BOFIT

Russian Economy - The Month in Review

Yearbook 2001

Russian Economy - The Month in Review

A four-page monthly survey in English focusing exclusively in recent developments in the Russian economy, public finances, and financial markets. In addition to this regular coverage, each issue contains commentary from an expert.

Bank of Finland
Institute for Economies in Transition, BOFIT

Russian Economy - The Month in Review
Editor-in-Chief **Vesa Korhonen**

ISSN 1455 - 7355 (print)
ISSN 1456 - 5897 (online)

Bank of Finland
Institute for Economies in Transition (BOFIT)

PO Box 160
FIN-00101 Helsinki
Phone: +358 9 183 2268
Fax: +358 9 183 2294
bofit@bof.fi
www.bof.fi/bofit

Russian Economy - The Month in Review 2001

Contents - 4th page

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
1•2001

Economic Developments

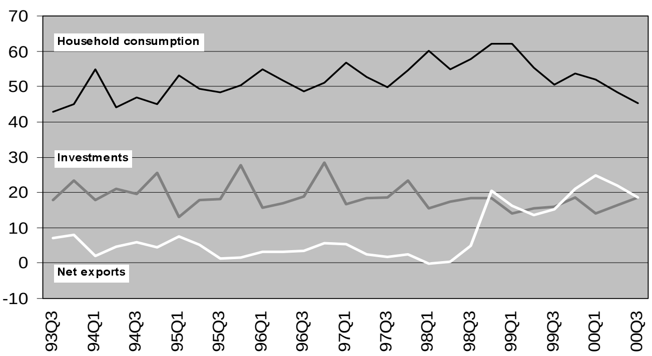
Last year's GDP growth was broadly based

According to the latest preliminary estimates of the Russian authorities, Russia's GDP volume expanded by a record 7.6 % in 2000 (3.5 % in 1999), although growth slowed down somewhat during the last quarter.

Regarding GDP demand components, last year's growth was based on private consumption, fixed investments and exports. Household consumption, which accounts for nearly half of GDP (see chart), increased well over 10 % in the first three quarters of 2000. This is an outcome of rapid real income growth (9 % during the year). The other domestic demand driver, fixed investments, jumped by nearly 18 % in 2000, although its GDP share was still below 20 % in the third quarter. Due to a rather tight expenditure policy, public consumption grew only slightly over 1.5 % during the first three quarters.

The significance of exports was two-fold in 2000. The increase in the export volume, estimated by the economy ministry at about 8 % last year, has contributed well to the rapid growth of GDP volume. Moreover, the spectacular rise in export prices for oil and gas and the decline of the rouble's nominal exchange rate (about 12 % on-year-average against the US dollar) have significantly expanded the share of export income in Russia's GDP value, and the export price leap has nicely raised the entire GDP income. The economy ministry estimates that the import volume rose 14 %, although declining import prices have moderated the import value increase. These export and import developments have kept the share of net exports in Russia's GDP around 20 %.

Structure of Russian GDP (demand components), %



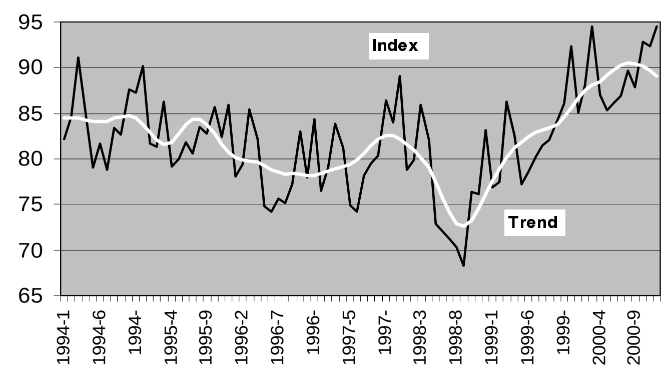
Source: Goskomstat, IFS

Booming industrial output takes a breather

For all of 2000, growth in industrial output reached 9 %, up from over 7 % in 1999. The fastest grower was light industry (22 %), although it accounts for a very small share of all industrial production. Among the larger industries, ferrous metallurgy and machine building & metal product industries grew over 15 %, which was partly a result of a more than 25 % production growth in the defence industry. Above-average increases were also recorded in the chemical & petrochemical industry (14 %) and non-ferrous metallurgy (11 %). Growth in the forest industry came in at just under 10 % while construction materials and the food industry scored a little over 7 %. Growth in the fuel industry was contained to 5 % as natural gas production subsided slightly (-1 %). Crude oil production expanded 6 % even if the supply response to higher world market prices tends to be constrained by export restrictions.

Industrial growth decelerated during the second and third quarters and further in the fourth quarter to 6.5 % y-o-y. In December, industrial production grew only 2.5 % y-o-y. Indeed, seasonally adjusted production volumes indicate an outright flattening of growth since last autumn. This outcome holds whether one applies seasonal adjustment methods that are relatively sensitive to the latest data (see chart) or methods that put less weight on the fresh figures (as is the practice of the State Statistics Committee and the economy ministry). Towards the end of last year, growth in most major industries either abated or decreased slightly.

Russian industrial production, Dec 1993=100



Source: Goskomstat, BOFIT

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	3.5	7.7	1-9
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	2.0	-5.2	8.1	9.0	
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.7	
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	94.9	1-11
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	39.5	1-11
Current account, USD billion			8.4	7.4	11.8	2.0	0.7	25.3	33.6	1-9

Sources: Goskomstat, CBR

Revenues from state assets and privatisation exceed expectations

Budget revenues from the use of state property and sale of state assets were nearly a third higher than expected in the 2000 budget – even taking into account all the revenue revisions made during the year. Almost two-thirds of a total RUB 51 billion (USD 1.8 billion) came from the sale of state assets and a bulk of these from selling an 85 % stake in the Onako oil company and an almost 2 % stake of LUKoil. The last third (RUB 19 billion) consisted of revenues from the use of state property. Revenues from a Russian-Vietnamese joint venture Vietsovpetro accounted for over half of these revenues. (See table)

Revenues from state assets and privatisation in 2000
(in billions of roubles)

	2000
Revenues from sale of state assets	**31.4**
Onako-shares	25.0
LUKoil-shares	3.0
Other	3.4
Revenues from use of state property	**19.2**
JV Vietsovpetro	9.8
Dividends	5.6
Leasing federal property	3.4
Use of assets abroad	0.4
Total revenues	**50.6**

Source: Minimuschestvo Rossii

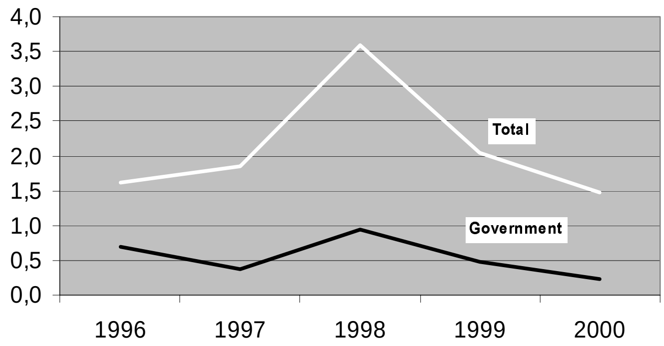
State arrears diminish

Without providing a clear picture on the magnitude of state arrears as a whole, statistics reveal substantial progress in reducing some arrears during the past few years. The extra revenues accumulated in 2000, largely due to high oil prices, created a situation unseen in many years whereby many budget assignations were either fully funded or even overfunded.

State pension arrears were paid off at the end of 1999 and state arrears on unemployment allowances were settled in September 2000. At the end of 2000, all outstanding wage arrears stood at around RUB 32 billion (USD 1.1 billion) and federal and regional budgets accounted for about 16 % (RUB 5 billion, 0.1 % of GDP) of them. During 2000, these state arrears diminished in nominal terms by over 50 %. In comparison, enterprise wage arrears decreased during 2000 by 20 %, and at the end of 2000 accounted for 0.4 % of GDP (compared to about 2 % of GDP in 1998). (See figure)

Regional budgets are responsible for most state-level arrears. As regards specific regions, state wage arrears are concentrated in Russia's Far Eastern regions, exceeding the central regions on a per inhabitant basis by seven fold.

Wage arrears in 1996 – 2000 (at year's end as % of GDP)



Source: Russian Economic Trends, Goskomstat

Land ownership – for and against

Land ownership, always a touchy issue in Russia, again made headlines at the end of last year. Despite the fact that many regions have had their own legislation for years governing the selling and buying of land, federal laws have yet to be passed. The communists and agrarians, the Duma's fiercest opponents to unrestricted purchase and sale of land, have succeeded in blocking the land code for years. In this sense, the approval at the end of January of the first reading of chapter 17 of the civil code dealing with land ownership, should be regarded as progress. The approval came after the Duma compromised and agreed to exclude agricultural land from the chapter until Russia's land code is approved.

The views of opponents to the unrestricted sale and purchase of land with full ownership rights have remained unchanged for years. They build on the fear that oligarchs and foreigners will buy Russia once it is legal. The leading proponents are the governors of regions that having already passed their own land legislation. Proponents are roughly split on accepting unrestricted purchase and selling of all land and those demanding to exclude agricultural land. Opinion polls have found that only about 20 % of Russians categorically oppose private ownership of land.

President Putin may be inclined to leave the land ownership decision to the regions. He has mentioned as a model the land reform of 1861, whereby the state only stipulated basic principles and left regions to determine their own specific land laws. Mr. Putin has emphasised that clear land ownership rights are essential to increasing investment. The present situation, where regional laws may contradict federal laws, does not encourage investment but allows extensive malfeasance and speculation. It also cuts the federation out of the process and subsequent financial flows.

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999	2000	2000	2001
Federal government						Jan.-Nov.	budget law	budget
- revenues	13.7	12.5	9.8	9.0	13.4	15.9	15	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	12.8	16	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	3.1	-1	0.0

* Figures for 1995-1996 exclude interest payments on short-term government debt

Sources: Goskomstat, IMF, MinFin.

Inflation picks up

After rising at about 1.5 % a month last autumn, consumer prices rose 2.8 % in January. This was expected as prices in Russia usually make a start-of-the-year leap due to seasonal factors and hikes in regulated prices. However, this January's jump was higher than a year earlier, and the highest monthly rise since summer 1999.

The biggest price increases took place in public services, especially passenger transport and services related to housing. The seasonal rise of food prices was relatively rapid. Judging by the mild price increase in non-food products, the time when producer prices start to exert clear upward pressure on consumer prices still lies ahead. For over two years, producer prices have been chasing consumer prices, which leaped ahead in the autumn 1998 crisis (see chart). Last year producer prices rose almost 32 % December-to-December. Their structure also saw changes in 2000 as the rise in different types of producer prices ranged from almost zero for intermediate goods to over 50 % for transportation.

Besides hikes in regulated prices, which are necessary steps in scaling down public subsidies, there are also apparent monetary factors that can contribute to a consumer price jump like this January's. These include the steep wage increases made around every new year, injections of money into the economy as provided by the decision stamped in December to spend over half of the budget 2000 extra revenue domestically, and further growth of Russia's foreign exchange reserves feeding into the money supply. It is becoming increasingly difficult to foresee how inflation could be kept in line with the government's forecast of 12–14 % in 2001, which has been freshly reiterated in the economy ministry's projections for 2001-2003.

Russian enterprises increasingly prefer money

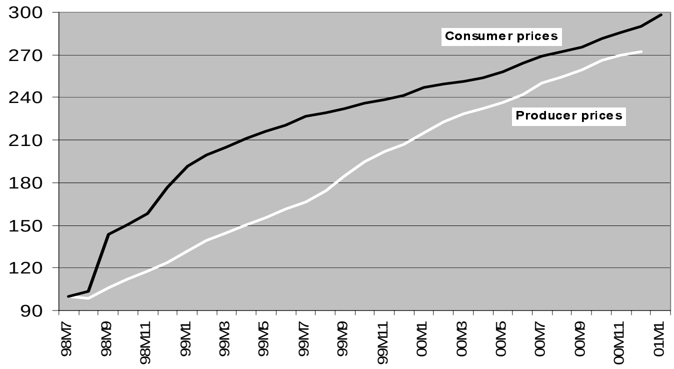
During the 1990s, Russian enterprises commonly used arrears, barter and other non-monetary surrogates to obtain finance and maintain transactions while circumventing harder budget constraints stemming from tighter fiscal and monetary policies and meagre prospects for bank credit. During the last two years, such practices have lost favour.

Overdue payables of Russian enterprises have decreased considerably in real terms and as a share of GDP. In late 2000 their share of the enterprises' total payables also declined to about 45 %. However, the overdue payables of enterprises still account for one-quarter of GDP. These include two equal-sized major items - arrears to suppliers and arrears to the public sector budgets (see chart).

A regular Goskomstat survey among Russia's largest tax payer companies and monopolies found a considerable rise of monetary forms of payment, from around 50 % of all payments in late 1999 to over 70 % in late 2000. The use of the major types of non-monetary payments has respectively fallen, including offsets against debts (14 % of all payments in late 2000), promissory notes (8 %) and barter (3 %). The Russian Economic Barometer, which surveys several hundred firms, also indicates a steady decline in non-monetary payments to about 20 % of sales last autumn.

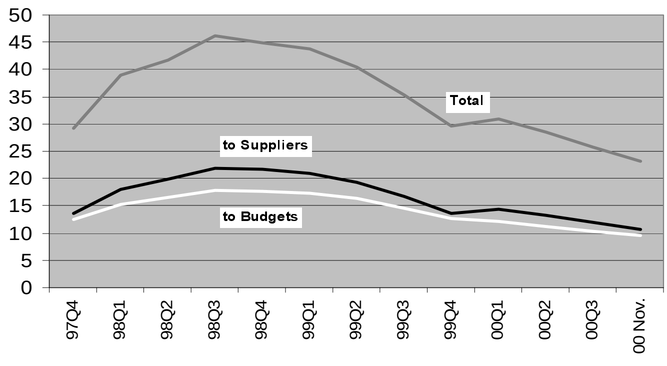
The withdrawal from intricate non-money payment arrangements is partly the result of government efforts that have greatly raised the role of money payments in budget revenue and expenditure. The state is now giving an opposite lesson of behaviour compared to earlier years when it gave in to tax arrears, resorted to budgetary offsets, and even took part in clearing inter-enterprise arrears. A major factor behind money use is also the much improved profitability and liquidity of Russian enterprises. The next challenge will be to maintain a higher level of monetisation in the economy if the overall economic tide turns.

Consumer prices and producer prices, July 1998 = 100



Source: Goskomstat

Overdue payables of enterprises, % of GDP



Source: Goskomstat, BOFIT

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	20.6	1
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4		
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135		
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6		11/00
- lending rate, %	320	147	46.2	41.5	40.1	18.2		11/00
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	29.5	2 Feb.
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	28.37	1

Sources: Goskomstat, CBR

The agricultural dilemmas

By Merja Tekoniemi*

Although prioritised “on paper”– with plentiful official documents aiming to reform it – agriculture ceased to be a sector of almost any priority from the very beginning of economic reforms in Russia. In the 1990s, the most visible change in agriculture was the emphasised importance of individual plots as a food producer. Now the agricultural sector is in deep crisis and it will take some real measures to drag it out.

Downhill in the 1990s

Since the early 1990s, Russian agriculture experienced shocks from at least two directions. The first was the slashing of state subsidies and the fall of purchasing power of the population after the breakdown of the Soviet Union and initiation of economic reform. The second was the impact of imported foodstuffs. Russian shops began to fill up with products that were unbeatably competitive by domestic food industry standards. Moreover, grain harvests were low in comparison to Soviet times – especially in the latter part of the 1990s.

The poor development of agriculture is easily witnessed by statistics. The gross agricultural output (GAO) has fallen substantially in the past ten years, with the share of agricultural land down by a quarter and deterioration in the quality of the remaining land. In 1999, GAO was less than 60 % of the 1990 level (see figure). Agriculture now employs some 14 % of the labour force, but produces less than 6 % of GDP. Also the share of agriculture in Russia’s shrinking capital investment has declined constantly. In 1991, agriculture accounted for 18 % of all capital investment, but since 1995 the share has been around 3 %. The majority (over 80 % in 1998) of these investments have been financed with the scarce own funds of agricultural enterprises and organisations. It is estimated that 75 % of Russia’s agricultural machinery is worn out. Workers in the agricultural sector have below-average wages, unemployment is more common and the mortality rate is higher.

The 1998 economic crisis and the devaluation of the rouble gave the Russian food industry an important competitive advantage. However, as real incomes of the population decreased and the harvests in 1998 and 1999 suffered, the agricultural sector was less capable in exploiting the devaluation than other import-substituting sectors. Agricultural production increased over 2 % in 1999 and 5 % in 2000 – but from a very low base. In the end of 2000, half of Russia’s agricultural enterprises were still posting losses.

Structural changes

Despite otherwise poor achievements, the structure of agricultural production changed during the 1990s. The former collective farms (*kholkhozi* and *sovkhozi*), some of which are now at least formally privatised, still represent a major producer group in agriculture. However, their share in agricultural production has fallen to less than half, whereas the importance of the many millions of family plots has increased to cover the remaining half of Russia’s agricultural production. A tiny amount of agricultural production comes from private individual farms. Land ownership issues, a shortage of capital, low prices of agricultural products and state support that focuses mainly on larger farms has slowed their development.

Real agricultural reform still ahead

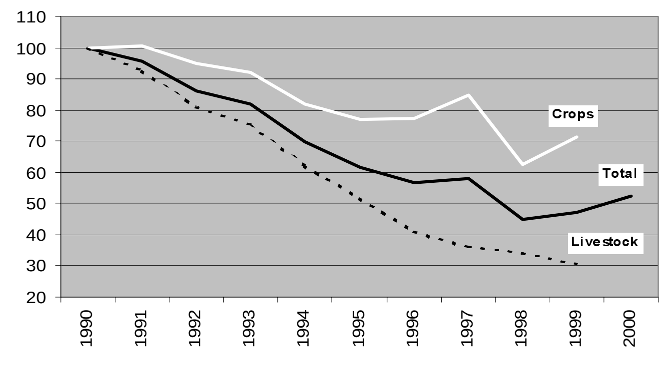
The depressing statistical data of agriculture in recent years is not necessarily a strong concern, because much of the decline was inevitable. As the old socialist system left much to be corrected, some of the above-mentioned trends should be welcomed. It is clear that e.g. the financial support system of agriculture has been too heavy, non-transparent and inefficient. Its continued downsizing irrevocably effects production and investments even more due to an absence of substitutive canals of financing.

A major obstacle to development of Russian agriculture is likely the absence of market-based approaches. It is not enough to acknowledge the poor state of this sector. Russia needs planned practical steps to move agriculture away from its past towards something at least resembling the market economy. The agricultural sector today languishes between old practises and a new mostly undefined system just taking shape.

The difficult – and still unresolved – question of full private ownership of land serves as an example. The discussion on this theme specifically excludes agricultural land. In the view of certain circles, agriculture would not benefit from private ownership of land. However, real ownership rights would enhance creation of private farms, farmers’ incentive to work, investments and competition. Under full ownership, it would be possible to use land as collateral for borrowing.

Another important question in reforming the agricultural sector in Russia is the creation of efficient food production chains. This Russia urgently needs. For such a vast land, especially in the case of food, it is vital to have systems that work from the bottom up. Russia presently loses an inordinate amount of food at harvest and in every subsequent stage of processing and distribution.

Russia’s agricultural production in 1990-2000 (index 1990=100)



**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
8 February 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
2•2001

Economic Developments

Exports income ballooned, imports grew in 2000

Russia's export income boom took off in autumn 1999 and sustained a remarkable pace throughout most of 2000. Russia's exports (goods) grew almost 40 % for the year, reaching USD 105 billion (see chart). Imports have also revived since autumn 1999, picking up 12 % to USD 44 billion last year. Russia's trade surplus expanded to a record USD 61 billion, or 25 % of GDP.

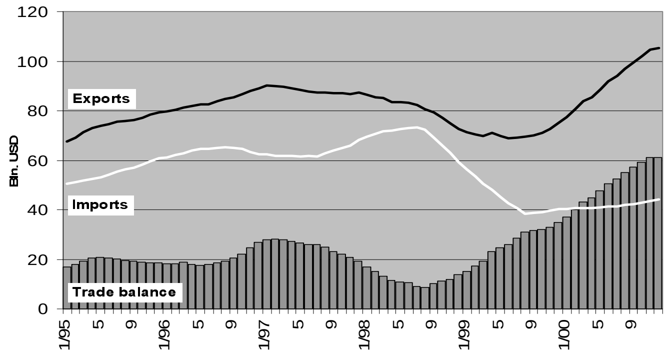
The economy ministry's latest estimate puts export volume growth at about 10 % in 2000. Deliveries of crude oil and oil products increased at nearly that pace, while the export volume of the major metals expanded much more strongly. The rise in export volume, however, is not a strong response to the rouble's collapse in late 1998 and subsequent low levels in 1999-2000. For a boon, prices for Russian exports were up on average almost 30 % last year. Export prices were driven by crude oil (an annual average price increase of almost 70 %), oil products (up 70–90 %) and natural gas (up about 60 %). The economy ministry also estimated that import volume grew almost a quarter in 2000, while import prices (in USD terms) declined on average, a reflection of the decline of the euro exchange rate and structural changes favouring less costly import items.

Russian exports to non-CIS countries jumped 42 % to USD 91 billion last year, while exports to CIS countries grew 20 %. Imports from non-CIS countries increased a modest 6 % to USD 31 billion. Imports from CIS countries widened 28 %, in line with the above-mentioned structural change in imports and supported by the strengthening rouble real exchange rate against the currencies of Russia's main CIS trading partners.

Soaring prices pushed the share of oil, oil products and gas to half of Russia's exports last year, while metals and metal products accounted for less than a fifth. Import statistics lay the share of machinery & equipment at 30 %, that of food products at over 20 % and chemical products at almost 20 %. Unfortunately, the total picture is blurred as Russian customs statistics continuously fail to record about a quarter of imports (as inferred from the trade data provided by the Goskomstat and the CBR).

In 4Q00, more moderate export price increases slowed Russia's export growth to 20 % y-o-y. Import growth picked up to 20 %, which is partly due to the continued rise of the rouble's real exchange rate, e.g. against the euro.

Russia's foreign trade, 12-month moving average, USD billion



Source: Goskomstat

Export income feeds profits and investments

Lucrative export revenue and economic growth have showed themselves in enterprises' net profits, which, indicatively and with due respect to gaps in statistics and bookkeeping, rose about a quarter in real terms in 2000. Of the USD 37-38 billion in officially recorded profits (likely a figure on the low side), crude oil producers more than doubled their earnings to over USD 9 billion, while ferrous & non-ferrous metal producers saw their profits swell to USD 7-8 billion.

Export incomes were also reflected in last year's investment revival (17 % volume growth from the lows of 1998-99). The crude oil industry doubled its share to close to a fifth of all fixed investments that totalled about USD 42 billion. On the other hand, metallurgy merely retained its 1999 share (5 %), preferring financial investments instead. Much of the rest of fixed investments went to the transport sector (almost a quarter) and housing (about 15 %).

As a whole, enterprises relied a little less on their own funds to finance investments (under a half against over a half in 1999). Last year they seem to have obtained proportionately more investment financing from other enterprises and investors (7 %). The budget sector provided over a fifth of investment financing, but the role of Russian banks in financing investments – a basic bank function – sank to just a couple of per cent.

Foreign investments & other financing were recorded to have provided some 5 % of financing of fixed investments last year. In the core, foreign direct investments (FDI) in Russia stagnated last year close to the low 1999 level.

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	3.5	7.7		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	9.0	5.3	1/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	17.7	9.2	1/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.6	1/01
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	105.2		
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	44.2		
Current account, USD billion			8.4	7.4	11.8	2.1	0.7	25.0	33.6		1-9/00

Sources: Goskomstat, CBR

Federal budget showed clear surplus last year

The realised federal budget for 2000 exceeded all revenue expectations. After many years of substantial budget deficits, the budget of 2000 showed a surplus equivalent to 2.5 % of GDP. On the whole, the considerable increase in revenues came solely from tax revenues. The value-added tax provided the largest single revenue stream, accounting for a third of all federal budget revenues. However, the single largest increase was recorded in customs revenues, which increased as a share of total revenues from over 14 % in 1999 to over 20 % in 2000. This was mainly due to increases in oil export duties.

Budget expenditures were kept quite low for most of the year, but towards the end of the year and especially in December after the division of extra revenues, expenditures rose significantly. The largest expenditure items were defence and debt servicing. The share of debt servicing costs (interest expenditure) in total expenditures was about 18 %, down from nearly a quarter in 1999. The primary budget surplus, which excludes debt servicing, was 5 % of the estimated GDP (see table).

Realised 2000 and 1999 federal budgets

	2000			1999		
	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP
Revenues	**1128**	**100**	**16.2**	**598**	**100**	**13.1**
Tax revenues	966	85.6	13.9	499	83.4	11.0
of which						
VAT	*372*	*33.0*	*5.4*	*214*	*35.8*	*4.7*
Profit tax	*179*	*15.9*	*2.6*	*78*	*13.0*	*1.7*
Customs duties	*229*	*20.3*	*3.3*	*86*	*14.4*	*1.9*
Excises	*131*	*11.6*	*1.9*	*83*	*13.9*	*1.8*
Other tax revenues	*55*	*4.9*	*0.8*	*37*	*6.2*	*0.8*
Non-tax revenues	70	6.2	1.0	44	6.2	1.0
Budgetary funds	93	8.2	1.3	55	9.2	1.2
Expenditure	**954**	**100**	**13.7**	**663**	**100**	**14.6**
Domestic debt service*	57	6.0	0.8	74	11.2	1.6
Foreign debt service*	116	12.2	1.7	89	13.4	2.0
Defence	191	20.0	2.7	113	17.0	2.5
Social sphere	133	13.9	1.9	85	12.8	1.9
Aid to regional budgets	101	10.6	1.5	62	9.4	1.4
Other expenditures	356	37.3	5.1	240	36.2	5.2
Balance	**174**		**2.5**	**-65**		**-1.5**

Source: EEG / MinFin
** includes only interest payments*

Duma passes 2001 budget amendments

At the end of February, after weeks of discussion on whether and how Russia might service its Soviet-era debt to Paris Club creditors this year, the Duma approved its own modified version of the government's suggested budget amendment. If the Duma amendment passes also in the Federation Council, extra revenues to the budget up to RUB 41 billion (USD 1.4 billion) will be directed to servicing the foreign debt. Revenues exceeding the sum will be divided equally between foreign debt service and all other expenditure groups, while all extra revenue above RUB 165 billion will again go to debt service. If passed, the prevailing practise of dividing all extra revenues up to RUB 70 billion evenly between servicing foreign debt and other expenditures will be replaced.

The original 2001 budget does not provide enough funds for foreign debt service this year because the government relied on postponing at least some of this year's Paris Club payments and receiving more foreign finance than it will. The finance ministry calculated that the 2001 budget lacks RUB 182 billion (USD 6.3 billion). The government estimates additional budget revenues this year will amount to RUB 107 billion – an assumption that will materialise as long as oil prices average more than the originally budgeted 21 dollars per barrel. Provided that the amendments are passed and the revenue estimate holds, about RUB 74 billion (i.e. 41 billion + 33 billion) in extra revenues should be directed to foreign debt servicing and RUB 33 billion to other expenditures. The remaining RUB 108 (182-74) would result from other sources, including extra income unused in last year's budget, borrowing on domestic markets and additional tax revenues. However, the planned extra privatisation revenues may not materialise soon as the Duma turned down the government's proposal to start privatising large government enterprises.

Plans to develop fiscal federalism

The system of organising financial flows between different levels of government has been under reform since the collapse of Soviet Union. Starting from the first years of economic reform, fiscal federalism in Russia meant competition among regions for federal financial resources. The foundation of the regional fund for financial support (RFFS) and the introduction of uniform regulations on division of tax revenues between the centre and the regions in 1993-1994 were a good start towards correcting the situation. Starting from 1996, however, the old practice of using individual agreements as a basis of fiscal federalism again gained ground.

In summer 1998, the government approved a concept on reform of financial flows between the centre and regions in 1999-2001. The goal of the concept was to develop a uniform, transparent and positive method to divide RFFS allotments. Since 1999, financial transfers from the RFFS are distributed using a method that takes into account e.g. the potential tax revenues of each region. The idea is to stimulate regions to maximise their own tax revenues. A basic problem of Russian budgetary system, "under-funded" federal mandates (tasks delegated to regions by federal laws), needs to be addressed. Currently, regional and local budgets tend to be overloaded with such mandates while lacking the possibilities to generate enough revenue to implement them.

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999	2000	2000 budget law	2001 budget
Federal government								
- revenues	13.7	12.5	9.8	9.0	13.4	16.2	15	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	13.7	16	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	2.5	-1	0.0

* Figures for 1995-1996 exclude interest payments on short-term government debt

Sources: Goskomstat, IMF, MinFin.

Paris Club debt to be paid this year, but 2003 looms

Following rather sharp public exchanges and involvement of top levels from various Western countries, Russia is back on track for servicing its Soviet-era debts to Paris Club creditors according to prevailing rescheduling agreements. This should avoid further impressions of an impending unilateral default. As for economic substance, no scenario justifying debt rescheduling in 2001 has emerged this winter from discussions with the IMF on an economic program and a new precautionary stand-by loan.

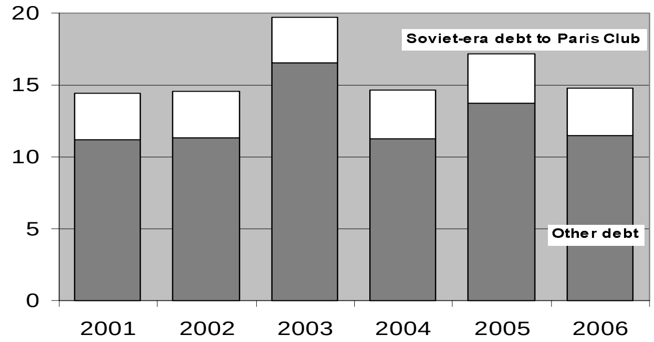
After payment delays early this year, Russia's debt service payments have started to catch up with existing schedules. Russia has assured that it will be fully current on its Paris Club debt within a month, including payments missed during the first two months, and that it would make all payments to non-Club members as well.

As all debt servicing payments were not included in this year's federal budget, the government turned to the Duma for agreement to spend more extra budget revenue on debt repayments that will fall heavily in the first and third quarters. For some relief sooner or later, Russia has also approached various creditor countries with requests to settle part of the debts in goods or through investments in Russian companies.

Russia has set its sights on the medium-term and will prepare an economic program for 2001-03 to continue discussions on a longer IMF program and initiate talks with the Paris Club on further debt rescheduling. Federal external debt servicing payments will peak in 2003, and preponderance of available data indicates a USD 4.5-5 billion jump in the payments from the level of 2001-02 (see chart). In fact, Soviet-era debt servicing payments to the Paris Club are virtually constant through the years; the 2003 peak is due to other maturing debt (notably Minfin IV bonds, which also stem from Soviet-era liabilities).

Overall, full external debt service payments can amount to about 30 % of federal government revenue this year. In 2003, the payments could consume up to 40 % of estimated federal budget revenue, and funding full repayment by suddenly cutting other expenditure could be difficult during that run-up period to elections of the Duma (Dec 2003) and the President (2004). On the other hand, if Russia started this year to prepare for meeting the payments increase of 2003, the federal budget should set aside an extra USD 1.5–1.7 billion per year in 2001-03, i.e. 3–4 % of the federal budget revenue (0.5 % of GDP). To the extent that such a policy will weigh less than concerns about insufficient domestic spending, the options naturally are to aim at rescheduling or find additional domestic or foreign funds to pay.

Federal external debt service payments in 2001-06, USD billion



Source: World Bank cited in Ekonomika i Zhizn 4/2001

New controls to combat capital flight

The beginning of 2001 saw an expansion of import controls to include imports settled with roubles and promissory notes, temporary imports and imports by individuals. In principle, all imports are now subject to controls while authorities expect the coverage of controls to rise from 60–65 % to 85–90 % of imports. A similar extension of export controls took place early last year, and authorities claim the coverage is almost 80 % of exports. New instructions from the central bank on rouble accounts of non-residents have also recently entered into force. Among other things, if the delivery of goods and services against advance import payments takes too long (over 90 days), the payments will be directed to accounts with rigid rules for converting the funds into foreign currency.

Officials face a daunting task in their efforts to curb capital flight from Russia via controls. Those wishing to siphon money out of the country have used a wide range of methods in trade transactions (e.g. non-repatriation of export earnings, fictitious imports and misreporting of export and import prices) and capital transactions (e.g. due to inadequate banking supervision). Estimates of capital flight stock and flows from Russia over the years vary wildly. Meagre meaningful data available in the Russian balance of payments (two items) suggests a decline of capital flight in 1999 and an increase in 2000. Last year, non-repatriation of export earnings and non-equivalent advance payments for imports remained at the 1999 level (about USD 4 billion in the first three quarters of 2000). The other item, statistical errors and omissions, in contrast to many other countries, always point to sizeable capital outflows from Russia (unless the CBR's own estimate for imports not recorded by customs is too low). Last year, the errors and omissions suggested an increase of outflow (to over USD 7 billion in 1-3Q00). If all private sector short-term capital flows would be included, the outflow figure would be in an oft-cited range of USD 20–25 billion per year.

Monetary indicators

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**as of**
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	22.2	2/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	55.3	1/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	2572	1/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6		11/00
- lending rate, %	320	147	46.2	41.5	40.1	18.2		11/00
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	28.3	2.3.01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	28.72	2/01

Sources: Goskomstat, CBR

Looking back at the Russian economy last year

By Vesa Korhonen*

Economy and external income grew briskly

Economic growth in Russia resumed in autumn 1999 and boomed in 2000, with GDP rising almost 8 %. GDP volume surpassed the pre-1998 crisis level. The high growth blew away the cautious forecasts of 1-2 % growth made a year ago. The major final demand components – exports and private consumption – increased swiftly. Domestic fixed investments rose by over 17 %. On the supply side, all sectors (industry, agriculture, construction, trade, services, transports) grew quickly, between 5 % and 12 %. The economy maintained the momentum gained from the rouble's plunge in late 1998, which did not create so much of a response of export industries as it encouraged extensive import substitution by domestic industries. The current account surplus swelled to about a fifth of GDP as world market prices for Russian oil and gas soared. This pushed the share of exports above 40 % of GDP.

Rapid growth brought open unemployment down last year to below 10 % of the workforce and also decreased the share of employees on employer-initiated leave and part-time work.

Late 2000, however, saw some slowing in GDP growth and industrial production. Export and investment growth also abated. Growth of export income eased as increments to export prices became smaller.

Economic policies less strained, inflation down

Russia's fiscal, monetary and exchange rate policies faced smaller pressures last year than in earlier years, but challenges remain.

The federal budget recorded hefty surpluses as revenues improved considerably as a share of GDP, due to the climb of oil export prices and tax collection. Federal budget expenditure was also held relatively tight until autumn, which was supported by the rescheduling of part of the foreign debt repayments. Later part of the year, however, saw additional spending due to non-budgeted revenues accrued. Federal expenditure accounted for 14 % of GDP last year and the entire public sector expenditure for about a third. The puzzle Russia now faces is how to fit all spending into the budget framework if debt has to be serviced in full in the coming years.

Monetary policy faced the fact that the large current account surplus drove up the proportionately small domestic money supply when the CBR lacks effective monetary policy tools to sterilise money growth. The measures taken (lowering of the refinancing rate, increases of interest rates for bank deposits at the CBR) were not of central importance as they cover rather small items in the monetary economy. The development of money market policy instruments (such as T-bills (used in 1997-98) and CBR bills) remains ahead.

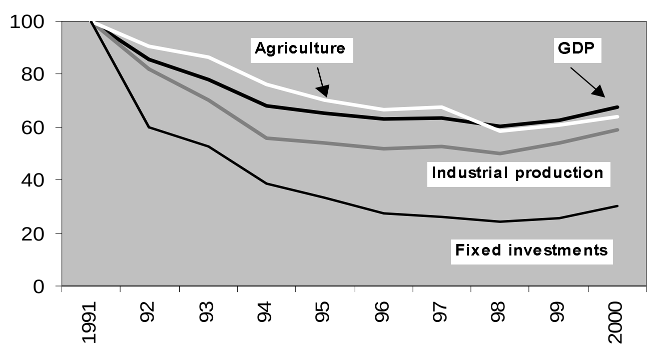
Exchange rate fluctuations were easily countered and the rouble was guided by the CBR with interventions using bits of its large foreign exchange reserves. Nevertheless, finding a stance between containing inflation and supporting economic growth on a shorter term is not easy. The rouble first strengthened in 1H00 and remained stable until late 2000. Then the rouble was allowed to depreciate supposedly in response to signs of weakening economic growth. At the end of 2000, the rouble's real exchange rate against its main trading partners' currencies had risen to about 70 % of the pre-1998 crisis level.

Although fiscal and monetary policy could not curtail domestic money supply growth (over 60 % y-o-y in December) and wages increased more than 40 % over the year, inflation decreased to the range of 20 % (consumer prices) to 30 % (producer prices). The fast money growth may maintain inflation this year while it would be important to leave room for the necessary increases of utilities' prices. An anti-inflationary structural change in money supply in favour of bank saving - as opposed to holding cash - does not look likely (it did not occur last year either) as the banking sector commands little trust. In addition, last year's rise in the demand for money may be hard to repeat as it came partly from a substantial remonetisation of the economy which crowded out reliance on payment arrears, barter and bills of exchange.

Economic reforms progress slowly

The implementation of the government's comprehensive economic program of last summer has taken a very gradual start. The main reforms made so far have concerned certain taxes (personal income tax, social security tax, VAT, excise taxes) and import tariffs, effective from 1 January 2001. The list of areas where legislation is under preparation is quite wide, including corporate taxation, restructuring of natural monopolies (in gas, electricity and rail service), simplification of business regulation, the banking sector, land reform, and labour law. The reform has gained some momentum from 1998-99 but it has still been slow. The preparation of the reforms in the various areas should start to yield more concrete results this spring.

Russian production and investments, 1991 = 100



Source:Goskomstat

**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
9 March 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
3•2001

Economic Developments

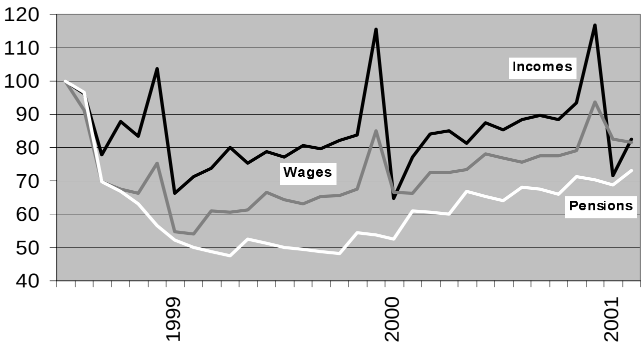
Incomes up in 2000, still below 1998 pre-crisis level

According to the State Statistics Committee, *real disposable incomes* of Russians grew 9.1 % in 2000 after falling about 14 % in 1999 (changes in annual average). Nevertheless, real disposable incomes are still some 20 % below the 1998 pre-crisis level (see chart). *Wages* have recovered more quickly, rising by nearly 50 % in nominal terms last year. In real terms, wages increased 22 %, but are also almost 20 % below the summer 1998 level. *Pensions*, which were increased several times last year, were up 55 % in nominal terms and 30 % in real terms. In real terms, however, pensions are still 25 % lower compared to summer 1998. The average monthly pension in 2000 (694 roubles, or 25 dollars) corresponded to about 30 % of the average wage (2,259 roubles or 80 dollars).

Due to positive economic developments, budgeted social sector expenditures were disbursed in full. State arrears, including arrears in wages, unemployment allowances and child benefits, either decreased or were totally paid off. The number of unemployed and persons on forced leave decreased substantially. Under ILO methodology, there were 6.9 million unemployed persons in Russia at the end of February 2001. The figure corresponds to less than 10 % of the economically active population.

Despite these generally encouraging developments, some 30 % of Russians (44 million) still live below the official minimum monthly subsistence level, which averaged 1,211 roubles (43 dollars) last year. Almost 50 % of statistically recorded money incomes were concentrated in the wealthiest quintile.

Real disposable incomes, real wages and real pensions, July 1998=100



Source: Goskomstat

Last year's current account surplus sets record

The CBR's balance of payments data for all 2000 puts the growth of Russia's export income (goods and services) at 36 % and growth of the import expenditure at 18 %. The trade surplus surged to over USD 60 billion. Thus, despite a growing deficit in the services balance and interest expenditure on government debt, the current account surplus grew to USD 46 billion. This equalled 19 % of GDP (up from 13.5 % in 1999).

On the capital and financial account, foreign direct investment into Russia decreased to USD 2.7 billion, while Russia's outward direct investment increased to USD 3 billion. Last year's partial write-off of debt to London Club banks is shown as a large capital transfer to Russia and negative portfolio investments. The large negative figure in "errors and omissions" increased, which suggests that capital flight continued unabated last year at a rate that matched earlier levels. Net capital outflows moderated the effect of the huge current account surplus on the CBR's currency and gold reserves, which grew USD 16 billion to USD 28 billion at year's end (USD 30 billion as of end-March 2000).

Russia's balance of payments in 1998-2000, USD billion

	1998	1999	2000
Current account	**0.7**	**25.0**	**46.3**
Trade balance	16.9	36.2	60.7
Exports, f.o.b.	74.9	75.7	105.6
Imports, c.i.f.	-58.0	-39.5	-44.9
Services	-4.0	-4.2	-7.8
Exports	12.4	9.1	9.6
Imports	-16.3	-13.2	-17.4
Investment income	-11.6	-7.7	-6.9
Received	4.0	3.5	4.3
Paid	-15.6	-11.2	-11.2
Other items, net	-0.5	0.6	0.3
Capital and financial account	**2.7**	**-16.0**	**-21.1**
Capital Account	-0.4	-0.3	10.9
Received	1.7	0.9	11.8
Paid	-2.1	-1.2	-0.9
Financial account	3.1	-15.7	-32.0
Direct investment to Russia	2.8	3.3	2.7
Portfolio investment to Russia	8.9	-1.3	-10.1
Other items, net	-8.6	-17.7	-24.6
Net errors and omissions	**-8.8**	**-7.3**	**-9.3**
Change in reserves	**5.3**	**-1.8**	**-16.0**
('-' growth, '+' decline)			

Source: Central Bank of Russia, 30 March 2001

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	3.5	7.7		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	9.0	3.1	2/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	7.6	2/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.6	2/01
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	105.2	8.0	1/01
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	44.2	3.1	1/01
Current account, USD billion			8.4	7.4	11.8	2.1	0.7	25.0	46.3		

Sources: Goskomstat, CBR

Consolidated 2000 budget shows surplus

Along with the federal budget, the realised consolidated budget for 2000 showed a clear surplus amounting to 3 % of GDP. Nominal revenues grew over 70 % to 30 % of GDP, while expenditures increased almost 50 % and amounted to 27 % of GDP. Revenues in 1999 were divided almost equally between federal and regional budgets. Last year, the federal budget's share increased to 54 %. On the expenditure side, the trend was reversed with regional budgets increasing their share to 54 % as transfers from the federal budget rose.

Regarding consolidated budget revenues, the largest increases were recorded in customs duties, profit taxes and revenues of budgetary funds (primarily the Road Fund). Expenditures from budgetary funds also increased accordingly and accounted for the largest single expenditure increase in the consolidated budget. Defence and law enforcement costs were also boosted. As a share of GDP, debt servicing costs (interest expenditure) were substantially down from 1999. Overall, Russia preferred to increase other expenses in 2000, rather than direct more realised extra revenues of over RUB 300 billion (over USD 10 billion) to debt servicing.

Realised 2000 and 1999 consolidated budgets

	2000			1999		
	RUB billion	**% of total**	**% of GDP**	**RUB billion**	**% of total**	**% of GDP**
Revenues	**2079**	**100**	**29.9**	**1214**	**100**	**26.3**
Tax revenues	1708	82.2	24.6	1008	83.0	21.9
of which						
VAT	*457*	*22.0*	*6.6*	*288*	*23.7*	*6.3*
Profit tax	*399*	*19.2*	*5.7*	*221*	*18.2*	*4.8*
Customs duties	*229*	*11.0*	*3.3*	*86*	*7.1*	*1.9*
Income tax	*175*	*8.4*	*2.5*	*117*	*9.7*	*2.5*
Excises	*166*	*8.0*	*2.4*	*109*	*9.0*	*2.4*
Other taxes	*282*	*13.4*	*4.1*	*187*	*15.4*	*4.1*
Non-tax revenues	132	6.3	1.9	85	7.0	1.8
of which						
State/municipal property or activity	*68*	*3.3*	*1.0*	*24*	*2.0*	*0.5*
External economic activity	*36*	*1.7*	*0.5*	*36*	*3.0*	*0.8*
Other	15	1.3	0.2	15	1.2	0.3
Budgetary funds	225	10.8	3.2	106	8.8	2.3
Expenditure	**1872**	**100**	**26.9**	**1258**	**100**	**27.3**
Social-cultural activities	534	28.5	7.7	367	29.2	8.0
Debt service*	191	10.2	2.7	190	15.1	4.1
Defence	191	10.2	2.7	116	9.2	2.5
Law enforcement	132	7.1	1.9	75	5.9	1.6
State administration	73	3.9	1.1	46	3.7	1.0
Industry, energy, construction	58	3.1	0.8	31	2.5	0.7
Agriculture and fishery	54	2.9	0.8	36	2.8	0.8
Other	416	22.2	6.0	296	23.5	6.4
Budgetary funds	223	11.9	3.2	101	8.0	2.2
Balance	**207**		**3.0**	**-44**		**-1.0**

*Source: Goskomstat / MinFin; *includes interest payments only. The consolidated budget includes federal and regional budgets.*

Federal budget shows deficit in January-February

After payment delays to Paris Club early 2001, Russia announced its commitment to servicing all external debt in timely fashion from the end of April onwards. Along with the payments due in February, Russia paid off part of payments missed in January. Despite a clear surplus in January, this action drove the federal budget into deficit by RUB 15 billion (1.2 % of GDP) in January-February. Tax revenues accounting for the majority of budget income were well above target in both January and February, but were insufficient to cover the higher expenditures. The deficit was financed with reserves held over from last year.

In mid-March, the Federation Council voted overwhelmingly to support the Duma's version of amendments to the 2001 budget. The amendments allocate most of Russia's extra budget revenue to servicing foreign debt (see Month in Review 2/2001).

Putin calls for fiscal reforms

In his annual speech to the Duma and the Federation Council, president Putin raised the question of reforming the fiscal relations between the federation, regions and municipalities. He demanded more effective fulfilment of obligations at different budget levels. He also stated his dissatisfaction concerning the operation of regional funds of financial support insisting on more transparency.

Mr. Putin further urged the start of a discussion on the possibility of dividing the federal budget into two parts in order to avoid the usual haggling in adopting the budget. The president's economic advisor Andrei Illarionov has advocated the idea and the IMF has indicated its support. The first part of the budget would guarantee the implementation of basic state obligations and be based on projected minimum oil prices. The Duma deputies could either adopt or reject it. The other part of the budget would consist of incomes received in case the international economic situation is better than expected. These incomes would make up a stabilisation fund to be used to support a stable economic development during an economic downturn. The fund would thus smooth the effects of international energy prices on the Russian economy. The use of incomes in this part of the budget would be decided after discussions with the Duma.

Mr. Putin also called for continuation of customs reform, noting that measures to merely simplify and lower the level of import tariffs were insufficient. A new customs code corresponding to the WTO norms should be adopted as part of the basis for Russia's wish to achieve fundamental agreement with the WTO member states by the end of 2001.

Fiscal indicators (per cent of GDP)

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2001**
Federal government							Jan.**	budget
- revenues	13.7	12.5	9.8	9.0	13.4	16.2	16.3	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	13.7	14.9	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	2.5	1.3	0.0

* Figures for 1995-1996 exclude interest payments on short-term government debt
** Preliminary figures from MinFin
Sources: Goskomstat, IMF, MinFin.

Tracking the rouble

As long as fundamental factors affecting the rouble's exchange rate (e.g. international oil price and domestic inflation) do not undergo large changes, the Central Bank of Russia can counter pressures for daily exchange rate fluctuations in the relatively thin market with its large foreign exchange reserves. Within limits induced by fundaments, the CBR can also guide the rouble to desired levels. Russia also lacks foreign short-term capital that could potentially flee and thus challenge the CBR forex reserves which (excluding gold) amount to almost 65 % of the total rouble money supply (M2) in the economy. Despite this seeming ease, Russia's exchange rate policy has increasingly become under focus as economic growth has started to virtually stall and as inflation stubbornly persists above targeted levels.

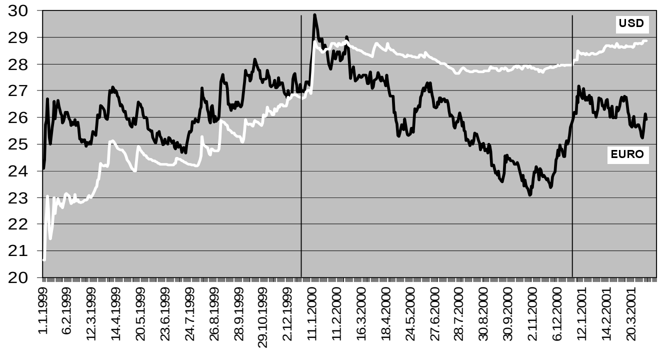
Last year, the rouble first appreciated in nominal terms in 1H00 due to increasing export revenue and market liquidity (see chart). Then it remained at that strengthened level until late 2000, which meant that Russia's domestic inflation (measured in consumer prices) made the rouble rise in real terms, in the CBR's calculations, by 20 % against the currencies of Russia's main trading partners in January-November (including over 30 % against the euro and 10 % against the US dollar). Using data on producer price inflation, these figures for the rouble's real exchange rate climb would be around ten percentage points higher.

Since late December, the rouble has been allowed to weaken more closely in line with inflation, from the level of less than 28 roubles to the US dollar to the current level of almost 29 roubles to the dollar. This has happened in parallel with the explicit worries that have surfaced about slowing growth and even stagnation of the economy. The rouble's weakening also appears to be well in line with the projection of the 2001 state budget, which assumed this year's annual average rate at 30 roubles to the dollar; a straight path would imply a year-end rate of 32 roubles. Given the budget's projection for inflation (12-14 %), the rouble real exchange rate was to decrease slightly during the year.

The CBR's more recent stated line is that the rouble will not fall below the level of 30 roubles to the dollar this year. With this exchange rate stance, the rouble will strengthen in real terms even if inflation slowed to targeted levels. Current expectations for the rouble this year among different banks and investors are still partly divided between the lines of 30 and 32 roubles at year's end, albeit most beliefs are now geared to the latest firmer line of 30 roubles.

The essential issue is that the 30 rouble set-up, and price competitiveness of domestic industry in general, should be supported via sufficient anti-inflationary restraint in the areas of fiscal, monetary and wage policies.

RUB/USD and RUB/EUR exchange rate



Source: CBR

Foreign direct investments still small

Goskomstat reports that foreign direct investment (FDI) flows into Russia amounted to USD 4.4 billion in 2000, after recording under USD 4.3 billion in 1999. This pick-up of 4 % is modest in the light of last year's domestic investment boom in Russia. Also, FDI figures shown in the balance of payments data have been less than in Goskomstat data for the past four years, and they declined last year (see page 1).

Of Russia's total FDI last year, over 40 % went to industry, mainly the food industry (20 %), oil extraction (10 %) and machine building (5 %). The transport sector received 20 %, trade and food services another 20 % and telecommunications about 10 %.

As for investor countries, a third of the cumulative USD 16 billion stock of FDI at the end of 2000 came from the US. Cyprus has increased to 20 %, suggesting that investing Russian capital in Russia via foreign company structures was more active last year. Germany, the Netherlands and the United Kingdom each account for 6 to 8 % of FDI.

Russia's country risk rankings almost unchanged

The fresh country risk ratings of *Euromoney* and *Institutional Investor* lowered Russia's ranking two places from September 2000. Russia now ranks 97th (out of Euromoney's 185 countries covered) and 93rd (out of Institutional Investor's 145 countries). A year ago, Russia ranked 133rd and 103rd, respectively. Among the CIS countries, Russia (in the other ranking with Azerbaijan) is second after Kazakhstan. It is still below the lowest ranked Central and Eastern European country, Romania.

The slight notch down for Russia likely reflects the slowing of economic growth this past winter, difficulties in bringing down inflation, and the slower-than-expected pace of reforms. Firmer world market energy prices and their current forecasts compared to last autumn's forecasts may have prevented a bigger drop.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	23.7	3/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	52.7	2/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	2760	2/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.2	4.1	1/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	18.6	1/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	29.7	3/01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	28.74	3/01

Sources: Goskomstat, CBR

FDI and the Russian energy sector: An ill-managed partnership?

By Juhani Laurila*

FDI inflows to Russia still quite modest

Even small amounts of foreign direct investment (FDI) constitute a qualitatively important catalyst for economic development, because FDI represents permanent economic participation and co-operation with the host country. The fact that the share of FDI is typically over 40 % of foreign capital stocks or flows in transition economies – but less than 20 % in industrial countries – gives some idea of FDI's relative importance for economies yet unable to tap into international capital markets.

Even so, FDI inflows to Russia have been truly modest by any standard. The State Statistics Committee reports that the gross flow of financial capital to Russia's corporate sector was USD 11 billion last year. Of that FDI was about 40 % or USD 4.4 billion. The accumulated stock of all financial capital in Russia (1993-2000) amounted to USD 32 billion, about half of which was FDI. In per capita terms, the FDI stock in Russia is among the tiniest in European transition economies. A hostile business climate and prohibitive controls efficiently bar access of FDI to Russia in general, and to the energy sector in particular. In fact, only about 10 % of last year's FDI went to the energy sector.

Production-sharing agreements – gates or barriers?

Production-sharing agreements (PSAs) were designed to attract foreign investors to invest in the energy and raw material sectors. They also seek to warrant Russian control and minimum involvement of 70-80 % with corresponding benefits from the exploitation of natural resources. These rules and the prevailing business climate explain why only three, or possibly four, of the 28 PSA contracts approved since the introduction of the PSA regime in 1996 are actually operational. According to some estimates, Russia loses one to two billion dollars a year that it could be earning if various PSA contracts had been approved and made operational without delay. Although the ministries of economy and energy recently agreed on modification of tedious authorisation procedures, doubts have already arisen about the tax rules introduced in the draft of the new PSA law, e.g. possible double taxation.

The PSA regime likely reflects the psychological or political ambivalence towards FDI felt by Russian officials, policymakers and citizens, particularly at the regional and local level. On the one hand, FDI is invited to finance and participate; on the other, Russians fear excessive exploitation of national assets and wealth to their disadvantage. The Russian government, however, acknowledges that foreign money and technology are necessary in modernising the energy sector and calculates that friendlier treatment of foreign investors could bring in USD 60-70 billion in foreign investments to Russia during the next 10-15 years.

The challenge of the EU-Russia "Energy Partnership"

According to scenarios for the coming 20 years prepared by the International Energy Agency (IEA), Western Europe plans to increase the use of gas in heating and power generation so as to cut down the use of coal and associated CO_2 emissions, to fill the gap created by running down nuclear power generation, and to put aside more oil from heating for use in transports. Europeans hope to cover their excess demand for primary energy with natural gas from the North Sea and Russia. For the last two years, the EU and Russia have pursued an "Energy Partnership", and this hoped-for co-operation was reconfirmed with handshakes of presidents Vladimir Putin and Jacques Chirac in Paris last October.

To meet the challenge, Russia will need substantial amounts of financing for exploration, extraction and transport of oil, natural gas and electricity to Western European markets. IEA and Russian estimates both foresee investments of USD 5-7 billion a year in the coming 20 years simply to sustain the current level of oil production. Around USD 2 billion a year is needed just to maintain production in depleting gas fields. Estimates about investments needed in the power sector are in the range of USD 5-9 billion dollars a year. Thus, during the coming 20 years around USD 15 billion a year will be needed to keep the entire Russian energy sector in business as expected.

Time grows short

Despite historically high world market prices for energy and raw materials that could assist in financing energy investments, the thinness of FDI is bound to seriously slow development of Russia's energy sector. Low, regulated domestic energy prices and non-payment of energy bills continue to add strain. Russian energy production and investments, burdened by high capital costs, must also compete with lower-cost energy from elsewhere.

Time is running out. Exploration and construction of production facilities, pipelines and related infrastructures takes years. It takes even longer to create market institutions and behaviour conducive to a healthy business climate. So while we wait for benign public and corporate governance to emerge in Russia, perhaps a more liberal and permissive PSA regime would serve Russian interests better by attracting FDI to Russia's energy and raw materials sectors.

**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
6 April 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
4•2001

Economic Developments

Economic growth has nearly stopped …

According to preliminary information, growth of Russia's GDP has decelerated to over 4 % y-o-y in the first quarter of this year, after expanding 7.6 % in the year 2000 and 7.4 % in the fourth quarter. The economy ministry calculates the seasonally adjusted GDP grew 0.7 % in the first quarter.

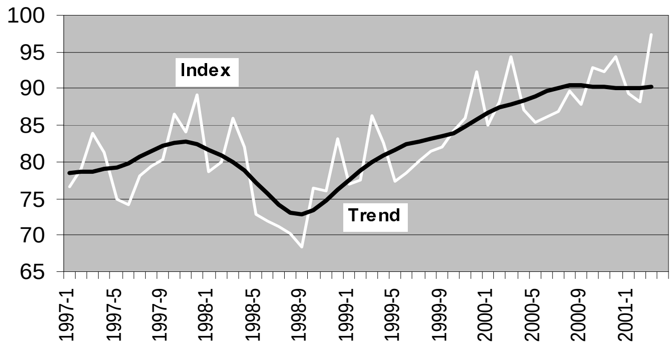
Production in five key sectors increased 3.6 % in the first quarter. Two sectors still grew fast. Construction increased over 8 %, although last year it expanded even quicker (over 11 %). The drop in the growth rate is linked with a fall in the investment growth rate to less than 7 %, much slower than last year (18 %). Retail trade kept up its pace of growth at over 8 %, almost the same as last year, which is stemming from rapid income growth and is partly feeding import growth. In contrast, agricultural production decreased slightly in the first quarter, after recording 5 % growth last year. The transport sector delivered less than 1 % more than a year earlier, against last year's increase of 5 %.

… and industrial production is stagnating

The fifth and largest key sector, the industry, accounts for a third of the GDP. In the first quarter, industrial production increased 3.3 % y-o-y, after scoring 9 % last year and still 6.5 % y-o-y in the fourth quarter. In March, the y-o-y growth was 3.6 %. Adjusted for the smaller number of working days in this year's first quarter, the quarter's increase was over 4 %. However, the trend of the seasonally adjusted production volume has during the early part of the year remained at the same level as in the second half of last year (see chart).

The slowing of growth in the first quarter concerns almost all industrial sectors. Only the fuel industry, which has not been a forceful driver of industrial growth during the past two years compared to all other main industries, retained its growth rate at almost 5 %. This was due to a continued increase of crude oil production (6 %) and despite a continued decrease of gas production (-1.7 %). The y-o-y growth rate of chemical and petrochemical production as well as the light industry slowed to 5-6 %. Production in non-ferrous metallurgy and machine building increased over 3.5 %, while the forest industry recorded an increase of 2 %. Activity in the construction materials industry, the food industry and ferrous metallurgy was at or slightly below the level of the first quarter of 2000.

Russian industrial production 1997-2001, Dec 1993=100



Source: Goskomstat, BOFIT

Projections of economic growth slightly down

The Government is expecting the GDP to grow 3.5-4 % this year. The IMF's fresh forecast maintains the earlier projection of 4 % growth while the EBRD has recently set its projection at 3.4 %. Many private western banks have scaled their expectations down to 3-3.5 % and some as low as 2 %.

Forecasts of the global oil price are higher than earlier but the recent slowdown in Russia has an impact on forecasts and some other factors have become less promising. Forecasts of a global economic slowdown have deepened, adding uncertainty e.g. to price scenarios. This also has some effect on Russian exports albeit the fundamental constraint is lack of competitive exports in Russia. Real appreciation of the rouble is stronger than thought earlier, due to inflation above target. This makes domestic demand shift quicker to imports.

Current account surplus remains large

The Central Bank has already issued preliminary balance of payments data for the first quarter of this year. The estimate puts the current account surplus at USD 11.5 billion which equals nearly 18 % of GDP (USD 11.9 billion or almost 20 % of GDP in the first quarter last year). The trade surplus of USD 14.5 billion was virtually the same as a year earlier while the services deficit increased to USD 2 billion.

Russia's export income (goods and services) increased 4 % compared to a year earlier. Import expenditure grew 10 % in USD terms and over 15 % in euros. Three fuel export items accounted for 54 % of total export income, including crude oil (23 %), oil products (8 %) and natural gas (23 %).

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	3.5	7.7		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	9.0	3.3	Q1/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	6.7	Q1/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.6	3/01
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	105.2	16.2	1-2/01
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	44.2	6.7	1-2/01
Current account, USD billion			8.4	7.4	11.8	2.1	0.7	25.0	46.3	11.5	Q1/01

Sources: Goskomstat, CBR

Budget policy guidelines for 2002

Budget policy issues were brought into focus last month in a joint memorandum of the government and the CBR on economic policy for 2001 and beyond, as well as in president Putin's budgetary address. Both documents contain the same broad budget policy guidelines. The most important budgetary task is to support macroeconomic stability. More concrete tasks included continuation of tax reform, rationalising budget expenditures and reform of interstate financial flows. Mr. Putin stressed the importance of adopting deficit-free budgets and advocated transition to a two-part budget.

The purpose of the tax reform is to simplify the tax system and reduce the overall tax burden. Overall public sector budget revenues are expected to decrease by some 3-4 % of GDP this year, but in the long run tax revenues are assumed to go up as tax collection improves and the share of illegal activities falls. The four new sections in the tax code (VAT, social tax, income tax and excises) will be accompanied with the introduction of an *enterprise profit tax*, which has already passed its first reading in the Duma. According to the draft law, the profit tax rate of 35 % will remain unchanged but the number of deductible expenses will increase. The *turnover tax* will be eliminated by the beginning of 2003. A batch of laws on *taxation of natural resources* will also be submitted to the Duma in early May. The draft laws propose a unified tax on the use of mineral wealth. It would be levied in roubles for each tonne extracted and eliminate the use of several popular, but illegal, methods of false pricing to avoid taxes.

In his budgetary address, president Putin mentioned ten priorities to reform budget expenditure policy. He stressed the importance of clear criteria, transparency and control in the use of state resources. All new laws must be accompanied with assessments of their budgetary impact. State purchases should be done on a competitive basis. The same principle holds true for interstate financial relations, which should be free of any malfeasance. The stability of regional and local budgets should be guaranteed by giving them right to certain revenue items for a longer period. Regions and localities should gradually be freed of the delegated federal government tasks, which they are financially incapable of dealing with.

Federal budget in clear surplus in the first quarter

According to latest MinFin information, the federal budget ended the first quarter with a surplus of nearly 3 % of GDP (RUB 54 billion or USD 1.9 billion). After heavy payments on external debt, Russia's federal budget in January-February was still in the red. The government enjoyed improved tax and customs revenues in the first quarter, and total revenue increased to some 17 % of GDP. The VAT and customs duties have remained the leading revenue sources of the federal budget. The switch to a flat 13 % income tax has been successful as according to preliminary information income tax revenues have increased by over 60 % in nominal terms compared to the first quarter of 2000. As the share of federal budget in income tax revenues has decreased from 16 % to 1 %, the improvement in these revenues is not shown in the federal budget.

State debt declined last year

In 2000, Russia's *foreign debt* decreased by less than 10 % (estimates range from USD 10 to 14 billion) to USD 144 billion at the beginning of 2001. The reduction was mainly due to debt forgiveness granted by London Club creditor banks in February 2000. The remaining London Club debt was swapped for two Russian Federation eurobond series, and the amount of eurobonds in Russia's foreign debt rose accordingly by USD 20 billion.

According to president Putin, Russia's debt policy should be based on improving the structure of debt and reducing its servicing costs together with flattening the hikes in debt service. Russia has succeeded this year in striking a London Club-type deal with Western creditors for forgiveness on USD 1.5 billion (for details, see next page). Finance minister Kudrin stated that Russia is committed to servicing its foreign debt in 2002 according to the agreed schedules and without further restructuring. The negotiations on restructuring Paris Club debt due in 2003 are expected to resume in late 2001 or early 2002.

Russia's *domestic debt* contracted last year by about 5 % and was about RUB 550 billion at the start of this year. The share of bonded debt in total domestic debt expanded as some MinFin debt owed to the central bank was converted to bonds. Today, nearly all domestic debt is in bonds.

Structure of federal government debt, 1 Jan. 2001

	USD bln	RUB bln
Foreign debt	**144.4**	
of which		
Loans	***90.8***	
of which		
Paris Club	48.6	
To non-Paris-Club countries	19.5	
Commercial debt	6.7	
IMF	8.8	
World Bank	7.1	
EBRD	0.2	
Bonds	***53.6***	
of which eurobonds	36.4	
Domestic debt	**19.9**	**557.4**
of which		
Bonds		***555.9***
Other		***1.5***
TOTAL bln dollars	**164.3**	

Source: MinFin. The exchange rate used is 28 roubles/dollar.

Fiscal indicators (per cent of GDP)

Federal government	1995	1996	1997	1998	1999	2000	2001 Jan-Mar**	2001 budget
- revenues	13.7	12.5	9.8	9.0	13.4	16.2	16.9	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	13.7	14.1	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	2.5	2.9	0.0

* Figures for 1995-1996 exclude interest payments on short-term government debt

** Preliminary Minfin information

Sources: Goskomstat, IMF, MinFin.

Inflation faster than targeted

Consumer prices rose over 2 % in February and almost 2 % in March. In March the prices were nearly 24 % higher than a year earlier (20 % in December).

The first quarter is usually a period of higher inflation as seasonal factors push up food prices and many regulated prices are raised. However, from December consumer prices have risen over 7 %, considerably faster than in the first quarter of 2000 (4 %). Two broad price categories are important behind the acceleration. Prices for services have gone up 13 % since December. On the road to scaling down subsidies and reforming the utilities, different services related to housing have been hiked 20 % and passenger transport services raised over 10 %. Second, food prices have climbed well over 7 %, including a 27 % leap of vegetable prices. According to data provided by the economy ministry, food prices accounted for over 55 % of consumer price inflation in the first quarter while public services contributed 25 %.

Industrial producer prices were 23 % higher in March than a year earlier (32 % in December). In the first quarter their increase was less than 5 % despite a considerable rise of the electricity price since fuel prices dropped slightly. Agricultural producer prices rose 9 %, much more than a year earlier. Transport prices increased only a couple of per cent. The pressure on the producer price front is by no means over since regulated prices of certain inputs to the industry have been kept low. For example, after the crisis of summer 1998 prices for electricity and gas provided to the industry as well as prices for railway freight have been raised by only 50 to 70% of the pace of industrial producer price inflation.

Besides hikes of regulated prices, fast growth of money supply last year and relatively large increases of wages and pensions around the year-end have propped inflation. In the first quarter the increase in money supply was negligible. The rouble exchange rate has provided some support to inflation by declining 3 % against the US dollar since October last year and by falling in December-January over 10 % against the euro, the currency of Russia's main partners for imports. In the wake of the first quarter figures for inflation, the authorities have raised their estimate of consumer price inflation for the whole year 2001 to 14-16 %. Many predictors have scaled their projections up to 18-22 %.

Restructuring with trade creditors agreed

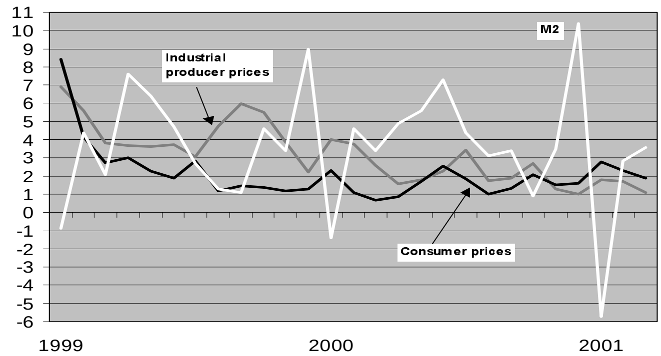
Russia and its trade creditors have reached an agreement in principle on restructuring Russia's Soviet-era debt that originates in unsecured trade credit from western suppliers to Soviet foreign trade organisations. The stock of debt, including capitalised interest, is estimated at about USD 4 billion. As anticipated, the terms agreed follow those of the restructuring deal reached earlier with the London Club of creditor banks. Thus, over a third of the trade debt or about USD 1.5 billion will be written off. The rest will be exchanged for two series of eurobonds, due in 2006 to 2010 and 2007 to 2030. It is expected that about USD 2 billion of the eurobonds will be issued this year.

Bank deposits grow slowly, lending increases

Growth of bank deposits has been slow during the past year, keeping the share of deposits below 10 % of the annual GDP (excluding accounts at Vnesheconombank; see chart). This reflects low confidence in Russian banks. Foreign currency deposits have grown slightly faster than rouble deposits and account for a third of household deposits and about three-quarters of corporate deposits. Three-quarters of both household and corporate deposits are shorter than six months although longer maturities grew relatively well last year. Households have kept 86 % of their rouble deposits and over a half of their foreign currency deposits at the Savings Bank (Sberbank).

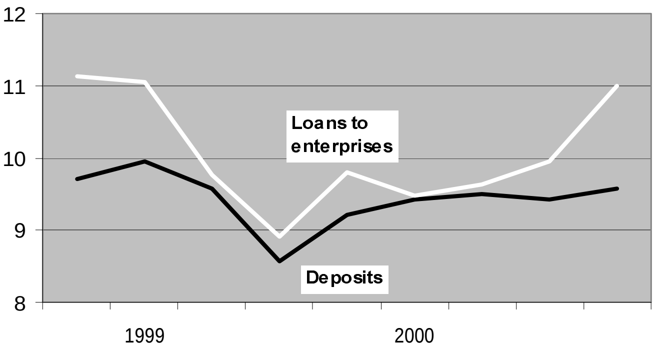
The stock of bank loans provided to enterprises grew to 11 % of GDP last year. Lending in roubles grew fast but about a third of the loans is in foreign currency. About 80 % of the rouble loans and a half of the foreign currency loans are shorter than one year.

Monthly inflation and change in money supply in 1999-2001, %



Source: Central Bank of Russia

Bank deposits and loans to enterprises, % of GDP



Source: Central Bank of Russia

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	23.7	3/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	53.0	3/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	2867	3/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	4.1	1/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	18.6	1/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	30.8	20.4.01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	28.83	4/01

Sources: Goskomstat, CBR

Putin's second year - and beyond

By Pekka Sutela*

Vladimir Putin's second year as the President of Russia has started with very mixed feelings among observers. While 2000 was arguably Russia's best year in macroeconomic terms since 1913, recorded growth on a seasonally adjusted month-to-month basis has been zero since October. A chill on investment, which is crucial for sustainable growth, seems to have commenced even earlier. If the current production level is maintained, annual growth will be about three per cent this year. In this light, the official forecast of four per cent is not that demanding. On the other hand, some analysts have already cut their annual growth predictions between one and two per cent, implying a decline in month-to-month levels.

While it is still too early to predict an imminent recession or crisis, the real appreciation of the rouble together with an expected slowing of world demand will likely force a narrowing of the current account surplus and increase fiscal strains on the economy. In this situation, Russia will still have to service its foreign debts to retain credibility and creditworthiness, but it also means that money will be unavailable for maintaining short-term aggregate demand. Moreover, some of the recent systemic improvement is endangered as barter may again pick up and arrears might grow.

Inflation remains a primary concern. Half of this year's inflation target was reached in just three months. Although recent money supply, which has actually declined slightly, presents no problem, there is considerable pressure to increase administrative prices. The electricity giant, RAO UES, is rumoured to want a four-fold increase in domestic prices over the next couple of years. They argue that otherwise there will be no money for the investment needed to maintain an adequate electricity supply. Such price increases will likely be blocked, but the pressure along with similar pressures on other prices will persist. Indeed, many companies are talking about major wage increases.

If inflation remains much higher than expected, the current exchange rate regime of an almost fixed nominal rate will be seriously challenged as the loss of price competitiveness is loathed. Unfortunately, few alternatives are available to Russian decision-makers. The markets are too thin to support a genuine float and crawling pegs have earned something of a bad reputation as inflation automata.

The authorities have outlined a wide-ranging, highly ambitious plan for structural reform. It involves continued tax reform with emphasis on enterprise taxation, as well as reforms in non-agricultural land, the public sector, the budget, banking, pensions, and perhaps most important, reform of natural monopolies, e.g. natural gas, electrical power and the railroads. Many other parts of the policy agenda, such as reform of the court system, will also have direct impacts on narrower economic matters.

Last year was not a lost year for reform, but much more could and should have been done. The menu for 2001 will burden decision-making and administrative capabilities to their utmost. While Russia has seldom suffered a lack of programmes or intentions, the lack of strategic thinking and implementation does occur.

The next few months may prove decisive. Many of the more liberal economic thinkers have already expressed disappointment and lowered expectations. The credibility of maintaining momentum probably demands visible change this spring. Elections are also drawing nearer, and Russia's international environment is not changing for the better.

During the last fifteen years, Russia has ended up in what an institutional economist would call a bad institutional equilibrium. There are many ways that systems can transition from one state of equilibrium to another. The probability of another top-down revolution is clearly much less than hoped by some in early 2000. In Russian history, change has often come from an external shock such as the Crimean war. Such a shock – beyond an eventual decline in export prices – is fortunately not foreseeable and any likely consequences are unclear.

Some change always takes place piecemeal, as the elite and institutions learn and adapt. Such change is also ongoing in Russia, particularly in many of the companies that have adapted to market realities and are thinking about the future strategically. Exactly how much is underway is however unknown, to most observers at least.

The perspective of change is often tied with overlapping generations. The members of the new elite that emerged in the Yeltsin era are typically young, often just at the start of their careers, and intent on holding on to power for a long time to come. It is not evident that the Russia's even younger "Generation Y" is sufficiently unified or self-conscious to pose an alternative.

This probably leaves the adoption of a European development perspective as the most certain bet for an engine of change. President Putin championed it in an on-line chat in March. The lack of credibility for this alternative may have been reflected in the fact that almost nobody in Russia or other CIS states paid any attention. The possibility of Russia aiming to become a true European nation still strikes most of us an occurrence utterly devoid of probability.

**The author is the head of BOFIT.*

RUSSIAN ECONOMY
The Month in Review
2 May 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
5•2001

Economic Developments

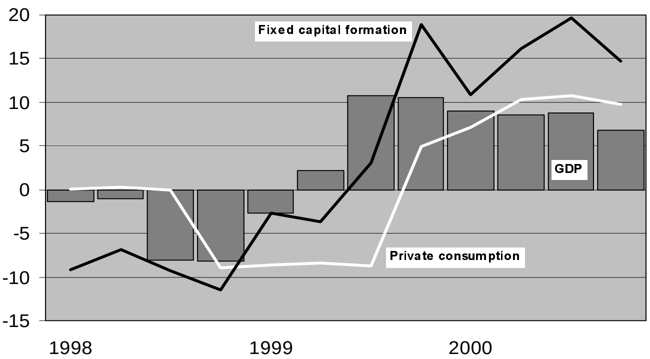
GDP growth in 1999-2000 revised upwards

The State Statistics Committee upgraded its assessment of the Russian economy's recent boom by issuing a substantial revision of the national accounts figures for 1999 and 2000. The revised data raise Russia's GDP growth to 5.4 % in 1999 (instead of an earlier 3.5 %) and 8.3 % in 2000 (earlier 7.7 %). The brisk recovery implies that last year GDP surpassed the 1994 level. The revision further suggests that GDP soared – over 10 % y-o-y – in the second half of 1999, and continued to grow by almost 9 % y-o-y until the fourth quarter of 2000 when growth eased to about 7 %. The revision values GDP for all of 2000 at slightly over RUB 7 trillion, which translates to USD 251 billion at the nominal exchange rate or USD 1,730 per capita.

Regarding production, the higher GDP growth figures were due to a considerable upward revision in the growth of value added in industry in 1999 and 2000, and agriculture in 1999. Value added in industry increased 12 % last year, while gross production in industry rose 9 %.

Among GDP demand components, the major adjustment was the realisation that fixed capital formation (investments) expanded quite fast already in the second half of 1999. Private consumption grew 9 % last year and fixed capital formation increased over 15 %, albeit both eased in the fourth quarter (see chart). The revised data show that the share of fixed capital formation in GDP rose last year to 18 %, while the share of private consumption declined to 47 %. Net exports climbed to 21 % of GDP, the result of export income rising to a record 46 % and import expenditure decreasing to 25 % of GDP.

Russian GDP and the main demand components 1998-2000, change from the respective quarter of the previous year, %



Source: Goskomstat

Production and investments plod along

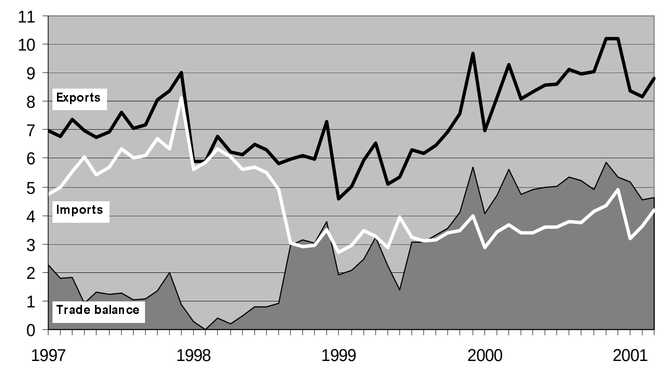
All main indicators for production - the GDP, the aggregate of five key sectors and industrial production - saw growth in January-April of around 4 % from a year earlier. Investment growth also slowed to 4 %. However, comparisons to more recent levels of production are more relevant. The economy ministry's seasonally adjusted calculations indicate that, after a decline towards the end of last year, GDP in April surpassed last autumn's level. Goskomstat and the ministry compute that seasonally adjusted industrial production also slightly passed its autumn level, while investments were still a little down from last autumn.

Export growth slows, import growth continues

After 40 % growth last year, Russia's *exports* grew 4 % y-o-y in the first quarter to over USD 25 billion. Exports to countries outside the CIS grew 6 % to nearly USD 22 billion, while exports to the CIS declined. *Imports* increased 10 % y-o-y (slower than in the second half of last year), reaching USD 11 billion. Imports from outside the CIS were up 11 % to nearly USD 8 billion. In euro terms, non-CIS imports continued to grow at a brisk 19 % in the first quarter.

First quarter export growth was affected by the mixed development of major export items. The price of crude oil was several per cent down from the first quarter of 2000, but this was compensated for by over 6 % growth in the crude oil export volume. By contrast, the export price for natural gas was about 40 % higher than a year earlier, but the export volume dropped more than 15 %, due to a sharp fall in exports to the CIS. Increases in export volumes of non-energy items were more rare than last year. With the investment boom past, imports of machinery and equipment showed slower growth than other imports.

Russian exports and imports, USD billion



Source: CBR

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	8.3		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	10.8	12.1	3.8	1-4/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	4.0	1-4/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.6	4/01
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	105.2	25.3	1-3/01
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	44.2	11.0	1-3/01
Current account, USD billion			8.4	7.4	11.8	2.1	0.7	25.0	46.3	11.5	Q1/01

Sources: Goskomstat, CBR

Tax changes in focus

With a prolonged spring session, the Duma continues to debate several important law drafts directly or indirectly connected with budget. These include the profit tax law and laws on amendments to the unified social tax and sales tax. As regards the profit tax, the Duma tax committee suggested that the government's proposed 35 % tax rate be lowered to 27 % over a five-year period after the law comes into force. The amendments to the social tax law aim at lowering the starting limit for regression.

The 2002 budget will be submitted to the government this week. It is still unclear, however, when it will reach the Duma. Fast approval of some basic tax laws before that would likely enhance the passage of a realistic budget for next year.

Division of taxes a hot topic

In May, the government approved a program on the reform of fiscal federalism until 2005 to complement the reform program for 1999-2001 approved in 1998. On one hand, the program aims to increase the authority of regional and local administrations to implement independent tax and budgetary policies. On the other hand, it seeks a strict delineation of rights and obligations between the federation and territories. The unclear division of power is currently most visible in financing of government obligations. Although many non-funded federal mandates (tasks delegated to territorial budgets by federal laws) were eliminated at the beginning of this year, territorial budgets are still not free from them. This has led to use of informal methods to create revenues such as illegal regional taxes, payments and off-budget funds.

Over 90 % of the tax revenues of territorial budgets presently come from federal taxes. One of the principles of the new reform program is a changeover to formation of regional budgets solely on basis of their own revenues. Federal taxes should be directed to the federal budget, territorial taxes to territorial budgets. The reform program, however, does not distinguish among federal, regional and municipal taxes in all cases. For example, income taxes are to be directed wholly to the territorial level, while at least 70 % of revenues from profit taxes are to be retained at the territorial level. The regions are now strongly demanding that they retain their right to grant concessions on their part of the profit tax. Last year the regions granted profit-tax concessions worth some 8 % of their total revenue.

The program also emphasises the importance of using unified methods in financial transfers from federal to regional budgets. The transfers should not be based on the actual revenues of each region, but on their potential revenues.

Fiscal revenues could fall

The issues related to fiscal federalism are prioritised also in the joint memorandum of the government and the CBR on economic policy for 2001 and beyond. According to the memo, government revenues are estimated to decrease by some 3–4 % of GDP this year with regional budgets accounting for the bulk of the fall (2 % of GDP). Given the present situation of rising tax intake and other revenues, the estimate seems to be quite cautious. In any case, the memo calls for restructuring and cutting regional expenditures. One elementary part of this process is the implementation of the above-mentioned reform program on fiscal federalism. Expenditures will be cut by reforming the financing of housing and communal services with the aim of transferring the related costs to end-users. The expenditures of regional road funds are to be reduced, although the memo does not specify how this will be done in practice. The fate and financing of the remaining federal mandates should be resolved by the end of this year.

Other priorities mentioned in the memo include the reform of tax and budget administration and budget expenditure management, which is to be improved by making an inventory of all budget organisations under federal budget financing. The off-budgetary accounts of budget organisations will be transferred to the Federal Treasury by end-2001. The transfer of the accounts of defence ministry will be finished also by end-2001.

The tax rates and division of some taxes and duties between budget levels

		Revenue to:	
	Tax rate	**Fed. Budget**	**Territorial budgets**
Tax			
Value-added tax*	0 % - 20 %	100 %	0 %
Profit tax (on enterprises)	35 %	31 %	69 %
Income tax	13 %	1 %	99 %
Excises**			
- oil, gas condensate	ATP	100 %	0 %
Natural gas, automobiles, etc.			
- spirits, vodka, liqueur	ATP	50 %	50 %
- other products made in Russia	ATP	0 %	100 %
- products imported to Russia	ATP	100 %	0 %
Customs duties	ATP	100 %	0 %

* products/services produced in Russia or imported there

* * See Tax code, part 2., chapter 22., article 193.

ATP = according to product

Source: 2001 Budget law, Tax code

Fiscal indicators (per cent of GDP)

Federal government	1995	1996	1997	1998	1999*	2000*	2001 Jan-Apr	2001 budget
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	17.7	15.4
- expenditures*	18.6	20.9	19.4	16.9	13.9	13.5	13.1	15.4
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	4.5	0.0

* The figures for 1999-2000 are based on new GDP figures from Goskomstat

Sources: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001)

2001 policy memorandum tackles banking sector …

The memo of the government and CBR on economic policy for 2001 originates in the joint work of Russia and the IMF on an economic program, even if Russia decided in late March not to formalise the program as an official agreement and opted for less-binding post-program monitoring by the IMF staff. The memo covers a variety of banking sector issues that reflect the sector's problems.

The bank reform tasks set for this year include passage of legislative amendments the IMF has strongly advocated for the past couple of years. The proposed changes in banking legislation include tightening bank licensing, especially criteria for the managers and shareholders. The changes further oblige the CBR to pull a bank's license when the bank fails to meet capital adequacy requirements. The CBR will also be able to demand that a bank write down its charter capital if it exceeds the actual equity capital. Furthermore, the amendments will set forth improved procedures for liquidating banks after license withdrawal. Last month, the Duma passed final readings of such amendments to banking legislation, and it continues with a bill on money laundering (the first reading just passed). The authorities also plan this year to prepare amendments to the general bankruptcy law and the Civil Code to improve the protection of secured creditors in bankruptcy cases. In the area of accounting, the launch of improved reporting standards is foreseen from 1 January 2002, and full adoption of International Accounting Standards by Russian banks should be in place by 2004.

The memo also addresses the state's more direct role in the banking sector. During this year and 2002, the state agency for bank restructuring (ARCO) should restructure the about fifteen banks currently under its care, preparing them for reprivatisation. The agency's role thereafter is yet to be defined.

As a standstill, no new state banks will be created and no additional privileges will be granted to existing ones. The state bank sector presently features 23 majority-owned banks that together account for about a third of the banking sector's total assets. A plan is expected by mid-summer on splitting Vnesheconombank, the specialised state bank, into a foreign debt service agency and a bank. This year, the CBR's foreign subsidiaries will be transferred to Vneshtorgbank, which is 99.9 % CBR-owned, and the bank will undergo review. The CBR's exit from Vneshtorg is scheduled for 1 January 2003. Regarding Sberbank, in which the CBR holds a 63 % stake, the measures laid down in the memo merely note reviews by external consultants.

For foreign banks, the authorities will develop measures before October that should support their activities – notably the free repatriation of profits. They will not introduce new restrictions on foreign ownership in banks.

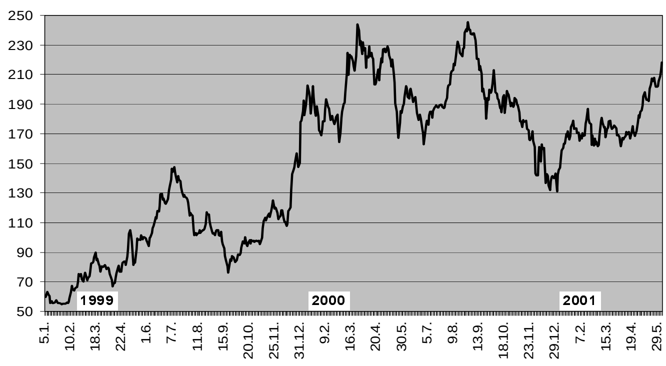
… and non-monetary enterprise income

Another area of the 2001 policy memorandum addresses payment arrears and non-monetary payments in the economy. Improving the legal position of secured creditors in bankruptcies is expected to help the corporate sector. The main focus in this area is on the revenues of natural monopolies, primarily those in the energy sector. The problem of households that do not pay for their heat and electricity supplies would be addressed through an amendment to the Civil Code this year that would allow utilities to disconnect them. As part of near-term and medium-term reforms, four large monopolies (Gazprom, electricity giant UES, oil pipeline operator Transneft and the Ministry of Railways) have been issued cash collection targets. These range between 80 % and 95 % of all revenue in the fourth quarter of this year. Special Goskomstat monitoring indicates that while the monopolies surveyed have overall improved their cash collection rates in the first quarter of 2001 from 72 % to 77 %, UES and the railways still had some way to go to reach their targets.

Equity markets pick up

Following a relatively flat period during the first four months of this year, Russian share prices climbed in May. The RTS index rose from 180 to 208 (15 %) over the month, and further to the range of 210 to 220 in the first days of June. Although this is far below the highs of 1997 and spring 1998 (300 to 550), the RTS is now back at the levels of spring and summer 2000. The RTS represents nearly 400 shares of almost 250 companies. Notably, half of its top 30 companies are involved with oil and energy. The top 3 are all oil companies and account for well over half of the RTS' total market capitalisation of more than USD 50 billion. Almost all the big gainers in May were oil and energy companies, and the upward world market price for oil in April and May has put some zest in the RTS. Last week, Gazprom's share price also took off at the Moscow Stock Exchange on news that the board had installed a new CEO.

Russian share prices in 1999-2001, RTS index



Source: RTS

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	24.8	4/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	53.6	4/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	2994	4/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	3.7	3/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	18.7	3/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	33.0	25.5.01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	29.09	5/01

Sources: Goskomstat, CBR

Faster progress through liberalisation

By Jouko Rautava*

Despite the recent recovery of Russia's economy, the investment climate remains notoriously bad. This is due in part to unfinished institution-building, but partly it reflects excessive regulations and bureaucracy. For example, some 400-500 commercial activities require a licence. Given the steps required in each permit process, the actual number of licensing requirements is closer to 2,500. In Western countries, the number of comparable commercial activities is probably between 30 and 90. Further, when it comes to product certificates or various inspections by authorities, the situation in Russia is even worse.

Excessive regulations together with poor institutions have made the business environment exceptionally cumbersome. This poses a natural question: What is the scale of inevitable costs related to the lack of clear rules and transparency?

Russia's costly peculiarities

In a new PricewaterhouseCoopers survey, "The Opacity Index" (www.opacityindex.com), the authors estimate extra costs related to the lack of clear rules and internationally accepted practices concerning investments in 35 countries. The index combines opacity ratings for five areas that affect capital markets (corruption, legal system, macro and fiscal policies, accounting and regulatory regime). The effects of opacity are then considered as a surtax on investment. The survey illustrates the situation in the latter part of 2000.

Presumably, opacity is very costly for Russia. Compared to Singapore, where the business environment was estimated to be most transparent of the 35 countries surveyed, Russia faces problems with corruption, legislation, regulations, etc. that imply an extra burden for investors comparable to an additional 43 % corporate income tax.

Naturally, Singapore is a bit artificial reference for Russia and it is more reasonable to compare Russia's situation to other transition economies in Europe. The Czech Republic, Hungary, Lithuania, Poland and Romania are included in the opacity report, and the results reveal that Russia's more opaque business environment translates into an additional 10-25 % surtax on investments compared to these EU candidate countries. Evidently, such a cost margin has a major effect on investment flows in Eastern Europe.

According to the survey, Russia is likely to lose at least USD 7 billion in FDI annually due to opacity. In 2000, FDI inflows into Russia amounted to less than USD 3 billion.

The above findings offer also interesting insights into Russia's current investment "strategy": Due to *ad hoc* tax holidays and other negotiable concessions the business environment has become even more opaque and, consequently, there has been less rather than more investment in Russia.

Institution-building takes time

Russia needs better institutions and more liberalisation to make its business environment more transparent and business friendly, as well as to lower the indirect costs of opacity. Regarding institutions, the relatively good working relationship between Putin's government and the Duma has opened new possibilities to progress in structural reforms. Indeed, the situation is probably better than many current critics claim, given the recent advances of several major legislative initiatives in the government and the Duma.

Nevertheless, institution-building is slow. Consider tax reform. After years of preparation, Part One of the new Tax Code was introduced in 1999, and Part Two was partly implemented at the beginning of 2001. The remaining parts are scheduled for implementation at the beginning of next year. Thus, one can reasonably assume that even in a favourable political climate like today's, it easily takes at least five years to push through major reform packages (such as banking, land code, agriculture and competition policy).

Liberalisation could bring quicker effects

From the strategic perspective, however, the government has an important "asset" to rapidly improve the investment climate – liberalisation. Certain stroke-of-the-pen measures could easily help Russia reduce its regulatory burden without requiring time consuming law-drafting or high administrative capacity.

Russian authorities have forwarded a de-bureaucratisation package to the Duma for evaluation, but so far it is difficult to see real progress in this field. Indeed, one can even find opposite tendencies as the recent problems related to customs procedures, initiatives concerning new product certificates, and increasing number of bureaucrats indicate.

Given Russia's reform history, it may be difficult to convince the business community that the authorities are serious with regulatory reform. Thus, it might be beneficial for Russia to adopt a clear, credible framework for liberalisation. The EU could serve as a benchmark so that every government plan and action could directly be compared to the situation in the EU area. Moreover, the EU and the OECD have long experience in regulatory reforms and so a lot of related material is available in this field.

Of course, the EU may not be the ideal model for regulatory reform, but it certainly can provide a credible benchmark for Russia. Incidentally, a lack of such benchmark or policy target is a major reason why Russia is lagging behind the EU candidate countries.

**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
5 June 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
6•2001

Economic Developments

Further output figure revisions, signs of revival

In addition to new, higher GDP 1999-2000 figures (see last issue), Goskomstat also upwardly revised its growth figures for industrial output in 1999-2000 to 11-12 % (earlier 8-9 %). The reason for the change is a new weight structure of industry branches (1999, instead of the earlier 1995) in computing the volume of industrial production. This year's industrial growth also rose by two percentage points, recording 6 % y-o-y in January-May. The revision yielded 5.5 % growth in the five key sectors in January-May, while the GDP grew 5 % in the first quarter.

Turning to more recent developments, new seasonally adjusted calculations from the economy ministry and Goskomstat suggest that after the 4Q00 slide, industrial production recovered during January-May to its previous peak of last autumn, while in May the GDP was a couple of percentage points above the previous peak.

Patterns behind the investment slowdown

The slowdown in investment growth (from last year's 17 % to 4 % in January-May this year) comprises slight sectoral changes. It appears that uncertain prospects for the world market price of oil no longer encouraged producers to major increases of investments. During the first quarter of this year, the oil industry's share of total investments thus stayed below a fifth, while the gas industry's share was less than 5 %. Metallurgy enterprises increased their investments, accounting for 6-7 % of the total. Investments in the transport sector kept the sector's share at a hefty fifth, while the housing sector's share remained at about 15 %.

No clear change is discernible in the structure of financing investments. Companies' own money provided a half of all investment financing in the first quarter. The public sector provided almost a fifth, including 13 % from regional and local budgets. Bank financing stood for 4 % of investment financing.

Foreign direct investments show slight increase

Goskomstat figures put foreign direct investment flows into Russia at little below USD 1 billion in the first quarter of this year compared to USD 850 million a year earlier (the balance of payments give lower figures, see below). Similar to last year, the industrial sector accounted for more than 40 % of FDI, including oil production at 10 %, the food industry down to 10 % and metallurgy up to 10 %. The transport sector continued to receive a fifth of FDI, while the share of trade and food services grew to a quarter.

Current account and capital outflow remain strong

The CBR's balance of payments figures for the first quarter confirm a current account surplus of almost USD 12 billion, equal to 18 % of GDP, which includes a trade surplus of nearly USD 15 billion and a services deficit of USD 2 billion.

The financial account deficit grew from less than USD 7 billion in 1Q00 to more than USD 8 billion in 1Q01. Behind this change was mainly the turn of portfolio investments to Russia from a positive USD 600 million to a negative USD 100 million. Foreign direct investments into Russia were recorded at the same level as a year earlier, i.e. USD 500 million. Russian direct investments abroad were larger and increased slightly to USD 800 million.

Russia's foreign exchange reserves grew USD 2 billion in Q1 but have increased over USD 6 billion during 1H01, and amounted to USD 35 billion at end-June.

Russia's balance of payments in 1999-2001, USD billion

	1999	2000	2001 Q1
Current account	**25.0**	**46.3**	**11.7**
Trade balance	36.2	60.7	14.5
Exports, f.o.b.	75.7	105.6	25.6
Imports, c.i.f.	-39.5	-44.9	-11.1
Services	-4.2	-7.8	-2.0
Exports	9.1	9.6	1.9
Imports	-13.2	-17.4	-3.9
Investment income	-7.7	-6.9	-0.8
Received	3.5	4.3	2.6
Paid	-11.2	-11.2	-3.4
Other items, net	0.6	0.3	0.0
Capital and financial account	**-16.0**	**-21.1**	**-8.4**
Capital Account	-0.3	10.9	-0.1
Received	0.9	11.8	0.1
Paid	-1.2	-0.9	-0.2
Financial account	-15.7	-32.0	-8.3
Direct investment to Russia	3.3	2.7	0.5
Portfolio investment to Russia	-1.3	-10.1	-0.1
Other items, net	-17.7	-24.6	-7.9
Net errors and omissions	**-7.3**	**-9.3**	**-1.5**
Change in reserves	**-1.8**	**-16.0**	**-1.8**

Source: Central Bank of Russia, 29 June 2001

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	8.3	4.9	Q1/01
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	5.9	1-5/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	4.2	1-5/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.2	5/01
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	105.2	34.2	1-4/01
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	44.2	15.4	1-4/01
Current account, USD billion			8.4	7.5	11.8	2.1	0.7	24.7	46.3	11.7	Q1/01

Sources: Goskomstat, CBR

Russian government outlines 2002 budget

The government delivered its 2002 budget framework to the Duma last month. The proposed 2002 budget assumes a surplus of 1.3 % of GDP with revenues equalling 16 % of GDP and expenditures at 14.7 % of GDP. It further assumes the price of Urals crude will average 22 dollars a barrel, inflation will run at 12 – 13 % and the average exchange rate will be 31.5 roubles to the US dollar. If pension fund revenues are partly transferred to the federal budget next year, revenues and expenditures will both rise by 2.5 % of GDP.

Russia expects to be able to service its debts in the next few years without further restructuring. To guarantee this, the government wants to establish a stabilisation fund next year. The government has not indicated the fund's operating principles, which will be defined under the 2002 budget act.

Profit tax cut on the way

At the end of June, the Duma approved the second reading of a bill that would lower the profit tax from its current level of 35 % (or 43 % for banks) to 24 % and eliminate all deductions and exemptions. Regions were given right to reduce the tax rate by up to four percentage points. In the bill's first reading in April, the profit tax was kept at 35 % with tax breaks. If the new version of the bill passes, it would enter into force from the beginning of 2002.

The division of profit tax revenues does not essentially differ from the current arrangement. The bill assigns regional budgets 14.5 percentage points of the profit tax (60 % of revenues), federal budget 7.5 %-points (31 %) and local budgets 2 %-points (8 %). Government estimates indicate the new law would ease the tax burden by some RUB 160 billion (USD 5.5 billion). It is unclear, however, whether the impact of the abolished tax exemptions is included in this figure.

Regional budgets will be hardest hit by the change. In January-May, profit tax revenues accounted for 41 % of regional budget revenues, 26 % of local budget revenues, but only 13.5 % of federal budget revenues in January-April. Profit tax revenues of the consolidated 2000 budget amounted to RUB 399 billion, or approximately 19 % of total budget revenues. The government has not suggested how the financing of the revenue losses at different budget levels will be made up. It is also unclear whether the tax change was taken into account when drawing up the 2002 budget framework.

Housing reform starts

Housing reform has been discussed in Russia since the early 1990s without notable progress. The most visible change is the fact that the share of housing costs paid by Russians themselves has risen from a couple of per cent in 1994 to an average of 40 % of actual costs last year. This trend has yet to promote reconstruction and maintenance of residential buildings.

At the start of economic reforms, most state property in the housing sector passed to local (mainly municipal) administrations. However, local budgets were not ready to take on the obligations of housing sector financing, and the transfer to full-cost coverage of households was delayed. In 2000, regions and municipalities allocated about 20 % of their budget expenditures to housing – the largest expenditure item of the consolidated regional budget.

Total housing expenditures last year amounted to RUB 300 billion (4 % of GDP), of which Russian citizens paid RUB 118 billion (40 %). Housing subsidies worth RUB 123 billion were paid out of different public sector budgets to the housing sector's enterprises, with poor households receiving some RUB 2–3 billion. The rest (almost RUB 60 billion) went unpaid. Presumably, this sum is mostly budgetary arrears, but it also includes arrears owed by citizens. As of 1 January 2001, the cumulative debt of Russians to housing enterprises amounted to RUB 14 billion. Most subsidies go to enterprises, which has led to widespread abuse of financial resources. Some estimates claim that over half of the housing sector enterprises' subsidies are spent on unknown purposes.

The latest plans of Russian government seek to transfer all the budget subsidies of housing enterprises to the most needy citizens or their housing associations. All others are obliged to pay their housing expenditures fully. According to the economy minister German Gref, the standard of living in Russia is too low to simply transfer all housing costs to all citizens without any social support in the next 10-15 years. The government will decide soon where the line between the rich and poor lies. The government plans also to decrease the present limit entitling a family to social support if housing expenditures exceed 22 % of family's revenues.

The new plan is expected to increase competition in housing sector, to improve quality of housing services and to cut overall housing expenses by some 15-20 %. As people are free to choose the enterprises offering housing services at best price-quality-ratio, the whole housing sector should be more interested in working cost-effectively. One of the obvious advantages of the new plan is that subsidies will be more transparently used and directed to low-income families. Due to targeted social support, the housing reform will, according to calculations, enable to cut the real housing expenditures paid by low-income families by 10-15 %.

For the time being there are plenty of open questions related to housing reform – especially financing. By mid-July, several ministries are to further develop the new plans and submit them to the government. Pilot projects to test the plans are to be launched in Moscow and Zelenograd in 2001-2002. The government expects the entire country to be ready next year to move to the new system.

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999*	2000*	2001	2001
Federal government							Jan-Apr	budget
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	17.5	15.4
- expenditures*	18.6	20.9	19.4	16.9	13.9	13.5	12.8	15.4
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	4.8	0.0

* The figures for 1999-2000 are based on new GDP figures from Goskomstat

Sources: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001)

Inflation marches on

After climbing 2-3 % per month in January-February and slightly under 2 % per month in March-May, consumer prices rose 1.6 % in June. Consumer prices were almost 24 % higher in June than a year earlier, and from the beginning of this year they have risen almost 13 %. Thus, the government's revised inflation goal of 14-16 % (from the original 12-14 %) looks very optimistic.

Leading the rise in prices, services were up 21 % in the first half of the year. The hike was spearheaded by reform-based increases in housing services. On the other hand, prices for services contributed only 23 % of consumer price inflation in January-May, while food prices, which are heavily weighted in the consumer price index, accounted for 60 % of inflation. Food prices were up 14 % in the first half of the year, including a more than 60 % rise in vegetable prices.

One impetus for higher consumer prices was an over 13 % rise in agricultural producer prices during January-May (compared to 6 % during January-May 2000). Industrial producer price inflation has moderated from last year, and scored 1 % per month in March-May. The 12-month increase was 21 % in May, while the rise since the start of the year was below 7 %.

The boom in food prices may to a degree represent the conjunction of various factors, such as extreme seasonal variation, deficiencies in the agricultural sector, or temporary import bans. Nevertheless, the monetary developments are worth recalling. Even if the growth of money supply has moderated considerably this year, the money growth of more than 60 % y-o-y until the start of this year has shown effect on the price front.

Rouble stability, real rise against the euro

The central bank's stated exchange rate line for 2001 earlier in the spring suggested firming, i.e. the exchange rate was not to be allowed to depreciate below 30 roubles to the dollar. More recently, it has suggested possible easing, i.e. inflation could give grounds for some more weakening of the rouble within the budget law's room of manoeuvre of up to 31 roubles to the dollar.

In any case, the central bank has intervened when necessary to keep the rouble remarkably stable against the dollar. In March-May the rouble's average monthly rate has weakened some 0.5 % each month. Since it broke through the 29 RUB/USD level in mid-May, the rouble's depreciation has been even slower. Meanwhile, the rouble appreciated against the weakening euro by 8 % during February-June, putting the rise of the rouble's real exchange rate against the euro at well over 10 % and bringing that real rate to 75-85 % of its pre-1998 crisis level.

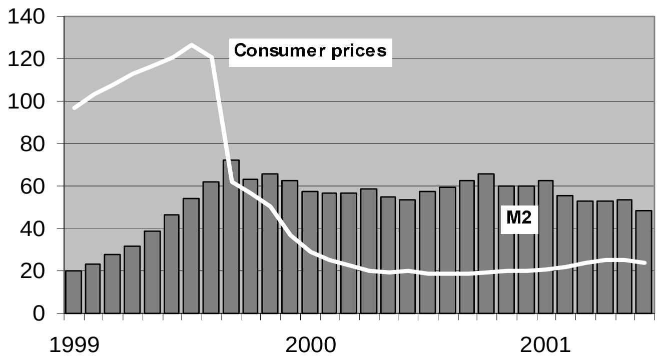
Steps to de-freeze foreigners' T-bill receivables

The central bank has issued further instructions to non-residents on using funds in so-called S accounts. As part of a restructuring deal in the wake of the government's default on its short-term T-bills (GKOs) in 1998, non-residents were compelled to keep the roubles they received in partial settlement in special S accounts.

The new rules allow transfer of S roubles to S accounts of other non-residents. Using S roubles to buy certain types of Russian bonds and shares was possible also earlier and now the interest and dividends received can be repatriated without first getting permission from the CBR. However, the new rules limit purchases to bonds and shares that are rated close to Russia's sovereign rating.

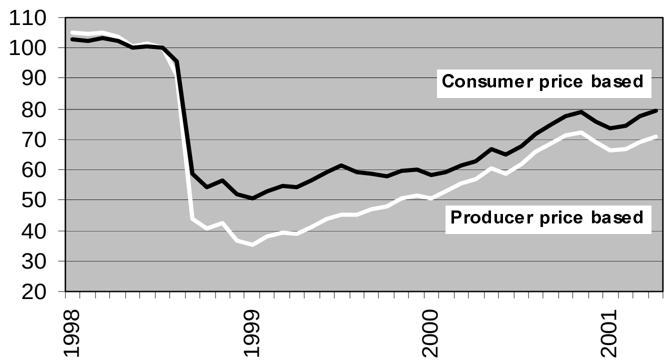
The main way of repatriating S roubles has been through infrequent foreign currency auctions or through redemptions of separately auctioned short-term T-bills. To date, over USD 1 billion has been repatriated by those means. Most estimates put the amount of roubles still in S accounts at USD 1-1.5 billion.

Inflation and change in money supply in 1999-2001, % y-o-y



Source: Goskomstat, Central Bank of Russia

Rouble real exchange rate against the euro (until April 2001), July 1998 = 100



Source: Central Bank of Russia, BOFIT

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	23.7	6/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	48.4	5/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	2981	5/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	3.5	4/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	17.4	4/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	35.1	6/01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	29.07	6/01

Sources: Goskomstat, CBR

Non-residents and the Russian financial crisis of 1998

By Alexei Medvedev*

Traditional view of the Russian crisis

The Russian crisis of August 1998 is usually attributed to purely domestic causes that surfaced following an almost 60 % decline of world oil prices during 1997–98. The fall in export revenues strongly impacted incomes throughout the entire economy, and ultimately, government finances. Federal budget revenues fell considerably even in nominal terms in spring 1998, while the stock of short-term T-bills (GKOs) grew rapidly. Thus, the earlier state policy of extensive domestic borrowing, especially in 1996, and the added bad luck of unfavourable external conditions were the clear determinants of Russia's debt crisis.

Non-residents in the T-bill market

Faced with the high costs of domestic debt service (almost 5% of GDP in 1996), the government sped up liberalisation of the T-bill market. Restrictions on non-residents' participation were gradually softened and then eliminated at the beginning of 1998. The share of non-residents more than doubled to 40 % by the end of 1997 (excluding the central bank). The Russian market benefited in 1997 from the inflow with interest on short-term debt (GKO) reaching its historical floor of 13 % in August 1997 when consumer price inflation was at an annual 15 %.

Non-resident behaviour had its first adverse effect in late autumn 1997 when the Asian crisis was having a global impact, including on Russia. The central bank heavily intervened in the T-bill market in an attempt to hold down interest rates. Contemporaneous market analysis suggests that non-residents were among the first to start selling T-bills and thereafter were behind all significant price fluctuations. This inside view seemingly contradicts the traditional view that the Russian crisis was due to purely domestic and non-financial external factors. One might suspect that the presence of non-residents added unnecessary volatility to prices and worsened the government's financial distress.

An empirical study by the author found that non-residents were indeed behind major contractions of the T-bills market in late 1997 to 1998 (see table).[1] Non-resident outflows noticeably exceeded domestic outflows from the market during all four major episodes, and in particular, the near collapse of the market in May 1998. Comparison of the share of buyers among residents and non-residents revealed that the observed regularity had a fundamental origin and did not merely reflect differences between leading foreign and Russian market participants.

The major market contractions associated with external events (except the last) evidenced that Russia suffered from contagion, which was probably related to a "wake-up call" effect, whereby a crisis in one country induces investors to reassess market fundamentals in other countries. Empirical studies on transmission of crises suggest that weaker economies are more vulnerable to contagion and this seems to apply to Russia in 1998.

The uncertainty over the July 1998 IMF emergency loan and its resolution resulted in large swings in foreign flows to the T-bill market. The IMF loan was intended to boost confidence among foreigners and for a while it had its expected effect. After the loan's announcement, USD 1.7bn of non-resident money flowed in and GKO interest rates immediately dropped to 50% from 120%. The government managed to restructure part of its short-term debt but failed to control the situation in the longer term. One possible reason that the market failed to recover after the loan was that the financing was insufficient. Despite a large volume of promised financing (over USD 20bn), its timing was conditional and did not match the speed of depletion of official foreign exchange reserves (about USD 1bn a week in August).

Did Russia benefit from financial liberalisation?

Even if foreign investors strongly contributed to the T-bill market contraction, it does not imply that Russia lost from financial liberalisation. We know that Russia benefited from foreign inflows during most of 1997, when the costs of borrowing diminished significantly. On the other hand, the T-bill market subsequently suffered from several bouts of contagious selling by non-residents. The empirical evidence can support two claims, i.e.

(a) non-residents played a decisive role in the 1998-debt crisis, but they actually delayed a crisis that would have happened earlier without their entry; or
(b) non-residents played no decisive role in the crisis that was fully attributed to domestic factors and unfavourable external conditions.

Both claims imply that non-residents cannot be blamed for the 1998 debt crisis, although they unambiguously affected its timing. While this result leaves the larger issue of the general role of non-residents unresolved, the study shows that the Russian experience provides a clear example of costs and benefits of financial liberalisation.

Period	**Event**	**GKO interest**		**Flows, USDbn**	
		Before	**After**	**Non-res.**	**Res.#**
Nov. 97	Asian crisis	18%	37%	-3.0	-1.8
Jan. 98	Indonesia: currency crisis	30%	44%	-1.1	0.8
May 98	Indonesia: currency crisis	30%	80%	-1.9	-0.2
Jul. 98	Uncertainty over IMF loan	50%	120%	-1.1	-0.2

 # Only dealers (licensed professional investors)

** The author is a senior economist at the Central Bank of Russia*

[1] *The study will be published as BOFIT Discussion Paper No 6/2001*

RUSSIAN ECONOMY
The Month in Review
9 July 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
7-8•2001

Economic Developments

Growth takes hold

The growth figures revised in early summer indicate that the Russian economy went from boom to zero growth and back to recovery – all in the past twelve months. Seasonally adjusted data show that between last autumn and early this year GDP stalled and there was a decline in industrial production. This drop was more pronounced than indicated by virtually any assessment at the time (see chart). Working behind that slowdown, investment growth took a pause and export volume growth more or less plateaued.

This year - for spring through July - has seen a resumption of GDP growth and industrial production according to the economy ministry's and other seasonally adjusted calculations. Compared to a year earlier, GDP (based on preliminary data) expanded over 5 % in 1H 2001.

Demand has also shifted somewhat. Private consumption has become a major driver, tentatively showing some 10 % growth in 1H 2001. Although investment growth has abated from last year's 18 %, the latest revised Goskomstat data tell that the deceleration has not been as strong as previous data suggested (over 7 % y-o-y in January-July vs. 4 % reported earlier for January-June).

As for the sectors creating the GDP, private consumption boosted retail trade growth to 10 % y-o-y in January-July. In the same period, construction increased almost 7 % and agricultural production grew favourably by 6 %. Industrial output rose 5.4 %, while the fifth key sector, transport, recorded a 2 % increase.

Production in most major industrial branches grew notably in January-July, albeit at rates below last year's record levels. Growth in the fuel industry accelerated to 6 % due to higher crude oil output (up 7 %) and despite lower natural gas output (down 2 %). The fastest growth was recorded in machine building (up 10 %), with high growth noted in several of its sub-branches producing investment goods. The food industry enjoyed brisk growth (7 %), followed by chemicals and petrochemicals, and ferrous metallurgy (around 6 % each).

Investment structures largely unchanged

The investment growth of 7 % in 1H 2001 unfolds some, though not major, changes in investment structures. Oil industry investors slightly increased their share to 18 % of total investments as the oil processing sector invested quite actively. The gas industry inched up its stake to over 5 %. Today, the crude oil and gas industry's capital stock has by far the lowest recorded average age (7 to 8 years) of any Russian industry, and well below the 17-year average of industries generally. Metallurgy accounted for 6 % of all investments in 1H 2001, while capital assets in this sector still have an average age of around 20 years. Transport sector investments remained above one-fifth of the total. The housing sector's share declined to under 15 %, with housing construction sliding to below 10 %.

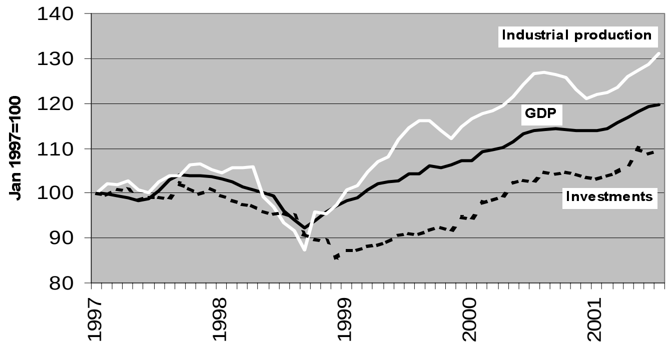
In the first half, half of all investment financing still came from companies' own pockets. The role of public sector financing notched down to below one fifth, due to proportionately fewer funds from regional and local budgets (13 %). Bank financing accounted for no more than 3 % of investment financing.

Exports up moderately, imports sizzle

Russia's export income increased a moderate 6 % y-o-y in 1H 2001, including a 5 % rise in exports to non-CIS countries. Imports, however, grew 20 % y-o-y reaching almost 30 % growth in 2Q 2001. In euro terms, Russia's non-CIS imports expanded 30 % y-o-y in 1H 2001.

Export earnings were supported by a 9 % increase in the volume of crude oil exports and export prices for natural gas which, despite a drop in 2Q 2001, were still up some 40 % for the first half as compared to 1H 2000. On the other hand, the export price for Russian crude oil was some 5 % down from 1H 2000 while the volume of natural gas exports fell over 10 %. The import structure remained remarkably unchanged in 1H 2001 with machinery accounting for 35 % of all non-CIS imports and food some 25 %. When comparing Goskomstat and customs data, about 20 % of imports went unrecorded by the customs in 1H 2001 (25 % in 1H 2000).

GDP, industrial production, investments (seasonally adjusted)



Source: Ministry of Economy/Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	8.3	4.9	Q1/01
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	5.4	1-7/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	7.3	1-7/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	8.3	7/01
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	105.5	52.3	1-6/01
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	44.9	24.4	1-6/01
Current account, USD billion			8.4	7.5	11.8	2.1	0.7	24.7	46.3	11.7	Q1/01

Sources: Goskomstat, CBR

New 2002 draft budget released

After the government's approval of the basic framework of the 2002 budget draft in June, the finance ministry revised its figures to account for new growth data. The government approved the new draft in August and Duma budget discussions are now set to start at the end of September.

The budget proposal targets a surplus of 1.2 % of GDP with revenues equalling 18.8 % of GDP (RUB 1,995 billion) and expenditures 17.6 % (RUB 1,867 billion). While the increase in revenues and expenditures looks substantial compared to this year, the increase is actually artificial as some of the unified social tax revenue will be channelled via the federal budget to the national pension fund. Without this, the shares of revenue and expenditure are 16.4 % and 15.2 % of GDP, respectively. The budget assumes an average price for Urals crude of 22 dollars a barrel, inflation of 10 – 13 % and exchange rate of 31.5 roubles to the dollar. GDP is forecast to grow by 4.3 %.

The largest single expenditure items are social policy (3.8 % of GDP), debt servicing and defence (2.7 % each). Not counting the social tax channelling, the share of social expenditures as a share of GDP (1.4 %) is essentially the same as this year. Defence expenditures will be shared between at least two budget items, which together account for some 2.8 % of GDP – a noticeable increase from the expected 2.5 % of GDP this year. The clear "losers" are agriculture, industry, energy and construction. Education is a gainer.

The operating principles of the "stabilisation" or reserve fund have yet to be decided. Nevertheless, the fund will likely be created from the 2002 budget surplus, unspent revenues from 2001 and privatisation revenues.

Revenues grow briskly, expenditure growth moderate

In the first half of 2001, better-than-expected macroeconomic development, high prices for oil and gas, and good performance of companies led to significant increases in tax and budget revenues as a share of GDP. In the consolidated budget, the improvement was clearest in revenues from customs duties, income taxes, profit taxes and excises. In the federal budget, the increase in income and profit tax revenue does not show since this year's approved division principles among federal and regional budgets allocate only about 40 % of profit tax revenues and 1 % of income tax revenues to the federal budget. However, revenue from VAT, customs duties and excises now make a larger contribution to the federal budget. Judging from the 1H 2001 results, the introduction of the flat 13 % income tax from the start of this year seems to have proceeded well. However, many employers postponed payment of some wages due in December 2000 to January 2001 due to lower taxes. This may have boosted first-half income tax revenues.

Expenditures have grown more moderately than revenues. Debt service, defence and social policy continue as top expenditure items in both budgets. Industry has made gains and federal transfers to other budgets, compared to H1 2000, have risen considerably. It is to compensate some of the expected revenue losses of regional budgets. The diminished share of budgetary funds in both budgets is a result of terminating some federal budget funds.

Realised H1 2001 and 2000 federal budget

	2001/H1			2000/H1		
	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP
Revenues	**711.0**	**100**	**17.6**	**507.7**	**100**	**16.4**
Tax revenues	661.8	93.1	16.3	443.2	87.3	14.3
of which						
VAT	*268.6*	*37.8*	*6.6*	*176.0*	*34.7*	*5.7*
Profit tax	*102.9*	*14.5*	*2.5*	*77.8*	*15.3*	*2.5*
Customs duties	*158.0*	*22.2*	*3.9*	*103.5*	*20.4*	*3.3*
Excises	*100.4*	*14.1*	*2.5*	*64.2*	*12.6*	*2.1*
Other taxes	*32.0*	*4.5*	*0.8*	*21.7*	*4.3*	*0.7*
Non-tax revenues	43.4	6.1	1.1	28.5	5.6	0.9
Budgetary funds	5.7	0.8	0.1	36.0	7.1	1.2
Expenditure	**549.8**	**100**	**13.6**	**402.0**	**100**	**13.0**
Social-cultural activities	84.8	15.4	2.1	57.9	14.4	1.9
Debt service costs*	128.4	23.4	3.2	93.7	23.3	3.0
Defence	106.7	19.4	2.6	82.2	20.4	2.6
Transfers to other budgets	109.7	20.0	2.7	47.2	11.7	1.5
Other	120.2	21.8	3.0	121	30.2	4.0
Balance	**161.1**		**4.0**	**105.7**		**3.4**

*Source: EEG (according to IMF methodology), *includes interest payments only.*

Realised H1 2001 and 2000 consolidated budget

	2001			2000		
	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP
Revenues	**1203.4**	**100**	**29.7**	**887.8**	**100**	**28.6**
Tax revenues	1051.4	87.4	26.0	756.8	85.2	24.4
of which						
VAT	*269.0*	*22.4*	*6.6*	*208.0*	*23.4*	*6.7*
Profit tax	*241.4*	*20.1*	*6.0*	*176.5*	*19.9*	*5.7*
Customs duties	*158.0*	*13.1*	*3.9*	*103.5*	*11.7*	*3.3*
Excises	*117.6*	*9.8*	*2.9*	*79.4*	*8.9*	*2.6*
Income tax	*108.4*	*9.0*	*2.7*	*70.4*	*7.9*	*2.3*
Other taxes	*157*	*13.1*	*3.9*	*119*	*13.4*	*3.8*
Non-tax revenues	81.3	6.8	2.0	50.5	5.7	1.6
of which						
State/municipal property or activity	*51.7*	*4.3*	*1.3*	*23.2*	*2.6*	*0.7*
Other	11.2	0.9	0.3	8.5	1.0	0.3
Budgetary funds	59.5	4.9	1.5	72.0	8.1	2.3
Expenditure	**1025.4**	**100**	**25.3**	**760.9**	**100**	**24.5**
Social-cultural activities	322.9	31.5	8.0	228.4	30.4	7.4
Debt service costs*	134.0	13.1	3.3	116.8	15.4	3.4
Defence	106.7	10.4	2.6	82.2	10.8	2.6
Law enforcement	72.6	7.1	1.8	54.6	7.3	1.8
State administration	45.0	4.4	1.1	31.0	4.1	1.0
Industry, energy, construction	51.0	5.0	1.3	15.7	2.1	0.5
Agriculture and fishery	24.2	2.4	0.6	22.0	2.9	0.7
Other	216.6	21.1	5.3	148.7	18.8	4.8
Budgetary funds	52.4	5.1	1.3	61.5	8.2	2.0
Balance	**178.0**		**4.4**	**126.9**		**4.1**

*Source: Goskomstat / MinFin; *includes interest payments only. The consolidated budget includes federal and regional budgets.*

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999*	2000*	2001	2001	2002
Federal government							Jan-June	budget	budget draft
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	17.6	15.4	18.8
- expenditures*	18.6	20.9	19.4	16.9	13.9	13.5	13.6	15.4	17.6
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	4.0	0.0	1.2

* The figures for 1999-2000 are based on new GDP figures from Goskomstat

Sources: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001)

Summer food prices halt inflation

Consumer prices, after climbing at around 2 % per month through January-June, rose 0.5 % in July and recorded a zero change in August. This brought 12-month consumer price inflation down to 21 %. Earlier this summer the government again revised its inflation target for this year upward to 16-18 %. During January-August, consumer prices rose 13 %.

Prices for services continued to rise through the summer, and in August they were up almost 40 % y-o-y. Prices for housing services were up about 55 % and passenger transport about 40 %. In response to inflation, there have been tentative indications that further hikes of regulated prices in Russia might be frozen for the rest of this year. This would, however, entail postponing reforms in certain sectors, and the price freeze's anti-inflationary impact would also be limited. First, food prices have climbed at an annual rate of over 20 % this year. Because of the heavy weighting of food items in the consumption basket, food prices have a big influence in determining inflation. In January-July, food prices accounted for almost 60 % of inflation. August's overall zero inflation rate reflected the fact that food prices fell 1 % and prices of seasonal greengrocery fell 15 %. Second, industrial producer prices continued to move up at an annual rate of 20 % through July. Agricultural producer prices were up almost 30 % y-o-y in July.

Enterprise arrears and barter have stabilised

With economic growth and greater liquidity there has been a decreasing reliance on barter and arrears in transactions between Russian enterprises and a decline in enterprise arrears to the public sector since summer 1998. The decrease continued this year.

As a share of enterprises' total payables, their overdue payables dropped from 45 % to around 40 % in the first half of this year. Their share of GDP also slid to about 22 %, with arrears to suppliers at about 10 % and arrears to public sector budgets below 9 %. Compared to earlier improvements, however, the decline has been relatively small this year (1.5 percentage points of GDP). Similarly, Goskomstat's survey of Russia's major monopolies and biggest tax payer companies shows that early this year their non-monetary payments dropped to below a quarter of all payments in their transactions. Since then they have stayed at that level. The Russian Economic Barometer of several hundred companies also indicates a relatively small decrease in the share of barter in sales of industrial firms between last autumn and this spring (from 19-20 % to 17-18 %).

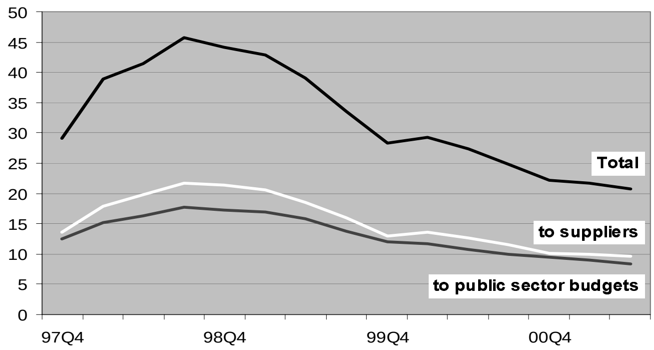
The slower improvement may partly stem from last winter's economic trough. The rest reflects deeper problems of enterprise restructuring and efforts of companies to survive. Although the revival of growth may bring further moves towards using money in corporate business in Russia, the most petrified arrears may not get solved until creditor rights improve and the threat of bankruptcy begins to bite more.

New rules on export earnings and money laundering

The compulsory share of export earnings companies must sell for roubles was lowered from 75 % to 50 % in August. The 50 % repatriation amount must be sold to commercial banks at market rates within a week from receipt. Concessions given by presidential decrees earlier will expire at the end of this year unless the concessions are explicitly longer. Many proponents of the change have referred to its confidence-building effects and anti-inflationary benefits of tuning down excessive liquidity build-up from external inflows. Opponents claim that the Central Bank's large forex reserves could suffer and the rouble exchange rate could fall uncontrollably. The economy ministry has drafted further changes to abolish compulsory forex sales by 2004.

The law against money laundering covers both domestic control and cooperation with foreign authorities. It makes various banking and other financial market operations of over 600,000 roubles (currently about 20,000 dollars) subject to the controls, forbids anonymous accounts, and foresees identification and reporting procedures as well as an inspection unit. The law will take effect on 1 February 2002. The international Financial Action Task Force (FATF) had decided in June to keep Russia on its list of non-cooperative countries. It also decided to recommend countermeasures against Russia at the end of September unless Russia enacts substantial legislation against money laundering.

Overdue payables of enterprises, % of the annual GDP



Source: Goskomstat

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	21.0	8/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	42.8	7/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	3290	7/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	3.7	7/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	18.5	7/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	37.5	8/01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	29.37	8/01

Sources: Goskomstat, CBR

Chance for SMEs in Russia?

By Juhani Laurila*

Russia now has a special opportunity to implement structural reforms. The impressive growth of the economy – over 5 % in 1999, over 8 % in 2000 and an expected 5-6 % this year – accompanied by foreign trade surpluses, improved budgetary performance, three-fold growth of forex reserves since the end of 1999 and promises of normal foreign debt servicing, all contribute to the economy's financial sustainability. While Russia seems set for some years to come even if oil prices fall, it is still essential to ask what could be done now to prolong and reinforce the sustainability of Russia's economic growth.

Off to a good start

The Russian government recently launched a raft of legislative reforms. The profit tax will be lowered to 24 % in 2002 with substantial normal rights to deduct business expenses. Income and sales taxes as well as the customs duty schedules and some of the regulations were modified earlier this year. Licensing, registration and inspection procedures are better codified to improve bureaucratic treatment of enterprises. Reforms of natural monopolies are expected to promote competition in the production and distribution of electricity and gas, and the operation of railways. There is also pending legislation on labour rules and pensions, as well as progress in land reform (albeit confined to urban land). Current reforms of Russia's law enforcement system are also long overdue and welcome.

These are, however, merely steps in the right direction in improving Russia's business climate. It remains to be seen if the new legislation will be enforced and the regional and local authorities will comply with the new rules. For the time being, capital, in net terms, continues to flee the country – and evidences the lack of interest among Russian investors to invest in their own country. And international risk and corruption rankings still place Russia on a par with some of the worst-run African regimes.

Why SMEs?

Currently, there are less than one million registered small and medium-sized enterprises (SMEs) in Russia. According to Goskomstat, 30 % of Russian SMEs were registered in industrial production and construction, and 45 % in trade and catering. All this is good, but also extremely modest given the growth challenge facing the Russian economy (see table).

As indicated by the figures, SMEs are known to be labour-intensive relative to large enterprises. By mobilising people to economic activity, an SME-based corporate sector could well contribute to a more equal division of incomes and wealth in Russia. In fact, an SME-based corporate sector would support the growth of a middle-class in Russia, an important constituency for promoting democracy and civil society. Moreover, some SMEs will become bigger corporates tomorrow.

The problem for Russian entrepreneurship is not so much lack of money or interest as the need to improve the business climate. Under excessive bureaucracy and unclear official discretion at the local level, SMEs are vulnerable and unable to defend themselves.

SMEs also suffer (possibly more than other Russian companies) from a lack of access to credit from local credit institutions. There are some promising recent developments in Russian banking in retail, commercial and mortgage lending to new areas in addition to lending to the traditional export-oriented natural resource industries. What Russian bankers would need from their potential borrowers is collateral and more accounting and reporting transparency supported by international standards. Bankers, in turn, need more discipline and professionalism to earn credibility in the eyes of potential depositors and investors.

New corporate sector is crucial to sustained growth

In the long run, Russia's economic success depends on the creation of a competitive, SME-friendly corporate sector. According to Russian experts, Russia will become a net importer of oil in about 15 years. Natural gas production, too, will suffer from high investment costs for exploring new fields, exploiting reserves and transporting gas to market. Continued heavy investments in the energy sector, or other traditional large industries, would anchor Russia with the past and prevent development of a modern Russian economy and Russia's participation in international economic integration on a more diversified basis.

Despite the promising signs in the Russian economy and economic reforms, creation of a business climate conducive to SMEs may easily take another ten years. Public subsidies or privileges are not the essential ingredients. Instead, a change of mindset brought about by education and training is necessary to turn administrators into civil servants willing to meet the needs of companies and individual entrepreneurs.

	Nr. of SMEs: million	per 1000 people	Nr. of SME employees, million	SME % share in: employment	GDP
Russia	0.8	6	8	13	10-11
EU	15.8	45	68	72	63-67
US	19.3	74	70	54	50-52

Source: Russian SME Resource Centre Survey, June 1998

**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
7 September 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
PO Box 160 • FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
9•2001

Economic Developments

Domestic demand drive

National accounts figures released by Goskomstat confirm that GDP increased 5.1 % in 1H 2001 from a year earlier, with growth at around 5 % in both quarters. The economy's locomotive was private consumption, which rose briskly at nearly 9 % in the first quarter and over 11 % in the second quarter. After last year's surge, the increase in fixed capital formation (investments) eased to around 3 % in 1Q but then picked up to 7 % in 2Q. Public consumption declined by about 1 % in 1H 2001.

The demand structure of Russian GDP shifted somewhat in 1H 2001. The share of private consumption in GDP climbed back to 50 %, while the share of fixed capital formation retreated below 16 %. As in 1999-2000, public consumption accounted for about 15 % of GDP. Net exports declined to 17 % of GDP. Behind that, export revenues fell to 41 % of GDP, while the share of import expenditure inched down only slightly, staying at almost 25 % of GDP.

Growth and inflation combined with a rather stable rouble exchange rate to increase the size of Russian GDP in dollar terms by over a quarter in 1H 2001 y-o-y. The dollar value of private consumption surged by a third and investments by 40 %. Thus, Russia grew fast as an export market for others, as evidenced by the 20 % growth of Russian spending on imports in 1H 2001.

Foreign direct investments indicate recovery

The flow of foreign direct investments into Russia revived to USD 2.5 billion in 1H 2001 from USD 1.8 billion a year earlier, according to Goskomstat records (as earlier, the balance of payments contains smaller figures; see next item). In 1H 2001, trade and food services proportionately attracted more FDI, some 30 % of the total. The transport sector retained its strong role with 15 % of FDI. Foreign investors generally favoured the same industry branches as earlier, although the share of food industry dropped to 11 % and crude oil production to 7 %. Machinery and equipment industries retained their 5 % share, while metallurgy rose to that level.

Russia's cumulative FDI stock stood at USD 17.6 billion at end-June. The US' share fell considerably to a fifth, the same level as Cyprus, a gateway for returning Russian capital. The UK substantially increased its proportion of FDI to 10 %. The Netherlands was also up to 11 %, while Germany stayed at 8 %.

Current account surplus remains hefty

The CBR balance of payments data for 1H 2001 show a current account surplus of USD 21 billion, equal to 15 % of GDP (21 % in 1H 2000). Along with a slight decrease in the trade surplus, the services deficit grew to USD 4.5 billion, due to increased expenditure on travel which accounts for over 15 % of all import expenditure.

The financial account deficit narrowed somewhat as less portfolio investments in Russia were redeemed in 1H 2001. FDI into Russia was recorded at only USD 1.2 billion (USD 1.0 billion in 1H 2000), while Russian direct investments abroad increased to USD 1.5 billion (USD 1.2 billion in 1H 2000). Net errors and omissions, continuously negative in Russia's balance of payments, did not decrease relative to the trade flows, suggesting no abatement in capital flight.

Nevertheless, the continuing current surplus pushed the CBR's foreign exchange reserves up by USD 7 billion in 1H 2001. During January-September the reserves grew by USD 10 billion, reaching USD 38 billion at end-September and providing coverage for 6 months' import expenditure.

Russia's balance of payments in 1999-2001, USD billion

	1999	2000	2001 H1
Current account	**24.7**	**46.3**	**21.1**
Trade balance	36.1	60.7	27.5
Exports, f.o.b.	75.7	105.6	52.2
Imports, c.i.f.	-39.5	-44.9	-24.7
Services	-4.3	-7.7	-4.5
Exports	9.1	9.6	4.4
Imports	-13.4	-17.4	-9.0
Investment income	-7.7	-6.7	-2.0
Received	3.9	4.8	3.4
Paid	-11.6	-11.5	-5.5
Other items, net	0.6	0.0	0.1
Capital and financial account	**-15.9**	**-21.0**	**-10.0**
Capital Account	-0.3	11.0	-0.3
Received	0.9	11.8	0.2
Paid	-1.2	-0.9	-0.4
Financial account	-15.6	-32.0	-9.7
Direct investment to Russia	3.3	2.7	1.2
Portfolio investment to Russia	-1.2	-9.9	-0.1
Other items, net	-17.7	-24.7	-10.8
Net errors and omissions	**-7.0**	**-9.3**	**-4.0**
Change in reserves	**-1.8**	**-16.0**	**-7.2**

Source: Central Bank of Russia, 28 September 2001

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	8.3	5.1	H1/01
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	10.8	12.1	5.3	1-8/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	7.5	1-8/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	8.2	8/01
Exports, USD billion	53.6	59.7	67.8	82.9	90.6	89.0	74.9	75.7	105.6	60.2	1-7/01
Imports, USD billion	43.0	44.3	50.5	62.6	68.1	72.0	58.0	39.5	44.9	29.0	1-7/01
Current account, USD billion			8.4	7.4	11.8	2.1	0.7	24.7	46.3	21.1	H1/01

Sources: Goskomstat, CBR

More changes to 2002 draft budget

The budget draft for 2002 has been under constant revision in recent weeks. The latest changes were made just before the budget bill was officially submitted to the Duma, where it passed in its first reading. The government caved to pressure from certain Duma committees for higher revenue targets and GDP estimates. In the latest version, revenues equal 19.4 % of GDP (RUB 2,126 billion) and expenditures 17.8 % of GDP (RUB 1,947 billion), leaving a surplus of some RUB 178 billion (1.6 % of GDP). The GDP estimate was also increased from RUB 10,600 billion to RUB 10,950 billion.

Government plans for debt management in 2002-3

Since the haggling over Paris Club debt at the beginning of this year, government sources have been rather consistent in assuring the world of Russia's commitment to meeting its debt obligations in the near future. The government, nevertheless, wants to be ready for a possible fall in energy prices by suggesting to the Duma the creation of reserve fund. Of the estimated RUB 178 billion (USD 5.7 billion) surplus in 2002, some RUB 69 billion will be earmarked for paying down state debt while RUB 110 billion (USD 3.5 billion) will be set aside in a reserve fund in anticipation of heavy debt servicing costs in 2003. For comparison, realised extra revenues for H1 2001 amounted to RUB 117 billion (USD 3.7 billion), of which over RUB 79 billion (USD 2.5 billion) was directed to foreign debt payments.

The 2002 budget surplus will provide the bulk of the reserve fund and will be augmented by some RUB 35 billion from privatisation revenues and RUB 11 billion from the sale of state reserves (primarily precious metals). As a precautionary measure, the government has also increased its maximum limit on eurobond issues to USD 2 billion.

Any further surplus revenues materialising next year should, according to government, also be dedicated to debt servicing in 2002-2003. Naturally, budget revenues will depend heavily on how well energy prices hold up next year. According to prime minister Kasyanov, a one dollar change in the oil price leads to a two-billion-dollar change in overall revenues to the Russian economy. The estimate includes a one-billion-dollar change in federal budget revenues.

Changes in regional budget structure for H1 2001

In H1 2001, consolidated regional budget revenues and expenditures, as well as the surplus in relation to GDP, increased. The importance of tax revenues as a share of total revenues decreased markedly, but was compensated for by a noticeable increase in financial transfers from other budgets. The most visible tax change compared to H1 2000 was the transfer of all VAT revenues to the federal budget. In 2000, 15 % of VAT revenues on products or services made in Russia went to regional budgets. There was also a substantial increase in income tax revenues. In the first half this year, 99% of income tax revenues went to regional budgets as compared to 84% last year. However, income tax revenues also increased with the introduction of the flat 13 % income tax at the start of this year. Profit tax revenues increased slightly.

The main expenditure items on the consolidated regional budget remained basically the same. The most striking difference between the H1 2000 and 2001 budgets was a considerable boost in funds allocated to industry, energy and transportation. There was also a distinct decrease in the debt servicing costs of regional budgets. Agriculture and fishing as a share of GDP received somewhat less than last year.

Realised H1 2001 and 2000 consolidated regional budgets

	2001/H1 RUB million	2001/H1 % of total	2001/H1 % of GDP	2000/H1 RUB million	2000/H1 % of total	2000/H1 % of GDP
Revenues	**591.7**	**100**	**14.8**	**420.1**	**100**	**13.5**
Tax revenues, *of which*	385.2	65.1	9.6	310.2	73.8	10.0
Profit tax	*137.4*	*23.2*	*3.4*	*97.4*	*23.2*	*3.1*
Income tax	*105.7*	*17.9*	*2.6*	*58.9*	*14.0*	*1.9*
VAT	*0*	*0*	*0*	*31.3*	*7.5*	*1.0*
Property tax	*36.3*	*6.1*	*0.9*	*26.0*	*6.2*	*0.8*
Natural resource payments	*32.0*	*5.4*	*0.8*	*23.6*	*5.6*	*0.8*
Sales tax	*20.5*	*3.5*	*0.5*	*15.6*	*3.7*	*0.5*
Excises	*17.1*	*2.9*	*0.4*	*15.1*	*3.6*	*0.5*
Other taxes	*36.1*	*6.1*	*0.9*	*42.3*	*10.1*	*1.4*
Non-tax revenues	38.7	6.5	1.0	22.0	5.2	0.7
Financial transfers	103.2	17.4	2.6	52.7	12.5	1.7
Revenues of budget funds	53.5	9.0	1.3	35.2	8.4	1.1
Other revenues	11.1	1.9	0.3	0	0	0
Expenditure	**547.8**	**100**	**13.7**	**397.6**	**100**	**12.8**
Education	107.5	19.6	2.7	78.2	19.7	2.5
Housing	97.9	17.9	2.5	72.3	18.2	2.3
Health care	70.2	12.8	1.8	52.7	13.3	1.7
Budget funds	47.4	8.7	1.2	29.3	7.4	0.9
Social policy	41.7	7.6	1.0	26.5	6.7	0.9
Industry, energy, construction	35.4	6.5	0.9	7.2	1.8	0.2
Administration	29.0	5.3	0.7	20.1	4.8	0.6
Transport, telecommunication	21.8	4.0	0.5	13.3	3.3	0.4
Agriculture and fishing	17.3	3.2	0.4	17.1	4.1	0.6
Debt service costs*	7.8	1.4	0.2	23.1	5.5	0.7
Other	71.8	13.1	1.8	57.8	14.5	1.9
Balance	**43.9**		**1.1**	**22.5**		**0.7**

*Source: Ministry of Finance, *includes interest payments only.*

Fiscal indicators (per cent of GDP, unless otherwise indicated ; end-year figures for debt)

Federal government	1995	1996	1997	1998	1999[1]	2000[1]	2001 Jan-July	2001 budget	2002 budget draft
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	17.7	15.4	19.4[4]
- expenditures[1]	18.6	20.9	19.4	16.9	13.9	13.5	13.5	15.4	17.8[4]
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	4.2	0.0	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	57.6	50.4[2]		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	137.9[3]		

[1] The figures for 1999-2000 are based on new GDP figures (Goskomstat), [2] of the June 00-June 01 GDP of RUB 7955 bln, [3] 1 July 2001, [4] including social tax channelled via the federal budget

Sources: budget figures: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001), debt: IMF (1995-1999), Minfin 2000-2002

Bank deposits and loans grow gradually

Households and enterprises have gradually increased their bank deposits since autumn 1999. Compared to 2000, deposit growth picked up slightly in the first half of this year. Nevertheless, deposits have just exceeded 10 % of annual GDP (excluding accounts with Vnesheconombank, which are not counted in CBR deposit data; see chart). Moreover, the share of household deposits (7 % of GDP) is not much larger than the share of rouble cash circulating in the economy (6 %), reflecting strong distrust in banks.

Developments regarding the currency of deposit and maturities are partly mixed. Households' share of deposits (68 % at end-June) was lower than last year as households decreased their reliance on rouble deposits (45 % of total). Enterprises, on the other hand, increased both their rouble deposits and forex deposits (24 % of the total). There was general movement towards maturities longer than six months, especially in household rouble deposits. At the same time, households increased their reliance on rouble demand deposits and enterprises on short-term forex deposits, possibly reflecting new clients.

The stock of bank credit to enterprises also grew – albeit slowly – in the first half of the year, and stood at 11 % of GDP. The share of rouble loans continued to rise, reaching nearly 70 % of the total. Notably, this was due to loans with less than one-month maturity, while forex loans moved towards maturities of over six-months. Comparing the maturities of deposits and loans, a grave mismatch continuously appears on the long side of the six-month line.

In addition to numerous institutional and behavioural features that restrain development of the financial intermediation function of banks, interest rates have also played a role. Interest rates on deposits have been strongly negative in real terms since the financial crisis of summer 1998 and no basic change has been discernible (see chart). Lending rates remain high, and the wide gap with deposit rates continues (at 13 to 14 %).

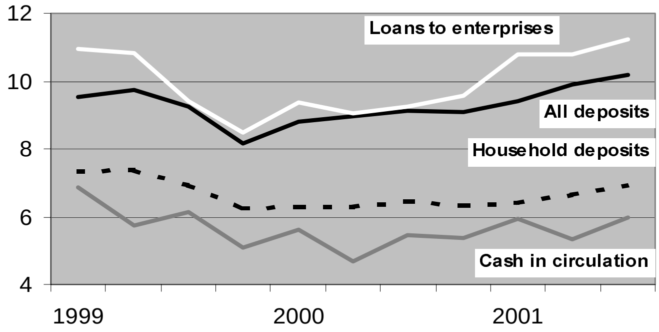
Lack of confidence in the Russian banking sector finally prompted the government and the CBR this summer to start preparation of a full-fledged bank reform plan. Finalisation of the current draft plan is expected early next month.

Equities slide

Russian share prices climbed up in May and June, then embarked on a downward path. The RTS index peaked in mid-summer at 230 and in late September and early October it was back in the 170 to 180 range of late April. Before early September the decline was relatively modest (to around 210). Following the New York tragedy on 11 September, the RTS was down 7 % for the week, and down another 10 % a week later in the wake of plummeting world oil prices.

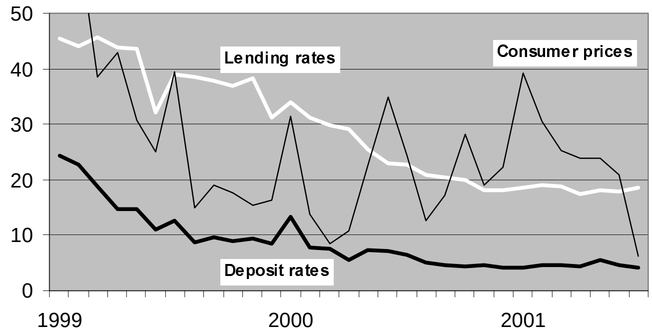
Along with general tendency to sell off in the face of increased global uncertainty, the heavy weighting of oil companies also helped push down the RTS (although among the biggest losers in September were some major telecom companies.) Gazprom shares, which are listed on the Moscow Stock Exchange, have also been on a downward path and are currently selling at their May levels.

Bank deposits, cash and loans in 1999-2001, at the end of the quarter, % of the annual GDP



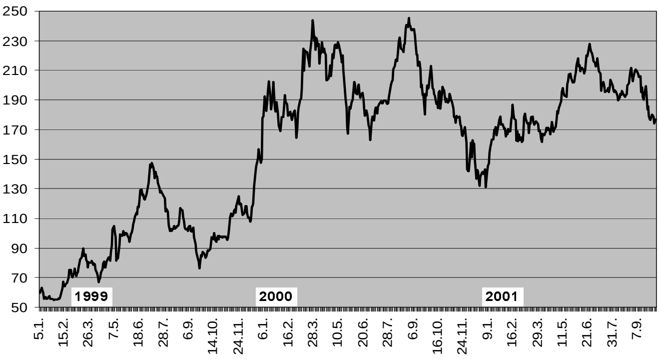
Source: Central Bank of Russia, Goskomstat

Interest rates on deposits and loans (under one-year maturities) and inflation (monthly, annualised) in 1999-2001



Source: Central Bank of Russia

Russian share prices in 1999-2001, RTS index



Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	20.0	9/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	42.2	8/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	3370	8/01
Interest rates, period average								
- deposit rate, %	102	55	16.8	17.1	13.7	6.5	4.2	7/01
- lending rate, %	320	147	32.0	41.8	39.7	24.4	18.6	7/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	37.9	9/01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	29.39	9/01

Sources: Goskomstat, CBR

Rapid recovery not possible without dynamic new private firms

By Jan Winiecki*

Several studies stress the importance of the new private sector in successful transition. They emphasize that the return to an efficient market economy is next to impossible without restoring what may be regarded as a normal structure of the economy in terms of the size of firms. Given communism's legacy of gigantic, inefficient mastodons, the rapid formation of new firms has been a must if networks of suppliers of inputs to large firms, necessary for efficient performance, are to be restored. Others have stressed the dynamizing, catalytic role of vibrant, entrepreneurial small and middle-sized firms. What has been generally neglected is the role of new private firms in shaping the path of output and determining an early, late (or, in some cases, nonexistent) recovery of output in the transition process. This author has underlined in a number of papers that in the short to medium run the role of new firms is decisive in making the shift from recession to recovery.

Behavioural differences, varying output paths

Other firms, whether they are state-owned enterprises (SOEs) or privatised firms, cope primarily with restructuring of their assets and, perhaps more importantly, with restructuring the working habits of their workforce (i.e. eliminating stealing, cheating and shirking). Even in privatised firms with strategic foreign investors, however, such change is not forthcoming quickly or easily. In contrast, intra-firm relations in new private firms are adapted to market conditions from the start. Moreover, SOEs and privatised firms (the latter in the early years of transition) typically focused on shedding labour, changing their product mix or improving quality. They rarely increased output volume. For example, in Poland, where transition proceeded rather fast, it wasn't until the fifth year of transition (1994) that SOEs managed to increase their output.

Thus, new private firms generate most, if not all, output growth in the first years of transition. New private firms add to total output almost from the start of the transition program. Furthermore, at a certain moment, the new private sector begins to increase its output by more than state-owned and privatised enterprises reduce theirs. At this point "transformational recession" (as called by Janos Kornai) is over and recovery begins. For example, in Poland growth returned in mid-1992, in the third year of transition. In the Czech Republic it also happened in the third year while it took place in Hungary in the fourth year.

Clearly, the striking difference between Poland and Russia in their respective output paths may be ascribed to the differing dynamics of the new private sector. In general it is *the* major difference between transition hopefuls and transition laggards. This can be illustrated with the ratio of entrepreneurs and inhabitants in transition countries (see table).

Fundamentals of the new private sector

Now, an all-important question is what are the determinants of the dynamic expansion of new private firms. This author stresses that explanatory variables operate at three levels. At the most mundane level, the regulatory regime very strongly affects companies, primarily small and medium-sized firms (e.g. the regulation of entry). At the middle level – as is usually noted as the determinant of success – we have progress in stabilisation, liberalisation and privatisation within the overall framework of rebuilding and building anew institutions of the market.

However, what this author underlines most strongly, there is a still more fundamental level of institutions of political liberty, law and order, and trust, that create environments most conducive to would-be and actual entrepreneurs. Freedom from fear that pursuit of profit during transition will not later become the reason for persecution is an important factor in entrepreneurial decisions. So is the certainty of safety, both personal and that of doing business. And the existence of a good measure of trust reduces transaction costs considerably.

The problem is that all these institutional characteristics were largely absent under the communism-generated anomie. Their existence is dependent mostly on the institutional inheritance from pre-communist past. Indeed, the most important variable affecting success in post-communist transition may well be the difference in pre-communist past between East-Central and Eastern Europe.

Entrepreneurial density in selected transition economies measured by number of entrepreneurs per 1,000 persons in the population

Country	Year	Ratio
Czech Republic	1998	139
Hungary	1998	64
Poland	1998	59
Slovakia	1998	56
Slovenia	1998	32
Romania	1998	15
Russia	1996	6

Source: Winiecki, Communist and Post-Communist Studies, Vol.33, 2000, p.512

**The author is Visiting Researcher at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
8 October 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 • FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
10•2001

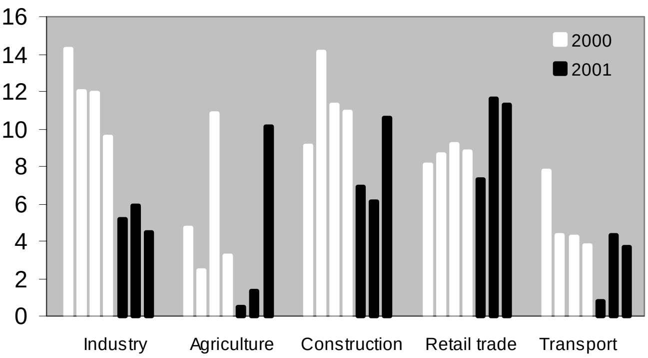
Economic Developments

The economy keeps climbing

Russia's economic growth, which resumed in early spring, continued through 3Q 2001. The composite indicator of five key sectors (industry, agriculture, construction, retail trade and transport) showed growth for the first three quarters of 2001 of 5.7 % y-o-y, while growth accelerated to 6.4 % in 3Q. Retail trade continued to expand, reaching 11-12 % growth in the second and third quarters (see chart). Construction increased over 8 % in the first three quarters, in line with investment growth. In addition, agricultural production rose over 10 % in the important 3Q harvest season. In contrast, industrial production growth eased from 5-6 % earlier in the year to 4.5 % in 3Q. The increase in transport remained at 3 %, largely due to a drop in sea and air transport.

In the industrial sector, food production rose 8 % y-o-y in the first three quarters, suggesting domestic producers, shielded by a cheaper rouble since autumn 1998, may have gained some foothold. Investments and consumption pulled up machinery and equipment production by almost 8 %. Likewise, civil production in the defence industry complex rose 12 %, while the entire complex was virtually unchanged due to a decline in military production. Chemical & petrochemical industry and the fuel industry recorded 6-7 % growth. The latter was due to crude oil production, which grew 7.5 %. Gas production was down 2 %.

Growth in key sectors of the economy 2000-2001, % change from the same quarter of the previous year



Source: Goskomstat

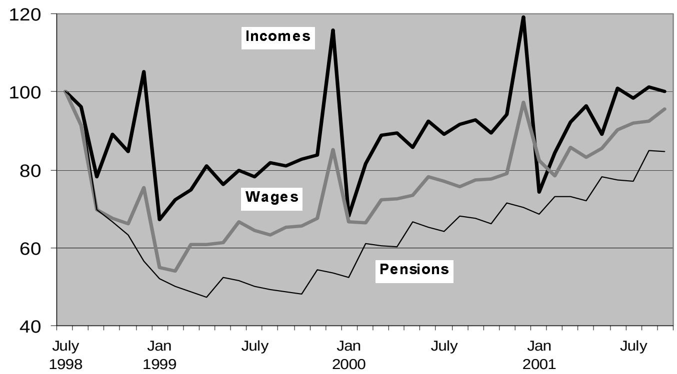
Incomes continue to rise

Throughout 2001, incomes approached 1998 pre-crisis levels (see chart). Real disposable incomes have even reached their July 1998 level, while real wages are still some 5 %, and pensions 15 %, below that level. In September, real disposable incomes were almost 8 % higher than a year earlier. Real wages rose 24 % and real pensions 26 %. Real wages were up 15-25 % in virtually all industry branches and thus considerably exceeded the rise in productivity. The average monthly wage in industry was 150 dollars in August (110 dollars a year earlier).

There are considerable differences in the wage level of various sectors. Wages are lowest in agriculture and education – in August, they equalled only 45 % of the average monthly wage (3376 roubles, equal to 115 dollars). Light industry, retail trade, forestry, culture, health care and public catering are examples of branches where wages lay in the range of 50-60 % of average wage. The other extreme is led by the gas and oil industry, with average wages about 4 to 5 times the overall average wage. Wages for workers in non-ferrous metallurgy and the financial and insurance sectors were almost 2.5 times the average.

Wage arrears have remained in check this year. In January, they stood at almost RUB 32 billion (0.5 % of GDP). At the beginning of October, they had reached over RUB 34 billion (0.4 % of the GDP of the previous 12 months). Wage arrears in industry account for 37 % of the total, including 15 % in machine-building & metal industry. Arrears in agriculture stand for over a quarter. About 15 % is owed in the construction sector while wage arrears in the social sector account for another 15 % of the total. The arrears in branches with the highest wage levels are quite low.

Disposable incomes, wages and pensions in real terms, July 1998=100



Source: Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	8.3	5.1	H1/01
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	10.8	12.1	5.2	1-9/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	7.8	1-9/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	8.1	9/01
Exports, USD billion	53.6	59.7	67.8	82.9	90.6	89.0	74.9	75.7	105.6	63.9	1-8/01
Imports, USD billion	43.0	44.3	50.5	62.6	68.1	72.0	58.0	39.5	44.9	33.5	1-8/01
Current account, USD billion			8.4	7.4	11.8	2.1	0.7	24.7	46.3	21.1	H1/01

Sources: Goskomstat, CBR

2002 budget sails through second reading

The Duma made slight changes to the 2002 budget before approving its second reading at the end of October. Increases from the first reading revenues were divided among several expenditure categories. Spending was trimmed slightly in categories such as “international operations” and “state debt servicing.” Funding was increased in the areas of social policy, regional transfers, construction and maintenance of roads, industry, agriculture, security and defence. The third reading of the budget is scheduled for 30 November.

The fact that the price of Urals oil has stayed close to the minimum level anticipated in the 2002 budget draft has activated further planning in the event the pessimistic scenario materialises. The government will suggest to the Duma a change in the 2002 budget, whereby part of non-interest spending would be financed only if extra revenues reach at least RUB 37 billion (USD 1.2 billion). Without the change, non-interest expenditures in the 2002 budget draft (not including the unified social tax) are about 1.5 percentage points higher than the realised non-interest expenditures so far this year (12.5 % vs. 11 % of GDP). President Putin also urged the government to propose changes to the 2002 budget draft.

Current oil price would mean borrowing to repay debt

After the federal budget was submitted to the Duma in late August, the oil world market price fell in mid-September from last summer’s levels of 24-26 dollars per barrel (for Brent crude) to around 22 dollars, and decreased further to around 20 dollars by early November. The government calculates that a one-dollar change in the oil price alters the federal budget revenue by one billion dollars (0.3 % of next year’s projected GDP). The draft budget for 2002 notes that if the price for Urals crude averages 18.50 dollars throughout 2002 (which corresponds to about 20 dollars for Brent) and budget expenditures now approved in two Duma readings remain unchanged, no surplus would accrue.

Next year’s repayments of foreign debt principal require USD 7 billion, which can only partly be covered from this year’s budget surplus. For January-August, the surplus was around RUB 200 billion (USD 6-7 billion), and recent expectations are that the entire surplus for 2001 will come in at around RUB 250 billion (USD 9 billion) after part of above-budget revenues is spent on domestic expenditures (as agreed with the Duma). After this year’s repayment of foreign debt principal, around USD 4 billion of the surplus may be left. The rest for next year’s repayments would be obtained through foreign borrowing (for which the budget includes a frame up to USD 2.9 billion, including USD 2 billion of eurobonds) and privatisation, as well as sales of state metal reserves (USD 1.5 billion).

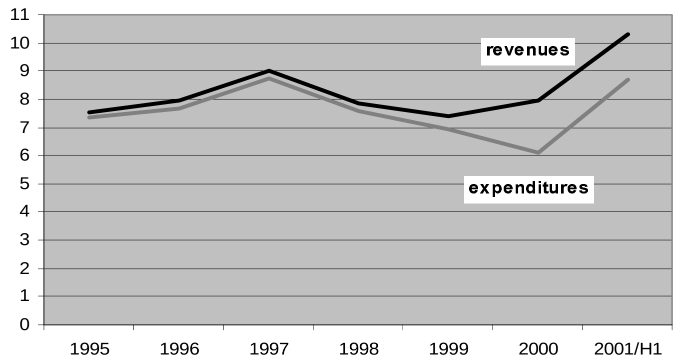
For 2003, the finance ministry’s tentative budget outline envisages no surplus if the current oil price level prevails. On the other hand, Russia’s repayments of foreign debt principal will rise to USD 11-12 billion (full foreign debt service payments including interest payments will be about USD 18 billion according to the government).

Russian authorities said these more meagre prospects have been discussed with representatives of the IMF and the Paris Club. Market observers indicated that Russia may presently be buying back some of its marketable debt falling due in the peak year 2003 in order to smooth its repayment path. A domestic option, albeit inconvenient, would be to restrain expenditures.

Extra-budgetary funds boost revenues

Revenues to Russia’s four federal extra-budgetary funds peaked in 1997 and then plunged after the 1998 crisis. With the current favourable macroeconomic situation, these funds have again improved their fiscal position during 2000-2001 (see chart). During this and last year, the funds have generated notable surpluses. The biggest improvement came in the Pension Fund, which absorbs about 80 % of all revenues to these funds. The revenues of the Pension Fund, which slipped to 6 % of GDP in 1998-99, rebounded to 8.5 % of GDP in the first half of this year. Compared to H1 2000, nominal revenues to the Pension Fund increased almost 70 % in January-June 2001. The Social Insurance Fund boosted its revenues from 1.2 % of GDP in H1 2000 to 1.7 % of GDP in H1 2001. The shares of the other two extra-budgetary funds – the Employment Insurance Fund and the Medical Insurance Fund – are insignificant.

Revenues and expenditures of federal extra-budgetary funds, % of GDP



Source: Goskomstat

Note: The 2001/H1 figure does not include data from the Employment Insurance Fund

Fiscal indicators (per cent of GDP, unless otherwise indicated ; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2001	2002
Federal government							Jan-Aug	budget	budget draft
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	17.3	15.4	19.4[3]
- expenditures[1]	18.6	20.9	19.4	16.9	13.9	13.5	13.5	15.4	17.8[3]
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	3.9	0.0	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	57.6	50.4[1]		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	137.9[2]		

[1] of the July 00-June 01 GDP of RUB 7955 bln, [2] 1 July 2001, [3] including social tax channelled via the federal budget (2.6 % of GDP)
Sources: budget figures: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001), debt: IMF (1995-1999), Minfin 2000-2001

Monetary policy faces continuous challenges

Despite a decline, Russia's current account surplus has remained large this year and capital flight has not accelerated. As a result, the CBR's foreign currency reserves have grown substantially (see chart). This, in turn, has boosted the money supply (rouble cash and rouble deposits in banks) – over 40 % during the past 12 months. At the same time, rouble cash in the economy has increased around 50 %.

Since the 1998 financial crisis, the CBR has lacked an effective range of monetary policy tools for reining in money supply growth and inflationary pressures. For one instrument, the CBR has made this year frequent interventions in the foreign exchange market, selling foreign currency to cushion downward movements in the rouble's exchange rate. Support in tying liquidity has come from Russia's budget surplus, which has increased government and other public sector deposits with the CBR. In the first nine months of this year, that increase equalled half of the increase in the CBR's foreign currency reserves.

In relation to banks, the CBR has not changed its reserve requirements since 1 January 2000. Regarding its deposit windows, the CBR this year has held occasional deposit auctions, which were followed by interest rate hikes at the deposit windows (see chart). Yet, bank deposits with the CBR appear to have declined this year.

The use of government T-bills in monetary policy has also been constrained, since conversion of government debt to the CBR into marketable securities (with sufficiently high interest rates) has lagged. Before issuing its own bonds, the CBR has waited for the abolition of an issuance tax (which happened this summer) and the lifting of an issuance limit (which was recently drafted by the government) Recently, the CBR issued bonds with two- and three-week tenors – its first issues since autumn 1998.

Central Bank prepays the IMF

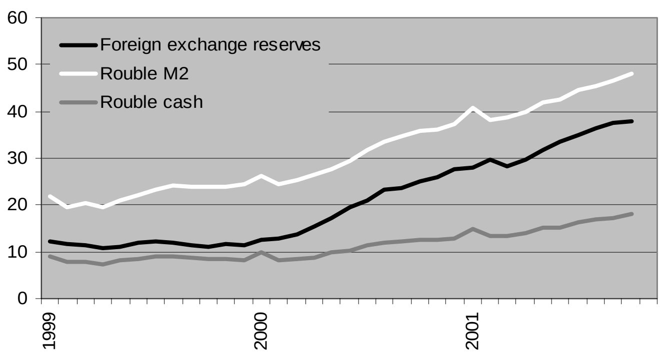
In a novel move (although not unusual among IMF member countries), the CBR will prepay the remaining USD 2.7 billion of a USD 4.8 billion loan that it received in July 1998 before the Russian financial crisis to stabilise the foreign exchange market. In the original schedule the principal to be prepaid is due in 2002-03, and in fact Russia has already made prepayments this year to the tune of USD 1 billion.

The measure reflects the set-up where the federal budget is a constraint on the government's debt service while the CBR is a possessor of ample foreign exchange reserves (almost USD 39 billion). The prepayments will not reduce the government debt to the IMF, which was slightly below USD 8 million at end-June. It remains to be seen what effect this confidence-building act will have on the price of borrowing if the government eventually goes ahead within next year's budget mandate for borrowing on international financial markets.

Russia's credit ratings improve

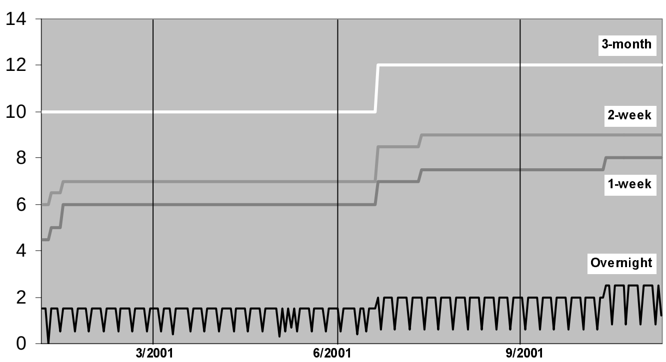
During recent months, major credit rating agencies have raised Russia's credit ratings. In summer Standard & Poor's lifted Russia's long-term foreign currency and local currency issuer ratings, as well as its rating on Russia's eurobonds, to B. Moody's raised Russia's long-term foreign currency issuer rating and the eurobond rating to B2 in early September, and lifted Russia's long-term local currency issuer rating to B1 in mid-October. In early October, Fitch upgraded Russia's long-term foreign currency rating and its eurobond rating to B+. It also lifted its long-term local currency rating to B. Markets have also shown increased confidence this year. For example, the spreads for most of Russia's eurobonds have declined from 1,000 to 1,200 basis points early this year to around 800 to 900 basis points through the summer and autumn.

CBR foreign currency reserves, rouble money supply and rouble cash, Jan 1999 to Sep 2001, USD billion



Source: Central Bank of Russia

Interest rates on bank deposits with the CBR, 1 Jan to 6 Nov 2001, %



Source: Central Bank of Russia

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.9	10/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	42.5	9/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	3511	9/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	5.3	8/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	18.1	8/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	38.5	2.11.01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	29.70	10/01

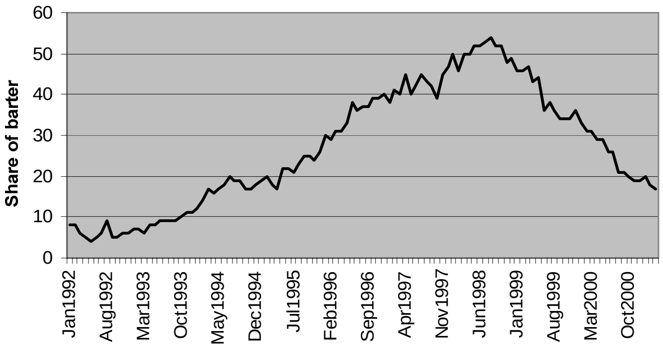
Sources: Goskomstat, CBR

Barter in Russia: causes and consequences

By Jukka Pirttilä*

Partial monetisation was one of the most peculiar features of the Russian macroeconomy in the 1990s. At its peak in 1998, over 50 % of industrial transactions took place without money, relying instead on various monetary surrogates such as barter, bills of exchange and inter-enterprise arrears. These Russian forms of barter served as a medium of exchange and a form of credit – functions normally assigned to money.

Share of barter in industry sales, %



Source: Russian Economic Barometer.

Competing explanations for barter

There is a heated debate among economists on what factors encourage barter. Apart from institutional weaknesses that allow barter to survive (such as poor bankruptcy and tax legislation) there are, broadly speaking, two competing views. Some argue that barter is a result of lagged restructuring, while others emphasise the lack of liquidity, caused either by insufficient money supply or the fragility of the banking system, as a prime reason for barter transactions. For instance, firms that have limited access to financial resources and suffer from liquidity problems are more likely to rely on barter. Tight monetary policy may also raise demand for non-monetary forms of exchange. These questions are addressed using Russian macroeconomic data from 1994 to 2000 in our forthcoming paper "Money, barter and inflation in Russia," co-authored with Byung-Yeon Kim and Jouko Rautava (BOFIT Discussion Papers, No 14/2001).

Support for both theories

Based on econometric analysis of the long-run relationships between barter and macroeconomic variables (real money, output, interest rates, exchange rate and consumer prices), we found that the main reason for the emergence and growth of barter in the Russian economy is associated with output losses. Barter thus served as a survival mechanism in the presence of sales or production difficulties. This provides at least indirect support for the theory that barter is a result of lagged restructuring in troubled firms. But tight monetary policy (measured as reduction in real money balances) also increased barter, through the link of reduced liquidity. Thus, firms are prone to rely on barter as an alternative source of funding (barter includes IOUs or other forms of bills of exchange that provide a form of trade credit to firms). It also appears that banking sector weaknesses have encouraged reliance on non-pecuniary forms of finance.

The rapid reduction in barter that started shortly after the crisis in August 1998 is compatible with these explanations. First, production increased in part due to improved competitiveness after the rouble's devaluation. This was reflected in the improved liquidity of export firms. Second, monetary policy was rather lax. Russia's money supply (M2) increased 57% in 1999 and 62% in 2000. Both factors reduced enterprise reliance on barter.

Barter affects functioning of the whole economy

Turning to the consequences of barter, the evidence shows that monetary policy was unaffected by movements in barter. Therefore, while reductions in real money holdings increase barter, the same is not true the other way round. One way to interpret this result is that money is a superior means of payment and credit. Once a certain level is achieved, barter loses its attraction.

A striking finding is that an increase in the share of barter tends to reduce the overall price level. Why this is so is unclear. Firms having difficulty with sales for money may use barter to increase production and then engage in barter transactions. Perhaps maintaining production in this way raises the supply of goods in the market and thus reduces cash prices. Finally, the dynamics of the model indicate that a high level of barter reduces output (probably because of efficiency losses associated with barter).

A final question is to what extent barter is a permanent feature of the Russian economy. Our findings hold for the period studied and existing institutions. With institutional improvements, it seems likely that reliance on barter will be further reduced. For the time being, however, this special phenomenon still influences the functioning of the Russian economy, and therefore needs to be acknowledged in macroeconomic research on Russia.

**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
8 November 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 • FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
11•2001

Economic Developments

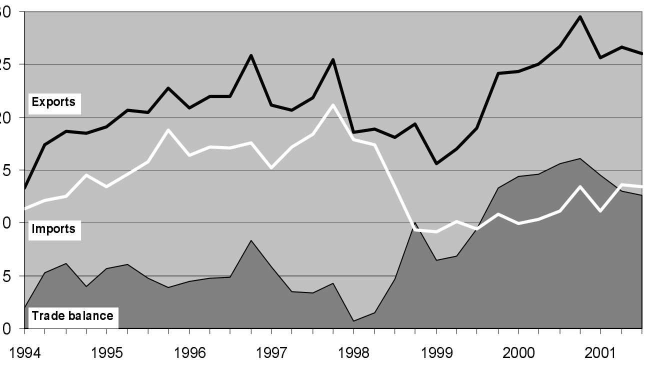
Exports show slight decline, imports steam ahead

Russia's export income increased a modest 3 % y-o-y in the first three quarters of this year. The third quarter saw exports decrease (3 %) for the first time since mid-1999. Imports, on the other hand, grew 20 % in 3Q, while growth of imports from countries outside the CIS accelerated to almost 40 %. The trade surplus of the first three quarters was still large (USD 40 billion compared to USD 45 billion a year earlier).

The downturn in 3Q exports reflected lower export prices. The oil price was over 10 % lower y-o-y, while the price of natural gas was down about 2 %. Export volumes, however, increased. The volume of crude oil exports grew well over 10 % y-o-y in 3Q and gas exports also rose about 10 % y-o-y. Income from non-energy exports in 3Q was more or less unchanged from a year earlier.

Regarding the structure of imports (as estimated by the CBR), 23 % went unrecorded by customs in the first three quarters. In recorded imports, the share of machinery and equipment (excluding passenger cars) was up slightly to 29 % but down slightly to 33 % in non-CIS imports. Overall, machinery and equipment imports (excluding the cars) rose 26 %. The fastest growing major item in non-CIS imports were food products and raw materials (up 35 %), which accounted for 25 % of the imports.

Russian exports and imports 1997-2001, quarterly, USD billion



Source: Central Bank of Russia

Grain harvest better than expected

By early November, this year's grain harvest was virtually complete and had reached a gross weight of 91.3 million tonnes. This translates to a net harvest of approximately 83 million tonnes. Nearly 90 % of grain is produced on large, mostly former collective farms. Favourable weather conditions, timely fuel deliveries and reduced losses during transport and storage all contributed to this year's good harvest. Further, the area of farmland under grain cultivation increased slightly. The average net grain harvest in the early 1990s was around 88 million tonnes, but fell to 65 million tonnes between 1996 and 1999. Last year, it amounted to 65.5 million tonnes.

Growth and inflation projected to slow in 2002

Encouraged by brisk growth this year, GDP growth projections for this year made in Russia and in the West have been revised slightly upwards from last spring to 5 to 6 % (see table). Next year's growth estimates were also cautiously raised, but most still see growth decelerating to 4 %.

Russia's current account surplus is expected to decrease in 2002, but would still reach 7 to 8 % of GDP. Behind this are projections of lower exports and higher imports (up by some 10 % in consensus forecasts derived from projections of private banks, companies and research institutions). The meagre export prospects are due to the international oil price, which key forecasts estimate will average 20 to 22 dollars per barrel in 2002, i.e. lower than in the spring forecasts.

The latest projections for this year's inflation in Russia are mostly in line with last spring's estimates, which were already considerably above the original targets of Russian authorities. For 2002, major international organisations foresee inflation abating considerably, in line with the forecast of the Russian government and the CBR. Consensus forecasts suggest a smaller decline of inflation next year.

Projections for 2001 and 2002

	GDP, % change		Inflation, %		Current account, USD billion	
	2001	**2002**	**2001**	**2002**	**2001**	**2002**
Government/ Central Bank	5.7	4.3	18.0	10-14	–	–
IMF	5.8	4.2	22.1*	12.9*	35	37
OECD	6	5	20	12	37	26
EBRD	5.5	4	21.4*	12.5*	36	–
Consensus forecasts						
- Economics**	4.6	3.7	19.1	15.2	34	24
- Tsentr ***	5.2	4	18.5	15	36	25

* annual average prices, otherwise end-of-year prices

*Sources: ** Consensus Economics Inc.,*
**** Tsentr razvitiya (Development Centre)*

Economic indicators

	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**as of**
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	8.3	5.1	H1/01
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	10.8	12.1	5.2	1-10/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	8.2	1-10/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	8.7	10/01
Exports, USD billion	53.6	59.7	67.8	82.9	90.6	89.0	74.9	75.7	105.6	78.2	1-9/01
Imports, USD billion	43.0	44.3	50.5	62.6	68.1	72.0	58.0	39.5	44.9	38.1	1-9/01
Current account, USD billion			8.4	7.4	11.8	2.1	0.7	24.7	46.3	21.1	H1/01

Sources: Goskomstat, CBR

2002 budget in the final stretch

At the end of November, the Duma approved by clear majority the third reading of the 2002 federal budget. The fourth and final reading in the Duma will take place in mid-December, when e.g. the federal investment program and distribution of state military purchases will be settled.

The oil price topped discussions of the Russian economy this autumn. The government has tried to show that, no matter what the oil price, Russia will manage. In November, the government revised its economy and budget scenarios for 2002 to better reflect the recent decline in oil prices. According to the scenario, the government will only need to take foreign loans if the average price of Urals-grade crude drops below 16 dollars a barrel in 2002. If the oil price drops to 15 dollars a barrel, Russia would have to take one billion dollars in foreign loans. In that case, Russia would face difficulties in meeting its 2003 debt servicing obligations (possibly two billion dollars in foreign loans would be needed and another billion in debt would have to be restructured).

Russian government economy and budget scenarios for 2002

Scenario	Urals oil price, Dollars/ barrel	Foreign currency reserves, bln dollars, + growth, - decrease	Inflation 12-month, %	Foreign borrowing, bln dollars	Reserve Fund, bln dollars, + growth, - decrease
Optimistic	23	+ 4-5	10-13	0	3-4
Middle*	18	0	about 13	0	2-3
Pessimistic*	15	- 5-6	13-18	1	0

* includes expenditure cuts of some RUB 37 billion (USD 1.2 billion)

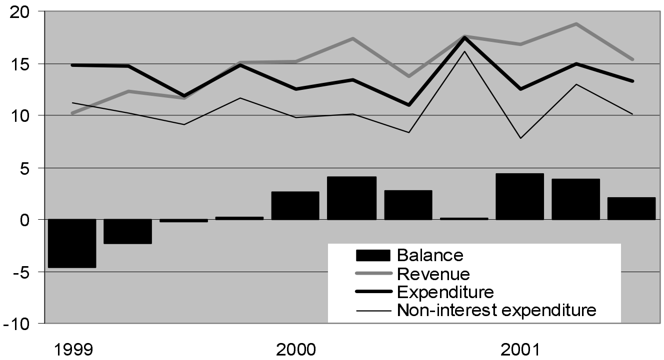
Beyond these scenarios, however, there are additional plans to cut non-interest expenditures if needed. In the third reading of the 2002 budget, the Duma agreed to transfer the financing of 69 billion in expenditures to the end of 2002. They will be realised only in case sufficient funds are available. According to estimates, the cuts would occur if the oil price drops to 16 dollars per barrel. The cuts would then be divided between different expenditure categories. Almost quarter of the sum (RUB 16 billion) would be implemented as cuts in financial aid to regions, while some 15 % (RUB 10 billion) would be taken from defence and 10 % from road maintenance (RUB 6.5 billion).

The third reading of the 2002 budget included two amendments to the budgetary process. The Duma voted for the government to set yearly ceilings on increases in charges for energy (gas, electricity and heating). The limits for 2002 should be decided by 15 January 2002. For 2003, the limits will be set before the 2003 budget enters the Duma. After the ceilings are approved, they can be changed only if the Duma passes corresponding changes to the budget law. The other amendment to the budgetary process concerns the reserve fund, which is to have a special account in the Central Bank of Russia.

Budget surplus contracts, but still substantial

During the autumn, Russia’s interest payments remained relatively large, while the share of revenues shrank in relation to GDP. Although the latter maybe partly due to seasonal variation, this led to contraction of the budget surplus, which in the third quarter was nevertheless still substantial – about 2 % of GDP. In August and September, the budget was nearly in balance, while in the first and second quarters the surplus was still about 4 % of GDP. However, the primary surplus (i.e. excluding interest payments) in January-September was 6.3 % of GDP. Interest payments were the largest single expenditure item in the federal budget during January-September – RUB 212 billion (3.2 % of GDP). Non-interest expenditures in the third quarter also contracted to the level of some 11 % of GDP after strong growth during the second quarter.

Russian federal budget, % of GDP



Source:EEG

Distribution of 2001 extra revenues approved

At the end of November, the Duma passed amendments to the 2001 budget law concerning the distribution of RUB 318 billion (USD 10.5 billion) in revenues above budget. In reality, the act had little effect as most of the sum had already been distributed beforehand. Under the amendments, RUB 244 billion (USD 8 billion) would go to servicing foreign debt, including RUB 25 billion to be placed to the reserve fund. RUB 75 billion would be distributed among several non-interest expenditure items. The approved distribution differs slightly from the plan in the 2001 budget, which gives more money to non-interest expenditures. They were boosted by some RUB 12 billion, which corresponds to the sum Russia “earned” from lower-than-expected interest payments this year.

Fiscal indicators (per cent of GDP, unless otherwise indicated ; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2001	2002
Federal government							Jan-Sep	budget	budget draft
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	16.8	15.4	19.4(3
- expenditures(1	18.6	20.9	19.4	16.9	13.9	13.5	13.8	15.4	17.8(3
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	3.0	0.0	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	57.6	49.0(1		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	137.9(2		

1)of the July 00-June 01 GDP of RUB 7963 bln, 2)1 July 2001, 3) including social tax channelled via the federal budget (2.6 % of GDP)
Sources: budget figures: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001), debt: IMF (1995-1999), Minfin (2000-2001)

Capital outflows show signs of abatement

Capital outflows from Russia have often been referred to as a sticky low remark given by the markets to Russia's business environment especially after the country's financial crisis in 1998. Russia's balance of payments gives some indications. Thus, recorded net capital inflows of the private sector (banks and enterprises) have been even more consistently negative after the crisis than during the pre-crisis years (see chart). Statistical errors and omissions of the balance of payments, which to a large degree are deemed to reflect unrecorded capital flows, show a similar pattern. In 2Q and 3Q of this year, however, both outflow measurements have declined in relation to the trade flows (together to around 10 % from 14-15 % in 1999 and 2000). Nevertheless, this is by no means a past issue since recorded private net outflows still amount to some USD 1 billion per month and the statistical gap to some USD 0.5 billion per month, which together equal 4-5 % of GDP.

Russia's country risk rankings slightly up

Alongside improved credit ratings (see previous Month in Review), Russia's country risk rankings have inched up this autumn (see chart). Russia's position among 185 countries surveyed by *Euromoney* climbed to 94 in September from 97 in March. Out of the 145 countries covered by *Institutional Investor*, Russia's ranking was 92 in September (93 in March). Among the larger CIS countries, Russia scored second after Kazakhstan (76 and 75 in the two rankings) and ahead of Ukraine (121 and 113).

Regarding the assessments behind the rankings, Institutional Investor's actual country credit rating (which is based on information compiled from economists and sovereign risk analysts) was almost unchanged for Russia. In that survey, Russia showed certain resilience against a declining global average rating. *Euromoney's* country risk score (which is composed of financial, economic and political information) for Russia was slightly down despite assessments of improved political risks since economic projections for Russia were a little weaker than last spring.

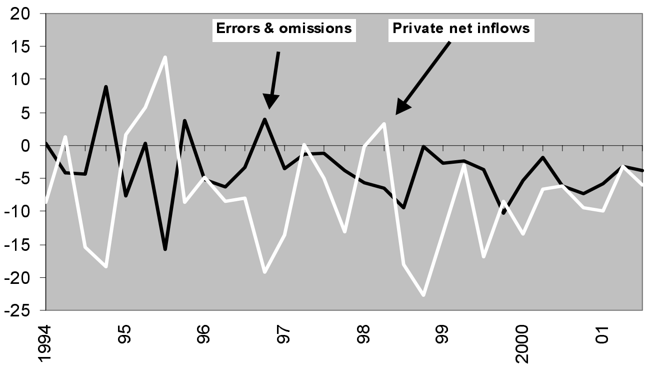
Steps for capital movements and against laundering

Russian foreign currency regulations have undergone further stepwise changes recently. Since October, Russian companies no longer need permission from the CBR to take loans with maturities longer than six months, unless the loan amount exceeds USD 100 million. For monitoring purposes, borrowers must still report such loans to the CBR. The effect is likely to be small as central bank permission has probably rarely been a constraint on Russian borrowers that get through foreign creditors' diligence processes.

In October, private individuals were also given the right to open bank accounts without prior permission in OECD and FATF (Financial Action Task Force on Money Laundering) member countries. Such accounts must still be reported to the Russian tax authorities, and the change does not concern business accounts. Private individuals will also be allowed to annually make up to USD 75,000 in money transfers for investments in foreign securities and stocks without first seeking CBR permission.

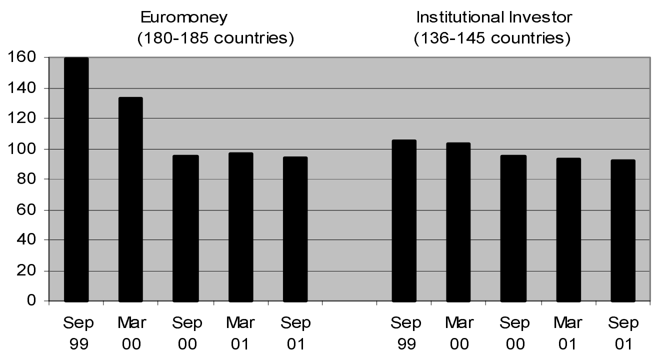
As for domestic controls, after Russia passed a law against money laundering in August, FATF removed its recommendation for additional countermeasures against Russia which were due end-September. Russia remains on the FATF's list of non-cooperative countries until its legislation is effectively implemented. Towards that end, Russia will set up a Financial Monitoring Committee to be functional as of 1 February next year. It may have up to 300 professional employees. The CBR also issued instructions for developing banks' internal controls and reporting.

Private net capital inflows and statistical errors & omissions in Russia's balance of payments, % of trade flows (goods & services)



Source: Central Bank of Russia

Russia's country risk rankings, Sept. 1999 to Sept. 2001



Source: Euromoney, Institutional Investor

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.8	11/01
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	43.9	10/01
Average wage, new RUB, end of period	736	1017	1210	1463	2272	3135	3473	10/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	5.5	9/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	17.2	9/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	37.3	11/01
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	29.90	11/01

Sources: Goskomstat, CBR

Will Russian banking sector reform take off in 2004?

By Vesa Korhonen*

Russia's banking sector is burdened by a double legacy of large state-owned banks inherited from the Soviet era and a plethora of various-sized banks with diverse ownership structures that sprang up during the economic transition of the 1990s. These "rich" features dominating the banking landscape, combined with slow institution-building processes, assure an abundance of banking reform issues. The Central Bank of Russia and the government only recently moved forward towards more comprehensive bank reform. A bank reform strategy was adopted in late September and an action plan is expected soon. The goals of the adopted strategy include increased competition in banking. The plan is a welcome step, but nevertheless cautious and partly vague on certain key issues.

Accounting reform takes time

After a decade of transition, accounting reform – a basic, but fundamental, area of bank reform – proceeds gradually. The CBR announced in autumn 1999 that banks would move to international accounting standards (IAS) around the end of 2001. To date, some 130 of the 1300 Russian banks apply IAS, and the CBR is currently drawing up a more complete review of the state of the banking sector. Russia will also participate in the IMF's Financial Sector Assessment Program (FSAP).

Tax reform, besides lowering the profit tax on banks from 43 % to 24 %, will guide the tax bookkeeping of banks towards IAS from early 2002 by widening the scope of deductible business expenses. However, banks would only have to make the shift to IAS from the start of 2004, along with other sectors. The ambiguity here is whether this move will be the finish or start of the shift - similar to the corporate sector that is supposed to adopt IAS during the second half of this decade. The inertia behind the long overhaul of accounting practices stems partly from vested interests. The CBR estimates that around half of Russia's banks would be in trouble if they applied IAS today, probably because they would have to show much lower net asset values.

Sberbank ownership a major challenge

The state holds majority stakes in over 20 banks, which represent a third of the Russian banking sector's total assets. The state also holds minority stakes in a couple of hundred banks. The bank reform strategy is quite defensive about state ownership, reiterating generally that the state will depart from some banks. As for two large banks, the strategy confirms that the CBR tentatively plans to exit Vneshtorgbank next year, and Vnesheconombank will simply be split into a state debt agency and a commercial bank.

Sberbank, in which the CBR holds the majority stake, controls over a fifth of the banking sector's total assets, including a third of credits to corporations and three-quarters of household deposits. Public ownership does not necessarily have to mean less competition, but many market participants and observers note that Sberbank (which also enjoys government deposit insurance) can indeed undercut loans of other banks with better terms. The bank reform strategy gives hardly any prospect of privatising Sberbank as its dominance is anticipated to complicate the privatisation. Instead, the aim is to to strengthen competition by reviewing and increasing the state's ownership control of Sberbank's policies. This can be a tricky task. Other indications by the CBR are that Sberbank's privatisation will only be addressed when a deposit insurance scheme extending to most banks lowers Sberbank's market share.

Deposit insurance and capitalisation

Weak trust in banks generally, along with e.g. tax avoidance and payment traditions, has kept bank deposits small (11 % of GDP) and maintained a high reliance on rouble cash (7 %) and foreign cash (some 10-15 %). To level the situation, the bank reform strategy spells out the formation of a general deposit insurance scheme, with a deposit ceiling. The scheme is initially voluntary (from next year), but with the introduction of IAS, the scheme will become compulsory and deposit-taking rights will be available only to solid banks. Sberbank is unwilling to switch to the general scheme until it is compulsory.

In another area of bank funding, most of the major recapitalisations in Russia's banking sector after the 1998 crisis have been made by the government or the CBR. Thus, the bank reform strategy wants to attract private owners to solidify their banks through higher capital adequacy requirements, albeit the timing is open. The minimum capital requirement is deemed more controversial, however, since an increase could wipe out half of all Russian banks (although they represent only a few per cent of the sector's assets). As for foreign capital, the process of acceptance gradually continues as the capital requirement for foreign banks is to be lowered and profit repatriation freed up.

Attractiveness of banking hinges on wider reforms

After rouble exchange rate volatility and T-bills ceased to provide easy bank profits, the focus of banking in Russia shifted to companies. The immediate task is to establish legal rights of creditors to better collect their credit collateral (especially where the debtor faces bankruptcy). Naturally, the determinants of corporate lending cover much wider reforms such as courts, land and enterprises (e.g. accounting). However, the banking reform should not wait, either.

**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
10 December 2001

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 • FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
The Month in Review
12•2001

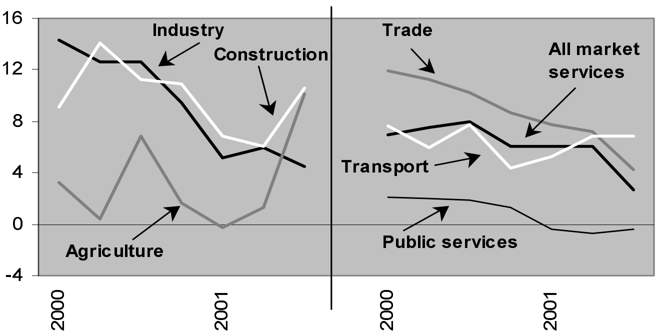
Economic Developments

Output growth slowed towards the end of last year

Although the composite five-sector indicator suggested faster growth in 3Q 2001 compared to 2Q, Goskomstat's GDP figures indicate that GDP increased 4.9 % y-o-y in 3Q after growing 5.3 % in 2Q. In the first three quarters of 2001, GDP was up 5 % y-o-y. The slackening in 3Q came despite a notable acceleration of growth in agriculture and construction (see chart). Growth in industrial output, which accounts for almost 30 % of GDP, decelerated in 3Q. Even more importantly, growth in market services (especially trade), which provide almost 40 % of GDP, slowed significantly. This reflects the risk that growth could be constrained unless the conditions for small and medium-sized firms improve

In October-November, the five-sector indicator showed 5-6 % y-o-y growth as the expansion in construction and retail trade accelerated further. However, the seasonally adjusted calculations of Goskomstat and the economy ministry suggest that growth in industrial output stalled in October-November.

Growth of GDP production components 1Q2000 – 3Q2001, % change from the same quarter of the previous year



Source: Goskomstat

Russia agrees with OPEC on oil production cuts

OPEC members initially decided in November to cut their production by 2 mbd as long as non-OPEC producers cut their production by 0.5 mbd. In early December, all of Russia's major private oil companies and the government made their third offer of a 0.15 mbd cut for 1Q 2002 (2 % of production and 5 % of exports). The oil price subsequently rebounded about one dollar per barrel in late December. One issue in the play was a notable rise of Russian production and exports in recent years. Between 1991 and 1998, Russian oil production fell about 40 % while OPEC's grew 20 %.

Current account surplus shrinks

CBR balance-of-payments data indicate a current account surplus of almost USD 29 billion (€32 billion) in the first three quarters of 2001, which corresponds to about 13 % of GDP (18 % a year earlier). In 3Q 2001, lower export revenues and rising imports reduced the surplus to about 9 % of GDP, compared to 15 % a year earlier. The services deficit increased to nearly USD 8 billion in the first three quarters mainly as spending on travel continued to grow.

Notably, the capital account contained an outflow item of USD 10 billion in 3Q. For an inflow counterpart, the financial account included a USD 11 billion decrease of the federal government's assets (in arrears). Private capital flows showed a shrinking net outflow compared to 2000. As a result, the financial account showed an exceptionally small deficit. Foreign direct investment into Russia rose slightly in the first three quarters. Russian direct investments into other countries increased to USD 2.4 billion.

Russia's balance of payments in 1999-2001, USD billion

	1999	2000	2001 Q1-Q3
Current account	**24.7**	**46.3**	**28.6**
Trade balance	36.1	60.7	40.4
Exports, f.o.b.	75.7	105.6	78.2
Imports, c.i.f.	-39.5	-44.9	-37.9
Services	-4.3	-7.7	-7.8
Exports	9.1	9.7	7.6
Imports	-13.4	-17.4	-15.4
Investment income	-7.7	-6.7	-4.0
Received	3.9	4.8	4.9
Paid	-11.6	-11.5	-8.9
Other items, net	0.6	0.0	0.0
Capital and financial account	**-15.9**	**-21.0**	**-12.8**
Capital Account	-0.3	11.0	-10.3
Received	0.9	11.8	0.3
Paid	-1.2	-0.9	-10.6
Financial account	-15.6	-32.0	-2.5
Direct investment to Russia	3.3	2.7	2.0
Portfolio investment to Russia	-1.2	-9.9	-0.6
Other items, net	-17.7	-24.7	-3.9
Net errors and omissions	**-7.0**	**-9.2**	**-6.2**
Change in reserves	**-1.8**	**-16.0**	**-9.6**

Source: Central Bank of Russia, 29 December 2001

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	8.3	5.0	1-9/01
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	10.8	12.1	5.1	1-11/01
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.7	8.3	1-11/01
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	8.8	11/01
Exports, € billion*	41.2	51.0	57.0	63.3	71.3	78.8	66.9	70.7	114.8	96.1	1-10/01
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	36.9	48.8	47.7	1-10/01
Current account, € billion*			7.1	5.6	9.3	1.9	0.6	23.1	50.3	31.8	1-9/01

*Sources: Goskomstat, CBR. *) Before 1999 values in ECU.*

The 2002 budget passes

Just before the end of 2001, the 2002 budget was approved in its fourth Duma reading. It was swiftly followed by approval in the Federation Council and signed by president Putin. The budget process went as smoothly as a year ago – thus the practice of having the budget passed only after the year concerned has started seems to be past now.

The basic parameters raised before the first reading of the 2002 budget remained in place. The planned surplus of some 1.6 % of GDP derives from revenues of RUB 2,126 billion (19.4 % of GDP) and expenditures of RUB 1,947 billion (17.8 % of GDP). The revenue and surplus plans assume an average oil price of 23.50 dollars per barrel (for Urals crude, or about 25 dollars per barrel for Brent). The 2002 budget plan would distribute the surplus between this year's instalments of state debt (RUB 69 billion) and transfers to the reserve fund (RUB 110 billion, USD 3.5 billion). The reserve fund has been established in anticipation of state debt payments in coming years, but its funds may also be used to cover deficits in certain budget revenues or foreign sources of finance. Finance minister Alexei Kudrin estimates the reserve fund currently exceeds USD 3 billion. Russia will pay some USD 14 billion this year on servicing its foreign debt, with nearly equal amounts going to payments on principal and interest. The ceiling on state foreign borrowing this year is about USD 3 billion.

Foreign debt declines, smoother debt servicing

During the first half of 2001, the Russian federal government's *foreign debt* decreased by USD 5.5 billion to just below USD 138 billion at the beginning of July 2001 and USD 139 billion at the beginning of October. The latter corresponded to 48 % of Russian GDP. *Domestic debt* remained practically the same and stood at slightly less than 7 % of GDP at the beginning of October. The bulk of the decrease in foreign debt came almost solely from paying off loans to Paris Club creditors. A minor part of the decrease was due to paid instalments on IMF loans.

While at the beginning of October the government's foreign debt still equalled about 250 % of estimated federal budget revenue in 2001, higher-than-expected budget revenues in 2001 meant that the government's USD 14 billion in foreign debt service payments consumed about a quarter of budget revenue rather than the 30 % anticipated in early 2001. This year, the foreign debt service payment ratio will stay at 24 to 26 % as long as the oil price remains in the range of 18 to 23 dollars per barrel and other revenue materialises as budgeted. For the sake of comparison, the ratio excludes social tax revenue that will be channelled via the federal budget in 2002. In addition, the foreign debt service peak looming in 2003 (some USD 18-19 billion) may ultimately be less steep. Market observers report that Russia has bought back some of its MinFin bonds maturing in 2003. The total sum of MinFin bonds due in 2003 is around USD 3.5 billion. The buy-backs are estimated to be in the range of USD 1 – 1.5 billion.

Structure of federal government debt, 1 July 2001

	USD bln	RUB bln
Foreign debt	**137.8**	
of which		
Loans	***84.4***	
of which		
Paris Club	42.9	
To non-Paris-Club countries	19.6	
Commercial debt	6.5	
IMF	8.1	
World Bank	7.1	
EBRD	0.2	
Bonds	***47.0***	
of which		
Eurobonds	36.2	
MinFin debt to CBR	***6.4***	
Domestic debt	**19.5**	**566.2**
of which		
Bonds		***565.6***
Other		***0.6***
TOTAL	**157.3**	

Source: MinFin. The exchange rate used is 29.11 roubles/dollar.

Putin calls for tax cuts to SMEs

The fact that small and medium-sized enterprises account for only about 10 % of Russian GDP has recently aroused considerable discussion. The minor importance of this sector reflects sour attitudes towards SMEs at the state level. The problems range from burdensome registration and licensing practices to a poorly developed system of state supports. To ameliorate the situation, president Putin wants lower and simpler taxes for SMEs. There are also plans afoot to add a special SME section to the tax code.

The recent amendments to the sales tax were also made in response to appeals from small entrepreneurs. Individual entrepreneurs, in particular, were hard hit by vagaries in sales tax collection procedures. Although the maximum 5 % sales tax is to be abolished from the beginning of 2004, the Duma made the requested amendments to the tax code.

Fiscal indicators (per cent of GDP, unless otherwise indicated ; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2001	2002
Federal government							Jan-Oct	budget	budget
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	16.8	15.4	19.4 (3
- expenditures (1	18.6	20.9	19.4	16.9	13.9	13.5	13.7	15.4	17.8 (3
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	3.1	0.0	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	57.6	47.8 (1		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	139.0 (2		

1) of the Oct 00-Sep 01 GDP of RUB 8549 bln, 2) 1 October 2001, 3) including social tax channelled via the federal budget (2.6 % of GDP)

Sources: budget figures: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001), debt: IMF (1995-1999), Minfin (2000-2001)

Stubborn inflation

Consumer price inflation stalled in late summer then rose at 1.4 % per month during the fourth quarter of 2001. While that rise was slower than in 4Q 2000, a pick-up in consumer prices in 1H 2001 kept inflation quite high for 2001 overall. Inflation was up 18.6 % y-o-y in December, compared to 20 % a year earlier. The original 2001 inflation target of the government and CBR was in the range of 12 to 14 %.

Inflation trends were mixed for the year. Non-regulated prices generally increased less in 2001 than in 2000. Inflation for non-food consumer goods decelerated from over 18 % y-o-y in 2000 to less than 13 %. Food prices still rose slightly over 17 % (18 % in 2000). The consumer basket used to measure inflation is heavily weighted with goods that have non-regulated prices. The economy ministry calculates that in January-November food prices contributed a half of consumer price inflation and non-food goods over a fifth (in both cases somewhat less than in 2000). It appears the rise of non-food items was moderated in 2001 by a considerable deceleration of industrial producer price inflation (11.5 % y-o-y in November against more than 30 % a year earlier). On the other hand, food prices for consumers were propped up by brisk increases in agricultural producer prices (19 % y-o-y in November against 22 % a year earlier). Money supply (rouble M2) growth, albeit down from 60 % in 2000, was still nearly 40 % y-o-y in November as there were few means to prevent a feed-through from the large current account surplus. Money supply growth notably included a rapid increase of rouble cash (over 45 %). Wages also rose rapidly, and were up over 45 % y-o-y in November.

Prices for services rose 37 % in 2001 compared to 34 % in 2000. This was due to brisk increases in prices for regulated services, especially housing-related services (up 57 % y-o-y) and passenger transport (up some 27 %). During January-November, rising prices for services contributed about 30 % of consumer price inflation. Almost 20 % came from regulated prices for housing services. Inflation in the prices of services eased towards the end of 2001 as important regulated prices (gas, electricity and railroads) were frozen at the federal level throughout the autumn, after hiking the prices earlier in pursuit of reforming the sectoral utilities and enterprises. Similar measures also occurred at regional and local levels.

The government and the CBR aim this year at reducing consumer price inflation to the range of 10 to 14 %. As pressure to raise regulated prices has been partly carried over to this year, federal authorities have raised the possibility that forthcoming tariff hikes would drive the inflation rate to around 15 %.

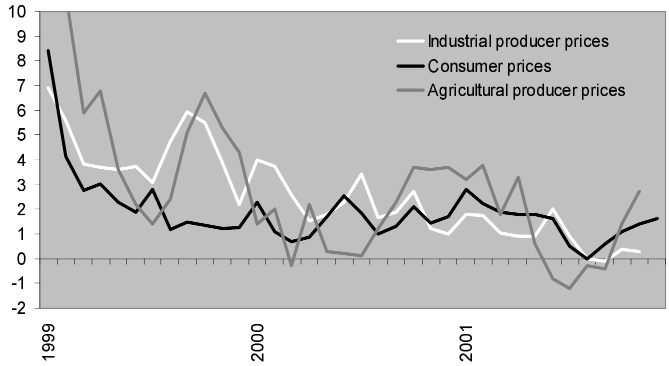
Rouble's depreciation accelerates slightly

Russia's exchange rate policy was more stringent in 2001 than assumed in the 2001 federal budget that foresaw the rouble exchange rate would *average* 30 roubles to the dollar in 2001. As indicated by the CBR in early 2001, the rouble *ended* the year at around 30 roubles to the dollar. This helped in countering higher inflation as imports of goods and services amount to almost a quarter of Russian GDP. The rouble weakened about 7 % against the dollar and the euro during the year. Its decline, managed through CBR market interventions, was remarkably slow throughout the summer and early autumn.

In November and December, the rouble's drop accelerated (to about 1 % per month against the dollar), falling after reported two-week interventions by the CBR to hold the rouble below the 30-rouble line. Part of the downward pressure on the rouble came from uncertainty over the oil price. Indications of slower growth in Russia and growing imports may also have affected.

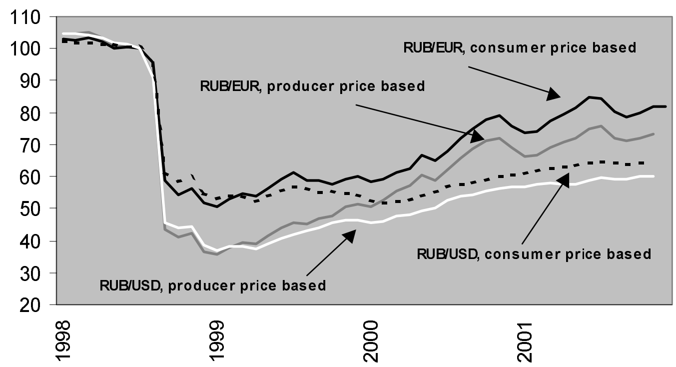
The rouble's real exchange rate rose some 6-7 % against the euro and the dollar in 2001. The second half of 2001 saw no strengthening of the real rate. In November-December, the real rate stood at 60-65 % of its pre-1998 crisis level against the dollar and 70-80 % against the euro.

Consumer prices and producer prices 2000-01, % change from the previous month



Source: Goskomstat

Rouble real exchange rate against the euro and the US dollar (until December 2001), July 1998 = 100



Sources: Central Bank of Russia, BOFIT

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	38.9	11/01
Average wage, RUB, end of period	736	1017	1210	1463	2272	3135	3655	11/01
Interest rates, period average								
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	5.5	10/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	17.4	10/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	

Sources: Goskomstat, CBR

Transforming fiscal relations between regions and the centre

By Merja Tekoniemi*

Recent fiscal news from Russia has been filled with positive stories. The federal budget has been in surplus since 2000, and Russia is well positioned to pay down state debt. It is even creating a reserve fund to support debt payments in the future. The large surpluses, however, tend to overshadow the slow progress of fiscal reform – in particular, in the fiscal relations between the centre and regions. The inter-budgetary reform programs of recent years, however, offer hope for progress in a sphere where regional and local budget revenues and expenditure account for 13-15 % of GDP.

The legacy of 1990s

The confused state of centre-regional relations in the 1990s resulted in a costly, inefficient and unfair system of bilateral agreements. This legacy reflected a compromise between letting go and possibly allowing Russia to fall apart, and trying to bring strict order to a country where its parts were forcefully seeking greater independence. President Yeltsin sought to preserve the country united while giving "regions as much autonomy as they can swallow."

During the past couple of years, president Putin's acts have aimed at re-establishing the dominance of the federal state. Even so, the practices of 1990s are still very much reality. The regions are overloaded with "unfunded federal mandates" – costly tasks delegated to them by federal laws. The most important federal mandates concern the implementation of the veterans' law and the law on child allowances. How well these laws are followed depends very much on the region and its particular financial situation. Over 80 % of tax revenues of Russian regions come from taxes divided between the centre and regions. The split on the tax take tends to vary each year. Fiscal relations between the centre and regions also continue to lack transparency and remain based on informal channels of financing and individual agreements. This is an important fact, though the magnitude of the arrangements is hard to assess.

Achievements of the past two years

The first serious reform program in the sphere of fiscal federalism was approved in summer 1998. Many of the 1999-2001 program's goals were never reached, although promising results followed the adoption of the program. For example, the principles for distributing financial resources from the federal budgetary fund for financial support – the main formal channel for levelling financial inequities among regions – were amended to encourage regions to pursue more rational and responsible budgetary policies. A budgetary compensation fund was created to finance some of the federal mandates that regions were incapable of handling. Currently budgetary transfers form about 17 % of the consolidated regional and local budget revenues. There have also been attempts at improving budgetary planning and legislation and to introduce uniform rules for fiscal relations between the centre and regions instead of individual agreements. The decision made in the 2001 federal budget to direct 100 % of VAT revenues to the federal budget and 99 % of personal income tax revenues to regional budgets is a step towards separating federal and regional taxes.

Latest plans await implementation

A reform program for 2002-2005 concerning inter-budgetary relations has been approved in August 2001. The program seems to acknowledge Russia's most pressing fiscal federalist problems. It seeks to increase the freedom of regional authorities to conduct independent budgetary policies in a framework of clearly defined budgetary responsibilities and obligations.

The program lists concrete goals in both revenue and expenditure policies. As the revenue base is still insufficient for regions to cope with all their responsibilities, there is a tendency to fix certain taxes for certain budgetary levels for a longer-term basis. This should clarify the present situation and help budgetary planning. The division of taxes between centre and regions envisaged to materialise by 2005 does not essentially differ from the one prevailing in 2001, however. VAT and customs duties would continue to go solely to the federal budget, and excises would continue to be split as at present. The profit tax would also be divided as in 2001, with 31 % of revenues going to federal coffers and the rest to regional budgets. As now, the most important tax revenue stream conceded entirely to the regions would be personal income tax. In combination with profit tax revenues, they accounted for over 40 % of all regional revenues during January-November 2001.

On the expenditure side, the program follows similar lines. The autonomy of regional budgets is increased, while joint expenditures with the centre are reduced and federal mandates decreased and eventually eliminated. Perhaps the most important single change is housing reform, which will reduce a huge financial burden on regional budgets. On the other hand, social expenditures should increase.

If the basic framework of the new program is implemented, it would be an important contribution to structural reform in Russia. It would also have important repercussions on regional economic policies and hopefully lead to intensification of regional economic growth via clearer budgetary rules and policies.

**The author is an economist at BOFIT.*

RUSSIAN ECONOMY
The Month in Review
9 January 2002

ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 • FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Vesa Korhonen