Gavrilenkov 2000: 50

The industrial structure of Russian regions is highly asymmetrical. The best example of the regional differences is the distribution of the enterprises of the fuel industry in Russian regions. The leader here is the Tiumen' Oblast: 80% of its economic growth is connected with the development of fuel industry. The fuel industry also plays important role in Komi Republic and Ingushetia (about 50% of GRPs), in Volga region, including Tatarstan, Bashkortostan, Astrakhan' Oblast, and, also, in Orenburg Oblast, Kemerovo Oblast and Sakhalin (20%). At the same time, the role of this industrial sector is insignificant in economic development of 40 other Russian regions (Klimanov 2000: 21-22).

The structural differences of the Russian regions are enormous: the most industrially developed are the regions of the European part of Russia – the regions with highly diversified industrial structure, – while the economic development of the so-called “new developing”

regions (including Siberian, Northern and Far Eastern regions) is usually monocultural, where the fuel resources play an important role. In some regions the development of one sector is connected with the development of 1-2 huge corporations (Belgorod, Vologda, Leningrad, Lipetsk, Ryazan' and Cheliabinsk Oblasts) (ibid.: 25). The structural imbalances in the regions determine the differences in the dynamics of economic growth, rates of unemployment, income differences, general financial situation, and the development of credit and financial institutions in Russian regions (see *tables 7 and 8*).

*Table 7. Selected Fiscal and Wealth Indicators of Russia's Major Regions*

|                           | Total regional budget revenues (% of GRP) | Budget transfers from the federal level (% of GRP) | Household monthly incomes (USD) |          |
|---------------------------|---|--|---------------------------------|----------|
|                           |   |  | 1997                            | May 1999 |
| Moscow                    | 15.8                                      | 0.2  | 605.9                           | 245.6    |
| Moscow Oblast             | 18.2                                      | 1.5  | 100.4                           | 43.0     |
| Tiumen' Oblast            | 2.0                                       | 0.2  | 385.8                           | 140.2    |
| St. Petersburg            | 18.1                                      | 1.4  | 172.7                           | 58.3     |
| Leningrad Oblast          | 15.7                                      | 3.3  | 108.6                           | 39.1     |
| Sverdlovsk Oblast         | 11.5                                      | 0.3  | 146.8                           | 49.1     |
| Samara Oblast             | 11.3                                      | 0.2  | 163.9                           | 77.7     |
| Republic of Tatarstan     | 18.5                                      | 4.9  | 116.6                           | 46.0     |
| Krasnoyarsk Oblast        | 11.4                                      | 0.1  | 179.1                           | 69.5     |
| Republic of Bashkortostan | 17.2                                      | 4.1  | 108.3                           | 42.3     |
| Cheliabinsk Oblast        | 11.1                                      | 0.4  | 119.7                           | 46.5     |
| Perm' Oblast              | 11.2                                      | 0.3  | 165.1                           | 62.3     |
| Kemerovo Oblast           | 12.7                                      | 2.1  | 174.6                           | 65.3     |
| Nizhegorod Oblast         | 13.1                                      | 0.9  | 110.2                           | 37.1     |
| Irkutsk Oblast            | 9.7                                       | 0.7  | 171.5                           | 70.5     |
| Rostov Oblast             | 14.0                                      | 2.3  | 110.7                           | 45.6     |
| Novosibirsk Oblast        | 11.8                                      | 0.7  | 118.4                           | 42.1     |
| Russian average           | 14.8                                      | 2.5  | 159.5                           | 59.8     |

Source: Gavrilentov 2000: 52

Table 8. The Most Important Russian Banking Centers in 1993-1999

| No. | Banking center | The share of Top 100 Russian banks in total assets, % |          |          |          |
|-----|----------------|---|----------|----------|----------|
|     |                | 01.07.93  | 01.01.96 | 01.07.98 | 01.01.99 |
| 1.  | Moscow         | 82,25   | 83,25    | 92,55    | 91,28    |
| 2.  | St. Petersburg | 1,52  | 3,70     | 2,71     | 3,96     |
| 3.  | Yekaterinburg  | 0,68  | 0,68     | 0,58     | 0,52     |
| 4.  | Ufa            | 1,51  | 1,48     | 0,59     | 0,21     |
| 5.  | Tiumen'        | 1,07  | 0,49     | 0,16     | 0,32     |
| 6.  | Samara         | 0,59  | 0,58     | ...      | 0,16     |
| 7.  | Togliatti      | 0,84  | 0,89     | ...      | 0,19     |
| 8.  | Kazan          | 0,21  | ...      | 0,37     | 0,50     |
| 9.  | Cheliabinsk    | 1,02  | 0,70     | 0,19     | 0,25     |
| 10. | Vladivostok    | 0,54  | 0,22     | 0,16     | 0,18     |
| 11. | Other          | 9,77  | 8,01     | 2,69     | 2,43     |

Sources: Gorlov 2000: 51-53, Klimanov 2000: 80-81

During the decade of transformation the redistribution of investments into fixed capital from the federal budget, regional budgets, and off-budget sources (mostly the own assets of the enterprises) in the regions of Russia illustrated the following regularities: 1) the amount of the investments into Moscow, Moscow Oblast and Tiumen' were higher than the investments into any other region of Russia; 2) the most part of these investments are directed to the most industrially developed regions<sup>4</sup>; 3) the least developed regions could not find huge sources of investments other than the federal budget (these were the most budget-oriented regions, but the level of total investments into the fixed capital was relatively low).

The investment activity in Moscow is much higher than in any region of Russia. The evidence of this is the level of development of financial sector in Moscow and underdevelopment of financial sector in the regions (see *table 9*); such a fast growth and high level of development of financial sector in Russian capital can be explained by a number of reasons: 1) the role of Moscow as the capital-city; 2) the allocation of the main institutions of state power in Moscow; 3) the fast development of infrastructure; 4) the availability of highly qualified workers and developed system of education in this city, etc. (Klimanov 2000: 106-107) There are also other regional leaders in the sphere of development of credit-financial sphere, including St. Petersburg, some regions of Northern Caucasus, Dagestan, Rostov krai, Volga region, Urals, etc. But these regions are much less developed than Moscow (even St. Petersburg,

<sup>4</sup> The higher level of investments from the federal budget was connected with the role of the region in the export-oriented industrial production (see *table 7*)

“the northern capital of Russia”, where local authorities try to do everything possible to create a well-developed financial sector) (see *table 9*).

*Table 9. The typology of Russian regions at the level of development of banking infrastructure in 1990s*

| The level of development of banking infrastructure | Regions   |
|--|---|
| Extra high   | Moscow  |
| Very high  | St. Petersburg, Bashkortostan, Tatarstan, Krasnodar krai, Moscow oblast', Rostov oblast', Sverdlovsk oblast', Tiumen' oblast'   |
| Above average                                      | Republic of Dagestan, Sakha (Yakutiya), Udmurtiya, Krasnoyarsk krai, Primorie, Volgograd, Irkutsk, Kaliningrad, N.Novgorod, Novosibirsk, Perm', Saratov, Tchelyabinsk oblasti.  |
| Average  | Komi Republic, Marii El, Chuvashiya, Altai krai, Stavropol krai, Khabarovsk krai, Amursk, Arhangelsk, Vologda, Voronej, Kaluga, Kemerovo, Magadan, Murmansk, Omsk, Orenburg, Sakhalin, Smolensk, Tver', Tomsk, Tula, Ulyanovsk, Yaroslavl' oblast's |
| Below average                                      | Buriatia, Kabardino-Balkaria, Karachaevo-Cherkesia, Karelia, Ingushetia, Astrakhan, Belgorod, Bryansk, Ivanovo, Kamchatka, Kostroma, Kurgan, Leningrad, Lipetsk, Pskov, Ryazan oblast's   |
| Very low   | Republics of Adigeya, Altai, Kalmikia, Mordovia, Northern Osetia, Tiva, Khakasia, Vladimir, Kursk, Novgorod, Orel, Penza, Tambov, Chita oblast's, Jewish autonomous oblast'   |

Source: Klimanov 2000: 116

## 2. Factors affecting the disproportions in the investment sphere and the spatial-economic imbalance in Russia

### 2.1. The process of privatization and creation of ownership structures

One of the main factors of imbalance in the investment sphere of Russian economy is the problem of property rights creation. From the very beginning of the “destatization” in Russia the active protection of clearly defined property rights was highly important, while it influenced the redistribution of the economic and political power in the country, created the advantages for some enterprises (obviously, the most powerful former state-owned monopolies) to the prejudice of the others. After ten years of transformation such an unbiased protection of private sector is suffocated by the most powerful corporate structures (oligarchs) and politicians which are interconnected. And, thus, the parameters of the economic system which was formed at the end of 1990s are hard to balance. To understand the ways how the imbalances in the investment

sphere emerged during the transformation we must look at the problem of privatization in a retrospect (from the first steps on the way of destatization until the end of 1990s).

**The first stage of the process of “destatization”** was the period of 1989-1991 (Gorbachev’s “perestroika”) – the process of “proportization of nomenklatura”. During this period very significant changes were made: the enterprises obtained some economic freedom; the decrease of the role of the state in economy; the liberalization of prices and activities of economic agents (Ericson 2000). At the same time many aspects of Russian social, political and economic spheres remained only superficially changed after the reforms of privatization and market liberalization.

The reforms were started from above, and the Russian style of governance remained autocratic. The reformers tried to save the system and make some small changes in it, and they failed. As Mihalyi correctly defined, “economic reform is unthinkable, if the system is believed to be in the process of continuous disintegration and the countervailing forces, which nonetheless keep the machinery running, are thought to be essentially outside the reach of economic decision-making”. (Mihalyi 1992: 45)

The old Communist elites took the majority of seats at the regional elections in 1990-1994 and became the major blocking conservative power against such important economic reform measures like liberalization, stabilization, and (especially) the reforms of institutions (Liu 1999). While industrially-advanced economies are usually based on private property, and money determines the power, the power of money in the transformation post-communist economies is strengthened much by the social capital – links and alliances (Williamson 2000, Aron 1998, Gaidar 1997). The lack of resources of economic power and control led to the symbiosis between governments and business. It was particularly important at the regional and local levels between governments and important businesses.

Thus, during the period of Gorbachev’s “perestroika” and after the collapse of the Soviet Union “the bureaucratic property” was gradually transformed into the private property of clan-corporative structures<sup>5</sup>. Gorbachev’s reforms “permitted a large-scale theft of state assets by opportunistic and entrepreneurial officials, almost all of whom were drawn from the existing elite, the nomenklatura” (Buitter 2000: 4), which got the opportunity to occupy the controlling positions with the help of their status, privileges and relations in new conditions.

**The second stage of the process of destatization** was the period of Gaidar’s radical reforms (1992-1994). Trying to satisfy the interests of the managers and employees of many enterprises, new technocrats had found that the best way was the distribution of 144 million vouchers among people, which could be exchanged for shares in any privatized enterprise. In

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<sup>5</sup> Richard E. Ericson called these structures “political-industrial(agricultural)-commercial networks with a loose hierarchical structure subordinate to the most important leader involved, be he politician or businessman” (Ericson 2000)

fact, there was a political reason why the fast voucherization took place: it was obvious for the politicians at that time that privatization of any kind will make the reconstruction of the communist regime based on state property impossible.

In the conditions when the mechanisms of bureaucratic and aggressive coordination dominated in the economic system the radical reforms of the 1990s resulted in the significant increase of the share of illegal or pseudo-legal activities aimed to appropriate the former state ownership (Gaidar 1997: 112). The state bureaucrats actively participated in the procedures of appropriation and redistribution of this property: most of them were simply given control of state-owned oil, gas, automobile, banking and other enterprises (Michaels 1997, Aron 1998)<sup>6</sup>.

**The third stage of destatization** began in 1995, when Russian government sold out the best and most prospective Russian companies. Some of the privatized enterprises had very composite nature, i.e. within the framework of one organizational form the property of employees, managers, shares of banks, foreign investors, and share of state could be combined (Chavance 1999: 12). During this period insider ownership became predominant: 60-67% of all ownership was distributed among the employees, 8-14% - among the managers. Meanwhile only 5% of firms had more than 40% of state ownership, and only 25% had about 50% of shareholders-outsiders (see Goorha 2001).

Privatization was peculiar for absolutely all post-socialist economies, but the main feature of Russian reforms was extremely high level of illegal activities. P.Goorha writes: “The problem is not that insiders have emerged as the winners of the Russian privatization program. Nor is the problem quite that politicians have control over several industries. It is that the specificity of these [property – *Authors*] rights is ambiguous” (ibid.: 407). The forms of property which were legally fixed did not correspond to their real content: even when the most part of the property of enterprises was in the hands of employees of these enterprises, the latter did not really control the activity of these companies in many cases.

The former state control now took the form of control of bureaucrats which usually wanted to get their personal benefits from the decision making in the sphere of redistribution of property rights. Taking into account the interconnections between managers of former state-owned enterprises (especially the most powerful oligarchs – managers of huge monopolies build in the socialist economy) and politicians (as a rule, integrated into the ruling elite), the shares which were in the hands of the employees usually allowed the concentration of the real property rights through falsification in the hands of the managers of these enterprises. Even if the

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<sup>6</sup> In accordance with the analysis made by Neil Robinson, the privatization scheme in 1992-1993 led to very small state revenues: in 1992 privatization receipts accounted for 1.1% of gross state revenue, in 1993 – 0.6%, in 1994 - 0.4% (Robinson 2001: 15). “Moreover, privatization meant that the government’s ability to take tax from economic activity in the Soviet fashion as a property owner ended *as it transferred its property rights to enterprises without affecting wide scale turnover in management*” [italicized by us – *Authors*] ( ibid.)

politicians did not have property rights in these enterprises, the managers used different kinds of bribes or created huge political support for the politicians (Goorha 2001: 408). The ramified system of limitations, permissions, and privileges accompanied by shortages of investment resources finally emerged. **In the current conditions, the emergence of Western style market institutions faces the limits, which are set by the powerful hierarchical structures, and comes into the conflict with the interests of the latter.**

## *2.2. Financial-industrial groups*

After the mass privatization and vouchers redistribution in 1992-1993, new Russian banks have taken large equity positions in the Russian industrial sector and started to create strong corporative structures by 1993 (Johnson 1997; Perotti & Gelfer 1999; Tsvetkov & Chistyakov 2001). These so-called “bank-led FIGs” (here and later, “FIGs” is an abbreviation of the financial-industrial groups) consisted of investment companies, industrial enterprises, trade companies, trust and financial companies, pension fund, insurance companies, advertisement and consulting agencies. The financial companies were the “core” of the group because they consolidated the shares of all other firms of the FIG (Johnson 1997: 334).

Here we would like to argue that financial-industrial groups (FIGs) are one of the main factors which lead to the imbalance in the investment sphere of Russian economy, especially influencing the structural disproportions, the dominance of the financial sector over the real sector of economy connected with the soft budget constraints syndrome.

The bank-led FIGs had much power to lobby for their interests. Since 1993, the political power of the bank-led FIGs, driven by their status as economic heavy weights, came from three major sources:

1. **Their acquisitions in Russian media.** During the decade of 1990s bank-led FIGs managed to gain control over a surprising number of the most important Russian media outlets. Thus Russian FIGs got the instruments of political and economical influence; they could involve into the sphere of their interests a lot of politicians, could create public opinion and influence changes in Russian society (see Kolganov 2000). For example, “*Interros Holding Company*” nowadays owns Publishing House “*Izvestiya*”, TV channel “*Severny Gorod*”, Publishing House “*Komsomolskaya Pravda*” and many other mass media companies; “*Logovaz*” until 1999 controlled ORT and “*Nezavisimaya gazeta*”; SBS-Agro – “*Kommersant-Daily*”; Yuriy Lujkov group – TVC (Ivanova 2000).
2. **Their investments in political sphere.** Since 1993 Duma election the big banks have been the primary source of investment in political sphere in Russia. The influence of bank-led FIGs “reached its zenith in the June-July 1996 presidential elections, when they threw their financial might and media power behind Eltsin” and were main instrument in

promoting alliance between Eltsin and Lebed' at that time (Johnson 1997: 349). Russian political scientist Sergei Peregudov writes also that largest Russian corporations participate more and more in the Duma elections, in which they play a role of so-called "electoral machines". One of the results of this activity was the emergence of interfraction group "Energiya" in Duma, which has more than 70 members and represent the interests of Russian oil and gas monopolies (Peregudov 2001: 20-22).

**3. The interconnection between executive positions in the banks and government.** High officials in the banks have moved freely from their corner offices to the corridors of power and vice-versa.

Beginning from 1993 FIGs started to invest into the light industries because the banks were allowed to get huge stakes in these enterprises. Banks purchased enterprises for the following reasons: (i) they provided banks with guaranteed customers; (ii) they created tax havens for them; (iii) there was less uncertainty in lending; (iv) revenue of the enterprises could let to promote short term financial operations.

Hyperinflation in 1993-1994 let the banks get huge profits from speculations on the financial market, but in the mid-1990s this source of profits dried up, and the banks started to develop more long-term programs of investment. In the mid-1990s bank-led FIGs have got huge political and economic power in the country using such methods as: 1) manipulating the institution of authorized banks; 2) purchasing the stakes in enterprises for lowest price in the "shares-for-loans" program; 3) hampering the activities of foreign investors in Russian markets.

The shares-for-loans program in 1995 was the best example of "stealing the state". A consortium of largest banks led by "ONEKSIMbank" offered to lend the Russian government 9 trillion rubles (about 2 billion USD) in exchange for getting management control over the state's shares of several large companies. These banks lobbied their interests and promoted "shares-for-loans" auctions which let several banks acquire significant stakes in the key Russian export companies for extremely low prices. The results were the following: "ONEKSIMbank" – 51% "Sidanko Oil", 38% "Norilsk Nickel", 15% "Novolipetsk Metallurgical Combine"; "Menatep" – 45% "Yukos Oil"; "LogoVAZ" – 51% "Sibneft Oil" (Johnson 1997: 352). In a few years after these banks even increased their stakes in the most profitable Russian enterprises through additional purchases via subsidiaries and holding companies. In 1995-1997 bank-led FIGs became not only important but the most influential economic (and even political) actors in Russia.

During 1993-1997 Russian bank-led FIGs have also used different measures for the limitation of influence of powerful MNCs and other foreign investors on Russian financial markets. "In particular, they lobbied to restrict foreign banks' activities in Russia, to limit foreign participation in the GKO market, and to keep foreigners from acquiring controlling stakes in

many privatizing Russian companies” (ibid.: 352-353). These measures included such activities as lobbying for legislation limiting the number and scope of foreign banks in Russia (e.g. “Law on Banks and Banking Activity” revised in 1996 prevented newly arrived foreign banks from immediately working with Russian customers), keeping the foreigners out of the first GKO auctions (the extraordinary sums of money have been earned by FIGs on speculative operations), restricting on privatization auctions the participation of wealthy foreign investors (it let FIGs to acquire property at fire-sale prices).

Such pressure of FIGs did not let investors from the West to become a stratum of owners in Russia and let the largest banks earn money on speculations and fraud during the 1995 shares-for-loans auctions. But in 1997 Russian bankers felt the need for the foreign investment: the phase of fast money and property redistribution was over. For almost four years (1993-1997) the main objective of banks were to earn money on speculations and to redistribute the property of weak Russian state. Only in 1997 when there were no more fast and huge profits there was an escalating tension among banks between the need for foreign investments and the desire to control competition.

In 1996-1997 bank-led FIGs took the first steps toward the restructuring and investment in the enterprises under their control, but the most restructuring involved shaking up management rather than investing a great deal of money in capital improvements. The biggest banks faced four difficulties: 1) the sheer size of the task; 2) lack of the experience of investment in real sector of economy; 3) “red” directors (with the long-live tradition of rent-seeking), and 4) shortage of cash (ibid.: 358).

The sheer size of task led to the stagnation of Russian economy, while neither foreign investments, nor the resources of banks were enough. In the end of 1990s there was a need to innovate more than 80% of all machines and equipment on the most part of Russian plants, but there was no strong financial market and still no clear incentives to invest into these enterprises. Many enterprises needed to be restructured, but FIGs had not enough capital to buy and restructure all of them. Moreover, the most part of banks’ capital went to the new companies and export-oriented enterprises (which could give much more profits for a shorter period of time), thus creating asymmetry in investment flows and leading to the imbalanced structural and regional development of Russian economy<sup>7</sup>.

All these problems became even more serious during and after the crisis of 1998, when the biggest FIGs faced huge losses. In fact, such banks as “SBS-Agro”, “Imperial”, “Inkombank”, “ONEKSIMbank” and “MENATEP” formally became bankrupts but still

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<sup>7</sup> Simultaneously Russian “red” directors did not want to create competitive enterprises: they considered these banks to be so called “cash cows” (like the state during the Soviet times) because of their legendary wealth (soft budget constraint syndrome)

continued to work. After the crisis there were some changes in the FIGs' development (Radygin 2000, Bruszt 2000):

1. The crisis brought to naught all the attempts of the top managers of largest FIGs to introduce the restructuring and effective management strategies. After the crisis the banks being close to bankruptcy could hardly invest in the industrial development. Their social and corporative capital, their connections and lobbying power were used only for the strengthening of themselves rather than the development of the enterprises they owned<sup>8</sup>.
2. The biggest natural monopolies ("Gazprom", "TNK", "Lukoil", etc.) got much more autonomy and opportunity to expand, and their role became even more crucial for the development of Russian economic system.
3. The weakening of former leaders gave an opportunity for the emergence and the development of small and medium competitors – regional clans, – which were much weaker before the crisis, but now could steps against the federal authorities and Moscow bank-led FIGs. On the one hand, the local elites got much more control over the biggest enterprises in their regions, and thus the asymmetry in relations between the federal center and the regions increased in size. On the other hand, it created new barriers on the way of the reorganization of Russian enterprises.
4. The weakening of bank-led FIGs led to the redistribution of property within the regions, where a huge number of holding structures were formed by the local authorities (creation of "Bashkir Energy Company" in Bashkortostan; the emergence of four holding companies in light industry and defense in Vladimir oblast', etc.)<sup>9</sup>. One of the main reasons why the regional and local authorities began to create strong business-political networks after the crisis was "their high responsibility for coping with the social and economic dislocations caused by the policies of the center. The only option left to them was to regain economic control over the largest firms once under their control by buying those company's shares. Purchasing these shares allowed them to maintain and stabilize local and regional economies by using the old strategies of bargain planning and redistribution" (Bruszt 2000: 22)
5. The strengthening of the role of the state owned companies – reanimation of state holdings in strategic sectors of economy.

In accordance with the results of research made by Enrico C. Perrotti and Stanislav Gelfer (Perotti & Gelfer 1999), the hierarchical structure of FIG<sup>10</sup> plays a positive role: in accordance

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<sup>8</sup> There were some attempts of such FIGs as "Interros", "Alfa", and "Rosprom" to reform their businesses, reorganize management and structure of their empires in summer 1998, but the financial crisis in August did not let them make these positive inceptions

<sup>9</sup> The most active redistribution of property was started in the regions where there was a big share of oil enterprises in GRP

<sup>10</sup> Here Perotti and Gelfer use the term "hierarchical" concerning the organizational structure of bank-led FIGs (Perotti & Gelfer 1999: 3)

with their calculations, FIGs now invest money into the real sector, and they create hard budget constraints for the enterprises which use their capital. In fact the results of many other researches show that the development of bank-led FIGs might play a positive role in the reconstruction of Russian hi-tech sectors of economy. For example, Sergey Peregudov concludes in his article that the lobbying pressure of FIGs decreased in 2000-2001. Thus Russian corporations now cannot get money from the state and use them for their personal benefits, but can create strong corporative associations in the interests of making profits on the market and with the help of the market (Peregudov 2001: 24).

Unfortunately, still these positivist feelings of some researchers cannot be proved by the real economic dynamics. There are a lot of examples of underinvestment and underdevelopment in different regions and different sectors of Russian economy (as I have mentioned in the first part of the work). Still we can find the examples when the enterprises have soft budget constraints and are not going to become bankrupts being big monopolies and having strong political instruments of lobbying their interests on the levels of the central and regional authorities. Even if the owners and managers of some big companies are ready to compete on the market nowadays, there is still no real market and there are a lot of constraints for market economy to develop in Russia: there is no ideological basis and there are no necessary conditions for the development of industrial enterprises and for the investment into real sector of economy (a lot of companies are still searching for rent from the state, but are not going to make profits); There are still no “good working” laws in the spheres of taxes and tariffs; there are no mechanisms of development of hi-tech industries (and no investments into these enterprises) (Nechaev 2001).

But the main problem is that **still no priorities of investments in real sector of Russian economy are created**. The FIGs are not interested in the development of hi-tech industries – for ten years their main priorities have remained the same: export-oriented industry, raw-materials, oil and gas. The investment orientation of FIGs towards these most profitable (but regressive in a long run) sectors of economy leads to highly vulnerable position of Russia in global economy.

### 2.3. *Soft budget constraints syndrome*

At the beginning of 1990s the reformers thought that the elimination of state control mechanisms will automatically lead to the formation of market relations between the economic actors. One of the measures was the hardening of budget constraints, the reason for which was the assumption that financial deficit could become lower if all enterprises would not get the subsidies from the state any more.

After the insider privatization “red directors” (who had been managing enterprises during the Soviet times) remained the official directors even when the most part of the ownership was distributed among the employees. They became *de facto* owners of their enterprises (as we have already mentioned above) with their own interests not corresponding to the interests of the employees. Their main goal was rent seeking, creation of connections with political elites, close links with local administrations and banks. They did not want to search for new markets, to develop new products, to use new technologies on their enterprises. Leon Aron mentioned that the response to the diminution of the subsidies to these enterprises was “lowered production, the sale of inventory, profligate and reckless borrowing, withholding of taxes, and the accrual of enormous inter-enterprise debts. In these strategies, the “red directors” were encouraged by their ability to secure a flow of state subsidies in the form of “loans” at a negative (that is, below inflation) interest rate. ...The regime’s timidity in forcing bankruptcies of failed enterprises, further strengthened managers’ belief in their political invincibility and in the eventual demise of market reforms. All they had to do was to wait and live well while doing so” (Aron 1998).

Many students of economic problems in Russia write that while there is an increase in number of unprofitable enterprises, the managers of these enterprises claim the shortage of financial resources as “the main limiting factor” affecting production (Gara 2001, Berzon 2001, World Bank 2001). And this fact indicates that the budget constraints do not seem to have hardened during the last decade. Even if the reforms started with the goal that the hardening of budget constraints could make the enterprises market-oriented, such expectations did not materialize, and the reforms collapsed, while **the soft-budget constraints (SBC) syndrome did not disappear.**

The main channels which stipulate the softness of budget constraints are: the lack of financial preferences of the state (the lack of strategy of investment policy); credit system; taxation.

It is possible to make the budget constraints harder through **the determination of the system of financial preferences in the law.** It is necessary to decrease and then refuse from the investments into the non-viable enterprises which could not be restructured successfully, but it

can not be made on the state level. The state can only set the rules of the game through legislation.

It is highly important that **the commercial banks** will be developed enough to create hard budget constraints for some enterprises and make them softer for the other enterprises. In Russian case, the softness of budget constraints of many enterprises can be explained partly by the backwardness of the financial system.

Another channel which can create SBC is the **tax structure**. If there is an opportunity for the enterprises to achieve the tax concessions, postponements in tax payments, and tax evasion, we can say that there is SBC. In fact, this situation leads to the lower possibility that the reforms will succeed, while the state just loses its resources, and the state activities are inefficient. In this situation the role of the state must be the control over the money supply.

The SBC syndrome which takes place in the economy during the transformation period is similar to the SBC in the socialist economy, but there are some differences. In accordance with Mark Shaffer's study of the SBC problem in transformation economies, there is a difference in basic conditions of the companies' development during transition. As Schaffer (1998: 87-88) proposed, the difference must be found between: (i) the financially distressed firms (firms which are highly indebted, but potentially profitable and market-oriented); (ii) economically distressed firms (i.e. the companies, which are not highly indebted, but, at the same time, not oriented towards the market), and (iii) both economically and financially distressed enterprises. These three types of **distress** determine the differences in the behavioral patterns of the creditor (including state and private banks, as well as non-financial organizations).

If we take financially, but not economically distressed company, the creditor's choice to subsidize that company may come from his expectation of future profit: he rescues "an economically viable but overindebted firm because the economic return is sufficiently large" (ibid.: 88). The company of this type is potentially able to pay its debts: it might have SBC only in a short or medium run, and the subsidies make it works efficiently in prospect.

If we take economically, but not financially distressed company, it can not get subsidies from the creditor institution, if the latter's choice to subsidize or not is pure economic (if such variables as profitability, demand and supply levels, etc. are taken into account). And, vice versa, these companies can get enough subsidies, if the creditor's choice will not be based on the variables of economic performance of this enterprise. If such company continues to obtain new loans from creditors, it has SBC. And here it is not possible to answer the question whether the company uses these subsidies for the restructuring or whether it will continue working as a loss making enterprise. Both variants of further development are possible.

But why some enterprises (even being unprofitable) can get enough subsidies while the others (profitable in the perspective) are not able to get these subsidies? Here we might suppose

that not only economic factors influence the choice of the enterprises by the credit institutions and the state to invest. The existence of clan-corporative structures, the interconnections between the economic and political elites, the non-monetary payments and nonpayment phenomena are the main reasons why the budget constraints are soft for some enterprises and sectors of economy, while they are hard for all other enterprises.

As we have already mentioned, the huge part of Russian enterprises are managed by the “red directors”, and some of these enterprises are in the sphere of control of huge clan-corporative structures (especially Moscow-based bank-led FIGs and regional clans). The softening of budget constraints for some enterprises is connected with the functioning of these actors, with their huge political and social capital, their “amicable” connections with the politicians, organs of state power and bureaucrats, with their huge lobbying power. The political and economic elites in Russia are interconnected and they are interested in SBC for some enterprises (especially for huge monopolies), while they get their own benefits. Thus, **the low-level equilibrium is achieved, when the elites gain huge benefits from the existing economic and political relations while the whole economic system suffers huge losses.**

The clan-corporative structures redistribute the investments in such a way that gives them the best possible outcome: some companies and branches of economy are chosen, which are then subsidized on a regular basis (have SBC). In fact, the subsidies taken from the state or banks usually create huge arrears, while the managers of enterprises do not want to make these investments highly efficient; on the contrary, they make everything to decrease the output and “earn a supernormal rate of return on the reduced quantity of output” (Goorha 2001: 411). Such a rent-seeking behavior creates huge structural deformations and makes the investments into Russian industry highly inefficient, while there are huge constraints created by the politicians, bureaucrats, “red directors” against the bankruptcy procedures on “their” enterprises. At the same time the other enterprises (even being profitable in a long term prospect) are underinvested, the facilities become older and can not be substituted, and amortization is extremely high (see data in *paragraph 1.2. Structural disproportions and the investments*).

The SBC syndrome usually takes place when the enterprises are highly indebted to each other. That was the situation of the mid-1990s in Russia, when the directors of different enterprises were connected with each other and created the “chains” of debts (inter-enterprise arrears). As Makarov and Kleiner wrote about it, these chains were not the result of cheating one director by another, but rather “the fraud by both directors of their labor collectives and the state” (Makarov-Kleiner 1996). Neil Robinson wrote about the phenomenon of inter-enterprise arrears (Robinson 2001: 14):

“...The build-up of inter-enterprise arrears meant that tax payments were delayed or could not be met; firms lobbied authorities for tax exemptions and tax payments from local authorities to the centre were squeezed, or began to be made

‘in kind’ so that their value could not be fully realized by the central government. This reproduced late Soviet practice and weakened the drive for enterprise commercialization and the monetization of economic exchange by perpetuating the ability of local authorities to provide soft budget constraints through tax breaks...”

The interconnections between the so called “red directors” helped them survive, on the one hand, but, on the other hand, they usually created two-tier organization, where the directors dominated over subordinate workers, and their rent-seeking worked only in their own interests. SBC did not lead to the restructuring of the enterprises (while they needed it so much), and at the same time not many procedures of bankruptcies took place. Sometimes the local political and economic elites were in informal agreement (social contract): if the enterprise would save overemployment it could get additional subsidies, it would pay lower taxes and have some other privileges on the local market guaranteed by the local authorities. SBC were created on the local level, because it led to the better payoffs for both local bureaucrats and politicians (less social conflicts connected with unemployment) and for the managers of former state enterprises. Such social contracts were widely spread, while the “red directors” lobbied many political decisions both on the regional and federal levels because of their monopolistic state on the local market, because of their size and relationships with local administrations which had been preserved since the Soviet times.

Thus, rent-seeking and SBC syndrome were characteristic features of early and mid-1990s showing that the strategy of radical reforms was absolutely wrong during that period. The redistributive activities took place on the level of local and federal political and economic elites, on the level of bureaucrats, altogether representing the adaptation of old nomenklatura institutions to new “market” conditions. The hardening of budget constraints for all in 1992-1993 led to a huge slump of production and gave birth to the use of the strategies of non-payments by the most part of Russian enterprises, which in turn created the return wave and made the budget constraints softer, but **only for the most influential actors – for those who could affect the political decision-making and bureaucratic apparatus activities**. The whole structure of the economy was strained, and the least prospective sectors of economy in a long run (extracting industries) became “the most preferred” for subsidizing both by the state and by the commercial banks (while the most part of them were export-oriented), while the most prospective enterprises began to stagnate because of underinvestment and lack of lobbying power.

#### *2.4. Problems of institution-building*

As many economists rightly stated, after the collapse of the old system there was a lack of new institutions, but the old institutional structure was only partly disorganized (see, e.g.:

Kolodko 1998, Polishchuk 1997, Dyker 2000). Here we talk about the institutions in a broad sense: these are different norms and principles, which determine the development and activity of economic agents on the market; banking system, which is in very close relations with the real sector of economy; the behavior of different economic agents; state itself and its organs. Grzegorz Kolodko writes about the problems of institution-building during transition (1998: 11):

“Before transition, functions performed by capital markets in market economies were conducted primarily by the state budget. Only a minor part of allocation went through non-liquid and limited quasi-markets, as regulated by the state cooperative banks or the grey foreign exchange market. The lack of financial intermediaries, sound commercial and investment banks notwithstanding discouraged accumulation and degenerating allocation of savings. Thus, immediately after the collapse of the socialism, the lack of proper regulation of the emerging capital market and the dearth of such key organizations as investment banks, mutual funds, a stock exchange, and a security control commission, etc., caused distortions that could not be offset by liberalization and privatization”.

Talking about the emergence of banking system (the institutions which had never been created during the Soviet times), we can find three most important problems which determine the underdevelopment of financial market in Russia. *First*, during the first half of 1990s about 40% of banks were so-called “zero banks” in which the owners, the customers and main depositors were the same people. These banks were created “to keep ailing enterprises going on the basis of ‘funny money’ in the form of unbacked credits from the bank, with a view ultimately to creating a situation where it will be politically very difficult for the authorities not to bail out ailing enterprise and zero-bank alike” (Dyker 2000: 14).

*Second*, the creation of banking system was one-sided: new banking institutions were so weak (especially during the first half of 1990s) that they could not create branches which were highly necessary for mobilization of savings on a large scale. Thus, from the very beginning the lack of savings in the banks led to the lack of investments of any kind (we discussed this problem when talking about the connections between savings and investments as an indicator of imbalance in the investment sphere).

*Third*, Russian banks were not interested in long-term investments into the real sector of economy from the very beginning of their existence; financial investments prevailed because these banks were uncertain about the legal enforcement of any kind of contracts. The underdevelopment of legal system in Russia is obvious, and this huge topic exceeds the bounds of my work; here we would like to highlight the most important aspects of institution-building which correlate with the problem of the transformation of financial capital into the real investments: (i) for the whole decade the property rights were not secured enough; (ii) the rights

of creditors are secured only formally, but norms are not being implemented; (iii) the system of execution of judgment is extremely weak; (iv) the system of banking supervision and banking regulation is highly bureaucratized, and all necessary procedures take much time for the banks (Nechaev 2001).

On the other hand, there is still a huge problem of “bad debts” and lack of bankruptcy procedures. Studying the SBC and rent-seeking behavior during transformation in *paragraph 2.3*, I considered that the enterprises could still borrow money from the state and banks, but there were no institutions built (at the first place, there was no legal enforcement to make them return these credits) which could prevent rent-seeking activity and eliminate the impunity of bureaucracy and directors of the enterprises. The legal system of Russia is traditionally the system of Continental Law. The activity of courts can not produce any legal norms as the result of particular legal cases; they can not regulate the relations between market agents. On the contrary, Russian legal system is such that the new laws are often far from being perfect (contain a lot of inaccuracies, ambiguities)<sup>11</sup>, and in these conditions the activity of the courts promote the corruption and rent-seeking activities, while the court decisions depend on the legal case and on the parties of this case. Thus, still the legal proceedings, the activities of executive and legislative bodies are badly organized, the rent-seeking activity and bribery are widely used (creating “bad” equilibrium for the richest strata of Russian society), and in such conditions there are no incentives among the entrepreneurs and statesmen for restructuring and further investments into the real sector of economy.

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<sup>11</sup> The recent example of “bad law” is the Law on Bankruptcy, which had been already passed in the second reading and which content reflects the interests of bureaucrats and “red directors”, but it does not create any incentives for restructuring and further investments into the real sector of economy. Thorough analysis of this bill was made by a group of experts and published by the Russian economic magazine “Expert” (see Tal’ 2002)

## Conclusion

The increase of the deformations in the investment sphere of Russian economy in 1990s was generally caused by the failed experiment of radical market reforms in Russia. The investment processes were also accompanied by the processes of general economic disequilibrium, including huge differentiation of the levels of economic development of Russian regions.

We tried to make an overview of the indicators of disproportions in the investment sphere and spatial-economic imbalance, and to study briefly how these disproportions were brought to life. We also wanted to show factors affecting investment processes and how these factors influence the spatial-economic imbalance in Russia.

We argued that still no priorities of investments in real sector of Russian economy are created. Nowadays huge Russian corporations are not interested in the development of hi-tech industries – for ten years their main priorities have remained the same: export-oriented industry, raw-materials, oil and gas. The investment orientation of financial-industrial groups towards these most profitable (but regressive in a long run) sectors of economy leads to highly vulnerable position of Russia in global economy. On the other hand, the structure of property, bad institutional structure and soft budget constraints still prevent the progress in the development of many sectors of economy and Russian regions.

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