

## **RUSSIAN FAR EAST'S ECONOMIC DEVELOPMENT: CURRENT TRENDS AND FUTURE POSSIBILITIES**

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For the second time in the reform period the Russian economy today exhibits signs of restoring its business cycle. As is commonly known, business cycle, which theoretically should have resulted from the transformation of a centrally planned economy into a market economy, has taken the form of a long-term downfall of business activity in Russia. Another commonly known fact is that the forming of a business cycle starts from different phases, depending on the specifics of the strategy that is adopted for economic system transformation. The sequence of a business cycle's phases in the initial period of economic transformation in most cases is closely related to the correlation between aggregate demand and aggregate supply dynamics.

In the case of Russian economic reform, the immediate effect of liberalization was a slump of business enterprises at every level of price for their goods and services. This marked the beginning of a stagflation process, when output decreases along with the growth of prices. This phenomenon is in fact standard even for stable market economies and is well known in countries that have experienced economic system transformations—e.g., Japan and East European countries. China is probably the only country which managed to avoid the slump phase in the beginning of its business cycle, and this was due to government control of both supply and demand.

The growth of prices, which followed the initial liberalization shock in Russia, was extremely unbalanced for certain goods and services. The largest growth occurred and was sustained in the most monopolized sectors of economy--namely in branches supplying raw materials and intermediate inputs, energy production, transport, and communications. In other words, the prices of production resources were growing faster than those of finished products.

Price proportions have undergone drastic changes since 1991. Producer prices in industry by year 2000 had topped consumer prices by an average of 1.2 times, while in late1997 this proportion was 2.4 and went down in late1998 due to devaluation and the depreciation of the ruble. As far as producer prices are concerned, as of year 2000 industrial prices are 5.6 times higher than average agricultural prices, while energy prices exceed general industrial prices by 1.6 times. Freight tariffs are 1.1 times higher than wholesale industrial prices, but the situation improved after the depreciation of the ruble.

Price imbalances should have led to an upward shift<sup>1</sup> of the aggregate demand curve, accompanied by a decrease of natural indicators of production output. The latter was due to the inability of enterprises to sustain the former level of output under the pressure of decreased volumes of working capital and growing prices. This resulted in the decrease of production demand not only from households but also from enterprises, adding to the abovementioned decrease of aggregate demand.

The process of increasing prices in monopolized producers of primary goods and services was induced not just by the liberalization of prices but by liberalization,

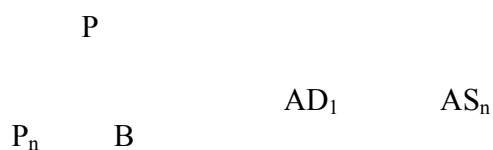
accompanied by the complete absence or extreme weakness of state control over “natural monopolies.” That is, institutional weaknesses in Russia created fertile soil for a redistribution of monopoly rent, which was previously claimed by the state and distributed into other branches of economy, to the advantage of *de facto* owners of monopolized resources, who had, to their own surprise, become managers and workers of monopoly enterprises. However, liberalization also gave strong stimuli for the producers of consumer goods to raise prices continuously, since the initially unbalanced internal market prices enabled them to reap enormous rent incomes. The inherent tendency of business firms in a market economy to maximize profit through achieving an equilibrium value of output and prices, was substituted in the specific Russian environment by the desire to receive as quickly as possible the maximum possible rent incomes from the non-equilibrium market.

Table 1. Price Indices in Various Branches of Russian Economy  
(times, 1990=1)

	1991	1993	1995	1996	1997	1998	1999
Consumer prices	2.6	637.9	4694.8	5633.8	6197.2	11704.1	23257.4
Producer prices in industry	3.4	1149.2	10239.4	13311.2	14642.3	17038.4	28505.2
Construction prices	3.1	579.0	8284.9	14084.3	15492.7	13363.5	....
Freight transport tariffs	1.5	568.9	12970.4	18158.5	19974.3	18638.5	22030.7
Electric energy producers' prices	2.0	1653.2	15342.1	21478.9	23626.8	....	....
Agricultural goods producers' prices	1.6	121.8	1206.0	1688.5	1857.0	2635.1	5043.5

Sources: *Rosyiskiy statisticheskiy ezhegodnik. 1998* (Moscow, 1998), C715; *Review of Economic Policy in Russia in 1998* (Moscow: ROSSPEN, 1999); *Social-economic Situation in Russia, 1999* (Moscow, 1999), p. 118.

This has led to an unmanageable process of supply and demand reduction, which in turn has formed a lasting stagflation trajectory in economic dynamics (Figure 1). The level of potential output has also gone down (the potential output line has shifted to the left). The Russian economy was following the AB trajectory, decreasing output and increasing prices from cycle to cycle. Consequently, the slowing growth rates are quite natural, just as the value of potential output is naturally decreasing with every new shift of supply and demand curves, due to change in the level of available amounts of production factors.<sup>2</sup>



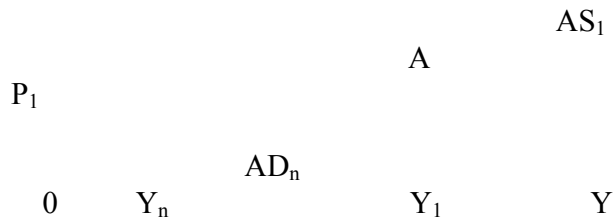


Figure 1. Stagflation Induced by Price Liberalization.

The stagflation process has continued in Russia for a long time. The first signs of its coming to an end appeared only in 1997. The financial policy adopted by the Russian government in the first half of 1997 was, for the first time ever, rationally directed at economic growth. There existed three main factors favoring the transition to economic growth: (1) a large positive balance of current payment accounts, a growth of hard currency reserves, and control over the ruble's exchange rate; (2) a rise in the inflow of foreign capital, to a large extent in the form of interventions in the GKO/OFZ (government treasury liabilities) market; and (3) a drop in rates on short-term loans, boosting the business expectations index and production volumes. These factors did not last long, but their influence was quite fully revealed by September of 1997.

What was not expected, at least not initially, was the impact of the global investment climate on the above factors.<sup>3</sup>

The Asian financial crisis cut short the fledging positive trends in the internal financial, currency, and production markets. First, capital began flowing out of risky markets, including the Russian market, making it difficult to sustain the stability of currency exchange rates. Second, increasing levels of investment risks led to interest rate increases, with negative consequences for the revitalization of the real sector of the economy which had just begun. Third, international demand for energy resources shrunk, bringing down the prices, and rapidly corrupting Russia's balance of payments through the worsening of current accounts balance. The latter put additional pressure on currency exchange rates.

All of the above resulted in a "double deficit," i.e., a budget deficit and a balance of payments deficit, with troubling consequences in both theory and practice. Remedies could have been found in rapid changes in the fiscal policy, in no less rapid changes in the credit and monetary policy (including devaluation of the ruble), or in drastic changes in the balance of payments structure. None of these changes occurred, however, and as a result, starting from the fourth quarter of 1997, Russia's economy entered a long-term financial-economic and monetary crisis.

In late 1997-early 1998 certain efforts were made to localize the impending crisis in the financial sphere. For instance, all write-offs of mutual arrears on the federal level were blocked in order to increase the collection of taxes in the form of actual money, which was supposed to improve the situation with internal debt servicing. In the fourth quarter of 1997 this increased the share of taxes from 6.5 percent to 8 percent of GDP, and to 9 percent in the first quarter of 1998. At the same time the level of direct borrowing from the GKO/OFZ market decreased sharply, from 4 billion rubles in the fourth quarter of 1997 to 1 billion rubles in the first quarter of 1998.

Moreover, the Central Bank stepped back from its previous policy of holding the nearly fixed ruble's exchange rate and increased the currency corridor. However, the bank continued to stabilize the exchange rate. Consequently, the balance of payments continued to worsen. In the first quarter of 1998 the current accounts deficit amounted to 1.6 billion rubles, compared to the 0.4 billion rubles surplus during the fourth quarter of 1997. Another Central Bank's decision, which added fuel to the growing fire of the unveiling financial crisis, was the continuation of the liberalization of non-residents' presence on the GKO/OFZ market. This actually increased the amount of speculations, which by then were ready to cause a currency market crash.

The government and the Central Bank were forced to make a decision: they could either change the exchange rate policy or the fiscal policy. The first alternative was of a short-term nature and easy to accomplish, while the latter was a long-term one and connected with large difficulties. The government chose the second course. The crisis became inevitable.

May 1998 was marked by an intermediate crisis, caused by the peek of investors' anxieties about the Central Bank's difficulty in meeting its obligations. Psychologically, investors' expectations were based up the fact that the main problems, which were described above, were never resolved, while the pressure from Russian exporters and banks connected with them towards the devaluation of the ruble was ever increasing. Hence, the resulting outflow of non-resident capital from the internal financial market. Raising the refinancing rate to 150 percent could not significantly alter the situation, since the investors in the internal market were paying attention to their own evaluation of the return on their initial investments, rather than to bank rates.

In August 1998 an extremely negative general economic and financial situation existed. Government domestic debt had reached nearly 390 billion rubles or 50 percent of GDP in that period's prices. By early August currency liabilities had reached 26 billion dollars, of which 15.2 billion were in arrears on immediate contracts for currency sales to non-residents. During one and a half months of summer of 1998 the outflow of residents' deposits constituted 10 percent of the total amount of deposits, raising serious questions about the bank system's stability. Ruble bank deposits of enterprises had shrunk by 6 percent, corresponding to the slump of production (6.3%).

Decisions of August 17, 1998 formally affirmed the government's inability to continue the previous currency and financial policy and were unprecedented in the practices of economic stabilization. As is well known, three decisions were adopted:

- To freeze the internal debt payments;
- To widen the currency corridor (which practically meant a shift towards a floating rate); and,
- To place a moratorium on external debts in the private sector of the economy.

Although each of these decisions had a previous history of practical application, their combined use was unprecedented. The profits were obvious for most exporters with clean currency assets, as well as for those commercial banks which managed to convert their assets to hard currency and had no debt obligations.

For the economy in general, the above measures had extremely harsh consequences. A year later, in the third quarter of 1999, the picture appeared positive at a first glance. In reality, however, what we witnessed was nothing more than the prolongation of those profits

which were already evident a year ago, in the form of profits for exporters and which have long-term nature as long as a positive difference continues between domestic and global prices at a given exchange rate.<sup>4</sup>

The devaluation led to a rapid growth of net exports (in ruble terms), with no signs of revitalization of investment and depressed consumer spending, as well as quite a sluggish dynamic--until August 1999--of state expenditures. This meant that the GDP growth, which appeared in the fourth quarter almost entirely depended on the country's trade balance.

In October 1998, the new government initiated a completely different financial policy, even though it never made public a rational system of interrelated measures. The separate measures and decisions adopted by the government boiled down to:

- introduction of a floating exchange rate with strong administrative regulation;
- considerable emission, controlled by the Central Bank;
- an attempt at transforming the principles of tax regulation; and,
- selective support of the banking system.

The Central Bank implemented the financial policy under pressure. The policy was to a large extent self-contradictory. Initially refusing to intervene in the exchange rate market to hedge against inflation--an absolutely necessary step, taking into account the very undefined situation with a balance of payments--the Central Bank by the end of the year returned to the strict regulation of the exchange rate in the absence of complete control over the supply of money.

Consumer prices grew by 84.5 percent in 1998, compared to 11 percent in 1997. Eighty percent of the inflation was due to the ruble devaluation and government deficit financing. However, producer prices went up by only 23.2 percent, paving the way for the revitalization of the market that ensued and the deflationary effect in the import-substituting branches. The total decline of GDP in 1998 amounted to 4.6 percent and the decline of industrial production was 5.2 percent. The largest decline was noted in agriculture.

September of 1998 was the most dramatic. During that month, the decline of GDP topped 10 percent and the decline of industrial production was 15 percent as compared to August. The decline of production in light industry reached almost 20 percent, with food industry and machinery declining by 10.5 percent and 26 percent, respectively. The main cause of such sharp decreases was a no less sharp increase of demand limitations. In September real private incomes shrunk almost 30 percent compared to a year earlier. The volume of the "shuttle" business went down by 10 percent and organized business slumped by 40 percent.

The realization of positive effects of devaluation, therefore, started from an extremely "low position." Growth was noted in several branches of industry starting in November 1998. Unlike the light industry, which never recuperated from the substantial decrease of demand, and the food industry and electric energy and export-oriented branches of the extracting industry almost fully restored their levels of production by December.

The improvement of market conditions continued in 1999, with GDP increasing by seven percent in the first nine months of the year. This was an increase over the nine month period of the previous year, and it needs to be corrected to account for the sharp decline of September 1998. Thus corrected, the record made for much lesser optimism. Most of the main factors of economic growth, with the exception of pure exports, remained inactive and did not contribute to the stimulation of the internal market. Already by the fourth quarter of

1998 both industry and GDP had started showing growth and had almost reached the pre-crisis level by year's end, which was to a large extent due to import substitution. (See Figure 2.)

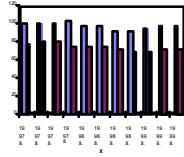


Figure. 2. Quarterly Dynamics of GDP and Gross Domestic Investment, 1997-1999 (% of the previous period; left bars - GDP, right bars – GDI)

The apparent growth signaled not so much firm improvements in the economy as a heavy downfall of the economy in the sphere of base parameters of economic growth, which resulted from the ruble devaluation. Indeed, no correction of the economic system has occurred and there are no signs of even a hysteresis equilibrium. There are serious strategic problems in sustaining the stability of positive growth of macroeconomic indicators.

The situation in the Russian Far East changed in a similar fashion, with some deviations in the area of qualitative estimations of visible and invisible dynamics.

Production declined reached 1.9 percent in the end of 1998 and 1.1 percent in the first half of 1999. In 1998 production shrunk in almost all branches of industry. Production of electric energy in the Far East was 96 percent of the previous year's level, oil 99 percent, coal 88 percent, timber 73 percent, saw-timber 83 percent, cement 102 percent, fishing 95 percent, freight transports by rail 88 percent and by water 86 percent. Export volumes had shrunk by 37 percent compared to 1997. In 1999, as in all of Russia, certain branches experienced some growth: electric energy by 105 percent, oil 103.5 percent, oil refining 133.5 percent, timber 129 percent. Growth in exporting branches could have been more significant, but unlike the rest of Russia, which benefited from the stabilizing oil prices, the Far Eastern region faced a new wave of world price declines for its raw material exports. As a result, the value of exports went down by 27 percent, while ruble incomes from exports increased.

In the third quarter of 1999 the situation improved, compared to a year earlier, although again we must keep in mind the decline in the third quarter of 1998. The region's industrial production volume increased by around seven percent over the first nine months of 1999, and increases were even higher in certain subjects of Federation, e.g., 10.5 percent in Khabarovskiy Kray and 14 percent in Sakhalinskaya Oblast. However, there are no signs of fundamental improvements in the Far East.

It is obvious that compared to Russia in general, the Russian Far East faces greater problems in taking advantage of ruble devaluation and receiving short-term effects, let alone in establishing a long-term basis for economic development. In the Far East, consumer goods industries occupy a much smaller position in the structure of production than in most other parts of Russia, and therefore the effect of internal demand growth due to the loss of price competitiveness of imported products is much weaker in the region, and the main stimulus comes from increases of hard currency's share in profits, rather than from the

possibility of reclaiming the internal markets through import-substitution. To summarize the situation.

- The main part of credit debts in the region is constituted by debts to energy producers most of whom are situated outside of the region, and therefore the growing revenues from increasing export incomes is distributed among external creditors, without producing noticeably strong monetary stimuli inside the Far Eastern region.
- Most of the Far Eastern exports incur transportation costs and since transport and freight processing tariffs are collected in hard currency, the transport share in costs is still high after the devaluation of the ruble.
- Natural resource companies of the Russian Far East receive equipment and technological inputs almost entirely through imports, therefore this part of the costs also has not changed after the ruble devaluation, while the increase of ruble incomes due to the devaluation was considerably lower than it could otherwise have been.

Nevertheless, the overall improvement of market conditions in Russia has led to an improvement in the economic dynamics of the Russian Far East. Table 2 and Figure 3 show the 1991-1999 dynamics of industrial production volumes in relative prices in the Russian Far East. Comparing volumes of industrial output to the 1991 level, we can see that production grew in 1999 for the second time since 1997 and the increase was more substantial than in 1997.

Table 2. Dynamics of Industrial Production to the Base Level of 1991  
(in %)

	1992	1993	1994	1995	1996	1997	1998	1999
Russia	81	72	57	55	52	53	50	54
Far East	84	70	56	46	40	38	37	39

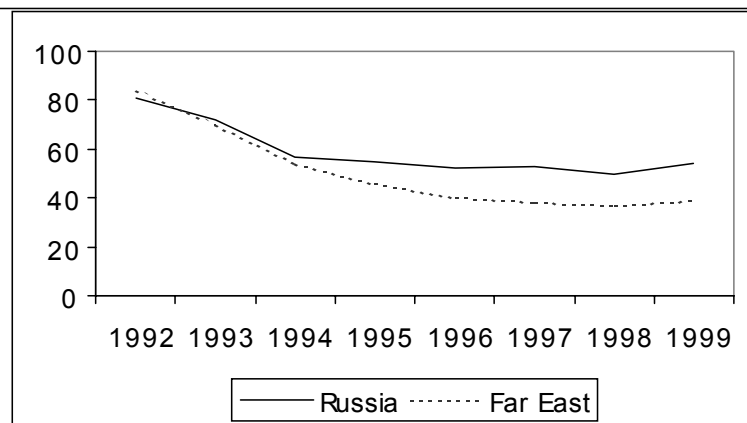


Figure 3. Dynamics of Industrial Production in Russia and Russian Far East

Two main factors enabled the growth of industrial production in 1999, while the other branches of economy experienced little or no changes, with the total GDP increase of only 3 percent for the year. First, the depreciation of the ruble after the default and devaluation of August 1998 sharply increased the supply of ruble, the currency entering the Russian monetary market when export revenues were converted. This was accompanied by the sustainable growth of world prices for energy resources, which in its turn contributed to the growth of the ruble supply in the domestic market, with hard currency earnings from exports being converted to rubles. At the same time, forecasts of Russia's expansion on international markets due to the depreciation of the national currency did not materialize. Due to the raw material-oriented structure of Russia's exports, the country was unable to exploit the favorable trade picture. That is, a sharp increase of raw materials exports could have improved the price competitiveness of those exports. Meanwhile, The low technological level of Russia's processing industries and the underdeveloped market infrastructure in the country prevent those industries from expanding their exports. On the other hand, import volumes shrunk due to the sharp increase of import prices on the domestic market. As a result, for January-November 1999 Russia's external trade balance achieved recorded a surplus of more than US\$28, compared to \$15 billion in 1998. The Russian Far East experienced a sharp decrease of exports due to a shrinkage of military sales to China, with the region's overall international trade declining to 33 percent of the 1998 level.

Growth of industrial production in the Russian Far East took place mainly in export industries (oil extraction grew by 12 percent, coal by 1.5 percent, and timber by 41 percent. Increase of exports led to the growth of railroad freight transports (8.5 %) and electric energy consumption in industry (7%). At the same time, the fishery industry fell victim to depressed world prices and disappointing domestic demand. Growing demand for construction materials was a boost to the general revitalization of industry. Ferro-concrete production grew 10 percent during the year. In the latter half of 1998 the index of entrepreneurial expectations improved from the negative levels of 1997 and the first half of 1998, and this made for a much more active redistribution of rising industrial gross income and encouraging domestic investment.

Another important factor that contributed to the revitalization of industry was the increase of currency supply. The money supply started growing in October of 1998, as the Central Bank responded to the financial and payments crisis. Between October and December of 1998, the Central Bank's currency emission exceeded 22 billion rubles, of which over 17 billion rubles was directed to increasing the liquidity of commercial banks. This indirectly contributed to the improvement of payments in Russia's economy. That is, whereas in August of 1998 the share of goods paid for with real money in all of the economy was only 35 percent, by November of 1999 this share rose to 52 percent. However, this did not reduce the absolute volume of arrears. On the contrary, arrears continued to grow, reaching 1160 billion rubles in August 1998 and 1,420 billion rubles in November 1999. Despite the expected improvements in the sphere of payments thanks by the growth of ruble incomes from exports and the Central Bank's emission, the share of credit arrears in GDP had gone up to 31.7 percent by the end of 1999, compared to 26.7 percent in 1998. The level of GDP monetarization grew by only 1 percentage point from 1998 to 1999 (14.8

percent in 1999) and remained extremely low for the Russian economy, demonstrating the small elasticity to the revitalization of market conditions.

The overdue credit arrears of large- and medium-sized companies of the Russian Far East had exceeded 104 billion rubles by the middle of 1999, compared to the regional industrial production valued at 94 billion rubles. The overdue credit arrears' share in the gross regional product exceeds 75 percent and is still much higher than the Russian average. This is a further evidence to the region's difficulty in taking advantage of the effects of devaluation, as well as to the real disparity of world prices for the region's export products and the rest of Russia.

Dynamics of consumer incomes (and therefore real demand) appeared extremely sluggish compared to the revitalization of industry. Consumer prices in the Far East grew by an average of 80 percent during the first nine months of 1999 compared to the same period of 1998. In contrast, the average wage in the region grew only 33.8 percent. As a result, real consumer income declined in the region, to 84 percent of the 1998 average.

The decreasing level of real income led to the consolidation in 1999 of a change in consumer behavior which had started right after the crisis of August 1998. Alarmed by the shrinking real income and high inflation expectations, people sharply decreased consumption of goods and services and increased savings. Private savings grew not only in the form of dollar assets, but also in the form of deposits in Sberbank--recently the only bank sustaining at least some level of trust of households. The high exchange rate of the dollar vis-à-vis the ruble meant that disposable income that went to the savings often could not be used to purchase foreign currency. In this sense, the increase of deposits in Sberbank was not by choice but by default. In any case, what resulted was a decrease of income directed to the consumer market. In the middle of 1999 the share of consumer spending in aggregate monetary consumer income in the Far Eastern subjects of the Federation was fluctuating between 39 and 85 percent, in comparison with the Russian average of 80 percent.

This naturally effected the dynamics of sales on the consumer market. Sales for the first nine months of 1999 stood at only 86.5 percent of the 1998 level. Agricultural production was also affected. Except for the slight growth (2% in the first nine months) in Yakutia and Jewish Autonomous Region, all other subjects of the Federation in the Russian Far East experienced a decline in agricultural production, ranging from 32 percent in Kamchatka to 6 percent in Amurskaya Oblast.

Thus, two main trends clashed on the market in 1999: the falling consumer demand and the growing industrial production in anticipation of improved market conditions. Entrepreneurs could ignore the current limitations of consumer demand because the stock of goods was also relatively small. However, it is becoming ever more evident, as stressed by government experts, that the low level of real demand has become a significant constraint on growth, and its role as a macroeconomic barrier may become even stronger in the future.

Another factor that may seriously obstruct the restoration of economic activity is the continuing threat of inflationary pressure. As Table 3 shows, the correlation of consumer and producer prices, which was characteristically seen in the 1992-1994 period, when fast growing producer prices were the main factor of inflation, returned in 1999. The situation in the Far East is not as straightforward as it is in Russia in general. However, here also available data for the first nine months of 1999 indicate the growth of producer prices exceeded that of consumer prices in Yakutia, Khabarovskiy Kray, Magadanskaya Oblast,

and Kamchatskaya Oblast. The situation in this sphere in some Far Eastern subjects of the Federation is better, since the share of consumer goods imported from other regions is quite high in these areas and therefore, the high index of consumer prices reflects the high indices of producer prices in the exporting regions and countries.

Table 3. Consumer/producer Price Correlations in 1999  
(compared to the corresponding period of 1998; in %)

	Consumer price index	Industrial producers price index
First quarter	116.0	117.2
Second quarter	107.0	111.4
Third quarter	105.6	114.4
Fourth quarter	103.9	112.0

Revitalization of investment activity compensated somewhat for the limitations of real demand in the consumer market in 1999. The all-Russian volume of investments in main assets in 1999 totaled 101 percent of the 1998 level. In the most economically developed Far Eastern subjects of the Federation, excluding Yakutia, these investments declined throughout January-September of 1999. However, by the end of the fourth quarter of 1999, the level of investment activity in Khabarovskiy Kray and Sakhalin Oblast experienced some growth, and the Far Eastern region in general witnessed a stabilization of this activity compared to 1998. (See Figure 4.)

In late 1999–early 2000 most experts and the Ministry of Economics of the Russian Federation were predicting and are still predicting continued economic based on the revitalization of industry in 2000. They expect that high world prices for fossil fuels and energy and many other raw materials will make growth inevitable. Another key issue in these forecasts is an expectation of political stability following the presidential election in March 2000, which the analysts suggest will help sustain favorable entrepreneurial expectations.

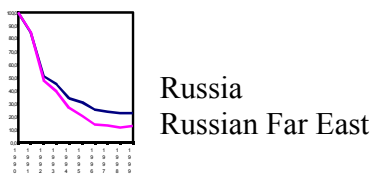


Figure 4. Dynamics of Investment in Main Assets  
(% of the 1990 level)

These factors are certainly important and should be taken into account. However, it is no less important to consider the direct and indirect threats posed to economic growth by strategic macroeconomic factors. These include the above-mentioned dynamics of real demand on the consumer market, investment dynamics, and expectation of inflation. For

example, the Y2K forecast of the Ministry of Economics demonstrated that inflation expectations were viewed neither as a threat to economic growth nor as a strategic factor. In any case, the prevailing forecasts place the consumer price index in 2000 at seven points lower than the producer price index. However, the inflationary pressure may negatively affect entrepreneurs' and investors' confidence in the growth of consumer demand. The expected increase by 20% of wages and social payments in 2000 will not make up for the anticipated inflation rate of 26% on the consumer market. If investors' confidence in consumer demand growth is compromised, then the hopes for the restoration of positive dynamics of gross investments in main assets will not materialize. And this in turn will block the demand for expanded investment, which is the second component of the aggregate demand in economics.

The Russian Far East's prospects for economic growth are largely connected with the realization of Sakhalin oil and gas projects, and especially with the start of Sakhalin-1 and Sakhalin-3 projects. The launch of these projects will allow for the practical solution of the problem of gas supply to the southern regions of the continental Far Eastern, i.e., Primorskiy and Khabarovskiy Krays. In addition to stimulating economic growth in Sakhalin, these projects may also present stimuli for investment activity in these regions due to the planned construction of gas pipelines and gas-fueled power plants there. In Khabarovskiy Kray, work has already started on the first stage of the Komsomolsk-na-Amure–Khabarovsk pipeline (the 40 km Komsomolsk-Amursk part) and this stimulated a growth of gross investments in 1999. The start of these projects can significantly increase the index of entrepreneurial expectations in the Far East, because it leads to expectations of cheaper electric power and increased price competitiveness of regional products.

The construction of the Burejskaya hydroelectric power station in Amurskaya Oblast in 1999 brought about an important change in the region's situation. The Ministry of Transport Ways and the Russian stock company UES (United Energy System) started their own financing to complete the construction and launching of the power plant. This may stimulate growth of gross investments in 2000 in Amurskaya Oblast, through a synchronous expansion of the contract portfolio of machine building and construction companies in the southern part of the Russian Far East. This will also foster growth of entrepreneurial expectations and economic activity in the area.

Increasing the state's procurement of defense products, which is secured in the federal budget of 2000, may also become an important factor of industrial production growth in the Far East. This is particularly the case in Primorskiy and Khabarovskiy Krays where defense industry is an essential part of the local economy.

In general, for the first time since the start of the radical economic reform, the restoration of economic dynamics in the Russian Far East depends not on external but internal sources of aggregate demand growth. Therefore, the role of the institutional component of regional economic growth becomes substantially more evident. This includes, first and foremost, the entire entrepreneurial and investment perspectives of the specific subjects of the Federation. Needless to say, they require considerable improvements. The presence of numerous and often irrational barriers to access to the market, ambiguous and unstable business policies and practices, discrimination of investors, and the predominantly fiscal character of general economic policy make domestic entrepreneurs reluctant to take risks even under current conditions, let alone in long-term investments.

The regional governors are still focused mainly on political means of building their influence and view the growth of their political weight as a necessary condition for achieving higher levels of control of the economy of their respective areas. From a more optimistic (economic) point of view, governors should view the success of business enterprises in their territory as building blocks for their political influence. The results of the State Duma elections of December 1999 indicate that the governors are still paying utmost attention to the strengthening of their command power, viewing it as a means of controlling economic activity and income flows in their territories. Such power of the governors in the post-Yeltsin era stems from the power and authority of the President, as during the Yeltsin period. Therefore, Putin's support for the "Unity" movement during the State Duma elections turned the elections in the subjects of the Federation into some sort of a competition. Governors tried to prove their loyalty to Putin by raising votes for "Unity".

As Table 4 shows there was a real race for votes in the Far Eastern subjects of Federation. The "Unity" movement won in all territories, except Jewish Autonomous Oblast and Sakhalinskaya Oblast. Moreover, the movement showed the best results in the regions most dependent on financial support from the federal center.

The focus of regional elites on the concentration of political power and gaining full control over their local economies has become a strong factor obstructing real improvements in the conditions necessary for economic growth. In this connection, the discussion of Putin's strategic objectives concerning changes in the current structure of power, including changes in the relations between the federal center and regional elites, will likely play a key role in evaluating the prospects for political transformations, as well as for the country's economic revival.

Table 4. 1999 State Duma Election Results in the Far East (in %)

	Union of Right-Wing Forces	Yabloko	Fatherland -All Russia	Unity	Communist Party	Zhirinovskiy Bloc
Yakutia	8.00	3.32	10.12	25.81	22.61	6.02
Primorskiy Kray	6.07	6.40	5.59	28.18	22.91	10.09
Khabarovskiy Kray	9.00	8.82	5.34	27.07	20.87	9.22
Kamchatskaya Oblast	9.76	6.15	6.12	29.61	17.97	10.97
Magadanskaya Oblast	4.78	3.00	1.40	46.32	17.43	13.00
Sakhalinskaya Oblast	9.17	8.25	4.96	22.98	24.14	10.57
Jewish Autonomous Oblast	6.92	5.12	6.40	21.01	33.96	8.74
Chukotskiy Autonomous Okrug	7.61	6.74	3.37	42.94	11.27	8.14
Koryakskiy Autonomous Okrug	5.12	6.39	4.32	42.93	11.47	7.21

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<sup>1</sup> As known from economic theory, the level of prices correlates with the volume of output in natural items, wages, and true value of inputs in the following manner:  $P = \frac{(1+z)W}{(1-\dot{p}_m)a}$ , where  $p_m$  is the relative price of inputs which is equal to the ratio of inputs' prices to the general price level,  $\dot{E}$  is input-consumption of one output item,  $z$  is a wage increment in price, accounting for the profit and costs of production factors other than labor,  $a$  is the real volume of output, and  $W$  is wage. Therefore, growth of relative prices for inputs (raw materials), at the given level of input-consumption and other price parameters, the level of prices will also grow and it will increase even more if fostered by a decrease of output at the given labor costs.

<sup>2</sup> The longer is the period of time during which the enterprise holds down the output at the minimum possible level--assuming that the profit does not decrease as a result of price growth accompanied by the decrease of natural output--the greater is damage caused to the application potential of physical capital by aging, lack of necessary maintenance and repairs. Often the amount of physical capital is decreased simply because the "unnecessary" equipment is sold. The same process affects the work force: without being able to apply their skills the workers are rendered ever less professional, and the most active and qualified of them may find other, more favorable employment opportunities. As a result, after demand reclaims its level or stops decreasing, reestablishing the supply level may turn out to be a task without solution. This is the essence of hysteresis.

<sup>3</sup> *Obzor ekonomicheskoi politiki v Rossii za 1999 god* (Moscow: ROSSPEN, 1999), p. 54

<sup>4</sup> The economy's revenue from devaluation:  $AD = C + I + G + NX$ , where  $AD$  is aggregate demand,  $I$  is investment demand,  $C$  is consumer demand,  $G$  is government demand, and  $NX$  is net export (export minus import).