

# Russian Entrepreneurship After the 1998 Crisis

Vadim Radaev

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State University, Higher School of Economics

More than one year has passed since the financial and economic crisis of autumn 1998. How do Russian entrepreneurs struggle through these critical moments? Who are the winners and losers in this enforced restructuring? What limitations have appeared and what new opportunities have been opened for entrepreneurs? This memo is a synopsis of a longer paper tackling these issues with special reference to Russian small enterprises (SMEs).

## **Data Sources**

Apart from expert estimates and mass media reports, we collected data of interviews with small entrepreneurs in Moscow, Tomsk, and Novosibirsk. Fifteen interviews were conducted in January and February 1999 in the following areas of economic activity: high-tech production, light industry, food industry, transportation, communication services, wholesale trade, retailing, business investment consulting, patent and intellectual property consulting, and agricultural farming.

More detailed analysis of the situation after the 1998 crisis was carried out by the author in cooperation with the Organization for Economic Cooperation and Development (OECD) in the Tomsk region in 1999. It was a follow-up study of the SME sector tracing changes that have occurred in the region since 1997. We also used the data of several standardized surveys of entrepreneurs, which had been conducted by different research centers after the 1998 crisis.

## **Immediate Impact of the Crisis**

Certain myths emerged immediately in the course of the financial crisis. One of them, that "small business has been ruined," was quickly dispelled. The sector proved to be active, though difficulties were many. The crisis led to payment arrears and the literal bankruptcy of a number of commercial banks. Purchasing demand shrank dramatically. According to expert estimations, about 30% of small enterprises were forced to cease activity after August 1998. Nearly 10% did not start working again. The critical situation peaked in September and October 1998; a partial recovery was observed by the end of 1998.

The "shuttle-traders" (chelnoki) who fill the clothing and food markets with imported goods provide a prominent example. The crisis of autumn 1998 has damaged them seriously. At least 50% of shuttle traders were driven out of business by the three-fold increase in the value of the US dollar and the consequent dramatic increase in price of imported goods. A significant part of trading stalls in clothing and food markets, previously characterized by severe competition, stood empty in September 1998. Though the quantity of goods sold at these markets fell, popular statements on the "death of informal trade" should be considered exaggerations. This sort of business started to recover at the end of the year and proved generally more stable compared to larger trading organizations.

It is noteworthy that negative trends in the SME sector started before the 1998 financial crisis. According to survey data, the financial indicators of SME activities were deteriorating during the two years prior to the crisis of 1998, which just aggravated tensions. All in all, the impact of the crisis was not as dreadful as believed at the initial stage. And more important, the impact was different for various market segments.

### **Winners and Losers**

The same economic factors produced opposite effects: some businesses suffered while others saw opportunities for expansion. The size of the enterprise was not the main factor, nor was the area of activity a decisive variable--though firms dealing with finance, tourism, advertising, and transportation services related to wholesale trade lost important segments of their markets. Certainly, there were individual reasons for this, such as low quality of management. In other cases, problems arose from the wrong choice of banks. Some of the enterprises and individual entrepreneurs had their money frozen at the accounts of commercial banks, which had to stop their transactions.

Structural reasons were more important here. There is one crucial parameter for measuring whether the impact of the crisis was positive or negative: involvement in import transactions and use of imported resources. The dramatic change in the exchange rate when the Russian ruble was devalued by three times within a few months undermined activities based on imported raw materials and finished products. Both trade and production firms using import inputs suffered most of all.

At the same time those having access to local inputs found themselves in a privileged position. First, the amount of imported goods declined considerably. Second, the prices on imported goods increased dramatically. The lack of consumer demand for expensive imports created a range of new opportunities for local producers and trading firms dealing with local products. One of the Tomsk producers stated in the interview that the "Russian government finally supported us by arranging this financial crisis, though they had no intention of helping."

The formula for economic success included three crucial elements:

- low price provided by local inputs;

- acceptable quality provided by imported equipment; and
- spare capital withdrawn from mediating and speculative activities.

The crisis encouraged a long-awaited inflow of trading and financial capital into the production sector. Given the shortage of some finished products and the lack of time for building up new production facilities, the tolling system became widespread. This system presumes the acquisition of production rights instead of property rights. Facing a severe shortage of circulation capital, many production enterprises found themselves in a weak bargaining position and were ready to negotiate.

Thus, the entrepreneurs having spare capital and spending it on local inputs and production rights built up a foundation for success both in the near and distant future. Small mediators lacking their own capital, and those who converted financial resources into US dollars, were pushed to the margins of the markets.

### **Shift to Local Products**

We have already mentioned that important shifts in favor of local goods occurred. This process of substitution was rather selective and bound by a number of factors. The choice was arranged along the following lines.

- The price of goods became even more important. More expensive consumer goods of European origin were not attractive. The market was filled by the inflow of goods that were cheaper though of lower quality. For example, in some Siberian regions the main traffic of goods changed from Turkey, Saudi Arabia and European countries through the markets of Moscow to the import of goods from China and Korea through the markets of Novosibirsk.
- The choice depended on the elasticity of demand for different products. Necessities (milk, butter, etc.), including more expensive imported items, were bought anyway. At the same time, in the Tomsk region the market for mineral water (for which SMEs are famous) was reduced several times over. As for the trade of expensive import furniture, it nearly stopped.
- The quality of Russian goods, which were potential substitutes for imported products, was important. In many cases concerning food, consumers initially moved to cheaper local products after the crisis but got dissatisfied with their quality and returned to imported products.
- Competitive advantage for local producers depended largely on their capacity to maintain the gap in the price level between Russian and imported goods. Not all of them were successful in this respect. Many entrepreneurs let their prices rise close to the prices on imported items. That strategy was a failure. Stimulation of local patriotism through slogans like "Let's buy Tomsk products" (Pokupaite Tomskoye) has thus far been ineffective at least in its pure ideological form, though campaigns of this sort were carried out.

## **Return to the Early 1990s**

Any crisis is a forceful shift in market relationships. According to our interviews with entrepreneurs, the situation after the crisis resembles the Russian economy of the early 1990s in many respects. There is a certain retreat to the age of early market, with many open niches and a lack of established conventions.

Before the 1998 crisis there was a tendency within business circles toward increasing exclusivity. Nearly everyone knew each other in his/her area of activity. Reputations were built up for years within business networks. After the crisis, many market segments became relatively demonopolized and therefore more open. New agents entered these markets. The destruction of long-term partnerships made the economic situation more chaotic. Trivial short-term contractual schemes tended to replace longer-term relational contracting. A deficit of liquid resources ("live money") was accommodated by barter exchanges, and money surrogates were strengthened.

Consumption patterns have also become more primitive, as they were at the beginning of economic reform in 1992. At that time, people were getting familiar with the new mass consumer products of relatively low quality. In the mid-90s consumers became more selective and their demands increased. After the crisis, people had to economize and be less demanding.

We have witnessed an upheaval of "wild market" relations. Attempts to cheat partners with references to "objective circumstances" were more frequent. As a result, some turned to violence as an instrument for dispute settlement.

The crisis marked the end of a political-business cycle. It forced changes in the rules of economic activity. However, it does not mean that it will take half a decade to stabilize the market structures and reestablish business norms. They will be restored much faster since the algorithms are already known. A certain retreat to the past is observed, but at the same time new opportunities have been created.

## **A Time of Opportunities**

Despite inevitable losses, the crisis created new opportunities. Major markets had remained largely monopolized since the early 1990s. It was very hard for a newcomer to enter a new area of activity. After August 1998 many arenas became more open. This was a chance for small business to come in and occupy the niches left by larger establishments. Enterprises were forced to look for additional resources and restructure their management strategies. Many entrepreneurs had to introduce more strict financial and labor discipline within their firms.

The crisis has made bank credit resources cheaper, as interest rates in rubles dropped to a negative level (though loans were not more available than before due to the lack of resources). Those small enterprises that were selling products to the population had the

advantage of getting "live money" and breaking down the heavy chains of barter exchanges.

Some costs have decreased. For example, the workforce became cheaper in the post-crisis period because workers and employees were more tolerant of the wage cuts and payment delays due to the pressures of the labor market. At the same time, management was getting more sensitive to opportunism. Bribes and favors by firm managers decreased after August 1998. Internal control within the firm tightened, and the risk of losing a job as a result of misbehavior was higher.

By and large, it was a time of new opportunities. And local producers have had a year after the crisis to take advantage of these outcomes. Of course, one year was not enough for creating new production facilities and implementing a fundamental restructuring. However, those who managed to use this time for getting ahead in terms of technology, new marketing strategies and capital for restructuring would enjoy privileged and more stable positions in the future once the competitive balance was restored.

### **Shifts in Policy**

It is clear at present that no consistent policy has been pursued regarding SME support and development. In its place, there have been bureaucratic fights over responsibilities and shrinking federal and regional funding. Novelties in the taxation system have contributed to general instability, and participation in electoral games has been prioritized over the protection of entrepreneurial interests.

The post-crisis period is a demanding time for the authorities. Their capacities for direct support of entrepreneurial projects are severely limited. Both federal and regional budgets do not have substantial resources for subsidies and low interest credits at the moment. It is clear that these resources will not be mobilized in the near future. Given the shortage of "live money," the main efforts in SME policy should shift in favor of alternative mechanisms of financial stimulation and improvement of the entrepreneurial environment. These issues are subjects for discussion at the Second Russian Congress of SME Representatives at the end of October 1999.

Investment credits present one instrument of financial stimulation, assuming that enterprises carrying out investment projects are liberated from some of their taxes. It is necessary to develop leasing schemes for the use of premises and equipment of large enterprises, which are in a state of decline. Creation of mutual assistance funds is also on the agenda.

The main task of federal and regional authorities in the field of legislation is to bring some stability to the system of state regulation. In this respect it is especially important to improve the legislative basis of the taxation system by rejecting the "experiments" that have been introduced largely for short-term fiscal gain. Another important task is to diminish the additional pressures on the entrepreneur from numerous administrative

bodies. This entails inventory of those authorities entitled to control economic activity, the centralization of numerous payments and decrease of their total amount, and abolition of under-the-law regulations. In sum, the main instruments to further stimulate development of the SME sector in Russia today are increased stability of the legislative and taxation systems, encouraging access of SMEs to economic resources, and the removal of administrative barriers.

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