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Financial Regulation in the Initial Phase of Market Reforms in Russia and Its Impact on Subsequent Economic Development

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***Abstract*-This article discusses the results of the retrospective analysis of market transition processes in Russia and shows how state financial regulation shaped the country's socio-economic development in the subsequent periods. The article provides an overview of the approaches to this problem proposed by the leading international and Russian economists. The authors believe that the market reforms made Russian economy vulnerable to external macroeconomic challenges in the following stages of development. This vulnerability becomes especially pronounced in the periods of cyclical decline. The dynamic comparison of volumes and sources of fixed capital investment in the main sectors of Russian economy and analysis of the key phases in its cycles have led these authors to the conclusion that in the periods of decline the internal economic environment becomes highly sensitive to the changes in the external environment. These results are supplemented with the results of a comprehensive analysis of changes in gross value added across the key sectors of economy.**

***The aim* of this study is to analyze the outcomes of the privatization campaign in Russia and to demonstrate that the current situation in Russian economy largely stems from the market reforms of the transition period.**

***Research findings*: it was shown that the key characteristics of the evolving Russian financial system mainly resulted from the 'shock therapy' privatization scenario, which was chosen for political reasons and which determined the investment trends and the increasing state influence on economy in the following periods.**

Keywords-financial regulation, financial system, socio-economic development, investment, economic growth

I. INTRODUCTION – RESEARCH OBJECTIVE AND ITS SIGNIFICANCE

Fundamental research in the sphere of financial regulation of economic processes is motivated by the importance that indicators of economic growth have for national economy. In Russia, financial regulation is particularly significant as the difficult period of market transformations the country went through required the government to rebuild the financial system, both in its institutional and infrastructural aspects.

One of the main indicators characterizing economic growth is investment, which satisfies financial needs of the country's economy [4] [10]. Therefore, theoretical and empirical studies of state financial regulation of socio-economic processes in Russia should include retrospective analysis of the tremendous impact that social and political transformations had on the country's economy and financial system.

The events that occurred in the initial phase of market reforms determined many processes in the Russian economic system, the key characteristics of the evolving financial system and those investment trends which, in their turn, subsequently shaped the potential of the country's economic growth. It should be noted that in our analysis of the changing parameters of the financial system and of the current state of Russian economy, we focused on the patterns of state macroeconomic regulation rather than on spontaneous interplay of market forces.

TABLE 1. EXTERNAL AND INTERNAL ENVIRONMENT PARAMETERS IN CRISIS PERIODS (1998-2008), USD

<table>
<tr><th>Periods/ Parameters</th><th>Oil prices</th><th>US Dollar/Rouble exchange rate</th><th>Inflation</th><th>Economic growth rates</th><th>GDP</th><th>Average salary</th><th>Unemployment</th></tr>
<tr><td>12.1998</td><td>10.5</td><td>6.2</td><td rowspan="2">84.4</td><td rowspan="2">– 5,3</td><td>424</td><td>171</td><td rowspan="2">11.6</td></tr>
<tr><td>09.1998</td><td>12.3</td><td>20.2</td><td>130</td><td>52</td></tr>
<tr><td>07.2008</td><td>123.5</td><td>23.4</td><td rowspan="2">13.3</td><td>5.2</td><td>1764</td><td rowspan="2">763</td><td>6.3</td></tr>
<tr><td>12.2008</td><td>40.1</td><td>29</td><td>– 7,8</td><td>1423</td><td>8.2</td></tr>
<tr><td>06.2014</td><td>112.5</td><td>33.6</td><td rowspan="2">11.4</td><td>1.8</td><td>2257</td><td>998</td><td>4.9</td></tr>
<tr><td>12.2014</td><td>57.4</td><td>58.1</td><td>0.7</td><td>1362</td><td>722</td><td>6.1</td></tr>
<tr><td>01.2016</td><td>34.7</td><td>77.9</td><td>12.9</td><td>– 3,8</td><td>1106</td><td>429</td><td>5.8</td></tr>
<tr><td>04.2018</td><td>74.6</td><td>60.8</td><td rowspan="2">4.2</td><td>1.7</td><td>1473</td><td>625</td><td rowspan="2">5.1</td></tr>
<tr><td>12.2018</td><td>53.8</td><td>67.3</td><td>0.6</td><td>1517</td><td>631</td></tr>
</table>

Compiled by the authors.

II. CONCEPTUAL FRAMEWORK AND METHODOLOGY

Crises in the post-Soviet Russian economy were often accompanied by changes in the external environment, which caused serious imbalances in the system's internal parameters (see Table 1).

As a result of the dramatic slump in global oil prices in 2008 (by 67.5%), oil production decreased by 19.3% and unemployment rose by 33.8%. Nevertheless, financial regulation of reproduction processes had a positive influence on the country's socio-economic development.

The following period was relatively prosperous until 2014, when the rising political confrontation of Russia with the USA and Europe together with the twofold slump in oil prices on international markets had serious repercussions for the country's economy. In the autumn of 2014, the Central Bank took the decision to abandon direct regulation of the rouble exchange rate against world currencies. The question as to whether this decision allowed the government to improve or at least stabilize the situation remains open for debate since, faced with the devaluation of the rouble, the government's priority was to maintain social stability by mobilizing internal sources of funding. At the same time companies and some of the economically active population were left to suffer the consequences of the catastrophic devaluation of the rouble and were thus rendered incapable of servicing their foreign-currency debts or buying imported goods.

Even though the country did not manage to fully recover from the consequences of the 2014 recession, the government's regulation efforts have yielded certain results.

The data in Table 1 show the following trends in investment dynamics relevant to the topic discussed here:

1) The investment downturn between 1990 and 1998 resulted in an almost fivefold decrease (to 21%) in the volume of investment as compared to 1990. Apparently, the reason behind this trend was the market reform, which affected the country's political, socio-economic and financial system.

2) Since 1999, investment activity started to recover, reaching 70% of the 1990 level. It is worth noting that the investment rate grew on average by 12% annually. This upward trend in investment mainly resulted from favorable external conditions, especially the steady rise in oil prices: Brent oil price rose from 32.15 (in 1999) to 105.23 (in 2008) USD per barrel. This factor determined general growth in all macroeconomic indicators, which allowed Russia to attract external and generate internal investment flows.

3) since the end of 2008 and throughout 2009, Russia was hit hard by the global recession in its acute phase with the plunge in oil prices, which provoked a fall in investment dynamics to 60% of the 1990 level;

4) in 2010, a period of revival started, including revival in investment activity;

5) in 2014 and 2015, there was a new decline in investment, caused by the combination of negative external factors – a new round of geopolitical tensions, which triggered another exchange of economic sanctions between the West and Russia, and another major oil price decline.

In-depth analysis of the reasons underlying the massive economic turmoil, which coincided with the beginning of market reforms in Russia, allows us to divide these factors into fundamental and situational. Fundamental factors are related to the radical character of the market reforms –the 'shock therapy' scenario of privatization, which swiftly led to dismantling of the administrative-command mechanism that underpinned the 'planned' financial system and the associated investment processes. Administrative-command regulation principles naturally imply that the state plays the main role in the investment sphere: it is the only investor and it is in charge of central planning and investment; the state also allocates funds to meet the needs of expanded production. Such system requires all other actors to be totally financially and economically dependent on the state in terms of investment.

The major factors that caused or contributed to the deep restructuring of the financial system in Russia are as follows:

1. Fundamental factors:

1) 'shock therapy' scenario of market reforms;

2) complete dismantling of the administrative-financial mechanism of financing investment;

3) radical methods used for the national privatization campaign.

2. Situational factors (related to the evolving macro-environment, which was shaped by the fundamental factors):

1) dramatic decline in production;

2) catastrophic drop in population and business incomes;

3) lack of developed financial sector (the way it exists in developed countries);

4) hyperinflation;

5) inefficient financial and socio-economic state policy in the sphere of financial and investment regulation.

Macro-economic indicators in Russian economy started to stabilize in the early 2000s. The stabilization process resulted from the impact of global financial and economic factors, primarily high oil prices, which allowed to accumulate assets on the state and corporate levels. It was the period when the state sought to create a favourable business climate in the country by reducing tax rates (personal income tax) and government borrowing.

Moreover, in that period, the exchange rate of the national currency against global currencies was relatively stable and 'comfortable'.

Russia was afflicted by the global financial crisis of 2008-2009 although the government managed to deal with the production decline in the real sector, the increasing unemployment and the currency devaluation. The falling national financial market was also stabilized with the help of balanced financial regulation: notably, the income tax was reduced from 24 to 20% at the end of 2008, which helped the government to level off the decline in reproduction.

III. DATA ANALYSIS

The cyclical fluctuations in Russian economy described above necessitate the analysis of capital investment in companies of different sectors with the view to assess the efficiency of state financial regulation in troubled periods of the country's economic development. The state alone could revive economic growth in the face of geopolitical sanctions of 2015-2016 and the 'flagship' economic sector quite expectedly became that of raw materials and minerals extraction: in this sector, there was a rise in fixed capital investment (+23,8% compared to 2013), which was particularly important if we take into consideration the general 7.9% decline on this indicator.

The fall in fixed capital investment in Russia reached its lowest point in 2016: the volume of investment in all sectors had dropped by 10.2% by 2014. Compared to 2013, the most significant decline was observed in the following sectors: construction (-28.2%); generation and distribution of electricity, gas and water (-26.4%); wholesale and retail trade (-17.2%); transport and communication (-15.5%) (see Table 2).

TABLE 2. SECTORAL DYNAMICS OF FIXED CAPITAL INVESTMENT IN LARGE AND MEDIUM-SIZED RUSSIAN COMPANIES SECTOR (COMPARABLE PRICES), %

Sector	**Results of 2016, change (%)**		
	Compared to 2015	**Compared to 2014**	**Compared to 2013**
Agriculture	– 3,1	– 4,7	– 2,6
Extraction of raw materials and minerals	7.4	17.8	23.8
Manufacturing	– 6,4	– 12,3	– 7,1
Generation and distribution of electricity, gas and water	– 7,9	– 30,1	– 26,4
Construction	0.8	– 20,2	– 28,2
Wholesale and retail trade	– 0,2	– 10,7	– 17,2
Transport and communication	– 5,2	– 16,2	– 15,5
Real estate	8.1	– 5,5	9.7
Overall dynamics	– 0,8	– 10,2	– 7,9

Source: Analytical Center for the Government of the Russian Federation.

Compared to 2015, the rate of year-on-year investment decline slowed down to 0.8% (Table 2). Having said that, the rouble exchange rate adjustment and the oil price recovery slowed down the rate of investment in extractive industry to 7.4%. Some positive dynamics was observed in construction industry and in the real estate sector (+8,1%).

Our analysis of fixed capital investment dynamics in different sectors shows that Russian economy has not managed to fully recover – the government's efforts to regulate reproduction in economy proved to be insufficient. It should be noted, however, that the state is by no means the only institutional and infrastructural element of the financial system capable of boosting investment after a recession. What is absolutely imperative is that companies should have their own internal investment resources. Table 3 shows the data on the structure of internal and external sources of funding for fixed capital investment in 2016. These data should be considered as indicative since economic downturns are usually associated with shrinking access to external funds. The 2014 recession in Russia was particularly illustrative in this respect due to the political factors, which made Russian companies' access to external funding especially difficult.

Since the absolute data are given in current prices, in nominal terms, the amount of investment funding continued to grow throughout the whole crisis period. We did not conduct this analysis in comparable prices due to the devaluation-induced price increases, which would have given us a distorted picture of the situation. As Table 3 shows, state financial regulation of reproduction is realized through capital investment into economic growth from budgetary funds of all levels and state extra-budgetary funds. The share of budget funds and extra-budgetary funds was slightly below 10% throughout the most difficult period (2014-2016).

TABLE 3. SOURCES OF FUNDING FOR FIXED CAPITAL INVESTMENT IN LARGE AND MEDIUM-SIZED ENTERPRISES IN RUSSIA, 2014-2016

Items	2014		2015		2016	
	billion roubles	share, %	billion roubles	share, %	billion roubles	share, %
Fixed-capital investment, total	10,379,6	100	10496.3	100	11266.9	100
Internal funds	4742.3	45.7	5271.1	50.2	5738.0	50.9
External funds	5637.3	54.3	5225.2	49.8	5529.0	49.1
Bank loans	1098.7	10.6	849.9	8.1	1172.8	10.4
including foreign banks	265.2	2.6	183.5	1.7	329.1	2.9
Loans from other lenders	660.1	6.4	701.0	6.7	674.4	6.0
Foreign investment	88.8	0.9	120.4	1.1	86.7	0.8
Budget funds	1761.3	17.0	1922.7	18.3	1855.1	16.5
federal budget	933.6	9.0	1185.7	11.3	1047.9	9.3
regional budget	676.6	6.5	600.3	5.7	679.6	6.0
local budget	151.1	1.5	136.7	1.3	127,:	1.2
State non-budgetary funds	24.0	0.2	27.3	0.3	27.8	0.2
Shared equity construction (funds provided by people and organizations)	367.6	3.5	334.3	3.2	341.2	3.0

Source: Analytical Center for the Government of the Russian Federation.

TABLE 4. GROSS VALUE ADDED BY SECTOR, 2014-2017, CURRENT PRICES, BILLION ROUBLES

GDP by sector	2014	2015	2016	2017
GDP, including:	79 199,7	83 387,2	83 101,1	86 101,2
Agriculture	2 665,9	3 241,5	3 014,4	3 087,0
Extraction of raw materials and minerals	6 241,5	7 293,6	7 377,8	7 456,6
Manufacturing	9 184,5	10 546,9	10 547,4	10 474,6
Generation and distribution of electricity, gas and water	1 992,5	2 244,0	2 243,9	2 407,4
Construction	4 681,5	4 744,0	4 747,2	4,976,6
Wholesale and retail trade	11 171,6	11 852,9	11 855,5	11 436,6
Transport and communication	5 394,0	6 033,2	6 033,8	6 623,9
Real estate	12 093,3	13 244,8	13 237,5	13 882,0

IV. RESULTS

We believe that the impact of state financial regulation on reproduction in national economy can be evaluated by looking at the dynamics of the gross domestic product (GDP). As stated above, our analysis focuses on the fixed capital investment data. Table 4 provides a sector-specific picture of the GDP and GVA dynamics in 2014-2017.

The GDP growth rate in 2016 compared to 2014 was 4.9% in current prices while fixed capital investment in the same period fell by 10.2%. This fact leads us to the following conclusions: either investment was not the driving force behind the growth or the rate of price increase accordingly outpaced the rate of production decline. We believe that in this case, it was the joint impact of both factors that resulted in the increase in the GDP growth rate. Similarly, if we look at the share of specific sectors in GVA and GDP, we shall see that there was a rise in production rates in such sectors as wholesale and retail trade, transport and communication, manufacturing, generation and distribution of electricity, gas and water while the investment in these sectors was significantly reduced in this period.

Theoretically, this trend might seem paradoxical but the fact of the matter is that it was the consequences of market restructuring and the geopolitical events that led the government to focus on ensuring social stability to the detriment of investment potential of the national economy.

Since market restructuring began, the state as the key regulatory institution has lost its monopoly status and the ability to influence the financial system. Thus, the state gradually came to assume the role of the regulator of financial and investment processes. Until the 2000s, regulatory competences were greatly diminished. On the one hand, new financial and legal institutions were evolving; on the other hand, government spending on investment decreased (from 78% in 1990 to about 20% in 1998). As a result, Russian enterprises, which had had no experience or needs of autonomous investment activities for decades by that time, could not in a short term adapt to dynamic economic environment of international business and its trends.

V. DISCUSSION

Discussing the outcomes of the privatization campaign, economists distinguish between the two key scenarios: using the terms proposed by J. Kornai, these were 'organic development' and 'accelerated privatization'.[2] The differences between these scenarios lie in the goals pursued by the state: the goal of the 'organic development' scenario is to create a solid class of efficient property owners through open sale of state assets to investors at genuine market prices. The key characteristic distinguishing this scenario from the other one is that it requires more time to be realized. According to American Nobel Prize-winning economist K.J. Arrow, privatization should be conducted at a moderate pace as private owners need time to accumulate enough funds to purchase factors of production. It also takes time to determine the real selling value of the main factors of production. The manufacturing sector has to be restructured before the privatization actually begins.

The Russian government chose the other privatization scenario – accelerated one, which was orientated towards fast elimination of state ownership and was largely a reaction, as J. Kornai put it, to the threat of communist restoration. This opinion is shared by many Russian researchers, for example, the Rector of the Russian Academy of National Economy and Public Administration, Prof. V. Mau, who points out that privatization can pursue three aims: political, economic, and fiscal. The first aim is to reinforce the political regime. It is obvious that in the 1990s the political aim prevailed. In reality, the privatization campaign in Russia followed the accelerated scenario and what in fact happened was the distribution of state assets at nominal prices among the members of a 'closed' circle of top managers and privileged bureaucrats [6]. One of the worst consequences of privatization was that it created a massive disproportion of income distribution, which put property rights in constant jeopardy. Thus, the government failed to secure the legitimacy of property rights in the eyes of the public. Social inequality resulting from such tremendously disproportionate income distribution has been growing and now, almost thirty years after, it continues to affect financial regulation of economic and investment processes and has a destructive impact on the whole national economy [7].

VI. CONCLUSION

The 'shock therapy' scenario of privatization led to the situation when most of the real manufacturing sector was controlled by agencies and people that were unable to bear responsibility for the results of their decisions, especially for the failure of the businesses they were in charge of. As a result, rent-focused behaviour became widely spread among the new owners. This kind of behaviour was irrational from the point of view of long-term investment efficiency.

The Russian fiscal policy in this period was primarily orientated towards servicing the growing internal and foreign debt by issuing government securities. The escalated pressure on the country's fiscal deficits forced the government to raise more capital by issuing short-term government bonds called 'Government Short-Term Commitments' or 'GKO bonds'. The resulting pyramid-like structure quite expectedly led to the following outcome: Russia defaulted on its domestic debt when the anticipated bond yields exceeded the volume of the monetary aggregate M2. The default caused a collapse of the stock market, rouble devaluation, and other negative consequences for the national economy.

All things considered, we have to admit that the 'shock therapy' scenario failed to prevent the large-scale investment crisis that emerged in the initial phase of the market transformations of Russian economy.

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