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Investment needs of the St.Petersburg
Economy and the Possibilities
to meeting them

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Investment needs of the St.Petersburg Economy and the Possibilities to meeting them

This paper addresses problems relating to the investment process in a region suffering a production slump.

Traditionally the investment needs of a city economy were reflected in municipal plans and programmes. Thus, a retrospective study of certain documents can be instrumental in highlighting the evolution of the idea of what functions city bodies should carry out and what role the state should play in the economy. By analyzing investment project lists one can also get a picture of specific features and vital areas for investment, and compare those with actual investment activity in the region, including investment volumes and breakdown by industry and sector.

Apart from external investment flows, the paper considers the possibility of mobilizing the savings of the local population for investment in the St.Petersburg economy.

1 Investment Process: Factors and Trends

Russian economic reforms are accompanied by a deep transformation-related general downturn in production which is generally believed to have passed the halfway mark. However on a region-by-region basis, the recession is characterized by considerable variations in both scale and causal factors. The most important of the latter is the particular regions' areas of which industrial specialization stem from the peculiarities of its stock of natural and raw materials, as well as from its former methods of production planning.

The productivity of equipment has fallen below 50 per cent at 40 per cent of enterprises, which casts doubt on the prospects for economic growth once financial stabilization is achieved. A chronic shortage of investment, which is typical of economies using inefficient technologies, has reached crisis proportions; the combination of runaway inflation and slumping production have magnified the risks attached to investment.

This crisis stems from the Soviet period when, in the latter half of 1980s, the efficiency of capital investment fell steadily as a result of a complete lack of responsibility as regards financial dealings. By 1987, not only was it impossible to expand capacity but even replacement investment dried up.

Liberalization of economic relations led to a new phase in the investment crisis, characterized by irreparable physical deterioration of the means of production.

Degradation of production capacity in turn exacerbates to the ongoing recession.

Nevertheless, the investment process did not come to a standstill, but with the numerous changes that have taken place, it has become difficult to analyse investment on the basis of official data.

In analyzing investment, one is faced with difficulties with respect to terminology and statistics. Formerly, Soviet and Russian statistics used the term "kapitalnyje vlozhenija" (capital investments) meaning expenditures for the reproduction and improvement of fixed assets. Capital investments are distinguished by their:

- purpose (production or non-production);
- direction (new construction, reconstruction or technical re-equipment, and repairs);
- type (purchasing equipment, assembly works, design and survey, construction); - method of implementation (contracted or non-contracted);
- source of financing.

For statistical purposes, the following sources of financing for capital construction are recognized:

- federal or regional budgets;
- enterprises' internal funds;
- borrowed funds;
- funds mobilized from the population.

At the same time, in modern texts one can often meet the term "investments" which has a broader meaning, ie it includes both direct investment and portfolio

investment. However, the statistics generally continue to account for only the direct financing of the economy; as to the scale of portfolio investments, one must rely on experts' assessments.

In the meantime, apart from the emergence of new (in the Russian economy) portfolio investments, direct capital investments have also undergone notable changes regarding not only volume, but also their structure, source, form of ownership, and direction by industry and sector. Thus the breakdown of capital investments by source for 1994 reflects an increased share of nonbudget sources, with the shares from federal and local budgets falling to 13.6 and 10.5 per cent respectively, as compared with 17.5 and 15.1 per cent in 1993 (Socialno-economicheskoye polozheniye Rossii 1994, pp.42-43).

It should be noted that the trend towards decentralization of the investment process began when enterprises were granted the right to carry out capital construction at their own expense and divestitures of state property provided incentive to enterprises to solve their own building reconstruction and equipment replacement problems. Thus in 1994, investment in non-state sector enterprises and organizations grew to 66 per cent from 47 per cent in 1993.

At the same time, the state fiscal crisis caused a decline in budget expenditures, and above all expenditure on productive investment. On the other hand, inflation, slack demand for enterprises' products, contraction in the output of traditional products and an increase in spare capacity combined to reduce the volume of investment from the internal funds of enterprises. As a result, in 1992 productive investment fell by 44 per cent from the previous year and in 1993 by 23 per cent. By the end of 1993 the scale of productive investment had dropped by 65 per cent as compared with 1990. The share of investment in the national income amounted to 15 per cent.

Beginning in 1991 there has been fairly constant growth in the share of capital investment in non-production facilities: it increased from 31 per cent in 1991 to 44 per cent in 1994. Of the total volume of productive investment, the largest share is in the fuel industry and power generation (37.4 per cent), and transport (15 per cent).

A peculiarity of the investment situation is a shift in the technological structure of investment demand: the volume of expenditure on equipment is shrinking, whereas that of construction expenditures is expanding.

The dynamics of capital investments can be seen from the following table.

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	1993 as % of 1992	1994 as % of 1993
Capital investments including by different types of facilities:	88	74
Production facilities	81	65
Non-production facilities	101	86

half of 1994, for the first time the share of saving in personal income showed an increase to 19 per cent, and households' investments in housing construction increased to 35 per cent. Thus, the multi-faceted changes in the structure and methods of investments, though difficult to analyse, do provide an opportunity for the formation of an investment mechanism. The most questionable aspect appears to concern state participation in the investment process, the state being, on the one hand, the prime mover of in the restructuring of the old system of capital investments and, on the other hand, a major investor itself.

Along with the general recession related to the ongoing market transformation, investment activity was determined by the government's fiscal and credit policy. With the tightening, consumer and investment demand would decrease, and interenterprise arrears would grow. As a result, another paper money issue would follow, pushing inflation still higher. It is generally known that sound investment activity and economic growth are impossible in the absence of financial stabilization, but this fact does not abrogate the need to provide incentive for enterprise and to encourage investment.

State regulation and support of investment is provided in accordance with the law on investment activity as follows:

- direct management of state investments;
- a tax system with differentiated tax rates and benefits;
- financial assistance in the form of subsidies, grants, budget loans and low-interest credits;
- financial and credit policy, price formation, securities issues, and amortization policy.

During 1994, the RF Government's Resolution On the Procedure of Allocating Centralized Investment Resources on a Competitive Basis (no. 744, 22.06.94), and the RF President's Decrees On Private Investments in the Russian Federation (no. 1928, 17.10.94), and On the Development of Financial Leasing in Investment Activity (no. 1929, 17.10.94) were adopted. These signified the first step towards limiting non-repayable budget financing and introducing repayable loans. New measures also extend the practice of joint state and commercial funding of investment projects irrespective of the industry or form of ownership. An incentive for productive investment will be provided by the state's 20 per cent participation in state-supported investment projects. Apart from that, the 1994-95 state investment programme foresees a regular (annual) fixed capital reassessment with a quarterly adjustment of an enterprise's amortization funds in accordance with actual investment resource price indices (*Ekonomika i Zhizn* 1994, p.11).

However, though the interests of the state are objectively focused on boosting investment activity, the interests of many managers do not reach farther than current consumption growth or, at best, renewal of the enterprise's working capital. As a result, not only are current profits spent on current consumption and working capital replenishment but, in many cases, amortization reserves as well (*Rossijskaja ekonomika v pervom polugodii 1994 goda. Tendencii i perspektivy*, Moscow 1994, p.103).

In 1994 the Russian economy followed to some extent a depression scenario which, had it been realized in toto, could have created a basis for macroeconomic stabilization and economic growth. During the year, inflation declined from 17.9 per cent in January to 3.2 per cent in August, with the discount rate decreasing correspondingly from 210 to 130 per cent. Unfortunately, the antiinflation trend

that emerged at the end of 1993 was reversed by the massive loan issue by the Central Bank: in July and August credits amounted to 14.3 per cent of the GDP compared to 7.8 per cent in the last quarter of 1993. In October 1994 the inflation rate began to climb again, and in December it exploded to 16.4 per cent.

Declining inflation rates had contributed to an accumulation of financial resources in the banking sector. However, the cost of loan financing still remained too high, thus dampening investment (*Ekonomika i zhizn*, no. 49, 1994).

International investment flows into the Russian economy are constrained by a number of political, economic and legal factors, and the investment environment (including the risk level), remains generally unfavourable. Russia's lack of attractiveness to investors is confirmed by its position in the world investment ratings (based on the main investment attractiveness indices), where it stands just above Iraq.

According to the State Statistics Committee, in 1994 international investors placed USD 1.37 billion in Russia (this figure includes the Central Bank's data on investments in commercial banks). Of this amount, only USD 1.03 (75 per cent) billion was in the form of direct investment. Portfolio investments amounted to USD 178 million (13 per cent), and loans to USD 164 million (12 per cent). About half of all investments (48.2 per cent) went into the Archangel Region, with 85 per cent of these going to the fuel industry. Moscow received 16 per cent of all investments, and Tyumen District, 3.1 per cent (*Finansovye izvestija*, no. 1, 12.01.1995).

Apart from this, there were rouble revenue reinvestments by enterprises with international participation in retail trade and public catering (17.4 per cent), the food industry (15.9 per cent) and finance (13.3 per cent). Less than half of all rouble revenues (43 per cent) was invested in enterprises in Moscow and the Moscow Region (*Ekonomika Rossii* in 1994, Moscow 1994, pp.52–53).

Thus the current business environment in Russia, in the face of the ongoing economic reform, is characterized by high risk levels stemming from the general system ie crisis.

Although, the investment climate is generally unfavourable, the negative factors (controversial economic trends, inconsistencies in reform implementation and the production slump) manifest themselves very differently in different regions of the country. And it is at this particular stage that the Russian regions, including St.Petersburg, have their chance to find a new role in the country's economy.

From the onset of market reform, St.Petersburg has been regarded as one of the leading regions, whose high research and technological potential should ensure investment flows sufficient for development. Both the city bodies and numerous foreign representatives have repeated time and time again how attractive St.Petersburg was as an outlet for investment. The reality proved to be somewhat different. Up to 1991, 95 per cent of all investment in capital construction came centrally through the ministries and from the city budget, with non-centralized investment, ie out of enterprises' internal funds and personal savings, remaining around 5 per cent. Beginning in 1991 there have been both quantitative and qualitative changes taking place in this area, with centralized capital investments falling to 65 per cent in 1992 and to 55 per cent in 1993.

In 1993 as compared with 1991, the manufacturing output of St.Petersburg declined to 67 per cent, and the amount of capital investment to 58 per cent. According to the quarterly statistics of Goscomstat, St.Petersburg, although having

entered the top ten Russian regions in terms of level of international investment, remains far from the upper end of the list. Thus in the first quarter of 1994 outside investment in flows into St.Petersburg amounted to USD 3.1 million against USD 42 million in to Moscow; in the third quarter these figures were USD 4 and USD 28.9 million respectively, with the Archangel Region having attracted USD 330 million during the same period.

Thus one can infer that the immense economic potential of the city has not yet been realized, nor has it been integrated into the process of ongoing reform. Furthermore, the city's defense sector and research and technological sector, as well as its cultural life, have been hit hard by the sharp downturn in investment and federal funding of a number of programmes. Construction is still in a crisis, and the municipal economy is still in a state of decay: up to 40 per cent of heat and water supply pipes are in need of replacement, almost half of the primary bridges and embankments need repair, and 15 million square metres of the city's housing stock need capital reconstruction. However, during the years of reform, capital investment shrank threefold, and the local budget is insufficient to cope with the burden of both maintaining and developing the municipal economy. The only solution to these problems is to create an enterprise-friendly environment in St.Petersburg which will attract the investments that the city needs so urgently. At present, the municipal bodies see the solution in attracting international investors to take part in city reconstruction projects, but taking into account the country's macroeconomic policy and the legislative trends in the regulation of foreign investment, one can hardly expect a rise in international investment in the near future.

2 Investment Needs of the Region

In order to determine the investment outlook for the region we should first consider the city's economic needs and the methods used in identifying those needs and attracting the requisite investment.

Formerly, the need to draft development plans was determined by both the very nature of the command system and the economic complexity of the city. Further having a plan gave the city the opportunity to obtain additional funding from the centre. Thus different periods of the Soviet era saw grand target programmes and concepts, such as the programme "Housing 2000", which signified town planning for Leningrad, or the programme "Intensification 90". All of these remained unrealized not only because of a lack of financing and the inability to use efficiently such funds as there were at the city's disposal, but also because of the deficient methods used in developing such plans. In the present period of transition the necessity to shape an investment strategy for St.Petersburg stems from both the pressing problem of insufficient resources for its sound functioning and development, and the changes taking place in the methods of economic management. However, currently this process will face two types of difficulties: new problems arising from the economic transition and old problems carried over from the previous regime when such strategies were executed by one group of researchers or bureaucrats supported by powerful bodies. Given the present situation with its frequent legislative power transformations, bitter feuds over economic influence, free interpretation of laws and decrees and constant reshuffling of interests in the state leadership, realizing such a programme and winning public support for it is extremely difficult. In this situation the inevitably narrow base for developing strategic documents excludes the possibility of organizing public discussion, or harmonizing the interests and expertise of different groups within the population. This also renders it impossible to solve the methodological problems, that is, the harmonization of sectoral and institutional approaches to the design of specific development programmes.

Long-range planning for the city economy requires that the aims and priorities for the city's development as well as the methods available for their implementation be known to both city bodies that make the decisions and to economic agents and outside investors who will have to abide by those decisions. Therefore, medium- and long-term forecasts, strategies, and programmes for socio-economic development are of vital importance. They should embrace the development priorities in the form of target programmes and set out needed changes in city-wide socio-economic policies. It would seem that such planning strategic must begin with a review of the current situation and a determination of the instruments needed to attack the problems involved. Also needed are a description of the parameters for the desired state of the city's economy and social structure as well as a set of measures that will achieve the desired development. The formulation of qualitative parameters must be accompanied by quantitative assessments of requirements and available resources as well as their interrelations and current limitations.

The first attempt of this kind was probably the drafting in 1991 of two sets of documents: A Concept of the Leningrad Zone of Free Enterprise, and A

Feasibility and Socio-Economic Study of the Leningrad Zone of Free Enterprise (with a subsequent unified Draft Regulation on a Zone of Free Enterprise).

The emergence of these documents was motivated by break-away tendencies in the country which had manifested themselves in various regions' drive for economic independence. The most important result was an analysis of the city's economic situation and a forecast of its socio-economic development, depending on the choice of one of the three suggested scenarios, which differed according to degree of integration into the international market. The developers, proceeding from an analysis of the structure of the city economy and the region's geopolitical situation, preferred the scenario that entailed the development of the export potential of the region. The feature that distinguished their work from that done previously was that they organized wide-scale discussion in various circles which included the participation of international experts and provided for the approval of some of its aspects by central bodies.

However, the concept of a Leningrad Free Enterprise Zone (LZSP), which had emerged to some extent in the wake of the idea of regional cost accounting and the "500 Days" Programme, did not have any real legislative footing and was based solely on a conglomerate of approvals and the outcome of a political struggle with the centre over a tax benefit for Leningrad.

Virtually at the same time, the Leningrad Executive Committee (in the face of the worsening crisis in the Soviet economy) developed an Anti-Crisis Programme which described concrete measures and bases for the development of the region. In 1991, a strategy for development of the region was worked out by teams of French and Finnish researchers. The search for a new role for St.Petersburg was behind the latest stage of the development of the LZSP concept: A Business Plan for the Zone of Free Enterprise, drawn up by the Leontief Centre, Coopers & Lybrand and Scottish Enterprises. This plan, for the first time, comprised a forecast of specific aspects of the restructuring of the region's economy (its transformation into a financial, transport and manufacturing centre); it also renounced, as a matter of principle, all public discussion of strategic development issues (this was the policy of the first post-communist government of Russia). However, realization of almost any local strategic plan depended entirely on central government decisions, which reduced the whole issue to lengthy negotiations and approvals, whose urgency was later dissolved by political changes in the country.

Thus the most valuable results of all the pre-reform city development plans and concepts were:

- the collection and analysis of information on actual economic conditions;
- the introduction of a methodological approach to strategy development.

However, the city bodies' direct participation in the socio-economic management of the city served as a clear indication of the state's inflated role in economic management. It was the first step towards a change in the idea of what functions city bodies' should carry out, though the real change was to come later in the wake of radical socio-economic transformations.

After price control was lifted, hyperinflation made the socio-economic situation in the region even less predictable. The factors having contradictory impacts on the economy multiplied. Correspondingly, the danger of possible tactical or strategic miscalculations increased significantly. On the other hand, a

need transpired for analytical review and forecasts that would take into account both new positive trends and persisting old problems.

Critical to the current economic crisis of St.Petersburg became the fact that federal bodies stopped financing the local budget. Other important factors were large federal construction and other projects, as well as the social problems of the region. These developments, normal in the context of national economic stabilization, will in the long run provide considerable advantages for the independent development of the region, but at present their immediate result is uncertainty and new problems.

For example, the municipal economy, is still financed from the city budget, despite the fact that city funds are incapable of covering either municipal housing construction or the necessary maintenance and reconstruction of the decrepit housing stock. Among the long-standing problems are those of the poor water - supply networks, purification facilities, transport, roads, and electric power supply to central districts. The maintenance of a mass of low-quality housing is a challenge to the city municipal economy in a situation where the overwhelming majority of city-dwellers cannot afford to pay market prices for heating or public utilities.

At the same time, the city management structure has been only slightly touched by market reforms, and the following market elements are virtually non-existent:

- a system of property registration and land survey;
- property taxation based on current market price;
- assessment and reassessment of real property market values;
- supervision over and commercial use of municipal property.

All these form a serious obstacle to increasing the role of land and property tax revenues in the local budget. On the other hand, the economic recession reduces the traditional tax base: incomes of enterprises and individuals. As a result of drastic cuts in funding for defense and the defense-related technological complex, the problem of hidden unemployment and a deteriorating standard of living has emerged.

It should be noted that there would be a wide choice of methods for adapting and regulating the ongoing socio-economic transformation, and these depend on the twists and turns in the political struggle. But in any case their application must be based on data analyses and development forecasts for the region.

In 1993–1994 the Leontief Centre undertook wide-scale economic research on the region and developed a programme for the socio-economic development of St.Petersburg to the year 2000. At the same time the Committee on Economic Reform, in cooperation with the Leontief Centre, designed a programme for the socio-economic development of the city entitled "St.Petersburg-2000". An additional incentive for creating the programme was the city administration's desire to demonstrate their ability to control the situation and manage the development of the city at a time of struggle between federal and local powers.

In the course of drafting the programme, five alternative development schemes for St.Petersburg (taking into account the pace at which economic reforms could take place) were analysed. In the end, preference was given to a proposal for active regulation of the region's economy. The programme was based on a forecast that the current downward trend would continue until 1996, when a gradual recovery (2.5 or 3 per cent p.a.) would take place that would by the year

2000 boost aggregate output and consumption to their pre-crisis levels, but on a new economic foundation.

The activization of local bodies, as formulated in the programme, foresaw a fourfold increase in investment by the year 2000, with 75 per cent being financed by enterprises' internal or borrowed funds, 10 per cent by budget subsidies and foreign investment, and 5 per cent by regional funds and loans. The programme comprised complex plans for the socio-economic development of city districts, and plans for individual municipal industries and sectors. Directions for realization of the programme were specified in the form of individual projects. Some of these 150 projects (e.g. the Goodwill Games) have been already implemented, but the fate of the majority remains uncertain.

The programme transformed the idea of a free enterprise zone into a system of local economic subzones with different functions: customs, warehousing, production, services, and research and technology. According to the forecast, of the 13 projected subzones only the customs and the customs and warehousing subzones will be developed during the first stage, and later the priority will shift to research and technology, and production. The financing of customs zones and subzones should be provided from federal budget sources, domestic and international target loans and investments and securities issues. The volume of investments necessary to implement the customs zones project alone is estimated at USD 4 billion. However, the sum would seem to be a rather rough and poorly substantiated estimate, considering its regard for funding sources. To obtain the amount needed from the federal budget and privatization proceeds etc. is hardly possible.

In drafting the aforementioned city policies, it was considered that the current transitional situation characterizes not only the economy but the management system as well; therefore the city administration was assigned both organizational and managerial functions, including supervision of the municipal economy, strategy development and creation of the necessary conditions for the emerging market environment.

The top priority industries in the programme were manufacturing, transport, telecommunications and information technology, culture, science and education, tourism, and finance. The primary methods of influencing the city economy were to be fiscal benefits, soft long-term loans, non-budget support funds, budget subsidies to priority programmes, and municipal decree. There was to be a shift in the essence of social policies: support to socially vulnerable groups was to be replaced by a provision for the co-existence of different social sectors.

Research findings at the Leontief Centre in connecting with the St.Petersburg 2000 Programme reflect a further evolution of the idea that interference by city bodies in the city economy should be strictly limited to property owned or directly supervised by such bodies. The Leontief Centre is apparently the first to offer a set of purposeful measures for easing the city administration out of the management of the city economy by introducing general business principles that would be obligatory for all economic agents, including the mayoralty. This approach acquires a special importance in a situation where the loudly declared policy of supporting market development in the region in fact not only does nothing to prevent city authorities from intervening in business but leads to the imposition of an administrative rent. The Centre's programme for the socio-economic development of the city consists of two parts: the concept and a set of target projects. The

concept bears traces of a type of inertia (continuity or inheritance) including former city development priorities and administrative goals.

As already mentioned, the essence of all these documents, pompously called a "programme", "strategy", or "concept", is in reality just a collection of data and analysis on the key social and economic characteristics of the city. They do not constitute a practical overall development concept, nor do they present individual priority development plans supported by specific projects and clearly defined management procedures. The reason, we believe, is that to design a precise long-term forecast in a situation of such extreme political and economic uncertainty both in the country as a whole and in the region is basically impossible. Furthermore, we maintain that the approach itself, based on forecasting by selecting a middle-ground development scenario and using it as a basis for calculating quantitative economic and living-standard parameters, is hardly sound. The method as such, is perhaps admissible but only when it is based on accurate and well organized data. One way to make the method more useful would be, to change the structure and content of the economic performance indices used in the underlying analysis.

Obtaining federal budget financing for ongoing federal programmes in St.Petersburg continues to be high on the city's agenda. According to A. Fedchenko, head of the Investment Policy Department at the RF Ministry of Economy, when the federal budget was drafted there was a real effort to continue state subsidies for the construction of housing and metro lines in major Russian cities, including St.Petersburg. Financing is urgently needed for maintenance and repair of a number of research, healthcare and cultural facilities, including St.Petersburg State University, the Hermitage, and the Academy of Sciences. St.Petersburg's application to the RF Ministry of Economy contains a request to finance 16 federal target programmes amounting of to RUR 3 622 980.2 million, and USD 20 million.

One way to study the investment requirements of a region is to analyse the so-called initiative projects. It should be noted that in 1994 the supply of investment projects far exceeded the demand. Investment projects generally reach the market in the following ways:

- by direct offers during negotiations;
- by offers from mediator companies;
- through investment project catalogues and data bases.

The latter is presently the most reliable source of information because the character of a direct offer is difficult to assess before the realization stage. As regards mediator companies, their data bases are usually closed.

Therefore this paper offers a review of recent investment project catalogues published in the city, normally prepared especially for international events. Almost half of the 74 projects and 8 investment programmes in the catalogue prepared for the EBRD Council Board deal with transport and telecommunications. The second largest group consists of production development projects. The payback period for the majority of the projects is one to three years. The amount of investment needed for half of the projects is from USD 10 million to USD 160 million each. Only 56 projects are supported by the necessary documentation. The purposes for obtaining investment funds are set-up of joint production, purchase and assembly of equipment or construction. The investment programme "A Ring Motorway around St.Petersburg" requires USD 410 million, the programme "Reconstruction

of the Sea Port", USD 180.3 million. The amount of realized investment in one of the 10 projects in the latter programme (construction of a container terminal) was USD 11.6 million. The "Golden Gate" project stands a good chance of attracting financing from different sources. The economic feasibility of a number of large-scale town planning projects ("New Holland"; "Peter the Great Tower", "Vasillievsky Island Agency") is unclear, not only to potential investors but to the population as well.

As distinct from these projects, the catalogue prepared for the international conference, Small Business in Russia, took into account the interests of potential international investors. Virtually all the 45 projects have been initiated by the private sector, with 62 per cent involving offers to establish joint production or purchase new equipment. About one-half required investments of under USD 1 million, and the payback period for over 55 per cent of the projects was one to three years. However, only half of the projects included business plans.

A catalogue of 110 investment projects presented at the international conference "East - West: Investments, Conversion, and Russian High Technologies" was surveyed by UNIDO experts, with 45 MIC enterprise projects receiving good marks. The most important of them were: the development of geo-information systems for the municipal economy, the production of polyurethane rubber coating, and the processing of thermoplastic wastes.

The catalogue prepared for 1994 by the Regional Development Fund contains 15 projects amounting to USD 90 million. The average cost per project is USD 5 million, and the average payback period three years. Over a half of the projects deal with the organization of new production.

Investment activity in the city was significantly augmented (from the point of view of both quality and quantity) by a block of 40 projects prepared for an international exhibition in Vienna (February 1995). These projects are characterized by precise and detailed information. Twenty-three involve the use of enterprises' internal funds, although the share of such financing is, generally smaller than that of external financing. Twenty-nine projects are based on R & D and are supported by patents and certificates.

A number of specialized organizations in St.Petersburg deal in investment project development and marketing, among which are the Regional Development Fund, the Research and Technical Development Fund, and the St.Petersburg division of the Interprivatization Fund. However, enterprises prefer to recruit investors on their own.

One of the weak points of investment projects in the St.Petersburg market is their lack of high quality business plans and precise project calculations. Or, sometimes they are overloaded with detailed technical descriptions, which shows that the authors were more interested in extolling their own production capacities or the public importance of their products than in the actual economic feasibility of the projects. Both extremes are especially harmful for those projects where the main investor is a municipal body as, for example, in the case of a high-speed railway between St.Petersburg and Moscow, a tunnel under the Gulf of Finland, or the megalopolis between Moscow and St.Petersburg. Such plans are obviously designed with a view to obtaining federal financing, but their authors must not forget to make them feasible for outside investors. Otherwise, if the flow of federal funds some for reason dries up, city authorities will be condemned to maintain unsound incomplete projects while trying to attract outsider interest in them.

An analysis of the city's investment climate shows the following regularities:

1. Investment projects mainly reflect enterprises' production capacities and R&D potential.
2. There is an evident lack of investment projects in services, tourism, and agricultural production.
3. The main aim in attracting investments is the creation of new, and renovation of old, production facilities.
4. The average payback period for investment projects is one to three years, with a profitability rate of 15 to 30 per cent.
5. Investment projects exist in the form of offers with various levels of execution.
6. Dissemination of information about investment projects and their development is mainly carried out through public means, without the active participation of consulting or other specialized companies.

3 Some Results of International Investment Flows in the Economy of the Region

The breakdown of international investments in St.Petersburg by scale and industry is an indirect indicator of investment demand.

As mentioned above, in such an unstable economic environment international capital focuses on the most profitable sectors, which according to the State Statistics Committee are the fuel industry, retail trade and public catering, construction, and services. To compare: in the first nine months of 1994 the fuel industry attracted USD 483.1 million against USD 24.6 million for mechanical engineering and metal working and USD 23.5 million for science and science-related services.

The total amount of international investment is rather low: less than three per cent of total investment in the region. Enterprises with international participation account for 3.1 per cent of Russia's GDP and for 14.3 per cent of the country's exports (*Ekonomika i Zhizn* 1994, no. 4, p.22).

One should also remember that actual investment may be significantly lower than the amount officially declared and stated in contracts. Thus in St.Petersburg, of the over 8 000 registered enterprises with foreign participation, only about 1 500 are known to be operating. According to the St.Petersburg Statistics Committee, in the first nine months of 1994 their exports of goods and services amounted to USD 164 million; imports to USD 175.3 million; and the volume of domestic sales to RUR 70.7 billion (USD 80.6 million). About 90 per cent of all international investment was accounted for by enterprises in mechanical engineering and metal works, retail trade and public catering, transport, telecommunications, construction, and science and science-related services. The total volume of foreign investment in 1994 was USD 10.4 million (RUR 1.148 billion). This is clearly insufficient to produce any noticeable impact on the economy. In part, this situation is due to the poor provision of information to potential investors, and because most projects are designed for large investors.

Unfortunately, St.Petersburg falls considerably behind other Russian regions in terms of the share of international investment in its economy. Thus according to the State Statistics Committee, in the first quarter of 1994 Moscow received foreign inflows of USD 42 million, whereas St.Petersburg received only USD 3.1 millions, which was far less than that received by the Archangel, Tomsk, Nizhni Novgorod, Irkutsk, Moscow, and Novosibirsk regions. In the second quarter this amount increased somewhat to USD 3.4 million, but in the third quarter St.Petersburg was not even in the top ten Russian regions by volume of foreign investments. In 1994, the fuel industry, retail trade and public catering and construction attracted the most investment. The total volume of international investment in St.Petersburg was USD 36.4 million, 80 per cent of which was direct investment, mainly in technical renovation, machines and equipment. According to city bodies, portfolio investments accounted for about 10 per cent.

Taking into account the industrial and geographical breakdown of foreign investments, any big change in the existing situation in St.Petersburg seems unlikely. However, although it has lost some ground to raw-materials producing regions, St.Petersburg boasts distinct advantages in the development of market relations, which in the long run will prove to be economically more beneficial

because, with time, regions with extensive commodity and capital flows will inevitably gain in importance. As integration between Russian regions progresses, the quality of services rendered to economic agents is going to play a critical role. Therefore, it is in the long-term interest of the region to develop its infrastructure and services sector. This idea has already proved its credence through certain achievements of the city in this area. It is not by chance that a half of all St.Petersburg banks are from other regions, attracted here by the favourable banking conditions. As the quality of telecommunications and transport services improves, there is a good chance that interregional financial flows will shift to St.Petersburg. Renovation of old and construction of new transport infrastructure for export and import flows may well serve this purpose too. Successful development of the programmes "St.Petersburg Sea Port", "Ring Motorway around St.Petersburg", and "Moscow-St.Petersburg High-Speed Railway" will give a boost to the development of service companies, especially taking into account that small and medium-sized service businesses in St.Petersburg still have ample room to grow.

New business opportunities are connected with privatization and the development of the stock market. The low cost of capital and the existing secondary market for privatized enterprises' equity make expansion of the investment process inevitable.

Three methods have been used to attract foreign investment through divestiture: specialized auction, voucher (and since mid-1994, cash) auction, and investment bidding. During the voucher phase, international participation in the auctions was insignificant: shares of only ten enterprises' (of 355 divested in St.Petersburg through auction) were purchased by foreigners. The largest purchaser was a British company that acquired shares in three mechanical engineering enterprises (Elektrosila, LMZ and Turbine Blade Plant), and this was on behalf of a Russian business (Energomashinostroitel'naja Korporacija). Skanska (Sweden) acquired a block of shares in the jsc Asphaltobetonny Zavod No 1, and Carl Fazer (Finland), acquired shares in the jsc Pekar. Half of the enterprises that attracted foreign attention were in the food industry. Later, despite the extremely low cost of shares, foreign investors showed only lukewarm interest in voucher auctions, which, was due not only to economic reasons but also to the auction procedure (bidders had to have a special bank investment account), as well as to the impossibility of purchasing a large equity stake.

The City Property Management Committee relied on investment biddings (tender) to attract foreign investment into St.Petersburg, and the approach proved to be successful. In 1993 at four of the six investment biddings the shares were awarded to foreign companies, which purchased 43.5 per cent of the authorized capital of jsc Baltika, 29 per cent of jsc Petmol, 15 per cent of jsc Samson, and 14 per cent of jsc Severnaja Verf. The most impressive results were shown by Baltic Beverage Holding (Sweden) which had offered a well-prepared investment programme amounting to SK 150 million and purchased the largest equity stake (43.5 per cent of Baltika's authorised capital). Later this company also purchased at a voucher auction a 9.64 per cent addition stake in the same company's authorized capital. It should be noted that the successful tenderer in an investment tender obtains a controlling share. In 1994 the City Property Committee allowed (Order no. 151 of 28.01.94) authorized capital to be increased by 50 per cent upon the purchaser's request, provided he has met the terms of the first phase.

A Leontief Centre study of foreign participation in the first phase of privatization showed that:

- a) the most attractive form of divestiture for international donors was investment bidding;
- b) during the closing stage of voucher privatization foreign interest subsided, both in investment bidding and in voucher auctions.

One can infer that the low profile of foreign investors in voucher privatization was determined by the divestiture procedure which precluded foreigners from obtaining a controlling stock of shares.

During the cash-auction phase of privatization another set of procedural shortcomings transpired, which provoked a clash of interests between investors and equity issuers at the preparatory stage of the investment programme and complicated both the bidding process and monitoring of the implementation of programmes.

The major drawbacks to investment bidding proved to be the following:

- the use of gross indices during the preparation of investment programmes;
- overly formal conditions for the formation of investment programmes;
- the use of a discount formula when calculating the amount of investments needed;
- a lack of efficient criteria for monitoring the implementation of investment programmes;
- legislative weakness regarding foreign investors' ownership rights;
- fights over the control of divested enterprises.

It should be noted that our analysis of foreign investor participation in the divestiture of St.Petersburg enterprises has implications for the whole country regarding the process of stimulating investment through privatization. In the first place, it is clear that the numerous improvements and amendments to regulations on foreign investment did not result in a healthy framework of legal conditions for foreign investors.

Moreover, the process of providing stimuli for investment in privatized enterprises is far from complete.

Implementation of investment projects with foreign participation and enterprises' post-privatization performance revealed specific problems related to the formation of a national regime for foreign investors.

The existing cash auction and investment bidding procedure need substantial changes to provide for both new stockholders' rights and better monitoring of the fulfilment of investment conditions.

Despite the fact that during the voucher phase of privatization investment bidding was found to be the most efficient form of attracting foreign capital, a search for new approaches to the problem appears to be imperative.

4 The Public as a Source of Investment Funds Population

As a means of ending the recession, additional investment is of critical importance. According to RF ministers, the annual need for investment amounts to USD 10 to 12 billion. Foreign sources cannot be expected to meet this demand. Therefore, in addition to attracting international funds it is necessary to mobilize all internal resources and develop an economically and socially efficient state strategy for capital investment.

Personal saving is a substantial source of investment capital. Prior to the reform, it accounted for one-fifth of all national savings and was used mostly by the state, and not to a great extent by individuals for personal investments. The transition to a market system and the formation of the securities market provide an opportunity for the public to freely place their monetary resources in deposits or profit-yielding assets.

These savings can be transformed into an important investment resource only under certain macro-economic conditions, including stability of the real interest rate, inflation rate, and the exchange rate against the US dollar. The lower the inflation expectations, the more direct the relationship between real incomes and real savings. Thus the price liberalization of 1992 exposed the rouble's true purchasing power and led to a redistribution of resources in favour of enterprises. However, after 1993 demand limitations began to be felt, and the share of personal deposits and savings in the total money stock quickly increased stimulated, among other things, by a slow-down in inflation.

It is important to note that a number of factors currently prevent any reliable analysis of living standards. The State Statistics Committee's data on average by-industry monthly wages, minimum living costs, minimum wages and pensions, as well as monthly nominal incomes and spending do not reflect profits obtained through business activity or real property or securities transactions. Nor do the statistics capture certain employment the scale, of which has been estimated to amount to up to half of all those employed. Nor are profits from private retail trade and services fully recorded. The official statistics completely overlook income in kind and social payments by enterprises. There are also well grounded doubts about how the cost of the minimum food basket is calculated. There are several methods of calculation. The most meagre consumer basket for this purpose, which completely excludes expenditures on furniture, "cultural supplies", domestic services, clothes and footwear, was suggested by the Ministry of Labour in 1992. The set of 19 main food products published by Goscomstat represents the minimum food basket which has a daily calorie content of 2240 kcal. Population polls conducted in Moscow and St.Petersburg clearly demonstrate that people regard the official minimum cost of living as highly biased. Interestingly, different income groups' assessments of the actual cost of living are about the same and have not changed for a long time. They equate the minimum cost of living with the per capita income.

At present there is a dangerous trend in the relationship between the minimum consumer basket cost and the minimum monthly wage. Traditionally the minimum monthly wage, on which all state enterprise salaries and many social payments are based, amounted to about 40 per cent of the minimum consumer basket cost. Indexation was effected when the ratio fell to 25 per cent. But since

the beginning of 1995, the minimum monthly wage has tumbled to 15 per cent of the minimum living cost, while the interims between adjustments and compensatory payments have become longer. As a result, wages in social sector industries fell below the minimum living cost, having become a kind of relief payment for being present at work. However, a widening in income differentials in conjunction with easing inflation can lead to an increase in real savings, which constitute a potential source of investment funds. In May–June 1992 alone the real saving income ratio exceeded inflation; in January 1993 it stood at 17 per cent, and for six months afterwards it never rose above 5 per cent. The longest period during which the saving income ratio exceeding inflation was in 1994: 3.2 per cent in February, 5.5 per cent in March and April, 8.1 per cent in May, 11 per cent in June, and 14 per cent in August. This period was characterized by:

- a transformation in the structure of savings;
- a transition to active forms of saving;
- a growth in income from property and financial operations.

In the first half of 1994 security purchases increased three-fold as compared to the same period of 1993.

A poll conducted by the Leontief Centre in mid-1994 showed that the population had switched to active forms of saving, entering the investment process. Representatives of all social and income groups, including pensioners and the unemployed, were found to own various types of securities. The total amount of savings, according to Leontief Centre estimates, was R 2.3 trillion. It was established that private investors' investment activity depended on their own estimate of their financial situation. The main investment medium for the public was then securities of such investment companies as Olbi-Diplomat, MMM, and Xoper-Invest (62 per cent of those polled). The poll revealed a discrepancy between the investors' opinion of the feasibility of purchasing certain securities and their actual behaviour in the securities market: despite the low esteem in which the shares of voucher investment funds and industrial enterprises were held, the actual proportion of those who had purchased them was very high. This situation can be explained by people having second thoughts about the soundness of their choices with respect to equity investments.

Indirectly the public's preferences in the investment commodity market could be determined by the poll. The most reliable form of saving, as before, was considered to be the purchase of hard currency. Such types of securities as state treasury bonds, bank and non-bank bills, corporate shares, or municipal loans were not popular as a means of investing "spare" money. However, 30 per cent of those polled would have preferred to buy municipal housing debentures, had they been available. Overall, about 30 to 40 per cent of the adult population of the city can be regarded as potential private investors with various degrees of activity and different forms of participation in the process. The key conditions for activating this sleeping potential are stabilization of inflation, positive real deposit rates, and an increase in the purchasing power of the rouble.

However, beginning from September 1994 a majority of macroeconomic indices have been showing an unfavourable trend, which is hindering the stabilization of consumer expenditures. In September and October 1994, real incomes fell by 8 per cent. Fuelled by a drop in the rouble-dollar exchange rate and a 15 per cent inflation rate, inflation expectations exploded and rouble deposits again began to be converted into dollars. From that time on, people's

savings have been dwindling, income differentiation growing, and tension in the consumer market increasing, sometimes even resulting in shortages of certain goods.

At the same time, civilized ways of saving spare resources continue to be limited because of the underdeveloped supply of investment outlets for individual investors.

Thus the practices followed in 1994 in regard to lending and other monetary matters clearly demonstrate how tight the relationship is between the financial stabilization and living standards that can make it possible to mobilize the population's investment potential.

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