BOFIT Russia Review Yearbook 2004

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.

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Economic Developments

2003 – The Year of Oil

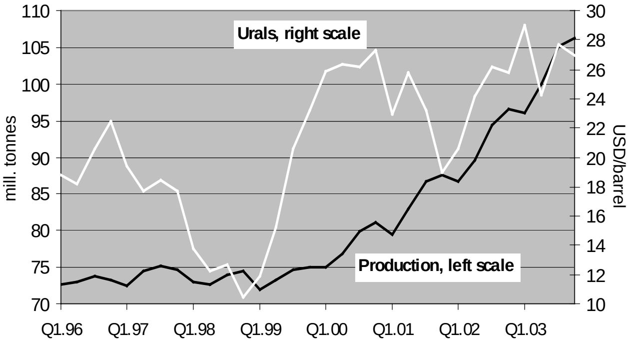
Russian economic growth in 2003 exceeded all mainstream forecasts. At the start of the year, the expert consensus forecast for GDP growth was below 4 %. Russian GDP is now estimated to have grown almost 7 % in 2003. Goskomstat's initial figures indicate on-year growth of GDP in January–September of 6.7 %.

Goskomstat also revised its GDP figures for the two previous years slightly upwards. The new figures show GDP increased 5.1 % in 2001 and 4.7 % in 2002.

Crude oil production swelled in 2003 as oil companies were eager to take advantage of the high world market prices. According to advance information from the energy ministry, over the whole of 2003, crude production averaged 8.46 million barrels per day (bpd), up 11 % from 2002. This production level made Russia the second largest oil producer in the world after Saudi Arabia. Indeed, as growth accelerated towards the end of the year, Russia actually exceeded Saudi Arabia in daily production. In December, Russian crude oil output hit a record 8.82 million bpd.

The largest Russian producers of crude oil last year were Yukos (1.61 million bpd), Lukoil (1.58 million bpd) and Surgutneftegaz (1.08 million bpd).

Russian oil production and price of Urals crude, 1Q1996–4Q2003



Source: Goskomstat, energy ministry

Oil exports also soared last year, despite the constraints of insufficient export pipeline capacity. In January–September, Russia exported 18 % more crude than a year earlier. Preliminary information from the Central Bank indicates Russia's export earnings on crude rose over 35 % during the year to $40 billion. The share of crude oil in Russian export income reached 30 %, while the combined share of crude oil, oil products and natural gas totalled 55 %.

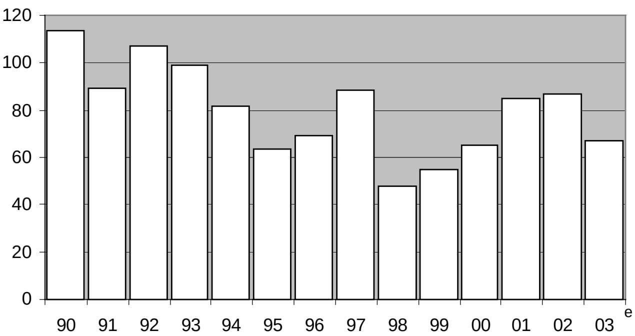
Grain harvest moderate

The agriculture ministry's preliminary estimate puts the 2003 net grain harvest at about 67 million tonnes, a figure quite satisfactory in comparison with harvests of the late 1990s and early 2000s. Compared to the first half of 1990s, however, the harvest was clearly smaller. Russia's grain consumption is estimated at 75–76 million tonnes, but with ample grain stocks from previous years, the grain supply should be sufficient for domestic needs this year.

Grain exports will naturally suffer. Russia managed to export record amount of grain (about 17 million tonnes) after the 2002/2003 good harvest. For the 2003/2004 harvest year, the export figure is expected to drop to around 5 million tonnes. As a preliminary measure to assure grain availability in the domestic market, as well as curb increases in bread prices, the Russian government has decided to impose an export tariff on wheat and rye until the beginning of May.

This is bad news for East European countries that suffered extremely poor harvests and are eager to buy grain from Russia. For instance, Ukraine's 2003 wheat crop was severely damaged by both winter kill and summer heat. Recent estimates put Ukraine's 2003 wheat crop at a mere 4 million tonnes, down from 21 million tonnes in 2002.

Russia's net grain harvest, 1990–2003 (million tonnes)



Source: Goskomstat

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	6.7	1-9/03
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.8	1-11/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	12.2	1-11/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.6	11/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	134.4	1-12/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	74.8	1-12/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	39.1	1-12/03

Source: Goskomstat, CBR.

New Duma dominated by pro-Kremlin forces

The new Duma convened for the first time in late December. The United Russia movement, formed in December 2001 to support president Vladimir Putin, succeeded in taking significant powers when the Duma organised its work in the first session. United Russia will now have the post of Duma speaker, both posts for first deputy speakers and five of the eight deputy speaker posts. United Russia further aspires to man most, if not all, chairperson posts of Duma committees. Altogether United Russia commands over 300 seats in the 450-seat Duma. The two-thirds majority gives it the power to pass not only ordinary legislation without having to seek opposition support, but constitutional changes as well.

The new Duma is even more supportive of Putin than the previous one, while the influence of big businesses on the Duma has declined. Observers note, however, that most new Duma deputies are in some way connected to big business. In any case, the continuation of economic reforms and their focus now depends more than earlier on the initiative and interest of the Kremlin. A new government will be nominated after presidential elections are held in mid-March.

Although somewhat higher than initially estimated, the 56 % voter turnout should serve as a reminder to decision-makers of the alienation of a significant share of population from the country's affairs.

The new Duma boasts a high educational level with almost all deputies having academic degrees. Although the number of female deputies grew by ten to 45, women still account for only 10 % of all deputies.

Duma seats won by major parties in 2003 and 1999 elections

	2003	1999
United Russia	223	141[1]
Communist Party	54	113
Liberal Democratic Party	36	17
Motherland bloc	36	–
People's Party	19	–
Yabloko	4	20
Union of Right Forces	2	29
Independents	75	125

[1] Seats held by Unity and Fatherland–All Russia parties, the predecessors to United Russia.

Many key laws enter into force this year

One of the most important laws taking effect at the start of 2004 was the customs act passed last May. In accordance with WTO guidelines, the new rules bring Russian customs practices closer to international compliance. Among other things, customs clearing times at the borders are expected to shorten substantially.

Amendments to several taxes were made from the start of 2004 with the aim of easing the economy's overall tax burden. The value-added tax was reduced from 20 % to 18 %, the ceiling on the corporate property tax was lowered to 2.2 % and agricultural producers were given the possibility to consolidate several taxes into a 6 % unified agriculture tax. The 5 % sales tax, introduced after Russia's 1998 financial crisis to bring funds to regional budgets, was abolished. On the other hand, extraction taxes on natural gas and crude oil were raised.

Amendments to the securities markets act lowered the securities tax rate from 0.8 % to 0.2 %. The measure is expected to enhance the growth of securities markets.

Other important laws entering into force during this year include amendments to the insurance act, which will further open up Russia's insurance markets to foreign firms. The maximum share of foreign-owned companies in the combined charter capital of all insurance companies will be raised from 15 % to 25 %.

The amended act on currency controls, which will come into force in the summer of 2004, eases currency controls and simplifies their procedures. Transactions that are not explicitly prohibited by the act will be allowed. The aim is that almost all currency controls excluding the repatriation requirement will be abolished from the start of 2007.

Reform agenda

Given the important pieces of legislation that were passed during the year, last year's achievements on the structural reform front can be regarded positively. Nevertheless, there were significant disappointments, including the government's failure to start reform of gas monopoly Gazprom. The reform was widely expected to be launched after president Putin changed the company's general manager in 2001. More than two years later, the fate of the reform remains open.

Last year's developments concerning the Yukos case will be reflected in this year's policy agenda. Taxation of natural resource extraction, including oil, will likely experience changes. The Kremlin has voiced the need to distribute the windfall earnings of resource-based industries more equally with the country at large. In another development, the state audit chamber announced plans to review this year the major privatisation deals that have taken place in the past ten years. President Putin has noted that the aim is to identify unlawful deals and that no major revision of privatisations is planned.

A large reform block waiting to be tackled is public administration, the reform of which Putin has repeatedly emphasised. Without efficient state administration, implementation of reforms in general will fail.

After victory in the recent parliamentary elections, Putin gave assurances that there are no plans to amend the Russian constitution and that he does not see for himself a third term as president. In the run-up to this spring's presidential election, Putin has lately been stressing the importance of social issues. In his address to the opening session of the new Duma, he asked deputies to focus on raising the living standards of Russians through improvements in health care, education and housing.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-year figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2004 budget law
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	19.4	1-10/03	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	16.8	1-10/03	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	2.6	1-10/03	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	28.3	9/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.6	9/03	

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–1998, Economic Expert Group 1999–2003. Debt: IMF 1996–1999, Minfin 2000–2003.

Russia met 2003 inflation target

The rise in consumer prices slowed in December to 12.0 % y-o-y, i.e. the top end of the government's 10–12 % target range. Decelerating growth of administratively set prices for housing and municipal services in the latter part of the year accounted for much of the slowing. Prices for services, however, climbed 22 % for the year as a whole, well outpacing the rise in goods prices. The sharpest increase, 29 %, was in municipal and housing services prices. Food prices were up 10 % y-o-y, while prices of non-food goods rose 9 %.

Debt servicing on track in 2003

Foreign indebtedness has ceased to be a major issue for Russia. Thanks to high export earnings, Russia was able to service its public sector debts in 2003 in full and in a timely manner. The finance ministry reports Russia paid some $10.5 billion in repayments and $6 billion in interest during 2003. Initially debt-servicing costs in 2003 were to exceed $20 billion. This peak was reduced, however, through acceleration of the payment schedule in 2001 and 2002.

According to the finance ministry, Russia's federal government foreign currency debt at the end of September 2003 equalled $119.6 billion, or about 28 % of GDP. Indebtedness was down by 3 % from the beginning of the year. Only the Central Bank provides a detailed debt breakdown. Its debt statistics cover federal external debt (i.e. debt held by non-residents in foreign or domestic currency). Of the $98 billion federal external debt recorded by the CBR at end-September, over half was inherited from the former Soviet Union. Most Soviet-era debt has been rescheduled with the Paris Club of sovereign creditors. Over half of the new Russian debt is in dollar-denominated bonds (mainly restructured bonds held by members of the London Club of commercial banks).

One of the goals of the government's debt plan for 2003–2005 is to change the structure of borrowing in favour of domestic debt. At the end of September 2003, domestic currency debt amounted to RUB 682 billion ($23 billion and 5 % of GDP), up about 4 % from the beginning of the year. The domestic currency debt share in the total federal government debt was 16 %. The share is to increase to about 27 % by 2006.

On paper, foreign countries, banks and enterprises owe Russia over $90 billion. However, the real value of these debts is likely much less. Most of them are debts denominated in non-existent currencies (e.g. convertible roubles and Soviet roubles) and have been converted to dollars using artificial exchange rates. Moreover, it is likely that most of the main borrowers remain unable to pay any of their debts, let alone settle in full. At the end of December 2003, president Putin announced Russia's willingness to start negotiations in the framework of Paris Club on forgiving Iraq's debt to Russia, nominally valued at $8 billion.

Structure of federal government external debt as of 30 September 2003, USD billion

External debt, total	97.7
Russian debt	42.7
Foreign currency bonds	24.2
IBRD	6.3
IMF	5.3
GKO-OFZs	0.3
Other	6.6
Debt of former Soviet Union	55.0
Paris Club	40.2
MinFin foreign currency bonds	3.6
Debt to ex-socialist countries	0.8
Other	10.3

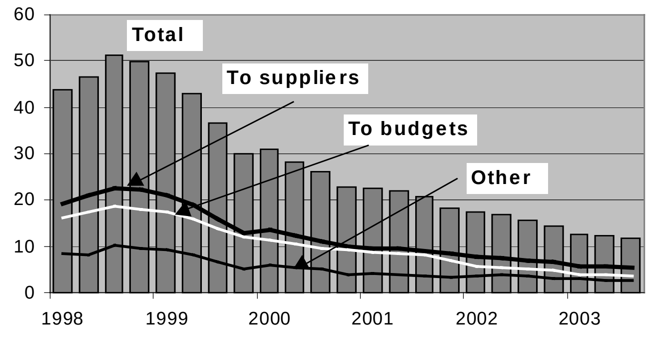
Source: Central Bank of Russia

Problems of enterprise arrears easing

The peculiarly Russian problem of enterprises' large and sustainable payments arrears has significantly eased since the 1990s. At the end of September 2003, payments arrears amounted to less than 12 % of GDP, down from some 50 % of GDP after the 1998 financial crisis. The number of enterprises in arrears has also decreased. Between 3Q2002 and 3Q2003 it was down by 12 %. While there seems to be a group of enterprises persistently in financial difficulties, it also appears that few new firms are entering this group.

At the end of September 2003, almost half of arrears was debt to suppliers, less than third arrears to federal and regional budgets and the rest debt to banks, wage arrears, etc. Industrial enterprises accounted for almost half of arrears, while enterprises in agriculture and in housing each had 11 % shares.

Enterprises' payments arrears, 1Q1998–3Q2003 (% of GDP of four previous quarters)



Source: Goskomstat

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	12/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	46.2	11/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	201	11/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.3	10/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	12.5	10/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	12/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	12/03

Source: Goskomstat, CBR.

Survey assesses social responsibility of Russian firms

by Tuuli Juurikkala*

Firms in Soviet society were charged with supplying the bulk of social services as well as a considerable amount of infrastructure. They often maintained housing, day care, schools, health centres – even vacation homes. Enterprises, for example, held 41 % of the total housing stock in 1992.

The general perception is that the divesting of social assets from industrial enterprises to the public sector has been mostly achieved in Russia. However, the results of a recent survey of 404 medium-sized and large industrial establishments in 40 regions of the Russian Federation show that firms are still quite active in service delivery.[1]

Is the involvement of firms in service provision forced or voluntary? Is the current situation transitional or deeply rooted in Russian business and society? Social assets within the firm could be an inherited burden, diverting resources from productive investment. They might also be the result of negotiations and exchange of favours with the local government, or simply a way for the firm to attach labour through fringe benefits as in most countries.

Decade of social asset divestment

Over 90 % of the surveyed firms held social assets in 1990, and over 90 % still provided or supported at least one service in 2003, although the extent of firm participation in social service provision diminished significantly during the last decade.

During the mass privatisations of the early 1990s, enterprises were obligated to transfer major social assets to municipalities. However, both the speed and the scope of divestiture vary significantly by the type of asset and by locality. The survey data show that the majority of day care facilities were divested in the mid-1990s, while housing divestment continues to this day.

While managers view social service provision as non-essential and costly, many firms still provide these services, even to users outside their own workforce. For example, 56 % of firms owned their own housing or supported local housing, while 73% of firms had recreational facilities or supported the recreational activities of their employees. Overall, there has been a switch from owning assets to other forms of support such as direct subsidies to employees.

Larger firms, measured by employment, are more likely to still own social assets and bear higher costs relative to their wage bill. General managers of larger firms are also more reluctant to divest of their current social assets than managers of firms with fewer than 500 employees. In 2003, firms that had assets built after 1990 were approximately twice as large as those lacking new assets.

Complicated relations with municipalities

In addition to efficiency considerations, social service provision is shaped by the relationships of firms with local authorities. This can be seen in the difficulty of divesting assets to municipalities. Regulatory capture appears to be a serious problem. As a rule, firms that provide above-average services have closer ties to public sector authorities than other firms.

Many managers believe their relations with the municipality would worsen if they sell off their assets. Municipalities can offer firms a variety of sticks and carrots. They can require firms to provide services as well as support the firm through purchases of the firm's products at above-market prices. There is an apparent incentive for informal agreements between firms and municipalities in service provision.

Labour attachment or social conscience?

Social services, and non-monetary payments in general, may be important for attaching workers to a particular firm. Indeed, among approximately half of the surveyed firms, at least some workers would quit if the firm stopped providing social services. This response was highest in firms with the highest social costs as a percentage of the wage bill. Relative to their wage bill, social service provision seems more important to the less-educated part of the workforce. In addition to extensive social service provision, over 40 % of firms employed considerably more people than they deemed efficient, an indication labour hoarding is still an important phenomenon.

The role of firms in the social sphere has undoubtedly diminished over the past ten years or so. 2003 brought signs of a trend reversal, however, as president Putin announced in May that fighting poverty is a national priority. Public criticism of Russian businesses for their social irresponsibility has increased recently. In response, the Russian union of industrialists and entrepreneurs announced big business' willingness to finance development of several major social projects.

Social assets according to the survey (% of firms)

	Type of asset (service)			
	Housing	Medical care	Day care	Re-creation
Firms owning assets for providing services	40	79	12	26
Firms financing municipal assets	12	15	17	6
Of those that have own assets:				
Deem it profitable	2	1	2	5
Want to get rid of	71	12	47	29

** The author is researcher at the Helsinki School of Economics.*

[1] *Haaparanta, Juurikkala, Lazareva, Solanko, Pirttilä and Zhuravskaya: "Firms and Public Sector Provision in Russia," BOFIT Discussion Paper 16/03.*

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Economic Developments

Fuel and related industries lead economy

Preliminary Goskomstat figures show GDP growth accelerated in 2003 to 7.3 %. GDP amounted to 13,305 billion roubles or 384 billion euros at the official exchange rate. Some 60 % of GDP was generated by the private and public services sectors. Industry contributed a 27 % share, construction 7 % and agriculture 6 %.

Industrial output increased 7 % y-o-y. The three fastest growing industries – fuel production, machine building and metal fabrication, and ferrous metallurgy – were directly or indirectly related to crude oil production. All three grew at around 9 % for the year. Within the fuel industry, crude oil production increased 11 %, coal production 8 % and natural gas production 5 %. Despite the gains in crude oil production, oil refining was up just 2 %. In the machine building and metal fabrication category, growth was strong in the manufacture of railway equipment and rolling stock, which was driven by increased rail shipments of crude oil. In the ferrous metallurgy category, pipeline production (mainly for oil shipment) was one of the fastest growing product groups.

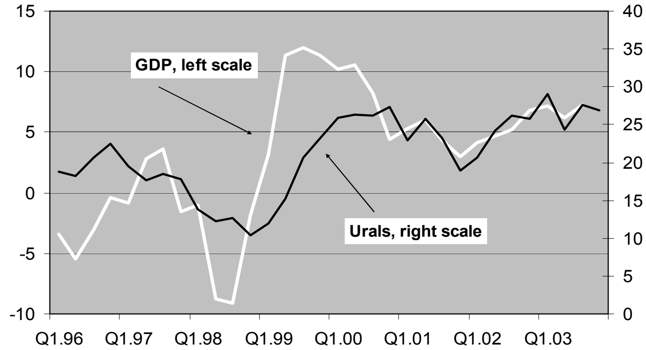
In other industries, foodstuffs production rose 5 % y-o-y while the forest industry and wood processing was up 1.5 %. Light industry, which produces goods for home markets only, continued to suffer from the strong rouble that encouraged imports of consumer goods. The decline in light industry output amounted to 2 % after a 3 % drop in 2002.

Construction rose 14 %, far outpacing growth below 3 % in 2002. The large increase in building activity partly reflected construction of new oil transport infrastructure. Growth in housing construction lagged behind other construction categories, but still managed to match its own 7 % pace set in 2002.

Freight transport increased over 7 %. This growth was mainly due to higher volumes of rail and pipeline transport, again due to the increase in crude oil production and exports. In rail transport, crude oil and oil products constituted the largest product group, accounting for 18 % of all freight.

The 1.5 % figure for agricultural output growth was a result of last year's relatively poor harvest. The ownership structure in agriculture is slowly changing with the share of small farms in total production rising. Large farms still account for the overwhelming share of grain production (84 %), while another legacy institution from the Soviet period, household garden patches, continue to dominate vegetable growing. Households were the primary source of potatoes (93 %) and other vegetables (80 %).

GDP (on-year % change) and price of Urals crude ($ per barrel, annual average)



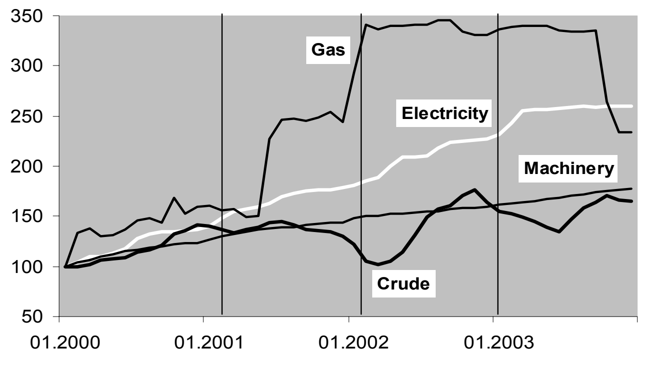
Source: Goskomstat

Consumer and producer prices down

In January, consumer prices rose 11.3 % y-o-y, a slight slowing from 12 % y-o-y in December. The drop in inflation reflected a two percentage point reduction in the value-added tax and the elimination of the 5 % sales tax at the start of the year.

Industrial producer prices increased over 2003 by 13.1 %, slowing considerably from 2002. The sharpest price increases were recorded in ferrous and non-ferrous metallurgy (29 % and 27 %, respectively), reflecting price developments on international commodity markets. Next came the building material industry, where producer prices rose 17 %. Producer prices rose 24 % in the freight transport sector and 10 % in the construction sector.

Selected producer prices (January 2000=100)



Source: Goskomstat

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	134.4
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	74.8
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	39.1

Source: Goskomstat, CBR.

Russians to choose between state and private pension funds

Pension reform started in Russia at the beginning of 2002 with the introduction of three major laws concerning work pensions, state pension security and mandatory pension insurance. The reform package envisages gradual transition from the pay-as-you-go pension system (i.e. pensions paid out of the salaries of current workers) to a fully funded system. Like in most transition economies in Europe, the key factors militating for reform of the old system were its fiscal unsustainability, complex administration and the weak linkage between benefits and contributions. The Russian reform does not include changes in pension ages, which remain at 55 years for women and 60 for men.

The first work pensions under the fully reformed system will be paid out in 2013. They are made up of three components: a basic pension (currently 450 roubles) is paid to all pensioners regardless of their earnings; the mandatory insurance and mandatory savings components are dependant on the individual's lifetime earnings and age. Pensions are financed by social tax contributions paid by employers and pension contributions of employees. Pensions to state employees or other special pensions, which are financed from budget revenues, are regulated by a separate law and determined by different methods than work pensions.

From the beginning of 2004, private investment funds, which until now have been able to deal with voluntary pension schemes, have been allowed to broaden their market participation. Last September, over 50 private investment funds were approved to act as investors of the savings component of work pensions. These firms may be selected by Russians willing to accept higher risk in exchange for higher interest rates on their savings. Experts expect that investments in these private funds could at present yield 3–4 % annually in real terms. State-owned Vneshekonombank, which invests on the behalf of Russians unwilling to trust their pension savings to private funds, is more strictly regulated in its investment decisions. Hence, currently it can only offer nominal interests below the inflation rate.

According to preliminary information, less than 2 % of the 38 million Russians eligible to participate (men born after 1952 and women born after 1956) have turned to private investment funds to act as investors of their savings component. The smaller-than-anticipated group of those opting for a private fund is due to several reasons. Perhaps the most obvious and understandable have to do with the lack of information on new funds and the fear of losing one's investment. The process of choosing an investment fund was also postponed by technical problems of the state pension fund to provide Russians with documents on the current status of their personal pension accounts.

As of end-2003, the total amount of funds accumulated from the savings part was some 90 billion roubles (about $3 billion), or less than 1 % of GDP. This year, some 50 billion roubles should be added.

The top five private investment funds together currently control the savings of over 60 % of the 700,000–800,000 people relying on private funds. Most of the nearly 50 remaining investment funds deal with tiny amounts of savings. The most successful private funds are connected with major industrial enterprises or banks. Over 100,000 Russians have savings worth about $11 million in the Rosbank fund. Measured by total assets, Rosbank is Russia's eighth largest bank. The popularity of private investment funds has also been dependant on the enterprise and the region. About a third of the pension savings acquired by the Rosbank fund came from Interros, one of the largest private investment companies in Russia and the main shareholder of Rosbank. In Tatarstan, the investment fund SIS, which is affiliated with the bank owned by the regional government, holds the savings of almost 90,000 people.

New stabilisation fund started to function

To support stringent fiscal policy, a new stabilisation fund was established to replace the reserve fund as of the beginning of 2004. The stabilisation fund functions in the same way as its predecessor, the reserve fund, but is more strictly regulated. The new fund will collect revenues from export tariffs on oil and oil products, as well as extraction taxes, when the price of Urals oil is above $20 a barrel. The resources can be used to cover budget deficits in coming years. Only in case the stabilisation fund exceeds 500 billion roubles, the extra resources can be used for other purposes approved by the Duma.

According to the finance ministry's preliminary figures, the resources of the reserve fund amounted to 255 billion roubles ($9 billion) at the turn of the year, up from 170 billion roubles at the start of 2003. Some 106 billion roubles of that sum were transferred to the stabilisation fund. Most of the remainder will be used to cover temporary cash discrepancies of federal budget during the first couple of months of 2004.

The 2004 budget assumes an average Urals oil price of $22 per barrel. This estimate also served as the basis for official calculations, according to which some 190 billion roubles (about $6 billion) will end up in the stabilisation fund by the end of this year (including reserve fund transfers). However, many expert appraisals assume a much higher average price of Urals oil ($26–27 per barrel) suggesting that the total figure at the end of the year would be $8–10 billion.

The CBR keeps the resources of the stabilisation fund separate from budget funds. The finance ministry can invest the money in government bonds of countries with investment-grade ratings.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-year figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2004 budget law
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	19.3	1-11/03	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	16.7	1-11/03	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	2.6	1-11/03	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	28.3	9/03	
Foreign currency debt, $ bn	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.6	9/03	

[1] *Since 2002 social tax is included in the federal budget.*
Source: Budget: IMF 1996–1998, Economic Expert Group 1999–2003. Debt: IMF 1996–1999, Minfin 2000–2003.

Central bank monetary policy faces challenges

The central bank succeeded last year in restraining the real appreciation of the rouble to 4 % against a basket of currencies of Russia's main trading partners. This was well within the target of 4–6 % appreciation set forth in last year's monetary policy program.

The CBR, under its declared policy, has allowed the real value of the rouble to appreciate gradually in the face of the country's continued large current account surpluses. When necessary, the CBR has intervened in the currency markets to smooth the development of the rouble's value. In 2003, most interventions involved buying of dollars to curb the rouble's rise.

The rouble's nominal exchange rate against the dollar was 29.45 roubles at the end of 2003, up by more than 7 % over the year. The rouble's real appreciation was even greater, 19 %. So far this year, the rouble has continued its nominal appreciation against the dollar.

Given the rouble's close relationship with the dollar, the rouble's value declined against the euro 11 % in nominal terms during 2003. In real terms, the rouble showed little change against the euro as rouble's nominal weakening essentially matched the difference in inflation rates in Russia and the euro zone.

The CBR's monetary policy program for 2004 envisages real appreciation of the rouble of 3–5 % against the currency basket. The tasks confronting the CBR, i.e. to keep the rouble from appreciating too quickly while fighting inflation, will be difficult in the presence of the steady currency inflow into the country.

Over 2003, Russia's foreign reserves grew by a record $29 billion dollars (61 %) to $77 billion. The growth accelerated towards the end of the year, and in December alone amounted to almost $9 billion. The rapid growth continued into 2004; at the end of January foreign reserves reached $84 billion.

In addition to strong export earnings, the currency inflow consists of active foreign borrowing by Russian banks and enterprises. A small part of the inflow consists of speculative money, attracted to Russia by the strengthening rouble and low returns elsewhere. Should circumstances change, this part of the inflow would reverse direction quickly.

The CBR is planning to restrict the inflow of capital through instruments granted under the new law on currency controls, which enters into force in June. According to the law, the CBR can require importers of capital to make temporary reserve deposits to the CBR.

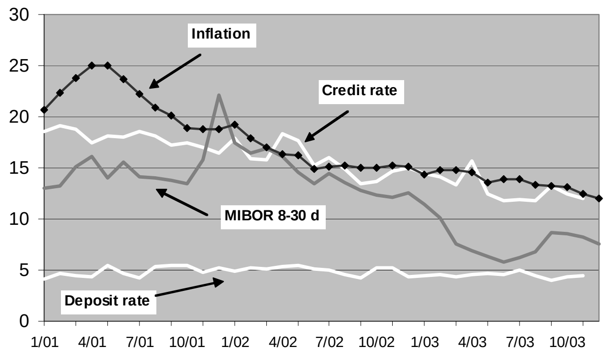
Interest rates down

On January 15, 2004, the CBR lowered the refinancing rate from 16 % to 14 %. It last adjusted the rate in June 2003 with a lowering from 18 % to 16 %. The CBR's refinancing rate has little practical significance as a monetary policy instrument, because banks do not take refinancing loans from the central bank due to their excess liquidity. However, it is the basis for setting penalty rates for delinquent payments. The lowering of the refinancing rate reflects lower inflation and lower market interest rates.

Lending rates on the interbank markets are substantially lower than the refinancing interest rate. In January, for example, the 8–30 day offered rate (MIBOR) ranged between 5.5 % and 7 %. Real interest is negative, a reflection of the excess market liquidity.

In general, retail banking interest rates have come down significantly in Russia since the 1998 financial crisis. The average rate on deposits with maturities up to one year was still negative in real terms last year (see the chart below). Moreover, the average rate on enterprise loans with maturities up to one year was generally negative.

Selected interest rates (% p.a.) and consumer price inflation (on-year % change)



Source: CBR

Further upgrading of Russia's creditworthiness

In late January, the international rating agency S&P boosted Russia's rating on long-term foreign-currency sovereign loans by one notch from BB to BB+. The new rating is still one level below investment grade, which means that Russia is considered to be suitable for speculative investment only. S&P previously lifted Russia's rating in December 2002.

S&P said the upgrade was justified by improvements in Russia's external liquidity, prudent fiscal policies, and falling government debt. The agency noted, however, that Russia still has problems stemming from its unfinished structural reforms, heavy dependence on raw material sectors and the lack of development of its political institutions and public administration.

Fitch still rates Russia one notch below investment grade. Moody's, in a surprise move last October, upgraded Russia to its lowest investment grade.

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.3	1/04
M2, 12-month growth, %	30	29.5	36.3	57.2	62.4	40.1	32.3	46.2		11/03
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180		
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.4		11/03
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	12.0		11/03
Forex reserves, $ bln (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	84.0	1/04
RUB/USD (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	28.49	1/04

Source: Goskomstat, CBR.

Wanted – Investment in Russia
by Seija Lainela*

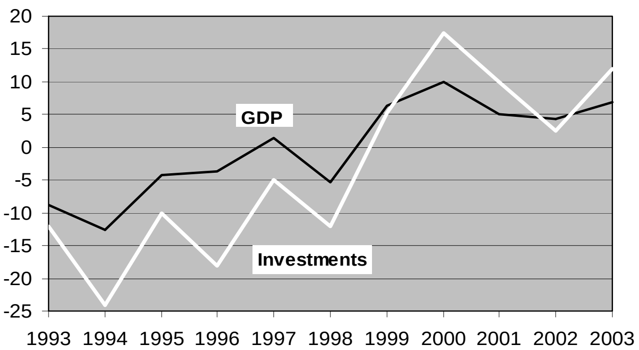
For Russia to attain sustainable long-term economic growth, the rate of investment must accelerate and its scope must widen.

When Russia's overall production began to recover in the late 1990s, growth largely involved putting idle production capacity back to work. Boosted by the weak rouble, it was relatively easy to press production for the domestic market back into service. As time has passed, however, the need to renovate production technologies and facilities has become increasingly acute.

With the surge of oil prices on world markets in recent years, production growth in Russia has been concentrated in those sectors benefiting from high export earnings and financial investment. This situation has exacerbated the economy's dependence on extractive industries, as investment to other sectors that would offer possibilities for diversification of the economy has been lagging behind.

Investment growth in Russia generally has followed overall production growth. It took until 1999 for Russia's post-Soviet economy to show signs of investment recovery. Since then, the rate of investment growth has fluctuated considerably.

GDP and fixed investment, on-year percentage change



Source: Goskomstat

The share of fixed investment to GDP has hovered around 16–17 % in recent years. This is a small figure considering the huge investment needs of the Russian economy. In the EU, for instance, the respective share is around 22 %.

Russia clearly could use the investment: the average age of industrial machinery and equipment is currently 21 years. The oldest equipment, between 21 and 23 years, is found in the electrical power, metallurgical and chemical industries. The most modern industrial sectors are currently wood processing and the food industry, where the average age of machinery and equipment is a mere 12 years.

Furthermore, Russia's decaying infrastructure demands greater investment in public utilities and transportation if the enterprise sector is to function normally.

Fuel sector dominates industrial investment

The fuel sector has received about half of all fixed investment of the industrial sector in the past three years. In 2003, it accounted for 22 % of Russia's overall fixed investment. Most fuel sector investment has gone to crude oil extraction and oil refining.

The second largest investment target is transportation, which in 2003 accounted for 18 % of overall investment. Again, investment related to the fuel sector has played an important role due to active oil pipeline and transport terminal construction. Non-ferrous metallurgy, which has profited from high world market prices, has been able to boost fixed investment rapidly in recent years.

Investment has also been strong in trade and catering, reflecting the higher real incomes of Russians. Communications, administration and finance have all ramped up their investments since 2001. Following the 1998 rouble crisis when several banks went under, the financial sector has staged a fairly strong investment recovery.

Public sector still important

State and local authorities accounted for 25 % of all fixed investment in 2002. Their share has been declining, while the share of the private sector has been increasing, reaching 44 % in 2002. The investment share of enterprises in mixed state and private ownership declined to 18 % in 2002. The share of foreign enterprises has stayed more or less constant at 2–3 % since 1998, while the share of joint ventures reached 12 % in 2000 and has since then hovered around 10–12 %.

The public sector continues to be an important source of investment financing for the enterprise sector. In 2003, 19 % of enterprise investment financing came from the public sector, while enterprises financed 54 % of their investments out of pocket and used bank loans for only 5 % of financing.

Not only is the share of bank financing in investment small, but more alarmingly, it has remained essentially unchanged during the past five years. Russian banks are incapable of providing adequate financing to enterprises. This poses serious problems, in particular, for small and medium-sized enterprises, and could ultimately hamper diversification of the Russian economy.

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Economic Developments

Production growth continued in January

The combined production index of five base sectors of the Russian economy rose 7.6 % on year in January with all the sectors, except agriculture, posting rapid growth rates ranging from 5 to 13 %. Agricultural output fell about 1 %. Developments in all these sectors largely follow the trends that prevailed in 2003.

In January, crude oil production continued to ramp up rapidly (10 % y-o-y) and averaged 8.8 million barrels a day. It boosted production in related sectors. In contrast, light industry faced serious problems related to mediocre production quality, low demand and increased competition from imports due to the real appreciation of the rouble. Light industry output continued to decline in January, falling 3 % after a drop of some 2 % over 2003. The share of light industry in Russia's overall industrial production was less than 2 % in 2003.

Differing GDP structure figures

Goskomstat reports the share of services in Russian GDP has increased continuously over the past decade. Last year, services amounted to 60 % of GDP compared to 51 % in 1995. Industry accounted for 27 % of GDP, construction about 8 % and agriculture 5 %. In other words, the Russian economy increasingly displays a production structure typical of a highly developed market economy.

In the last couple years, some observers have begun to dispute Goskomstat's portrait of GDP structure. They argue that the share of industry must be higher, considering the significance of oil and gas for the Russian economy. For example, in its February 2004 "Russian Economic Report" (www.worldbank.org.ru), the World Bank argues that many oil firms use their trading companies for selling oil to customers at market prices. Oil companies sell their oil to the trading companies at lower transfer prices. This is done to reduce taxes, as trading companies may be in a better position to take advantage of tax relief. As a result, a large part of the value added actually generated in the industrial sector has been recorded as service sector value added. According to the World Bank calculations, the actual share of industry in 2000 in Russian GDP was 52–55 %, rather than the 32 % recorded by Goskomstat. Accordingly, the share of oil extraction in GDP was 13 % rather than 7 %.

Real incomes soar

The Russian economy's rapid expansion has been visible in the ongoing increase in real incomes. Goskomstat preliminary figures indicate wages last year rose 10 % in real terms, while pensions were up nearly 5 %.

The average monthly wage in 2003 was 5,512 roubles (which amounts to 160 euros at the current exchange rate and about 450 euros when adjusted for purchasing power). The average monthly pension totalled 1,637 roubles (47 and 140 euros according to current and purchasing power parity exchange rates, respectively).

In oil extraction, wages were 350 % higher than the economy's average, while in natural gas production, wages exceeded the average by slightly over 300 %. Notably, financing and insurance followed in third place with wages 140 % above average. Fourth place went to non-ferrous metallurgy, with wages exceeding the average by 130 %. In coal production and ferrous metallurgy wages were 45 % above the average.

In the service sector, higher-than-average wages were paid – in addition to financing and insurance – in science (30 % above average) and administration (24 % above average). Wages were lower than average in several other service fields. In retail sales, they were only 60 % of the average, in education 67 % and in health care 73 %.

Population continued to shrink in 2003

The final results of the population census held in Russia in October 2002 show that the number of Russians fell 2 % from 1992. There were 145 million inhabitants in Russia in 2002, down from the peak of 148 million in 1992. The reasons for such a development lay in both high mortality rate and low birth rate, mirroring the legacy of Soviet social policies and the broad transformation of the Russian society after the break-up of the Soviet Union.

Despite some positive development trends, the population continued to shrink in 2003. The natural population decrease of about 890,000 people was due to continuing, although decelerating, mortality growth, which still exceeded the growth in the birth rate. The birth rate, which declined in the 1990s, has risen during the past four years. As regards mortality, circulatory diseases were the reason for over half of the deaths in 2003. The natural population decrease was only slightly offset by positive net migration, which continued to follow a declining trend.

The present demographic projections predict a further population decline for Russia. The most optimistic of the three scenarios made by the United Nations expects the Russian population to equal some 132 million by 2020 and 113 million by 2050.

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3		
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	7.5	1/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	13.7	1/04
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9	8.0	1/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	134.4	13.9	1/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	74.8	8.4	1/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	39.1		

Source: Goskomstat, CBR.

Government reshuffle just ahead of presidential elections

Following the dismissal of prime minister Mikhail Kasyanov by president Vladimir Putin on February 24, the Duma approved on March 5 the nomination of president Putin's pick for new prime minister, Mikhail Fradkov. Other cabinet members continued in the caretaker government.

The biggest surprise was the timing of Kasyanov's sacking. It was generally thought that the government would be disbanded after the presidential election as the constitution stipulates. On the other hand, rumours of Kasyanov's impending ouster have circulated in Moscow for most of his almost four-year tenure (the longest of any prime minister in post-Soviet Russia). Kasyanov was the last important minister to have participated in Boris Yeltsin's governments in the 1990s.

The selection of Mikhail Fradkov as prime minister apparently reflects the president's desire to have the cabinet led by an experienced bureaucrat, who will closely toe the president's policy line. In other words, the government will work whole-heartedly at implementing reforms supported by the president.

What remains open is the actual scale and content of the reforms the president intends during his second and (constitutionally) last term of office. The reforms remaining are the most challenging, both technically and in terms of their social consequences. If Mr. Putin wishes to be supported by the electorate and push through a successor of his choosing in the 2008 election, he may have to forego pushing the most painful reforms.

One of the first tasks facing the Fradkov government is administrative reform, widely considered the cornerstone for improving the functioning of the public sector and the key to success of many other reforms. Fradkov already announced that he wants to make the government more efficient by slashing the number of ministries and other state organisations, cutting cabinet staff and limiting their oversight of the economy. Observers have widely praised Fradkov's choice for his first deputy prime minister, Duma first deputy speaker and long-time budget and tax commission chairman Alexander Zhukov. Zhukov is considered an experienced economic reformer.

High oil revenues fail to boost federal budget

As a share of GDP, the realised 2003 federal budget produced a surplus (1.8 % of GDP) roughly the same in size as in 2002, although the shares of both revenues and expenditures were down. This was in line with the government's general aim of reducing the tax burden and decreasing or keeping expenditures unchanged.

Revenue performance was quite surprising, given the fast growth of oil and oil-related industries, which are generally estimated to generate a fifth to a quarter of all federal budget revenues. Apart from customs duties, all major types of tax revenue declined in 2003 in relation to GDP. The decline in profit tax revenues, which have been falling for several years as a share of GDP, was particularly sharp. The main reason for the drop was that the division of profit tax revenues was changed in favour of regional budgets, bringing the federal share down to 25 % from 31 % in 2002. Another reason may relate to the more popular use of tax code stipulations that allow enterprises to deduct all "economically justified" expenses without stating what they actually are. As all vagaries in the code are interpreted in favour of the taxpayer, this tends to decrease tax income.

VAT revenues, which constitute the lion's share of federal budget revenues, have also been falling in relation to GDP in recent years. The main reason for the decline in 2003 is not fully known, but has been partly explained by growing tax fraud, reflected e.g. in the increase in the amount of counterfeit corporate documents.

The decrease of expenditures as a share of GDP was not achieved through cuts in non-interest expenditures, which grew as a share of total budget expenditures. Rather, interest payments on debts remained essentially unchanged, and thus fell in relation to GDP. The social sphere and unified social tax expenditures, although higher in absolute terms, also decreased as a share of GDP and total expenditures.

Regional budgets ended the year with an aggregate deficit of 0.4 % of GDP, despite increased federal financial aid to regions and the above-mentioned boost in the share of profit tax revenues retained by regions.

Realised 2002–2003 federal budget

	2002			2003		
	RUB bln	**% of total**	**% of GDP**	**RUB bln**	**% of total**	**% of GDP**
Revenues	**2202**	**100.0**	**20.3**	**2583**	**100.0**	**19.4**
Tax revenues	1696	77.0	15.6	2029	78.6	15.2
VAT	*753*	*34.2*	*6.9*	*882*	*34.1*	*6.6*
Customs duties	*323*	*14.7*	*3.0*	*453*	*17.5*	*3.4*
Profit tax	*172*	*7.8*	*1.6*	*171*	*6.6*	*1.3*
Excise taxes	*215*	*9.8*	*2.0*	*253*	*9.8*	*1.9*
Natural resource payments	*214*	*9.7*	*2.0*	*250*	*9.7*	*1.9*
Other tax revenues	*19*	*0.9*	*0.2*	*20*	*0.8*	*0.2*
Non-tax revenues	151	6.9	1.4	174	6.7	1.3
Budgetary funds	15	0.7	0.1	14	0.5	0.1
Unified social tax	340	15.4	3.1	365	14.1	2.7
Expenditures	**2004**	**100.0**	**18.4**	**2355**	**100.0**	**17.7**
Interest on domestic debt	37	1.8	0.3	45	1.9	0.3
Interest on foreign debt	186	9.3	1.7	176	7.5	1.3
Non-interest spending	1449	72.3	13.3	1766	75.0	13.3
Defence	*295*	*14.7*	*2.7*	*356*	*15.1*	*2.7*
Social sphere	*287*	*14.3*	*2.6*	*305*	*13.0*	*2.3*
Transfers to regional budgets	*318*	*15.9*	*2.9*	*428*	*18.2*	*3.2*
Other expenditures	*549*	*27.4*	*5.1*	*677*	*28.7*	*5.1*
Unified social tax	332	16.6	3.1	368	15.6	2.8
Balance	**198**		**1.8**	**228**		**1.7**

Source: Goskomstat and Economic Expert Group

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-year figures for debt)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003,**	**as of**	**2004 budget law**
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	19.4		17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	17.7		17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	1.7		0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	28.3	9/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.6	9/03	

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–1998, Economic Expert Group 1999–2003. Debt: IMF 1996–1999, Minfin 2000–2003.

Oil production and exports soar

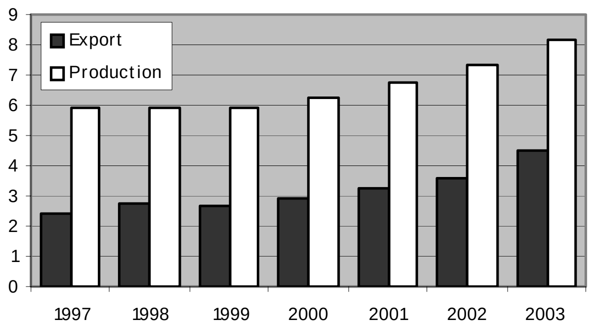
Given booming demand in China and other developing economies, as well as economic recovery in much of the developed world, global oil consumption is expected to continue growing this year. With high world market prices, Russia is poised to benefit substantially from planned significant increases in its oil output.

Goskomstat data show that Russian crude oil output averaged 8.2 million barrels per day (bpd) last year, an 11 % rise from 2002. According to the energy ministry's recently revised forecast, Russia will produce 6–8 % more crude oil this year than in 2003, i.e. daily output will average somewhat below 9 million bpd. Oil industry representatives and market analysts are even more optimistic. Yukos chief executive Simon Kukes says Russia will produce 9 % more crude oil this year than in 2003. In coming years, the increase should slow. Kukes estimates that Russian crude output will reach 10.5–11 million bpd in 2009, which will make Russia at that time the biggest oil producer in the world.

Goskomstat reports that in 2003 Russia exported crude oil 4.5 million bpd, up 12 % from 2002. The bulk of the crude (83 %) was exported to non-CIS countries at an average price calculated from the customs statistics of $24.70 per barrel. The average price for CIS-exports was significantly lower, around $18 per barrel.

Most of Russia's exported oil is transported through pipelines owned and operated by Transneft. The state oil transport company has a monopoly in pipeline transportation. Transneft plans this year to increase crude exports by about 15 %, or 600,000 bpd. Oil companies also export some crude themselves, mainly by rail or river. These exports are expected to increase, too.

Production and exports of crude oil, millions of barrels per day



Source: Goskomstat and State Customs Committee

New oil transport capacity

During recent years, Russia has been very active in the construction of new oil pipelines and export terminals. The massive construction effort focuses on opening new and geographically more favourable export outlets to meet the growing demand for transport capacity from oil producers. Russia's domestic oil consumption is not expected to increase significantly, so the bulk of increased production will go to exports.

The need for increased transport capacity was enhanced by the Russian authorities' decision a year ago to stop using the former export route through Latvia. The restrictions that Turkey has recently applied to oil tanker transit in the Bosporus Strait have also prompted Russia to look for sea terminal construction possibilities elsewhere. Furthermore, Russia's main oil terminals, situated on the Black Sea, tend to suffer from adverse weather conditions in winter.

North-Western Russia is becoming more and more important for Russian oil exports. Transneft's new Primorsk oil terminal on the Gulf of Finland has been rapidly increasing its loading capacity, which will reach 840,000 bpd this month, two months ahead of schedule.

Last year, Russia also relied on the use of some existing oil export terminals outside its borders. These include the Lithuanian port of Butinge and the Polish port of Gdansk. Yukos boosted its oil exports by rail to China.

Rival plans for new export routes

Transneft continues to build most of the oil transport capacity in Russia. As recently as a year ago, Russian oil companies entertained high hopes of building their own oil transport pipelines, e.g. from the Western Siberian oil fields to Murmansk on the coast of the Barents Sea. Initially, the pipeline was to be built jointly by several oil companies, but after the authorities cracked down on the dealings with large oil firms (and Yukos, in particular) the prospects for the emergence of private pipelines dimmed. The oil companies are still holding out for the Murmansk pipeline, but possible as a joint project with Transneft. The Murmansk pipeline would provide convenient access to the Atlantic and facilitate exports of Russian crude to the east coast of the US.

The government, on the other hand, has given priority to increasing the capacity of the Primorsk terminal, which is to become one of Russia's top oil export terminals on a par with the giant Novorossisk terminal on the Black Sea. Transneft plans to continue expanding operations in Primorsk until they reach a loading capacity of 1.25 million bpd. Some analysts, however, caution about natural constraints. The sea at the Primorsk terminal freezes over in winter and special-hulled tankers and icebreakers are required.

In the Russian Far East, Japan and China are backing alternative plans for construction of a new Russian pipeline through Eastern Siberia. Yukos supports running the pipeline to China, while Transneft supports a pipeline to the Russian port of Nakhodka. The Russian government has been leaning towards the latter option.

Monetary indicators

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004,**	**as of**
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	10.7	2/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	57.4	1/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	209	1/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.4		11/03
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	12.0		11/03
Forex reserves, $ bln (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	86.3	2/04
RUB/USD (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	28.52	2/04

Source: Goskomstat, CBR.

Russia's large foreign currency inflows causing liquidity problems

by Tapio Korhonen *

A huge trade surplus, combined with the recent reversal in foreign capital flows into Russia, have dramatically increased liquidity in Russia. The Central Bank of Russia has responded to this deluge by purchasing massive amounts of foreign currency in order to restrain rouble appreciation.

Exchange rate stability leading to monetary instability

Foreign currency purchases to stabilise the rouble-dollar exchange rate have nearly doubled Russia's foreign currency reserves since early 2003. The increase in reserves during the period corresponds to Russia's simultaneous current account surplus. Up to 2002, substantial (and largely unrecorded) capital exports tended to neutralise foreign currency earnings generated by the current account surplus. Rapid growth in corporate borrowing from abroad ended this phenomenon last year. Since end-2002, Russia's foreign currency reserves have increased $40 billion to nearly $87 billion, or by almost 10 % of GDP.

Because sellers get roubles in return when the CBR purchases foreign currency, interventions increase liquidity in the economy. In 2003, the value of these interventions roughly matched that of the second main money supply category, credit granted by banks to the public. The stock of credit granted by financial institutions to private enterprises and households increased 45 % in 2003.

Broad money (M2), which rose over 50 % in 2003, would have expanded even faster in the absence of several factors. First, the Russian Federation soaked up public liquidity by running a budget surplus and increasing its deposits with the central bank. The Federation also paid back some of its debts to the central bank. It also transferred oil tariff revenues to a stabilisation fund. (The fund was recently reshaped to allow investment of its resources in foreign government bonds.) These measures, however, only managed to absorb a fraction of the flood of foreign currency.

Low interest rates insufficient to neutralise bank liquidity

The torrent of money can also be seen in bank liquidity. The CBR sops up bank liquidity mainly through deposit and repo operations at various maturities. Low yields offered are intended to discourage capital imports. The one-week rate, for example, is currently just one per cent. However, it makes no real difference from a bank's standpoint as assets would otherwise be sitting at the central bank as non-interest bearing deposits.

Fortunately perhaps, Russia's monetary economy is still heavily dependent on the use of cash. The growth in bank liquidity was dampened by the almost 50 % growth in the supply of rouble cash last year (and corresponds to about half the increase in the CBR's currency reserves). Central bank notes – essentially zero-interest deposits with the central bank – are still broadly considered more trustworthy than bank deposits.

New currency act and liquidity control

The new foreign currency act, which enters into force in June 2004, is based on the premise that Russia's foreign capital movements should generally be free, but allows the central bank, and ultimately the government, the authority to impose reserve requirements on capital imports and exports.

Banks can be required to deposit as much as a 100 % of a capital-export transaction's value for up to 60 days with the central bank. For capital imports (the real problem currently), the reserve deposit has a ceiling of 20 %, although it can be held for as long as a year. In practice, a capital exporter or importer makes such a deposit with a commercial bank, and the bank then deposits it with the CBR.

This reserve system, as it is only meant to stabilise capital movements during the liberalisation phase of the economy, will be phased out at the beginning of 2007. The act's provisions, however, may prove difficult to implement; it is unlikely that the CBR would even attempt to invoke them except in the event of large speculative attacks.

Impact of rapid credit expansion hard to judge

Russia's money supply and public credit expanded vigorously last year – much faster than nominal GDP, which climbed about 20 %. However, the ratio of corporate and household borrowing to GDP rose to just 21 %, while that of broad money rose to 30 %. Only half of M2 is in the form of rouble bank deposits. Rouble cash is 30 % and foreign currency deposits 20 % of M2.

By international standards, the level of the Russian money supply and the level of credit are extremely low. Thus, higher deposits and a further expansion of credit are positive for Russia's economy. Currently, consumption and investment are overly concentrated in those parts of the economy where savings are generated. One key to development of financial markets is finding ways to channel assets to those sectors that can invest them most effectively.

On the other hand, the expansion of deposits and credit should not be so rapid that it threatens price stability and the solvency of Russia's financial institutions. Russia has problems in both respects. Real interest rates (and specifically the prevailing interest rates used to neutralise liquidity) are for the most part negative. The CBR has set for 2004 an inflation target range of 8–10 % and an M2 money supply growth target of 19–25 %. Despite a modest slowing in the fourth quarter, money supply growth exceeded this figure by about double last year.

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Economic Developments

Export prices and volumes up last year

According to revised Central Bank of Russia balance of payments data, Russian exports in 2003 totalled $135.9 billion (up 27 % y-o-y) and imports $75.4 billion (up 24 % y-o-y). Russia posted a record trade surplus of $60.5 billion.

Foreign trade statistics are kept in dollars, so some export growth reflects the weakening of the dollar last year. Nevertheless, most export growth was due to increased prices and volumes. The export price of crude oil rose 13 % and that of natural gas about 25 %. Prices for several metals also increased substantially.

The economy ministry reports the volume of exports climbed over 10 % and exceeded the rate of growth in 2002. According to customs data, the energy sector led again as crude oil export volume soared a record 18 %, while oil products were up nearly 4 % and natural gas 2 %. The volume of coal exports increased 43 % and electricity export volume 16 %. Coal and electricity are still a relatively minor part of Russia's overall exports.

Russia exported as much as 53 % of the crude oil it extracted last year.

Export volumes of some metals also rose markedly. Exports of ferrous metals increased 26 % from 2002, while the volume of aluminium exports grew 13 % y-o-y. Chemicals remained a major export category. Ammonium and mineral fertiliser exports were up 23 and 8 %, respectively. In the forest sector, exports of processed products rose as much as 22 %, while exports of non-processed products increased only 2 %.

The role of energy and raw materials in Russian exports increased further in 2003. Crude oil brought in 30 % of export earnings, followed by natural gas (15 %) and oil products (10 %). Altogether, energy accounted for 56 % of export earnings. Basic metals represented 11 % of exports, chemical products 7 % and forest industry products 4 %. The share of machinery and equipment declined slightly over the year to 9 %.

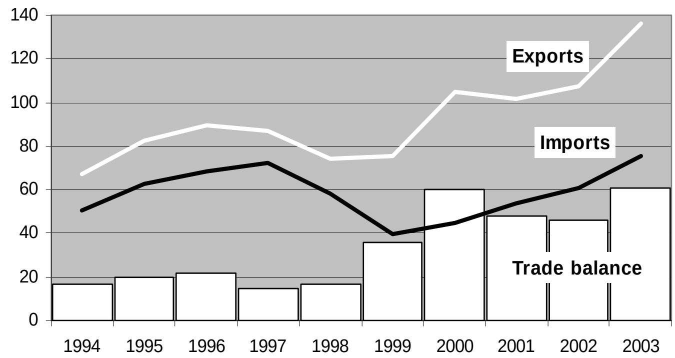
Machinery dominated imports

Average import prices in Russia were up a couple per cent over 2003, while the volume of imports rose some 17 %.

Increasing private consumption is visible in the import figures of the State Customs Committee, which show that the share of machinery and equipment rose to 37 % of all imports. Notably, this does not necessarily signify a marked increase in capital goods imports. Rather growth appears to have been boosted by the 50 % volume increase in passenger car imports and a boom in cellular phone imports. Foodstuffs, the second biggest group, represented 21 % of total imports. The rapid growth in imports of alcoholic beverages continued, with volume nearly doubling over the past two years. The share of chemical products in total imports rose to 17 %, due in part to a rapid increase in pharmaceutical imports.

Approximately a quarter of goods imports are not recorded by Russian customs. (However, the CBR includes in the balance of payments an estimate of these flows.) Anecdotal evidence suggests such imports largely consist of textiles imported for resale by private individuals known as "shuttle traders." It also helps explain why clothing imports have such a small share in Russian custom's import figures.

Russia's exports and imports, 1994–2003 (US$ billion)



Source: Goskomstat

EU's growing importance for Russia

Last year, 35 % of Russian goods exports went to the EU and 38 % of imports came from the EU. The share of the ten new EU member countries was 12 % of Russian goods exports and 8 % of imports. Thus, EU enlargement means that the EU will account for nearly half of Russia's foreign trade in goods. On the other hand, Russia continues to be a relatively small trading partner for the EU. During recent years, EU exports to Russia have accounted for some 3–5 % of total EU exports, while the EU has imported 2–3 % of its imports from Russia.

Germany, the Netherlands and Italy are the absolute leaders in EU exports to Russia. In relative terms, the biggest exporters to Russia are Finland (6 % of total Finnish exports in 2001), Greece (3 %) and Germany (2 %).

Last year, 15 % of Russian exports went to CIS countries, while 24 % of Russian imports came from them.

Macroeconomic indicators

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004,**	**as of**
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3		
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	8.1	1-2/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	13.4	1-2/04
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9	8.1	2/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	134.4	35.8	Q1/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	74.8	18.8	Q1/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	39.1	11.0	Q1/04

Source: Goskomstat, CBR.

Changes in government structures

In response to the task set by president Putin of improving the efficiency of public administration, prime minister Mikhail Fradkov's government is leaner than any of its predecessors. The number of deputy prime ministers was pared from six to one, and ministerial posts from 23 to 15. Several ministries were merged, while others saw a change of status or were abolished altogether. On the other hand, the total number of government bodies (including ministries) grew from 58 to 76.

Observers generally take positive views of appointees to the new cabinet. The reform-minded key ministers of the government's economic bloc retained their posts: Alexei Kudrin continues as finance minister and German Gref as economy minister. Former deputy prime minister Viktor Khristenko will lead the newly created industry and energy ministry. They all now have greater responsibilities than in the previous government.

The *industry and energy ministry* has undergone the most sweeping changes, and now includes the energy ministry, atomic energy ministry and Russia's space agency. The *economy ministry* has also taken on several important functions. It now incorporates the Goskomstat, the customs committee and the energy tariffs commission. The *finance ministry* has taken over the former tax ministry, which manages tax collection.

Most heads of "power" ministries, which report directly to the president, kept their posts.

Under Russia's constitution, the Fradkov government must be disbanded before the inauguration of president Putin for his second term on May 7. The renaming of the Fradkov government is expected to be a formality.

The government reorganisation also affected the central bank. CBR deputy chairman Oleg Vyugin was nominated head of the new *federal financial market service*. In addition to the functions of the former securities market commission, the new service also oversees the investment activities of pension funds. Deputy finance minister Alexei Ulyukaev will become the deputy chairman of the CBR responsible for monetary policy and macroeconomic issues.

Putin keeps focus on administrative reform

In its widest sense, the administrative reform is aimed at reconfiguring the relationship between the federal government and the rest of society, a relationship still characterised by habits from the Soviet era. To this end, president Putin wants to encourage entrepreneurship, as well as increase bureaucratic efficiency and slash corruption.

Administrative reform has already seen certain progress over the past couple of years. A leading issue is the ongoing reform of the judicial system, which will set the basis for the normal functioning of civil society and market economy in Russia. Another major issue is the clarification of the administrative and budgetary relations of federal, regional and local levels. Further reform of budgetary relations remains a priority and will strongly affect all sectors financed through the budget, namely education, health care, social security, culture, housing and municipal services.

In a narrower sense, the administrative reform deals with reorganisation of government bodies. A special commission on the reform was established under the chief of government administration Dmitri Kozak. The commission continues work that has been going on in different forms for almost a year.

The presidential administration was reorganised last month, and later the government staff will also face reform. A concrete task confronting the reform commission is to decide on how to reduce the number of civil servants and departments in federal government bodies.

Finance minister Alexei Kudrin estimates that so far only 10 % of the administrative reform has been implemented.

Implications of government reshuffle for economic policy

President Putin has apparently succeeded at keeping his government busy throughout the election period, despite the shake-up. Announcements of Russia's economic policy stance for the second presidential term already started to emerge before the presidential election. Since the election, information on future policies has become more concrete. The new government and the presidential administration are currently tackling administrative changes caused by the structural reshuffle of government bodies on top of their regular duties.

Continuation of the tax reform, which has already lasted several years, is targeted as a near-term economic policy priority. The general aim of the reform remains unchanged, i.e. the overall tax burden will be eased and the emphasis of taxation will shift from processing industries to extractive industries (and crude oil production, in particular). According to some plans, the value-added tax would be further reduced from the current 18 % (it was just cut from 20 % at the start of 2004). The social tax will also be modified. Its regressive scale will likely be reduced so that the highest rate of 35.5 % is cut to 26 %. Some worry, however, that such cuts in tax income could endanger the sustainability of the new pension regime.

The government will make concrete decisions on various taxes in the near future. The aim is to submit proposals on tax rates and new taxes to the Duma so that they will be in force when the 2005 budget is discussed.

During the Duma's spring session, the government plans to submit a proposal on a new act on subsoil use. It is hoped that the new act will increase the transparency of the permit-granting process and better secure the status of companies holding licences (something foreign oil companies, in particular, have wanted).

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-year figures for debt)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004,**	**as of**	**2004 budget law**
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	19.4	20.4	1/04	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.4	17.7	10.8	1/04	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.8	1.7	9.6	1/04	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	28.3		9/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.6		9/03	

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–1998, Economic Expert Group 1999–2004. Debt: IMF 1996–1999, Minfin 2000–2003.

Despite the loss-makers, aggregate enterprise profits rose in 2003

Analysing the financial position of Russian enterprises is complicated and results are equivocal by any measure due to the statistical deficiencies and use of accounting standards incompatible with international practices. The statistics suffer from data unreliability and lack of scope. Tax evasion is common in Russia, and since the financial data submitted to Goskomstat are also used by the tax authorities in calculating taxes, enterprises are strongly motivated to underestimate profits. As regards scope, Goskomstat reports that about four million enterprises are registered in the official state register of enterprises and organisations. However, at the end of 2003, half of these had failed to reregister as required, implying they either ceased to exist or neglected their registration duty.

Besides Goskomstat, some research institutions publish regular surveys that cover certain groups of enterprises, usually including the large companies. Surveys often concentrate on specific aspects of enterprise behaviour or on particular branches of industry.

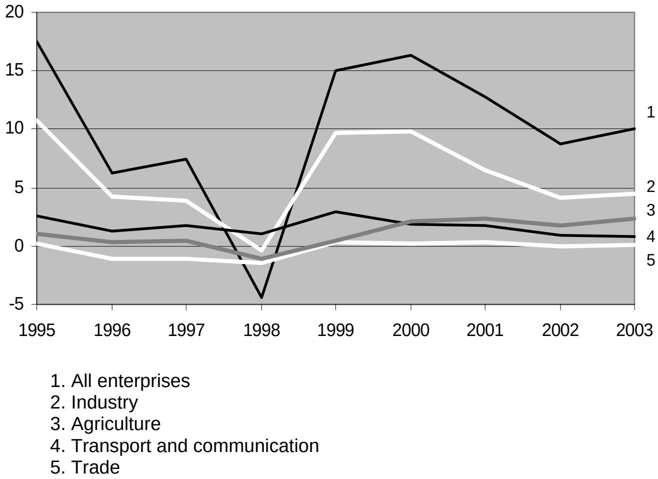
Goskomstat's enterprise profit survey covers about 100,000 large and medium-sized enterprises and organisations. The sample excludes small enterprises, banks, insurance companies and budgetary organisations. In 2003, the aggregate net profit (profits minus losses) of the sample enterprises grew considerably. It stood at RUB 1,343 billion ($46 billion), up from 2002 by 43 % in nominal terms. Some 45 % of aggregate net profits were generated by industrial enterprises; another fifth came from trade and catering enterprises.

Among industrial enterprises, fuel production had the largest profit share, 17 %. That share, however, was down from 20 % in 2002 and 22 % in 2001. For trade and catering, the trend has been quite the opposite, with their share having increased from 18 % in 2002 to 23 % in 2003.

The increasing significance of trade and catering in recent years can at least partly be explained by the rising popularity of transfer pricing. For example, a recent World Bank study found that oil and gas companies sell their production to trading companies at below-market prices to avoid taxes. The trading companies, often situated in regions granting them tax benefits, resell the products to final customers and enjoy large price margins. The practice distorts the perceived financial performance of both oil and gas producers and traders.

Against this background of rising aggregate profits, is the fact that over 40 % of the sample enterprises in 2003 posted losses. Their aggregate losses amounted to RUB 265 billion ($9 billion). Although the share of loss-makers has dropped from a peak of over 50 % in 1998, it remains high and indicates that the Russian economy has yet to function as a normal market economy. Depending on the branch, the share of loss-making enterprises varied in 2003 from 17 % in pipeline transport to 62 % in housing.

Net profits of surveyed enterprises by main industries in 1995–2003 (% of GDP)



Source: Goskomstat

Number of small enterprises increases

After a sharp decrease in 1999–2001, the number of small enterprises began to rise again in 2002. At the end of 2003, Russia had about 891,000 small businesses. (This figure does not include several millions of individual entrepreneurs.) The growth of small firms is partly explained by tax benefits and reduced bureaucratic burdens in recent years. Some of the growth may also reflect break-ups of middle-sized firms seeking tax relief. Large enterprises have also spun off small firms for the same reason.

At the beginning of 2003, a new regime was introduced to simplify and lower the taxation of small enterprises. Small enterprises were given the possibility to pay a single unified tax instead of five separate taxes – VAT, profit tax, sales tax (abolished from 2004), property tax and part of the social tax. They could also choose between paying a turnover tax of 6 % or getting taxed on the difference between revenues and expenditures at a rate of 15 %.

In February 2004, the government reviewed experiences with the new regime and suggested changes. According to early official statements, the emphasis in the future will be on further reducing red tape rather than decreasing the tax burden on small enterprises.

Despite the recent increase, small enterprises still only account for a relatively small share of the labour force. In January-September 2003, small enterprises were estimated to employ some 11 % (7.4 million people) of Russia's employed labour force, up from less than 10 % (6.2 million) in 1998.

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	10.3	3/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	56.9	2/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	210	2/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.4	4.7	1/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	12.0	12.2	1/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	83.4	3/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	28.49	3/04

Source: Goskomstat, CBR.

Russia's growth prospects for 2004–2006

by Jouko Rautava*

Russia's real GDP growth accelerated last year to 7.3 %, about 3 percentage points higher than most forecasters expected at the beginning of 2003. The growth surprise resulted from high world commodity prices. According to some calculations, oil and gas industry accounts for over a fifth of Russian GDP. Hence, developments in the oil and gas sector strongly affect the rest of the economy. This applies in particular to the fiscal sector.

Strong import demand despite slowing output growth

The Bank of Finland has developed a small, quarterly econometric model of the Russian economy. In our analysis of the period 2004–2006, we have concentrated on the role of oil prices and exchange rate developments in Russia's medium-term growth dynamics. Technically, we apply a cointegration and error-correction approach to allow fluctuations in oil prices and the rouble's real exchange rate to influence Russian GDP through both the long-run equilibrium condition and short-run direct impacts of the variables.

International commodity prices have a significant impact on Russia's economy, but output growth is not solely an oil play. Economic reforms and investments in recent years have encouraged modernisation and productivity growth in various sectors. Our estimates indicate that the output growth trend for the Russian economy, independent of oil prices and the real exchange rate, has accelerated in recent years and is currently about 4 % per annum.

We have assumed that the present relatively high international oil prices (Brent) will fall to $28/bbl by the end of 2004 and will remain at that level until the end of 2006. Further, we note that the Central Bank of Russia is considering replacing its managed float based on the US dollar with a currency basket approach (indeed, some sources say this is *de facto* already the case). Even so, we do not believe a possible regime shift in exchange rate policy will alter Russia's price competitiveness compared to today's situation. Accordingly, we find the trade-weighted real exchange rate of the rouble will appreciate about 3 % per annum in the forecast period.

While recent high oil and commodity prices will give the Russian economy an extra boost for some time to come, real appreciation of the rouble will gradually reduce Russia's competitiveness and, consequently, restrain economic growth. As the chart (opposite) shows, Russia's output growth should decelerate from over 5 % in 2004 to close to the 4 % trend growth in 2006. Despite gradually decelerating output growth, Russia's import demand will remain strong. This reflects the opening up of the Russian economy, real appreciation of the rouble and strong liquidity guaranteed by a large current account surplus (9 % of GDP in 2003). We estimate that Russia's import demand in volume terms will increase 10–12 % annually in 2004–2006. In 2003, the volume of Russian imports increased 17 %.

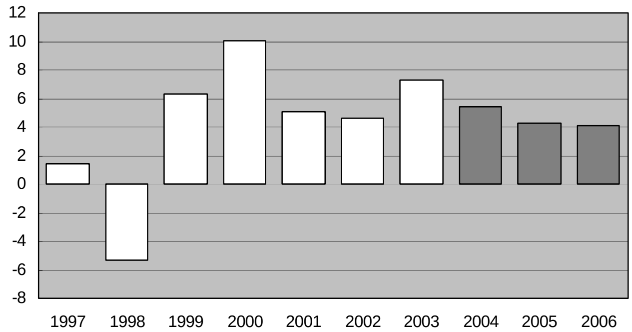
Uncertainties range from oil prices to developments in China

To assess Russia's vulnerability to fluctuations in international oil prices, we computed various scenarios based on different oil price assumptions. For example, assuming that oil prices fall permanently to $20/bbl at the end of 2004, Russia's GDP growth in 2005 will be about 2 percentage points below the base scenario.

Another obvious risk relates to cost trends. The real appreciation of the rouble is a result of persistent inflation that runs well above that of competitor countries. Moreover, in addition to various long-term needs to increase domestic prices, it is possible that some administratively set prices (energy, communal services, transportation) were deliberately kept low before the recent election cycle. Hence, we might expect additional short-run price pressures from these items.

China has also emerged on the scene as a wild card in Russia's economic development. Not only has China begun to exert a substantial impact on international commodity prices, its specific demand for Russian energy and raw materials has begun to modify Russian output trends. China's share of total imports to Russia rose from 2 % in 1995 to 6 % in 2003. Chinese exports to Russia already outpace those of all developed industrial countries, except Germany. Besides developed industrial countries, Chinese output also poses a substantial challenge for Russian industry, which will have to find a role for itself between the high productivity of European industry and the extremely low production costs of its Chinese competitors.

Russia's GDP, y-o-y %-change



Sources: Goskomstat, Bank of Finland

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Economic Developments

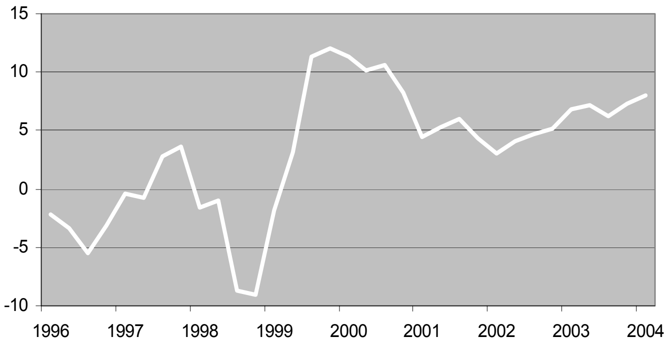
Strong growth in first quarter

Advance information from the economy ministry states that GDP was up about 8 % year-on-year the first quarter of 2004. This pace somewhat exceeded growth in the same period a year earlier. Growth was driven mainly by high world market oil prices. Urals-grade crude averaged more than $30 per barrel in early 2004.

The State Statistical Service (formerly Goskomstat) reports that workday-adjusted industrial production increased over 6 % y-o-y (7 % unadjusted) in the first quarter. Booms in construction and investment, as well as strong consumer demand drove growth. Highest industrial growth, 22 %, was recorded in glass and china production. Among the main industrial sectors, machine building and metalworking rose 18 %, construction material production 12 %, chemical industry 11 %, while both the medical industry and fuel production were up 9 %. In the fuel sector, the volume of crude oil extraction rose more than 11 % from 1Q2003. The respective figures for natural gas and coal were 3 % and 1 %. First-quarter crude oil production averaged 8.9 million barrels per day.

Construction remained brisk in 1Q2004, up 14 % from a year earlier, while freight transport rose 8 %.

GDP by quarters, on-year % change



Source: State Statistical Service

GDP forecasts revised upwards

In April, the economy ministry released a revised GDP growth forecast for the current year. Due mainly to higher global oil price projections, GDP is now expected to grow 6.4 % instead of 5.2 % as initially forecast.

The economy ministry has also been working on economic growth scenarios for 2005 and beyond. The forecasts, which has been preliminarily agreed on by the government, sets the annual GDP growth during 2005–2007 at 6.2 %. This scenario assumes the world price for Urals-grade crude averages $24 a barrel over the period.

The IMF also published in April its latest growth forecasts for individual countries. The Fund matches the consensus estimate of experts that Russian GDP will rise 6 % in 2004. For 2005, the IMF forecasts growth of over 5 %.

Ambitious inflation targets

In March, Russian consumer prices were 10.3 % higher than a year earlier. Since the start of the current year, consumer prices have grown 3.5 %. The government is confident that the target of 8–10 % for current year's inflation will be met.

Consumer inflation may, however, be boosted in coming months by cost developments as producer prices have recently increased much faster than consumer prices. Industrial producer prices have soared since the start of the year, in part reflecting developments in world market commodity prices. Producer prices in March were up 19.2 % y-o-y. Since the start of the year, producer prices have risen 9.5 %. Moreover, administrative price increases for e.g. utilities were kept to a minimum ahead of this spring's presidential elections. If these prices climb, further pressure to consumer prices can be expected.

The IMF has warned Russia on the dangers of persistent high inflation and expects that consumer price growth will this year slightly exceed the upper limit of the government forecast. It also wants Russia to implement stricter fiscal and in particular monetary policies to dampen inflationary pressures. One means of achieving tighter monetary policy would be to allow faster appreciation of the rouble.

Consumer and producer prices, previous month = 100

Source: State Statistical Service

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3		
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	7.6	Q1/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	13.1	Q1/04
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9	7.9	3/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	134.4	35.8	Q1/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	74.8	18.8	Q1/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	39.1	11.0	Q1/04

Source: Goskomstat, CBR.

Federal budget headed for another surplus year

Despite large interest payments on foreign loans made during the first quarter of 2004, preliminary figures from the finance ministry indicate the federal budget produced a RUB 63bn (€1.8bn) surplus. The surplus corresponded to 1.8 % of estimated GDP for the quarter. Budget revenues were RUB 689bn, which exceeded budget by 8 %. Expenditures, in contrast, were 8 % below budget.

Finance minister Alexei Kudrin estimates this year's overall budget surplus will equal 1 % of GDP, i.e. exceed the target of 0.5 % of GDP set out in the 2004 budget act. Some observers foresee a budget surplus of nearly 2 % of GDP. The growth in the surplus reflects higher-than-anticipated oil export prices, which, in turn, are boosting customs and tax revenues.

The first-quarter surplus was transferred to the stabilisation fund, which at the end of March stood at RUB 143bn (€4bn). The purpose of the stabilisation fund is to provide for budget needs in years when oil prices are low. Sources in the Russian government expect the stabilisation fund to reach RUB 300bn (€8.4bn) or about 2 % of GDP by the end of this year. When the stabilisation fund reaches RUB 500bn, further surpluses may be used for other purposes.

The wisdom of placing a ceiling on how much money is accumulated in the fund can be validly challenged. A fund with assets equal to some 3 % of GDP is sufficient to help in ironing out temporary business cycle effects, but inadequate in the face of, say, a large structural imbalance precipitated by a collapse in oil prices. For comparison, the size of the Norwegian Petroleum Fund exceeds 50 % of the country's GDP.

Government approves tax changes – oil industry on the firing line

Russia's tax system has undergone continuous modification since the early 1990s. Despite the reform attempts, the federal budget remained in red throughout the 1990s and only began to show surpluses in recent years in part because oil prices went up. The current wave of tax reform began with adoption of the first part of the new tax code at the beginning of 1999. It defines the basic framework for the tax system. The second part, which includes sections on individual taxes, is being adopted by the Duma incrementally.

In late April, the state Duma quickly approved government suggestions for increased taxation of the oil industry. The government is now expected to submit to the Duma proposed changes to VAT, the unified social tax and several other taxes. The changes aim at promoting diversification of the Russian economy by enhancing investment in non-resource-based sectors and raising the degree of processing.

Oil companies will see changes in the mineral extraction tax (MET) and oil export duties. The basic MET rate on oil will rise 15 % (from 347 roubles to 400 roubles per tonne) from the start of 2005. The base rate is used in a formula, which determines the amount of MET. The formula includes both the oil export price and the RUB/USD exchange rate. The government is expected to soon discuss a finance ministry proposal on differentiating the MET according to characteristics of oil fields.

From the beginning of August, the current three-tier scale of oil export duties will be replaced with a four-tier scale. Under the new system, oil export duties range from 0 % when the price for Urals-grade oil is below $15 per barrel to 65 % when the oil price exceeds $25 per barrel.

Compared with the current situation, the combined effect from changes in oil export duties and the MET will increase taxation of oil companies when the Urals price exceeds $18 dollars per barrel. At the current Urals price of some $30 dollars per barrel, the federal budget would annually gain an additional $3 billion in revenues. Two-thirds of the sum would come from increases in oil export duties and a third from changes in the MET.

VAT, which was lowered from 20 % to 18 % at the beginning of 2004, will not be lowered further until 2006. The government is considering the introduction of special VAT accounts to reduce abuse of VAT refund rules.

The government is also seeking to raise the tax on dividends from 6 % to 9 %, index excise duties to inflation and introduce changes to the taxation of land and property of natural persons. The reforms would be implemented in 2006.

Pensions jeopardised?

Planned cuts in the unified social tax have precipitated a heated discussion on the future of pension reform, because social tax revenues are used mainly to finance pension outlays. Instead of the present four-level regressive tax scale, the government has proposed the introduction of a three-level scale with the maximum tax rate reduced from 35.6 % to 26 %. The changes would enter into force from the start of 2005 and drop the effective social tax rate from 29 % to 24 % of an organisation's payroll. This translates to approximately RUB 280 billion ($10 billion) in annual tax relief for enterprises.

The reductions would decrease federal budget revenues, particularly to the pension fund. Increases in oil taxes would not fully cover the revenue loss. To correct the situation, the government has suggested changes to the newly created pension system that would reduce benefits for certain categories of employees. Employees born in 1953–1966 (men) and 1957–1966 (women) will be partly excluded from the new pension system. Instead, they are urged to voluntarily pay at minimum 4 % of their wages to state pension fund or private funds. The state would pay a minor yearly supplement to their contributions. Critics argue that the credibility of the pension system will be destroyed if the Duma approves the government's suggestions.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-year figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2004 budget law
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	19.4	19.6	1-2/04	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.4	17.7	17.4	1-2/04	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.8	1.7	2.2	1-2/04	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	26.9		12/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	121.6		12/03	

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–1998, Economic Expert Group 1999–2004. Debt: IMF 1996–1999, Minfin 2000–2003.

Nearly half of Russia's trade surplus consumed by spending on foreign services and capital earnings payments

Although Russia's trade balance continues to improve, its current account surplus appears to have levelled off. In the first quarter, the current account surplus, an impressive $11 billion, was nevertheless slightly smaller than in 1Q2003. For all of 2003, the trade surplus was $60 billion, while the current account surplus was $36 billion. Both figures – 14 % and 9 % of GDP, respectively – are relatively large by international standards.

In addition to the trade balance, the current account includes costs of services related to foreign operations, payments on foreign capital, wages paid to foreign workers and income transfers. Wages paid to foreign workers and income transfers (e.g. foreign workers sending money home to their relatives) represent a relatively minor share of Russia's balance of payments in terms of both inflows and outflows.

In services, only freight transport produced net income for Russia. Foreigners paid Russian transport companies nearly double the amount Russians paid to foreign transport companies. The net earnings for Russia last year amounted to $3 billion, or almost 1 % of GDP.

Spending on tourism showed a strong net outflow. Russian tourists spent nearly $13 billion abroad, i.e. about 3 % of GDP, while foreign tourists visiting Russia only spent about a third of that. In other service categories, Russian net outflows abroad were somewhat smaller.

The deficit on capital earnings widened rapidly. Although interest payments have fallen as the state has paid down foreign debt, company interest payments on foreign loans and dividends to foreign investors more than doubled last year to $11 billion, or nearly 3 % of GDP. In particular, the earnings of foreign investors in Russia increased dramatically.

Notably, although Russia has more claims outstanding on foreign entities than foreign creditors have on Russia (even according to official figures), Russia nevertheless found itself remitting far more money to foreign creditors than it than it received from abroad. The net outflow was equivalent to 3 % of GDP.

It is possible, of course, that some of Russia's foreign earnings have not been recorded in the balance-of-payments figures, or it may be that some of the growth in payments on capital earnings is temporary. In any case, the main reason for the imbalance appears to be the fact that most Russian claims abroad are either zero interest (e.g. foreign banknotes and non-performing loans) or extremely low yield (e.g. short-term deposits and short-term securities such as those held in the CBR's foreign currency reserves). In contrast, foreign investors in Russia typically demand relatively high real rates of return on both fixed-capital and portfolio investments due to Russia's high country risk and uncertainty over long-term economic trends.

Exchange rate debate

Russian officials have recently begun to discuss exchange rate policy publicly. The debate has two themes. First, from a policy standpoint, what is the appropriate anchor currency or currency index by which to measure the rouble's exchange rate? Second, what is an appropriate target rate or appropriate fluctuation range to impose on the rouble's movements? The discussion has been muddied somewhat by statements from politicians on different sides of the debate to the effect that established inflation targets are more important than exchange rate policy in setting economic policy. In any case, no official changes in exchange rate policy have been declared.

In recent years, the CBR has set annual limits for the rouble's effective exchange rate (foreign-trade-weighted basket), while avoiding a simple exchange rate target. This year, assuming oil prices remain high, the rouble's trade-weighted exchange rate adjusted for inflation will be allowed to appreciate as much as 7 %. The appreciation is justified in light of e.g. recent strong gains in productivity.

Public debate traditionally only focused on the rouble-dollar exchange rate, and CBR interventions typically sought only short-term stabilisation of the rouble's exchange rate against the dollar. CBR deputy chairman Konstantin Korishchenko recently announced that monetary policy will now instead be anchored to a currency basket based mainly on the dollar and the euro. While the euro's initial share would only be 10–20 % of the basket, its share would eventually rise to 50 %. The 7 % ceiling would apply to the real value of the new currency basket.

The share of euro trading in the Russian forex market is still quite small. Moreover, while a third of Russia's foreign trade is conducted with countries of the euro area, most pricing is done in dollars. In this respect, a 50 % euro weighting in the currency basket seems quite large.

Despite major CBR interventions, the large current account surplus has driven the continued rouble strengthening. In the first quarter of 2004, the rouble strengthened 2.6 % nominally and 4.7 % in real terms against the trade-weighted currency index. The rouble strengthened 2.3 % overall against the dollar in the first four months of this year. In April, however, the rouble weakened against the dollar 0.6 % – perhaps in part due to the policy shift.

President Putin, meanwhile, continues to stress the importance of an inflation target. Both the government and the central bank have targeted an 8–10 % rise in consumer prices for this year and 6.5–8.5 % for next year. Substantial inflationary pressure now exists as a result of high prices for Russian export products and the rapid expansion of credit in Russia. If it begins to look like Russia will be unable to keep inflation within the declared target range, a tighter monetary stance appears inevitable. The central bank might also in such case accept further strengthening of the rouble.

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	10.3	3/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	54.1	3/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	230	3/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.4	4.2	2/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	12.0	11.0	2/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	83.4	3/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	28.88	4/04

Source: Goskomstat, CBR.

Russian education levels surprisingly low

Aku Alanen*

On paper, Russia's labour force is educationally on a par with the EU average. In 2002, about 22 % of the labour force held tertiary education. St. Petersburg's 37 % share was impressive even by international standards. Nevertheless, since countries define quality differently, ranking countries by their assertions on educational quality tells us precious little about the actual skills of a particular labour force.

Even with the dearth of national information on education quality, a number of international comparisons have been attempted. The most respected and ambitious among these is the OECD's Program for International Student Assessment (PISA), which focuses on comparative surveys of the reading, mathematics and science literacy skills of 15-year-old students in various countries. PISA is quite forward looking from the standpoint of competence. Learning achievement is evaluated broadly from three perspectives: further education, everyday and working lives and future participation in society.

In previous international comparisons, test questions were taken directly from set curricula. PISA testing, in contrast, requires that student show proficiency in solving problems involving multiple branches of knowledge and synthetic processes. No amount of rote memorisation can help as PISA tasks are closely akin to actual situations confronted at work.

Poor basic education

The Russian educational system, traditionally perceived internationally as highly successful in hard sciences, received a crushing repudiation in PISA's first survey concentrating on reading literacy. In almost every category, Russia found itself grouped with the weakest performers in the study. Similar results were provided from the science literacy survey. In mathematical literacy, the results were only slightly better. The findings indicated Russian schools, while good at teaching how to complete school assignments, were quite poor at preparing individuals for the real world.

Reading literacy was evaluated according to three main criteria: the ability to acquire information, reading comprehension and interpretation and critical thinking. Russian students were among the poorest performers according to all these criteria. Often only Mexico and Brazil ranked lower. For example, Russian students were poor at discerning relevant information from fact clusters; instead they tended to treat all facts as equally relevant.

Moreover, PISA found that Russian teenagers performed poorly despite the relative abundance of classical literature and other cultural artefacts in their homes. An ability to read, it seems, is no guarantee of an ability to grasp content.

When analysing PISA results, Russian experts acknowledged that Russian teaching approaches are antiquated. Russia's Academy of Education said that Russian students are unfamiliar with independent analysis, in part, because the humanistic tradition in Russian education has tended to focus on ultimate truths rather than systematic examination and evaluation of multiple perspectives. The Academy further noted that education in Russia does not emphasise information acquisition, modern research approaches or an ability to synthesise multi-disciplinary information independently.

Weak in science

A previous international comparison in mathematics and science, the Trends in International Mathematics and Science Study (TIMMS) limited its test problems to those similar to what was taught in school. The TIMMS results indicated that Russian students belonged in little above the middle internationally and generally outperformed their US counterparts. This made PISA's findings in mathematics and science an even greater letdown for the Russians.

Physics, chemistry and biology are taught as separate subjects in Russia. PISA questions demanded application of these subjects in real-life situations. Although Russian students had decent, even excellent, knowledge of subjects like physics, they were incapable of applying this knowledge outside familiar contexts.

Russian students also appeared to be very poorly oriented towards such matters as ecological thinking, healthy life styles and the relationship of science and society. Such considerations simply never arise in traditional textbooks or curricula.

Innovation culture not appreciated

Russia has done little to date to change its educational model. Instead, Russian schools continue to turn out students who are modestly prepared for higher education and poorly prepared for the demands of working life and civil society. While it is well recognised that the ability to think independently and critically underlies a successful career, the current curriculum produces fungible workers with generic skill sets to serve the needs of hierarchical organisations. If and when Russian organisations become less hierarchical, employers can surely be expected to value other talents.

Even the Russian Academy of Education warns that, without major changes, the international competitiveness of Russian schools will continue to decay.

Improvements in education require efforts from all parts of society. Unfortunately, neither the Russian state nor the society-at-large possess the interest or patience to see through major educational reforms. If anything, the state and society currently seem to be embracing more authoritarian attitudes. How can schools promote critical thinking and independence when society doesn't value it?

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Economic Developments

Is growth up or down, industry diversifying?

Economic growth in this leap year may be slightly exaggerated by the additional working time. The economy ministry's preliminary GDP growth figure of 7.4 % y-o-y in January-April yielded 6.3 % growth when adjusted for the number of working days and seasonal variations. In January-April 2003, the adjusted figure was 5.9 %. Any higher growth this year should not be very surprising given that world market prices for oil, gas and metals rose strongly last year. Most sectors of the economy that produce little or no tradable output grew fastest. In particular, construction continued strong showings, followed by trade. Growth in pipeline transport of oil and rail transport drove the freight transport. Statistics suggest private services grew much faster than a year earlier. Agricultural output fell slightly, despite increased protection from imports for certain produce.

For industrial production, the January-April growth of 7.4 % y-o-y translated into 6.4 % workday-adjusted growth, slightly slower than in January-April 2003. There are some signs of diversification. First, although oil production was still among the fastest growing branches of industry, it contributed less of total industrial production growth (35-40 %) than in recent years (40-60 %). The growth contribution of basic metal industries also fell (to less than 10 % from 15-20 %). The contribution levels result from applying sector weights devised by the World Bank this spring, which are apparently more realistic than the weights suggested by official statistics (see *BOFIT Russia Review 3/2004*). Second, among the sizeable non-resource industries growth of the food industry accelerated. The machine-building industry, e.g. including the relatively weighty car industry, and some chemical branches grew rapidly.

On the other hand, imports continued to boom for the fifth year in a row. This held the growth rate of domestic production below that of domestic demand.

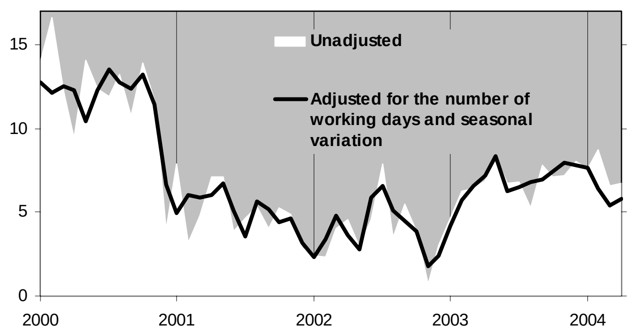
The economy ministry relatively cautiously revised its projection from its recent spring projection so that the oil price is now expected to rise slightly this year from last year's level and GDP should grow 6.6 %. Consensus estimates have shifted towards 7 % growth.

Export and import growth slightly slow

Russia's export income continued to rise in 1Q04, albeit slightly slower than last year. Measured in dollars, exports grew 20 % y-o-y. Like the two previous years, the dollar's depreciation accounted for some of the high growth. Preliminary estimates indicate the export volume was up around 10 % y-o-y. Oil exports continued to boom, rising 15 %. Exports of oil products increased 6 %, while natural gas was up only 1 %. The rise in export prices (in dollars) primarily reflected a jump of metal prices last year. The export price of natural gas was up less than 10 % y-o-y and the crude oil export price was virtually the same as a year earlier.

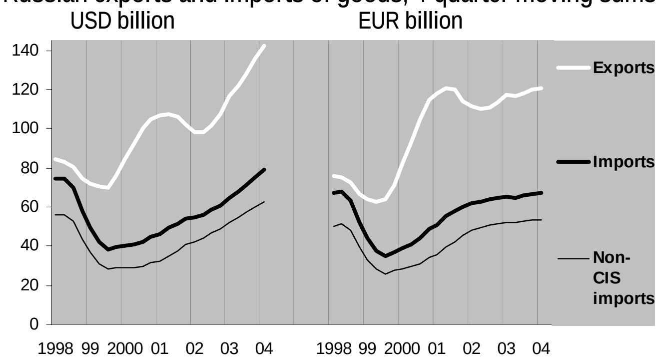
Import growth slowed slightly in 1Q04, but imports still increased over 20 % y-o-y in dollar terms. Non-CIS imports increased slightly less. Measured by the CBR's currency basket of Russia's trading partners, import growth was around 10 %. Imports of machinery and equipment increased rapidly, but due in part to a near tripling in passenger car imports from 1Q03 in quantity terms. Machinery (excluding passenger cars) accounted for about 35 % of total goods imports recorded by the Russian customs. The share of food and raw ingredients was down to 19 %, while the share of chemical imports was around 16-17 %.

GDP, % change from a year earlier



Source: Ministry of Economy

Russian exports and imports of goods, 4-quarter moving sums



Source: CBR

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3		
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	7.4	1-4/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	12.9	1-4/04
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9	8.3	4/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	134.4	35.8	Q1/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	74.8	18.8	Q1/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	39.1	11.0	Q1/04

Source: Goskomstat, CBR.

Putin demands speedier social reform

In his yearly state-of-the-nation address, president Putin laid a much stronger emphasis on social reform than in his previous speeches. He noted plenty of problems in the social sphere. Despite a significant decline in the number of poor, about 30 million Russians still have incomes below the poverty line. Most Russians also encounter housing problems. Education, although of high quality by world standards, does not match with needs of Russian society. The reform of medical care has lagged significantly.

The President called for greater competition in the housing sector as today too few apartments are constructed and those that get built are often below quality and safety standards. He would like to see at least a third of Russians acquire a modern apartment by 2010 (instead of every tenth today). To achieve this, housing construction monopolies would have to be dismantled, a housing credit system developed, the real estate registration system improved and the property rights of the apartment owners secured.

Putin stressed the importance of linking the provision of education to the demands of the labour market. He wants Russia’s educational system to strive for a situation where majority of graduates from schools can work in the fields of their specialisation. At present, over half of university graduates do not find jobs in their areas of specialisation while the intake to universities has tripled since the Soviet era. Thus, the educational system needs to be redirected towards professional education. Imposing stricter educational standards would also assure equal access to schools and guarantee transparent and objective evaluation of the knowledge of those wishing to enter educational institutions.

Reforms of the Russian medical system have yet to produce significant results. The average life expectancy of Russians remains much lower than in many countries, reflecting e.g. high death rates in the working-age population. Child mortality also remains high. The president said all Russians deserve equal access to high-quality, free medical care, and that voluntary medical insurance should also be encouraged.

Economic growth to raise living standards, fiscal policy focal

The President observed that the basis for higher living standards lies in the sustained economic growth – essentially a restatement of his earlier call for doubling the GDP per capita within a decade. He stressed the need for balanced fiscal policy and a shift to result evaluation in budget expenditure management. He noted it was possible to slow annual inflation to 3 % and reach full convertibility of the rouble earlier than 2007 as planned by the government and the CBR.

Putin pointed out that the current Russian tax system is too oriented towards fulfilling fiscal functions. To promote Russia's competitiveness, the tax system should favour investments and business more than in the main rival countries. Putin singled out the planned reduction of social taxes and VAT. He also stressed the need to draw a line between legal and illegal tax minimisation, as well as provide transparent, uncorrupted access to natural resources.

Transport infrastructure needs to be modernised

This was the first state-of-the-nation address to deal with development of transport infrastructure. The President stressed the importance of modern transport infrastructure as a prerequisite for the unity of Russia and for raising its competitiveness, noting that underdeveloped road and port infrastructure already hampers growth.

Putin urged the government to speed up decisions on major infrastructure projects, i.e. new pipelines for exports of oil and exports and domestic distribution of gas, and modernisation of domestic and transit road links. The government intends to decide by the end of this year on whether to build a new pipeline to serve Japan and possibly also other Pacific markets from Angarsk in Siberia to Nakhodka, or alternatively, to Danqing in China. There are also plans to build a pipeline from Siberian oilfields to the Port of Murmansk.

Considering Russia’s geographic immensity, Putin’s remarks on development of transport infrastructure are strongly welcomed. During the Soviet era, remote parts of Russia were integrated to core regions through state subsidies. After the collapse of the USSR, these subsidies essentially vanished. In particular, Russia’s Far East and parts of Siberia have become more isolated. The Far East has substituted internal trade with other Russian regions with trade and cooperation with nearby countries, China in particular.
With sufficient infrastructure investments, Russia stands to benefit from its large size and specialize in transit transport between Asia and Europe. A step towards this was Russia’s decision to participate in the UN-coordinated Trans-Asia Highway Agreement, under which some 140,000 km of highways, stretching from the Far East to Western Europe, would be constructed or improved. There are also great prospects in the railway sector. Transport times from Pusan in South Korea to Europe via the Trans-Siberian railway could be notably shortened if the railway link between Northern and Eastern Korea, reconnected in summer 2003, was put back in operation. The planned Northern East-West multi-modal freight corridor linking China to North America would proceed via Russia and the Atlantic.

In recent years, development of transport infrastructure had a low priority. Consolidated budget expenditures on transport and road maintenance have hovered around 2 % of GDP during the past four years. The government approved a state transport policy in 1997 that has only partly been implemented. Although the draft transport strategy prepared by the transport ministry at the end of 2003 has yet to be submitted to the government, the government recently discussed the highway development part of the strategy. The highway part may be decided this year.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-year figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2004 budget law
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	19.4	19.7	1-3/04	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.4	17.7	15.8	1-3/04	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.8	1.7	3.8	1-3/04	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	26.9		12/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	121.6		12/03	

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–1998, Economic Expert Group 1999–2004. Debt: IMF 1996–1999, Minfin 2000–2003.

Bank deposits continue to expand amidst shift to roubles

The revival of bank savings in Russia after the 1998 financial crisis has been coupled in the past year with substantial "de-dollarisation", i.e. replacing foreign currency with roubles. At the end of 1Q04, the stock of deposits of households and enterprises in banks operating in Russia had grown over 30 % y-o-y in nominal terms or 20 % in real terms, implying a slight deceleration in bank deposit growth. Confidence in banks is gained gradually, so a steeper rise may require clear movement towards completing the assessment of banks to determine which ones will be allowed into the new household deposit insurance system.

Regarding both rouble deposits and rouble cash in circulation, their growth accelerated to 40 % y-o-y in real terms, while foreign currency deposits declined 10 %. Thus, money supply growth in Russia does not look as alarming as suggested by the 40 % y-o-y growth of the conventional measure of rouble money supply (M2). In fact, money supply figures that include forex deposits (M2X) rose only slightly over 20 %. That growth figure may also be too high for the actual money supply (M2X+foreign cash), since e.g. data for last year and this year on foreign cash transactions between banks and households, and on imports and exports of foreign cash by banks suggest some movement away from foreign cash.

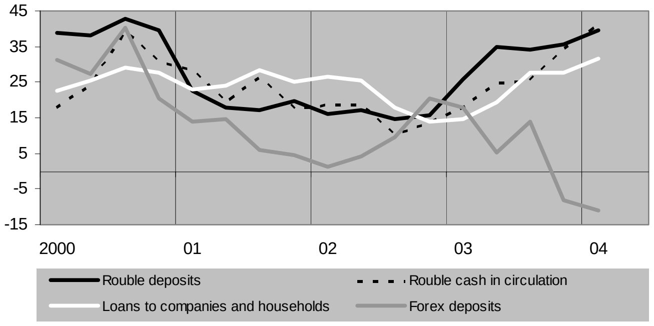
Trust in the rouble has thus increased in line with the dollar's decline from early 2003 to early 2004. Of course, foreign cash still equals some 10 % of GDP (or more), while rouble cash is at little over 8 % and bank deposits at 22 % of GDP. The data on banks' foreign cash operations also indicate a gradual ongoing shift from the dollar to the euro as both a phasing-in process and a response to the euro's significant appreciation from spring 2002 to the end of 2003.

Bank lending booms

Bank loans to companies and households have also expanded at an increasing tempo, making the stock of loans at the end of 1Q04 over 30 % larger in real terms than a year earlier. Loans to companies increased about 30 %, while the growth was constrained by the fact that some of Russia's largest industrial companies have preferred to borrow on international markets. Indeed, at the beginning of this year, the enterprise sector's foreign debt was over one-half the size of the sector's domestic bank debt. Also, the share of domestic bank loans extended to companies in the industrial sector declined last year to 37 %. Meanwhile, loans to households have become a rising banking business in Russia. Although such loans represent no more than 12–13 % of all bank loans to companies and households, the stock of household loans doubled between the end of 1Q03 and 1Q04.

The rouble is also gradually establishing itself in bank lending, although 30 % of all bank loans were still forex loans at the end of 1Q04. Loan maturities have continued to lengthen, which has raised the share of loans with maturities over one year to almost 40 %.

Bank deposits and loans; rouble cash in circulation; % change in real terms from four quarters previous



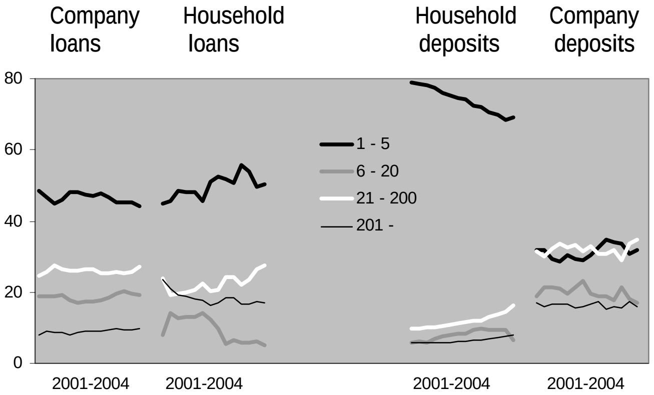
Source: CBR

Smaller banks increase market share

In the crowd of over 1,300 banks operating in Russia, banks that do not rank in the top 20 in terms of total assets have succeeded in expanding their role on the major deposit and loan markets faster than the top 20. The banks outside the top 20, some of which are essentially financial units channelling funds of their owner enterprises, have had a smaller success during the past year in increasing their share of company deposits and company loans. Their share of company loans exceeded 35 % at the end of 1Q04, even as banks in the 6-20 largest category also lent actively.

The 2-5 largest category of banks has been successful in attracting household deposits, while the smaller banks have also expanded their share of these deposits to one quarter. In contrast, giant Sberbank's share has slipped gradually, standing at 61 % at the end 1Q04. To some extent, the success of smaller banks may indicate channelling of salaries of the employees of the bank's owner or of an important borrower to the in-house bank. Sberbank and the 21-50 largest banks, in turn, have moved to respond to household borrowing needs.

Shares of deposits and loans held by Russia's approx. 1,330 banks, Jan. 1, 2001–Apr. 1, 2004 (banks ranked by assets), %



Source: CBR

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	10.1	5/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	49.4	4/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	229	4/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.4	4.0	3/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	12.0	11.7	3/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	85.6	5/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	28.99	5/04

Source: Goskomstat, CBR.

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Economic Developments

Economic growth and oil output slow slightly

Growth of *industrial* production slowed in January-August to 6.4 % y-o-y in workday-adjusted terms (7 % in 2003). The figure partly reflects a slack July and August.

Most resource-based industries reduced the growth rate. Growth in Russian oil production slowed to about 8 % y-o-y in late summer (from 11 % in 2003 and over 9 % in 1H04), as Yukos and other large producers eased off on their drive to boost production. Output of the gas industry, on the other hand, has picked up since late spring, rising 5-6 % during the summer. On the whole, the fuel industry expanded 7-8 % in January-August. Electricity and power production had zero growth, and the rise of metal industries slowed from 2003.

Among other significant industrial branches, production of machinery and equipment, and chemicals, saw on-year growth accelerate in January-August to almost 14 % y-o-y and 8 %, respectively. Certain other non-oil-driven sub-branches also showed strong growth in goods intended for consumption, construction, as well as industrial or agricultural use, although some of this activity (e.g. car production) occurs behind a rather sturdy shield against imports.

Among *non-industrial* sectors, trade and construction were the fastest large contributors to overall GDP that grew 7.5 % y-o-y in 1Q04 and 7.3 % in 2Q04. The construction boom eased during the summer, while wholesale and retail trade steamed ahead. Growth in cargo transport slowed in the summer as less new oil was piped or shipped by rail. The impact of last year's large rise of export prices of oil, gas and metals likely fed through the economy in 1H04. The rise in oil price this summer is expected to support near-term growth.

Although the government has raised its forecast for growth and oil price, it still expects growth to slow a bit. GDP is projected to rise almost 7 % this year and around 6-6.5 % a year in 2005-2007 if the average price for Urals grade does not fall below $28 a barrel. However, the forecast cautiously foresees the growth of oil production slowing to 0-3 % per year in 2005-2007 and growth of gas production falling to around 1 %. While other projections expect less of a slowdown in oil production, the rest of the economy should grow briskly in any case to reach the projected GDP growth.

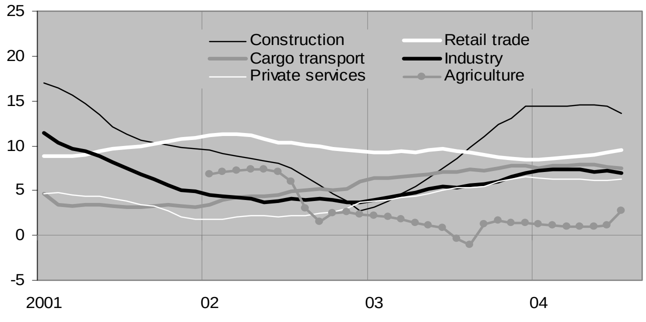
Export income and imports rise faster, while oil exports shrink

Russia's export earnings in 2Q04 rose 30 % y-o-y in dollar terms. With the dollar's drop stabilising, its on-year decline accounted for much less of the growth figure than any period since early 2003. The rise mainly reflected oil export prices that shot up almost 40 % y-o-y, and high metal prices. Russia's oil export boom of recent years appears to have peaked; in January-July oil exports grew 2 % y-o-y, falling notably in May-July from a year earlier. Otherwise, diversification in exports lags production and has focused on certain basic metal, chemical and forest industry products. Their export volumes have grown briskly for the past three or four years.

Imports into Russia gained new speed in 2Q04, rising almost 30 % y-o-y in dollar terms and also over 20 % measured in the currency basket of Russia's main trading partners. Imports from CIS countries, in particular, boomed. Car imports continued to rise, accounting for 7 % of all goods imports recorded by customs in 1H04. Imports of other machinery and equipment also grew a little faster than total imports.

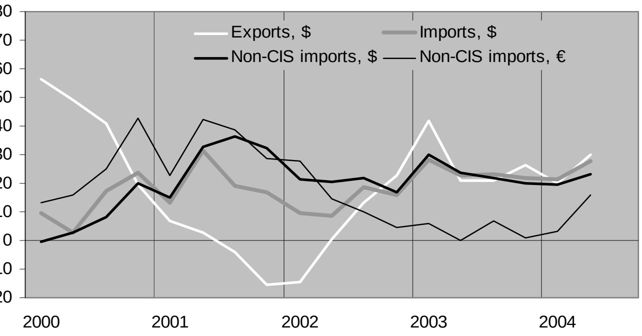
The boom in imports to Russia could well continue several years. The current account surplus would vanish in some four years if fast import growth (about 20 %), fairly rapid growth of export volume (10 %) and high export prices were sustained. On the other hand, the surplus would shrink earlier if the export prices declined and the volume of oil and gas exports fell to around or below 3-4 % per year in the next couple of years, as the government projects.

Volume of activity in main sectors of the economy, 12-month moving sum, % change from a year earlier



Source: State Statistical Service

Exports and imports, % change from a year earlier



Source: CBR

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.4	H1/04
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	6.9	1-8/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	12.3	1-7/04
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9	7.1	7/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9	93.2	1-7/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4	50.6	1-7/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	22.6	H1/04

Source: State Statistical Service, CBR.

Duma passes social benefit reforms

Last month's passage of changes in the social benefit system by a pro-Putin parliament proceeded with no difficulty. The social reform will be implemented in phases. This first phase affects social benefits mainly to the elderly, disabled and war veterans, replacing in-kind entitlements with financial benefits. Federal and regional responsibilities for funding the benefits will also be reconfigured. Regional authorities argue they have been saddled with too many responsibilities compared to their budget resources; their federal counterparts respond that the changes in taxation and system of federal transfers will improve the situation. In any case, the regions have a right to eliminate certain minor benefits they cannot afford. The finance ministry has also promised regions that part of the collections from the tax claims on Yukos oil company will be used to help some poor regions pay for their social responsibilities.

Tentatively, people in the revised system would receive a basic monthly benefit package worth 450 roubles (13 euro) to cover costs of medicines, spa treatments and public transport from the start of 2005. Moreover, there would be a monthly cash benefit of 350-1,550 roubles, depending on the beneficiary category. From the start of 2006, the basic benefit of 450 roubles may be taken either in cash or services.

It is unclear if comprehensive plans to reform the entire social security system have been considered. At least benefits for housing and municipal utility services are excluded from the first reform phase. The ongoing pension reform has not proceeded very successfully. President Putin has also indicated he may want to deviate from the reform line by letting occupational groups such as the military and civil servants preserve their in-kind benefits.

Strong 1H04 budget performance

Following the rising prices for oil, gas and metals, Russia's budgets continue to produce surplus, especially at the federal but also at regional level. In the 1H04 federal budget high energy and metal prices boosted customs duties and natural resource payments, which accounted for 36 % of all revenues compared to about a quarter in 1H03. VAT and excise tax revenues dropped, however. At the beginning of 2004, the VAT rate was cut from 20 to 18 % and the gas excise tax was removed.

In the consolidated regional budget, profit tax revenues became the most important revenue source while federal budget transfers decreased. However, the budget performance of the 89 Russian regions probably varies greatly depending on their industrial structure.

Federal and regional budget expenditures as a share of GDP were smaller in 1H04 than in 1H03. In the federal budget, interest payments on debt declined. Non-interest expenditures to GDP also shrank as transfers to regions fell.

Education, health and housing have long been the top spending categories in regional budgets. They accounted for about half of all regional expenditures in 1H04. However, the share of housing spending continues to diminish. In 2000, it represented a fifth of all regional expenditures, but by 1H04 its share had dropped to 12 %.

Realised federal and regional budgets, % of GDP

Federal budget			**Consolidated regional budget**		
Revenues	1H04	1H03	Revenues	1H04	1H03
Total	20.6	20.7	Total	14.0	14.5
Tax revenues	16.2	16.1	Tax revenues	10.3	9.9
VAT	*6.3*	*7.0*	*Profit tax*	*3.8*	*2.7*
Customs duties	*4.9*	*3.4*	*Income tax*	*3.3*	*3.2*
Natural resource payments	*2.6*	*1.9*	*Property taxes*	*0.9*	*1.1*
Non-tax revenues	1.5	1.6	Non-tax revenues	1.1	1.1
Unified social tax (UST)	2.8	2.8	Transfers	2.2	2.9
Expenditures	1H04	1H03	Expenditures	1H04	1H03
Total	15.9	17.6	Total	13.2	14.0
Transfers*	2.7	3.5	Education	3.1	3.0
Defence	2.6	2.6	Health	1.9	1.9
Social spheres**	2.1	2.2	Housing	1.6	1.8
Law and order	1.8	1.8	Industry, energy, construction	1.3	1.6
Interest on debt	1.4	2.0	Social policy	1.3	1.3
UST	2.8	2.9			
Balance	4.7	3.1	Balance	0.8	0.4

* mainly transfers to regional and local budgets
** includes mainly professional education and pensions of the military and law enforcement, but also health, social policy, mass media, culture and the arts

Source: State Statistical Service, Minfin

Draft budget 2005 revised upwards

The government approved its 2005 budget draft in late August, upping the main parameters it considered in June. Revenues and the surplus (now 1.5 % of GDP, up 0.5 %-points from the June draft) reflect higher forecasts for oil prices (now $28 a barrel for Urals grade) and GDP growth. Expenditures also went up a bit. The budget draft supports the overarching goals of diversifying the economy, increasing non-resource-based investment and completing the tax reform.

Compared to 2004 budget, revenues, expenditures and the surplus (not including the social tax) as a share of GDP would be larger. However, both revenues and the surplus would be smaller than currently projected for 2004.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004,**	**as of**	**2004 budget law**	**2005 draft budget**
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	1-6/04	17.9	17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	15.7	1-6/04	17.4	16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.7	1-6/04	0.5	1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	25.2	3/04		
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	117.9	3/04		

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–2000, State Statistical Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

Little shift from bank deposits, bigger shift from rouble

Rumours of impending bank insolvencies in May-July slowed growth of the banking sector. However, the banking sector assets overall did not shrink, even in July. The decline in total deposits of firms and households in July was limited to well below 1 % of total assets. The drop was smaller than last October when Yukos' boss Mikhail Khodorkovsky was arrested. Rouble deposits fell considerably in July but foreign currency deposits increased; a similar currency shift occurred in April, when the rouble began to decline against the dollar.

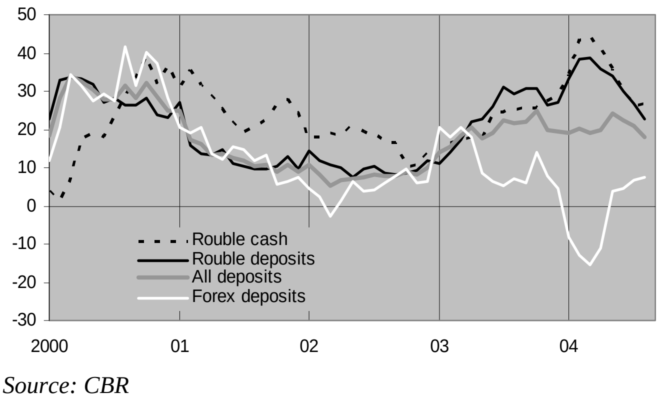
Banks replaced the summer's deposit withdrawals with funding from the federal authorities and shareholders. Of course, the situation could have been more fragile without the old state deposit guarantee enjoyed by state banks and the temporary guarantee granted to other banks in mid-July. Going forward, the two deposit guarantee arrangements should give the CBR the peace it needs to complete screening of the over 1,100 banks that have petitioned to join the general deposit insurance system, currently set for launch at the start of 2005.

On the asset side, the CBR granted major relief in July by cutting reserve requirements in half (banks had already withdrawn most of their deposits with the CBR in spring). The July measure released compulsory reserves equal to 2 % of total assets. This facilitated further growth of loans to private firms and households, as well as foreign assets.

Behind the aggregate balance, July's bank alert led to deposit withdrawals from banks both outside and within the top 30 banks. Notably, the two largest banks, state-owned Sberbank and Vneshtorgbank, which have long enjoyed state-guaranteed deposits, reported brisk deposit growth.

While some deposit withdrawals were exchanged for rouble cash, a larger movement seems to have been a migration to holding foreign currency, particularly dollars. Sales and imports of foreign cash by banks climbed to unprecedented levels during April-July (in gross and net terms). The dedollarisation wave, which emerged in spring 2003, was thus reversed.

Deposits at Russian banks and rouble cash, % change of the stock in real terms from a year earlier



Source: CBR

Inflation raises its head

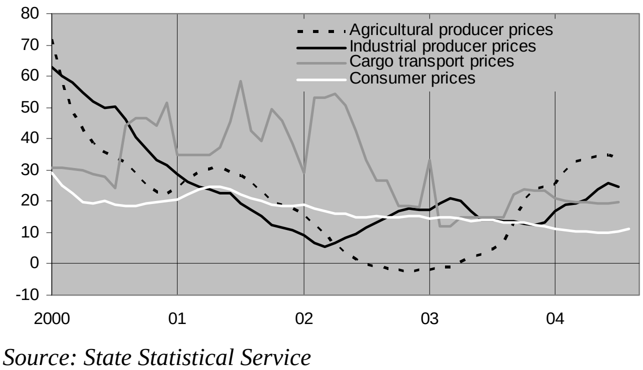
The rise of consumer prices accelerated during the summer, reaching over 11 % y-o-y in August (12 % in 2003). Price hikes for payable services, many of them regulated by federal and other authorities, moderated this year to 17 % y-o-y (22 % last year). For example, price increases for housing and the related services slowed to 25 %; telecom prices declined from a year earlier. Prices of non-food goods also rose more slowly (8 %) than last year (9 %), and the slowdown would have been even more substantial if not for the soaring domestic price of gasoline. The slowdown covered a full range of goods and was supported by a rouble that was stronger than a year earlier and helped limit imported inflation.

However, the rise of food prices sped up to 11 % y-o-y in August against 10 % last year; the customary seasonal fall in fruit and vegetable prices was much smaller this year than in previous years. Moreover, prices of certain basic food items with heavy weights in the food basket rose faster than last year (e.g. meat 16 % y-o-y) or as swiftly (bread 30 % and milk 15 %). Partly the price rise is the combined result of measures against imports and a weaker-than-expected supply response by the poorly reformed agricultural sector.

Demand factors played a role in driving consumer price inflation. Wages continued to rise (over 25 % y-o-y), which probably influenced prices of food but imports of non-food goods. Rapid growth of the money supply, which was supported by Russia's large external surplus to the extent that the rouble exchange rate was not allowed to adjust upwards, slower monetisation, rapid growth of rouble cash and the recent steps back into dollars also propped inflation.

Cost pressures grew, as industrial producer prices climbed 25 % y-o-y in July (13 % in 2003). This was due in part to hefty hikes in domestic gas prices (up 33 % y-o-y). However, world market price developments also worked: domestic oil prices climbed 50 % y-o-y and prices of ferrous metals soared 60 %. For the food, agricultural producer prices rose 33 % y-o-y in July, with animal products up over 20 % and crop prices up over 50 % (domestic grain prices rose 80 %). The rise of cargo transport prices slowed slightly from 2003, to 20 % y-o-y in July. So far this year railway cargo prices were raised like last year while monopolies operating oil and gas pipelines were granted smaller price hikes.

Consumer and producer prices, % change from a year earlier



Source: State Statistical Service

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.3	8/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	37.3	7/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	246	7/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.4	7/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.1	7/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	88.7	8/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	29.24	8/04

Source: Goskomstat, CBR.

Gas in Russia – The drive to liberalise meets industrial reality

by Gundi Royle*

Liberal economists have long demanded the deregulation of Russia's gas sector and the break-up of Gazprom, which currently accounts for 90 % of Russia's gas production. We suggest a more pragmatic course would be to sponsor a moderate liberalisation approach. However, sound commercial reasons keep disaggregation of Gazprom off-limits for the foreseeable future.

Ample reserves, but rising production costs

Russian gas is the cornerstone of Europe's energy needs. In 2003, Russian gas deliveries to European markets amounted to 133 billion cubic metres (bcm), a 25% market share. Russian gas reserves and resources, particularly those on the northern continental shelf, will supply Europe well to the end of the current century. However, the large take-or-pay contracts that underwrote the first generation of Russian gas export projects are no longer compatible with EU liberalisation aspirations.

Gazprom has a comfortable reserve cushion, but the new generation of field developments faces significant technical and commercial challenges. Gazprom's giant fields of Urengoi and Yamburg are declining. Zapolyarnoe was the last giant developed at a low capital cost of $50m per bcm of capacity. Near and mid-term replacement reserves are located within the existing gas infrastructure corridors in smaller fields and deeper horizons, particularly the resource-rich Achimovsky Formation.

However, development unit costs are rising as fixed costs are allocated over smaller and technically more complex reserve pools. Operating costs are also rising as smaller fields achieve lower efficiencies. This change is already starting to be borne out in Gazprom's profit and loss account.

Beyond 2010, Gazprom has to commercialise in excess of 10 trillion cubic metres of gas on the Yamal Peninsula. Development costs are estimated to be in the order of $80-100m per bcm production capacity – nearly double the estimated unit development cost of Zapolyarnoe.

Balancing the lure of export markets and domestic needs

We assess the real challenge lies in connecting Yamal to markets. European gas liberalisation has created commercial conditions that no longer allow the high upfront cost (over $20 billion) of a new pipeline from Yamal. Gazprom is likely to connect Yamal through the Urengoi and Yamburg facilities and to increase the capacity of the existing transportation corridor. The decline of Urengoi and Yamburg will create spare capacity in the processing plants and transportation infrastructure. However, this means that Gazprom's capacity to move gas from its core region has a ceiling, at least in the 2030 planning cycle. This ties in with the company's desire to reduce its domestic market share to 60 %. Northern Russia and the valuable export markets are priorities and capital is preserved for other growth options such as East Asia, liquefied natural gas (LNG) and gas-to-liquids (GTL).

So who will supply Russia? All Russian industry participants recognise that resource utilisation and transportation need to be optimised, but in more concrete terms views differ since participants have different optima. De facto liberalisation is already underway – gas prices are rising and Gazprom is striking deals with Russian producers. A case in point is Lukoil's deal; Lukoil develops its resources in the Archangel province, builds a spur to tie into Gazprom's infrastructure and sells to Gazprom domestically. Gazprom shifted some economic rent to Lukoil by offering a composite of the domestic and international gas price. Lukoil also did not press for access to foreign markets. The deal was done in the spirit that no Russian party, including the government, wins if gas-on-gas competition occurs on the Russian side of the border for the EU market. We conclude, therefore, that pragmatism rather than a fundamental shift of conviction is driving liberalisation, which is in train.

Large-scale effort needed to address the gas challenge

The merger wave of western oil companies in the last ten years resulted out of the need to create sufficient balance sheet width and breadth to accommodate higher technical, commercial and political risks and to take on larger projects with higher equities as companies prepare for their asset renewal cycle.

As we noted above, Gazprom is entering an asset replacement cycle with higher costs and technical risks at a time when counter-party risk in its European markets is increasing. Like its global competitors, Gazprom needs a large balance sheet and revenue base to accommodate this push into uncharted territories. As in any integrated entity, Gazprom has the profit and loss account and balance sheet depth to finance the asset renewal on the Yamal Peninsula, develop LNG in the Barents Sea and contemplate a pipeline to China. A disaggregated Gazprom would be an industrial and financial midget without the capacity to take on the giant new projects of the next 50 years.

Calls for the disaggregation of Gazprom ignore the commercial realities governing the rest of the global resource industry.

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Editor-in-Chief Vesa Korhonen

Military industrial revival in Russia?

by Steven Rosefielde*

Things are looking up for Russia's Defense Industrial Complex (OPK), better known as the Military Industrial Complex (VPK). After suffering a 90 % fall in weapons production 1991-1998, output officially surged ahead at 30 % per year. The military industrial modernization plan signed by president Putin in 2002 concentrates funding on weapons R&D through 2005, followed by rapidly escalating fifth-generation, full spectrum procurement to the Soviet level (territorially adjusted) by 2010.

VPK revival would be feasible

Like most Russian stories and statistics, official statements are only crude benchmarks. Vitaly Shlykov, former Deputy Chairman of the Defense Council under Yeltsin, rejects claims of surging weapons production, and notes that schemes put forward to finance a full weapons modernization program are inadequate. Similarly, while defense spending has risen notably in recent years, most of the money covers services previously requisitioned free of cost.

Nonetheless, all of the 1700 military industrial organizations and enterprises that existed in 1991 survive to this day. Machinery and equipment have been maintained and could be reactivated to full capacity within a year or two. The human military-industrial capital is in disrepair, but even that problem can be solved with money and patience. The same oil and gas resources that financed Soviet superpower could be redeployed to the VPK. Resumption of full capacity weapons production with improved fifth-generation technologies by 2010 therefore isn't a pipedream. It is only a matter of preference, because the supply side isn't a binding constraint.

Back to the future?

Will Putin employ Russia's markets to restore dormant superpower? Social scientists aren't prophets. Their forecasts are hardly better than those of Helsinki's meteorologists. However, it is worth recognizing that the Federation still retains some 42,000 nuclear warheads, has ample delivery systems, and an armed force including para-military troops close to 3 million soldiers. Russia has consistently maintained powerful militaries, despite the high social costs, since the rise of Muscovy under Ivan the Great. The contemporary evidence is consistent with this half-millennium trend.

Since the Iraq War of March 2003, the Kremlin has curtailed its "partnership for peace" with Washington. It has demanded concessions for the accession of former Soviet bloc nations into the EU, sniped at the West for Nato expansion, conducted a mammoth nuclear exercise, announced the successful development of a new intercontinental ballistic missile to defeat the US national missile defense and has sought "imperial" spheres of influence in Moldova, Georgia and the CIS. On the domestic front, it has continued to spin grandiose schemes for market liberalization and economic justice, co-opting the liberal agenda by promising to secure property rights, while contradictorily persevering in its criminal prosecution of Mikhail Khodorkovsky likely to culminate in the state's seizure of Yukos assets, signaling that rent seekers should not confuse their caretaking with inalienable rights of sinecure and property. The staffing of the bureaucracy and government with security and military personnel has proceeded apace, and the embers of democracy have been all but extinguished in two "managed" elections that eliminated the liberal parties from the Duma and may have made Mr. Putin president for-life in fact, if not de jure. Finally, martial rhetoric has escalated to the Soviet level. A recent article "Fortress Russia" by liberal Yabloko party member and former Duma deputy chairman Mikhail Yuriev conveys the mood some at least believe is being cultivated by the *siloviki* in the Moscow White House, with Putin's tacit approval.

Fortress Russia

Yuriev blames "normalization" for impoverishing Russia and dangerously reducing its material capacities. He contends that G7 policies have been maliciously designed to subjugate the Kremlin, and will succeed unless Putin abandons Yeltsin's course. "If we do not close this gap or at least reduce it substantially, we are certain to lose our status as an independent country and separate civilization in the foreseeable future." Salvation requires Moscow to turn its back on an "open" economy and its face toward a "closed" one. This doesn't mean repressing domestic markets. Yuriev explains that expelling foreigners and confiscating their assets under the banner of a Russia first ideology will be sufficient to make the superiority of the Russian way of life transparent. Hence, "Russia should withdraw from all multilateral international relations and base its bilateral relations on the rejection of common human values, and in general, of everything but our interest." If his ranting is even remotely indicative of the shape of things to come, then Russia will not be anything like a "normal country" meandering toward democratic free enterprise and global integration.

Russia's authoritarian slide, juxtaposed with Orwellian democratic-libertarian rhetoric has had serious repercussions. Besides expressing displeasure, the Bush administration has repudiated the SORT agreement limiting the US and Russia to 2,200 nuclear weapons (in response to the Kremlin's de facto abrogation), upgraded Russia to a "developing" nation status (curtaining its special "transition" treatment), and threatened to eject Russia from the G8. The interplay has raised the spectre of a new cold war, which while premature, nonetheless presages the danger.

A reversal of these negative dynamics should be in everyone's interest. Russia in particular risks degrading the efficacy of an already inefficient market, foregoing the opportunity of integrating into the global economy, foreclosing significant improvements in living standards, and getting ensnared in an arms race with the US and China it cannot win. But there is little substantive evidence that Putin shares this assessment. For the moment, it appears likely that he will proceed with the rearmament plan he signed in January 2002, making foreign investments in Russia's defense industries attractive, if one doesn't mind the expropriation risk.

A full, documented account of these complex matters will be provided in Steven Rosefielde, *Russia in the 21st Century: The Prodigal Superpower,* Cambridge University Press, London, 2005.

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Economic Developments

Non-energy investment expected to pick up

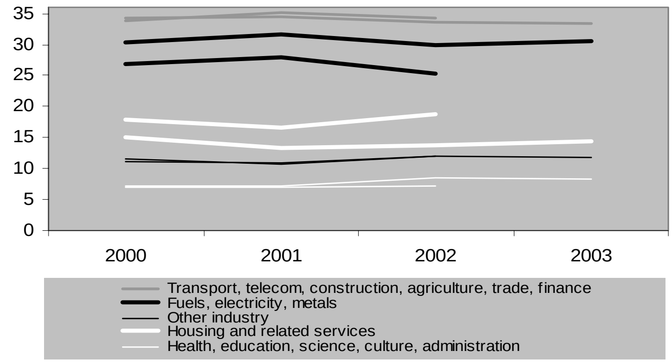
Russia's leaders have repeatedly called for economic growth of at least 7 % a year, which would bring Russia to current western European living standards within 15 to 20 years. They recognise that the economy must diversify to grow and investments must therefore redirect. The emphasis is no longer so much on the role of public investment (although state enterprises weigh notably in certain key branches) or industrial policy which can be difficult, risky and susceptible to corruption. It is on attracting private investment, both domestic and foreign, with a better investment climate created through good macroeconomic policy and market reform.

A major constraint to diversification, by most accounts, is indeed Russia's capital stock. The trickle of new capital (annually 1–1.5 % of fixed assets in industry) and slow exit of capital have caused the capital stock to age badly. Some 45 % of production capital on the balance sheets of industrial enterprises is over 20 years old, while only 12-13 % is under ten years old. Despite low domestic energy prices and regional and local barriers to competition that have supported a rise of capacity utilisation ratios (to around 50 % in the industry in 2003), the usefulness of older stock is questionable.

Investment increased about 60 % in 1999 to 2003. It represented a notable demand component in GDP (which grew 40 % over the period) and a factor supporting growth. However, the shunning of investment during the uncertain 1990s in Russia crippled fixed capital formation, which was still not higher than 18 % of GDP in 2003, i.e. much below the levels that fast-growing economies have typically reached and sustained. In that vein, the economy ministry currently projects that GDP will grow at around 6 % per year in 2005 to 2007 if investments increase at about 10 % per year.

Investments in Russia also lean towards natural-resource industries, particularly energy and metals. The share of investments in energy production and pipeline transportation is still at least a quarter of total investment (although sectoral data here appears about 1.5 years after the fact; the share is about 30 % of investments in the up-to-date data which excludes small firms and the unrecorded economy). The metallurgy sector absorbs about 5 % of investment. All other industry branches together account for just 12 % of investment – and their share has remained rather constant in the past two years. Thus, while investment in non-oil, non-metal industries has matched the rise of investment generally, a scale needed to propel proper industrial diversification lies ahead. Instead, stronger investment diversification in recent years emerged from telecommunications and trade.

Fixed investments in major sectors, % shares



Note: Lines for 2000-03 mark investments excluding small firms and unrecorded economy, lines for 2000-02 mark total investments.

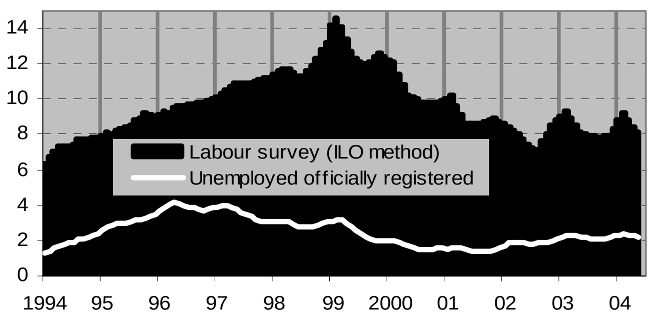
Source: State Statistical Service

Employment up, unemployment unchanged

State Statistical Service data suggest the size of Russia's workforce was unchanged in 2003 but increased 1 % y-o-y in January-May to about 72 million people. Employment also grew over 1 % y-o-y, following last year's slight decline. To the extent employment figures proxy labour input, productivity of labour rose 8 % in 2003 and 6 % so far this year.

The number of unemployed, after rising in 2003, was virtually unchanged in February-May from a year earlier (around 6 million people in April-May). Their share of the workforce fell slightly to just above 8 % in May. As in many countries, the broader employment/unemployment picture is blurred by a hazy line between unemployed and some people recorded as being outside the workforce. The State Statistical Service labour survey suggests last winter some 5 million working-age people outside the workforce were willing to work while 4.5 million of them were not seeking jobs.

Unemployment, % of work force



Source: State Statistical Service

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.4	Q1/04
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	7.0	1-5/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	12.8	1-5/04
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9	8.1	5/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9	76.8	H1/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4	42.1	H1/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	22.6	H1/04

Source: Goskomstat, CBR.

Reform of social benefits in the making

The government in June announced plans to replace certain in-kind social benefits with cash payments. The step followed president Putin's call for wide-scale social reform in his state-of-the-nation address in May. Early this month, the Duma passed in the first reading the amendments to a large number of laws. The final reading is set for August.

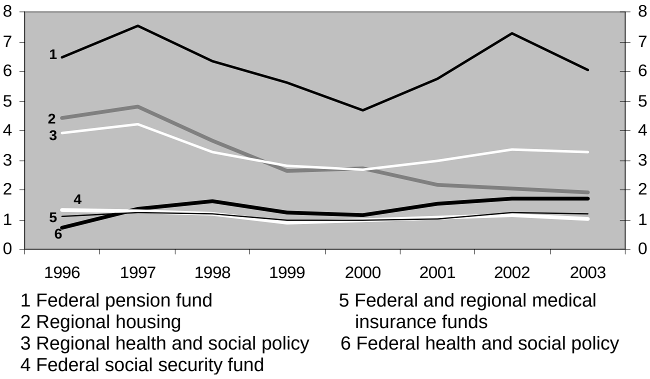
The government wants to dismantle the Soviet-era inefficient and corrupt social security system from the beginning of 2005. According to preliminary information, the planned changes mainly affect Russia's tens of millions of elderly and disabled. Switching to cash benefits should make the system more transparent and fair. Different categories of beneficiaries would be given a specific sum of money, and recipients could use that money to buy the services they prefer. There are also plans to let beneficiaries select either cash payments or no-charge social services. Changes in housing benefits would be postponed until 2006.

Despite the assurances of ministers that the new system would reallocate social sector funds better and improve the wellbeing of many types of beneficiaries, the plans provoked protests across Russia. The Communists insisted on a national referendum, claiming that the compensation offered for the lost benefits was too tiny to maintain the present living standards of those affected. Many also feared that the new cash benefits would not be indexed. While calculations on the effect of the planned changes vary, it is evident that not all benefits will be compensated. On the other hand, under the current system many benefits do not materialise due to the lack of funds (i.e. unfunded budget mandates).

The planned changes to the social security system are part of ongoing efforts to redistribute power between the federal centre and regions. Particular categories of beneficiaries will be financed from the federal budget, and others from regional budgets. Regions will be given wide authority to decide on the organisation of social security services, which in practice means they will get to decide on the level of social services they provide and the amounts of compensation offered. While social expenditures of regions are generally expected to increase, federal authorities give assurances that the planned changes in the division of tax revenues allow for the increases. The share of the federal budget in total consolidated budget revenues will slightly increase, and many revenue sources are transferred from local to regional budgets. As the federation will no longer impose detailed social security expenditure responsibilities on regions and municipalities, it should be possible for regions to eliminate some current benefits if their financial situation justifies it. The centre, in turn, is limited to influencing regional decisions indirectly through the five funds for federal financial aid to regions. By directing more funds to certain types of aid, the centre can encourage poorer regions to sustain certain benefits.

The IMF mission that visited Moscow in mid-June estimated that the reduction in the unified social tax (UST) and partial transfer to cash-based social benefits would cost 2 % of GDP. The IMF considers it unrealistic that regional and local governments, burdened with increased social responsibilities, can decrease their overall spending and produce surplus budgets in 2005 as the government anticipates.

Public social and housing expenditures, % of GDP



Source: State Statistical Service

Federal budget expenditures to rise in 2005

The draft federal budget for 2005, the main parameters of which were approved by the government in mid-June, foresees a surplus of 1 % of GDP. Although it is more than the surplus of 0.5 % of GDP in this year's budget, it is substantially less than the surplus forecast for 2004 (2.4 % of GDP). Compared to the 2004 forecast, revenues as a share of GDP are expected to decrease (see table in footnote), since revenues from the unified social tax (UST) as well as other revenues will fall. Total federal budget expenditures will decline because the channelling of the UST revenue to the pension fund and interest expenditures will fall, while non-interest expenditures (excluding the UST) are to increase. Exact targets for expenditure categories are yet to be revealed.

The 2005 budget assumes a higher price for Urals-grade crude oil ($26 a barrel in 2005 vs. $22 in 2004). The average rouble/dollar exchange rate is projected to be 30.2 instead of 31.3 in the 2004 budget. If oil prices stay high, the stabilisation fund will surpass its ceiling of RUB 500 billion ($16.5 billion) by mid-summer or fall 2005. Under the budget code, once the ceiling is exceeded, fund resources may be used for purposes other than covering federal budget deficit. The government plans to tap the fund in 2005 for covering part (an estimate of some $2.7 billion) of the pension fund deficit and for paying down foreign debt ($3 billion). The IMF agreed only on debt repayment. The need for increased financing for the pension fund reflects changes in the UST passed by the Duma at the end of June. The amended law lowers the maximum tax rate from 35.6 % to 26 %, while changing the regression of the UST and reapportioning tax categories. With the cut of both the UST and the share of the federal budget of UST revenue, the draft 2005 federal budget foresees federal revenues from the UST to drop to about half of their current level as a share of GDP.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-year figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2004 budget law	2005 draft budget
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	19.4	20.3	1-4/04	17.9	17.2
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.4	17.7	16.8	1-4/04	17.4	16.1
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.8	1.7	3.6	1-4/04	0.5	1.0
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	26.9	25.7	1.1.04		
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	121.6	119.7	1.1.04		

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–1998, Economic Expert Group 1999–2004. Debt: IMF 1996–1999, Minfin 2000–2003.

Private capital flows increase both ways, notable exit via banks

CBR balance-of-payments figures suggest that in 1H04 the net outflow of private capital increased to about 2 % of the period's GDP. The outflow was substantially larger than in 2003, about the same size as in 2002 and much less than the outward stream of 5–10 % of GDP in preceding years. Depending on the type of capital flow considered, impressions about Russia's investment climate slightly vary.

In the corporate sector, the net capital outflow (excluding CBR figures for foreign cash flows) surged in 2H03 to over 6 % of GDP, a level not seen for some years, while outflow dried up in 1H04. However, corporate sector net overlooks distinct differences among businesses.

Large Russian companies (mainly gas, oil and metals) increased their borrowing from abroad to well over 3 % of GDP in 2H03, and continued in 1H04 at almost the same pace.

Meanwhile, fictive services import deals to pump money out of Russia remained a nasty problem. Although the CBR estimates that such phoney contracts have declined, they still created capital exit equal to over 2 % of GDP in 2003. Combined with a more recently reported gimmick, i.e. fictive deals with securities, such capital outflow stood at 3.5 % of GDP in 2003 and continued at about 3 % of GDP in 1H04. The negative score for errors and omissions in the balance of payments, which suggests unrecorded net capital outflows (when transactions on the current account are recorded correctly), has shrunk during this decade (to below 2 % of GDP in 2003 and in 1H04). True, part of this reduction likely reflects improved discovery of the fictive devices used to export capital.

Direct investment (DI) flows into Russia surged in 2003 to 1.5 % of GDP while Russian DI into other countries boomed even more (2 % of GDP in 2003). Attractiveness may have risen both ways, while individual DI can also cause fluctuations in the inbound and outbound DI flows.

Banks were net importers of capital from mid-2001 until late 2003, with the net inflow reaching well over 2 % of GDP in 2003. Then the tide turned in 1H04 to an equally strong net outflow of capital, driven mainly by an increase in banks' foreign assets. Rising interest rates and the prospects in developed markets and a turn downwards in the rouble exchange rate probably propped some of the outflows, while concerns about uncertainty in Russia likely keep the actors sensitised.

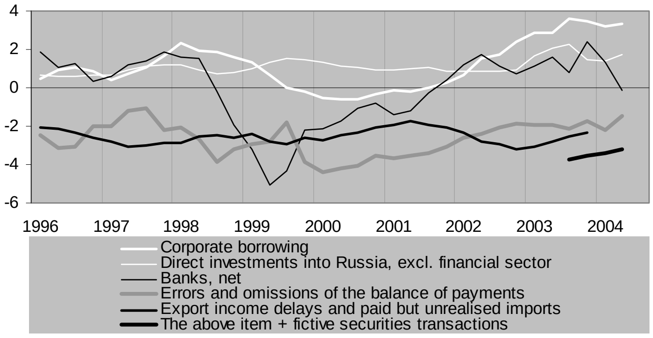
Bank alert prompts express deposit guarantee

The capital outflow via banks in 1H04 curbed liquidity on the domestic interbank market. However, after domestic rouble deposits had grown briskly for several years, the fragility of that recovering confidence in banks was exposed after a bank lost its license in mid-May on suspicions of money laundering. This event triggered rumours that more of the same might come, led to the closing of some credit lines on the riskiest fragment of the interbank market, and caused some deposit withdrawals. The CBR reacted in mid-June by easing money market liquidity through lowering one reserve requirement and certain money market lending rates, and by expanding the palette of securities it uses in money market operations.

Nevertheless, a relatively large bank, Guta Bank, citing lack of funds, stopped servicing its clients in early July. The reinforced unrest provoked notable withdrawals of deposits, even from Russia's largest private bank, and made the authorities take stronger measures. The CBR cut sharply all reserve requirements, and even announced its readiness to apply bank-specific requirements as needed. State-owned Vneshtorgbank, Russia's second largest bank, agreed to buy a majority stake in Guta Bank, while the CBR offered a low-interest loan to Vneshtorgbank to finance the deal.

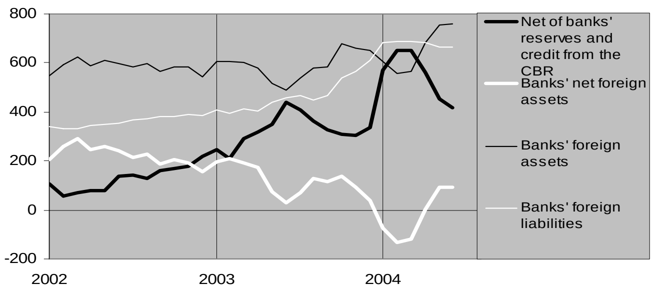
Some of the deposits withdrawn were redeposited with state-owned banks, which enjoy a 100 % state deposit guarantee, and possibly with foreign-owned banks, but the episode also meant a step back towards a cash economy and foreign currency. To avoid a stronger spiral, the CBR had the Duma approve a special deposit guarantee law which obliges the CBR to cover the deposits of each individual up to 100,000 roubles (about 2,800 euros) in a bank bankruptcy, retroactively from end-2003. While the guarantee may add to the CBR's moral hazard risk, the practical risks are rather limited. For illustration, household deposits in all banks other than the CBR-owned Sberbank amount to a fifth of the CBR's balance sheet or 4 % of GDP. The deposit guarantee should provide calmer working conditions for the CBR as it screens the over 1,100 banks hoping to join the general deposit insurance system that was enacted at end-2003.

Private capital flows to and from Russia, four-quarter moving sum, % of GDP (a positive value denotes inflow)



Source: CBR

Banks' foreign assets and liabilities and claims on the Central Bank, 1 January 2002 – 1 June 2004, RUB billion



Source: CBR

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	10.1	6/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	43.7	5/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	227	5/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.9	5/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	13.0	12.8	5/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	88.2	6/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	29.03	6/04

Source: Goskomstat, CBR.

Democracy key for Russia's long-term growth

by Jukka Pirttilä*

A new Freedom House study, *Nations in Transit*, suggests that Russia, among the countries surveyed, has experienced the greatest overall decline in the democratic freedom score. Russia's scores dropped in five categories out of six, including electoral process, development of civil society and media independence. Comments to this effect were also heard during the recent presidential election, when, according to the Organisation for Security and Cooperation in Europe (OSCE), the elections did not meet the criteria "necessary for a healthy democratic election process."

Democracy is a development goal of intrinsically great virtue. This is what e.g. Noble Prize winner Amartya Sen thoughtfully argues in *Development as Freedom* (Oxford University Press, 1999). Taking a narrower approach, what are the potential economic benefits of democracy for a country like Russia?

Democracy supports growth through various channels

In *Democracy, Governance, and Economic Performance* (MIT Press, 2003), Yi Feng examines linkages between economic growth and democracy using cross-country growth regressions. He demonstrates that more democratic governance structures lead to long-term increases in the educational level of populations. A more educated labour force also attracts greater physical investment. Thus, improvements in governance and education promote economic growth.

His book further provides evidence that democracy reduces income inequality over the long term. Even if one was not fully prepared to accept growth of median income as a social welfare criterion, democracy also appears to be useful from a distributional angle.

Feng shows that political freedom leads to economic freedom, while the converse does not necessarily hold. Thus, views that justify authoritarian rule as a natural phase in a country's development ignore the fact that even if authoritarian regimes provide economic freedom, they may never develop into fully democratic societies.

Good quality public services urgently needed in Russia

Russia faces a tremendous task in diversifying its economy away from resource dependency and towards increased competition in other economic spheres. Since the potential for *dirigiste* industrial policy is arguably limited in modern economies, the emphasis in the role of the public sector in this process lies in the support it can offer for a functioning market economy.

Many public services are key in this respect. For example, Russia's education system urgently needs reform (see *BOFIT Russia Review 5/2004*). Also, as Hill and Gaddy argue in *The Siberian Curse* (Brookings Institution Press, 2003), the country may need to relocate millions of people from remote Siberian areas to more productive locations. Moreover, huge infrastructure investments are probably needed to maintain service of the enterprises' needs. The list could go on.

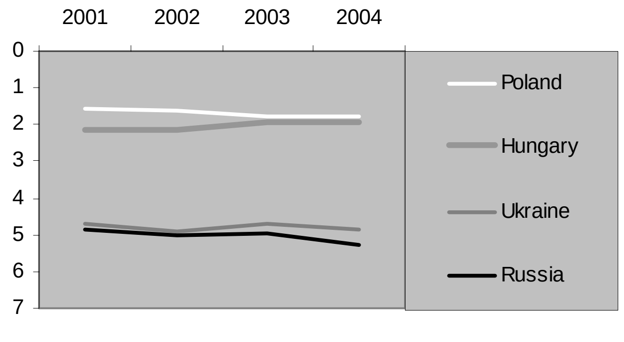
These examples imply that demand for a well-functioning public sector is acute, and maybe most pronounced at the regional and local levels, where the decisions on how to allocate public funds on services are often made. If the public sector can deliver services in a reliable, uncorrupted and cost-efficient manner, it has great potential for improving the modernisation and diversification of the Russian economy.

Putting Putin's words into action

Democracy can do a great favour. This year's World Development Report, *Making Services Work for Poor People* (World Bank, 2004) argues that voice and accountability are key ingredients for efficient and fair provision of public services. Besley and Burgess (*Quarterly Journal of Economics*, 2002) present evidence indicating that states in India with greater newspaper circulation have governments that are more responsive to the needs of the populace. It appears that democracy and press freedom, especially at the local level, provide the checks and balances that are urgently needed to assure that public funds are used for productive purposes and not directed to shelter rent-seeking activities or outright corruption.

In his annual state-of-the-nation address to parliament in May, President Vladimir Putin called for improvements in educational and health system and transport infrastructure. He further vowed, "Our goals are absolutely clear: high living standards, …a mature democracy and a developed civil society." Accomplishing sustainable growth requires that democracy and civil society can also thrive in practice.

Democracy scores for some transition countries
(1 is the highest level and 7 the lowest level)



The democracy score is an average of ratings for electoral process; civil society; independent media; governance; constitutional, legislative & judicial framework; and corruption

Source: Freedom House

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Economic Developments

Oil investments shrink, telecom investments boom
Total investments in Russia have increased this year over 12 %, the same pace as in 2003. However, the structure of investments has undergone relatively large changes. In 1H04, investments in crude oil production fell in volume terms from a year earlier, something not seen for many years. Their share of total investments (excluding small firms and an unrecorded economy estimate) fell to 11 % from 13–15 % in the previous years. Declines also occurred in the gas and food industry, and housing-related communal services.

Conversely, investments in ferrous metals and the forest industry grew notably faster than total investments (though still at low levels). A large rise took place in housing investments. Telecom investment boomed, equalling almost 7 % of the total in 1H04. Telecom sector activity has expanded around 20-25 % per year (in terms of volume of value added) since 2001, and may well continue at this pace. For one segment, the number of mobile phone subscribers rose this year from less than 40 million to almost 60 million, which is still nowhere near market saturation.

Oil prices projected to support Russian growth
Oil price forecasts have been raised considerably. The fresh IMF global economic outlook projects the world market price for crude oil will average over $37 per barrel this year and in 2005 (last spring's outlook foresaw $30 per barrel for this year and $27 for 2005). The current projection implies this year the oil price will be almost 30 % higher than in 2003. Accordingly, the projection for Russian GPD growth was also raised notably to 7.3 % this year and 6.6 % in 2005. Russia's current account surplus is expected to decline both in dollar terms, suggesting rapid import growth, and relative to GDP (from this year's 10 % to 8 % in 2005). The federal budget surplus is anticipated to remain at around 3.5 % of GDP in 2004–05. Inflation would ease slightly to 9 % in 2005.

Fall in price competitiveness supports import growth
Imports into Russia have grown considerably faster (15–20 % per year in volume terms) than domestic demand and domestic production (5–10 % per year) for over four years. This year has been no different. In 1H04, imports rose over 20 % y-o-y, while domestic demand was up about 10 % and domestic production 7–7.5 %.

While the rouble's collapse after the 1998 financial crisis gave Russia's price competitiveness a huge boost, domestic inflation soon started to erode this advantage. After a stable period in 2002 and 2003, cost pressures from price, wage and exchange rate developments emerged this year.

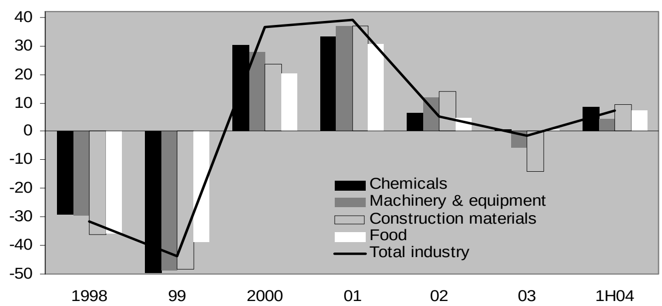
The largest manufacturing branches of Russian industry that compete with imports to a varying degree have countered cost pressures by strongly improving labour productivity every year since 1998 (much more than resource-based industries) by increasing output and reducing the number of employees. The rise in real wages has also moderated in recent years, tracking (or even lagging) productivity growth. This year, however, rising wages, which account for 10–20 % of costs in various Russian industrial branches, combined with a stable rouble exchange rate. Thus, wages have increased faster in euro, dollar or renminbi terms than productivity growth (chart).

Domestic prices of other crucial production inputs such as fuels and metals have risen swiftly, pushing the level of Russian industrial producer prices up 20 % y-o-y in euro terms in 1H04. Cargo transport prices climbed at nearly the same pace.

Some of such indicators are currently at or close to their pre-crisis levels; e.g. economy-wide real wage/productivity is at the 1997 level and euro-denominated unit wage costs are at 95 %. Others are much lower. For example, in the above-mentioned import-competing industrial branches, real wage/productivity stands at 60–75 % of the 1997 level and unit wage costs in euro terms are at 55–70 % (and slightly lower in terms of competitiveness, when taking into account the rise of unit wage costs in the euro area). Even so, imports continue to grow.

Going forward, price competitiveness is hard to maintain without lower domestic inflation and restrained wage growth, when the external surplus bolsters the rouble or in the absence of further productivity gains that require more new investments as idle production capital and chances to shed labour become scarcer. Domestic industry's *real* competitiveness, e.g. domestic product range and quality produced, also requires fresh investment. That realm naturally defines those segments of imports sensitive to price competitiveness; other imports will flow in more or less independent of domestic price competitiveness.

Unit wage costs*) in industry and the largest manufacturing branches in euro, % change from a year earlier



*) wages per volume of gross output per employee

Source: State Statistical Service, CBR, BOFIT

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.4	H1/04
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	6.9	1-8/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	12.2	1-8/04
Unemployment, % (end of period)	9.3	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.4	8/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9	124.6	1-9/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4	66.5	1-9/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	35.9	1-9/04

Source: State Statistical Service, CBR.

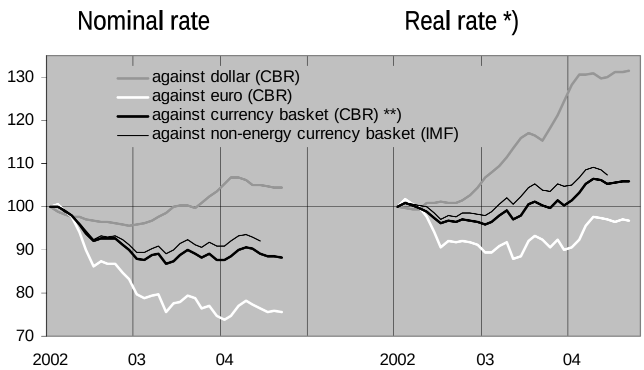
Exchange rate policy counters rouble's rise

Russia's current account surplus remains substantial despite rapid import growth, and it swings with world energy prices. This puts upward pressure on the rouble's exchange rate. In the first nine months of this year, the surplus was $36 billion. The upward pressure was eased by simultaneous net capital outflow from the private sector ($11 billion) and the federal government and CBR ($6 billion, excluding foreign exchange reserves). Nevertheless, the CBR intervened on foreign exchange markets to dampen the remaining upward pressure. CBR purchases of foreign exchange increased the central bank's foreign exchange reserves by $18 billion in 1–3Q04 to $95 billion, an amount equivalent to almost 80 % of annual imports of goods and services.

Overall, the rouble has weakened since spring, falling to end-2003 levels in September. The real exchange rate (RER) also stopped appreciating in spring and has stayed relatively unchanged ever since. The CBR is making an effort to keep the RER from rising beyond the 7 % December-to-December ceiling defined in its monetary program for 2004. At the same time, the above-mentioned CBR market interventions feed the rouble money supply that props inflation.

Russia continually faces the question of balance between higher inflation and a stronger rouble, the two components of the RER. In its 2005 monetary program, the CBR sets a RER appreciation ceiling of 8 % and an inflation goal of around 8 %, implying a rather stable (or slightly weakening) nominal exchange rate. That goal could be hard to attain as it is based on a projected oil price of about $30 per barrel in 2005.

Rouble exchange rates, January 2002 (100) to September 2004



*) based on consumer prices
**) basket of currencies of Russia's main trading partners

Source: CBR, IMF

Privatisation proceeds slowly

With privatisation revenues totalling just 13 billion roubles in the first half of 2004, prime minister Fradkov expressed dissatisfaction on the slow implementation of the 2004 privatisation plan at an early-August government meeting. However, by the end of September, the 40-billion-rouble privatisation target for this year had been clearly exceeded. The change reflected the sale of a 7.59 % stake in LUKoil for about two billion dollars (70 billion roubles) to American oil producer ConocoPhillips.

The LUKoil deal reveals much about Russia's privatisation efforts. First, foreign companies are interested in buying promising Russian companies, especially in the energy sector. Second, a few big privatisation deals each year typically account for the bulk of revenues accrued from the selling of state property. The privatisation sales of most state properties generate little revenue as most of state enterprises are relatively small and of little value. The third aspect of Russian privatisation is that it has been slowing. Many state assets (including LUKoil) have sat on the privatisation list for years. The delays in sales may relate to market conditions, but often they merely reflect bureaucratic sloth. The unwillingness of ministries and state agencies to identify state assets for privatisation reduces the overall number of assets listed. For many ministries, state enterprises under their jurisdiction are a major revenue source. Lately the slowdown in privatisation sales has also been a symptom of planned or on-going administration reforms.

Naturally, privatisation success can also be judged by other measures. After more than a decade of privatisation, Russia has diminished the number of state enterprises and organisations to less than 4 % of the total. State enterprises account for some 12 % of Russia's industrial production. However, state enterprises here typically mean those having more than 50 % state ownership. Enterprises like Gazprom are not counted in the figures. The role of privatisation revenues in financing the budgets at federal, regional and local levels has been negligible, hovering between 0 and 5 % of total revenues of the budgets in 1998–2003.

In 2005, the government plans to divest over 1,300 state unitary enterprises and sell off stakes in almost 600 companies. These sales are expected to raise 40 billion roubles (€1.1bn). The earlier goal of completing the privatisation process by end-2007 will likely not be achieved. The privatisation of most remaining assets will be difficult as many stock packets offered only give minority stakes. Moreover, the most lucrative items are typically strategic enterprises, which require presidential authorisation to be privatised. President Putin's latest list, issued at the beginning of August contains over a thousand strategic enterprises and state agencies, including Gazprom, national air carrier Aeroflot, telecommunications giant Svyazinvest and insurer Rosgosstrakh. The list also includes Vneshtorgbank, oil pipeline monopoly Transneft and oil producer Rosneft. In addition, there are some 2,000 other assets subject to other special regulations.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2004 budget law	2005 draft budget
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.5	1-7/04	17.9	17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	15.6	1-7/04	17.4	16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.9	1-7/04	0.5	1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	25.2	3/04		
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	117.9	3/04		

[1] *Since 2002 social tax is included in the federal budget.*

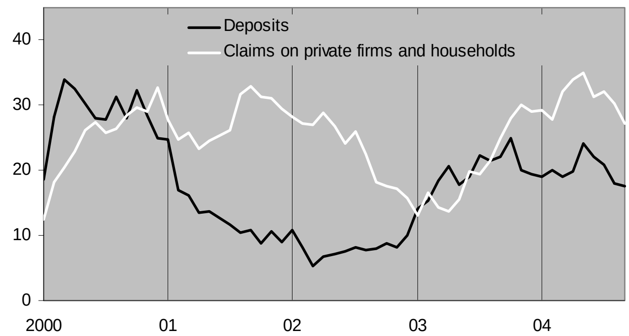
Source: Budget: IMF 1996–2000, State Statistical Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

Growth of bank deposits and lending revives

Total balance sheet of the banking sector grew again in August, after stalling in July after the early summer banking scare. Household deposits and deposit certificates declined in July, while corporate deposits rose to fill much of the gap. This may reflect corporate owners' support for their banks. Total deposit growth revival in August was entirely attributable to rouble deposits, although in on-year terms deposit growth kept slowing to below 20 % in real terms. Deposits account for over half of the total liabilities and currently equal 21 % of GDP, the same relative level as a year earlier. The bank insolvency rumours also precipitated a dip in bank IOUs (*veksel*), which account for 8–9 % of total liabilities.

Growth of bank lending to firms and households overall continued broadly unshaken over the summer, but showed slowing on-year growth (27 % in real terms in August). Credit represents over 60 % of the total assets and currently equals 23 % of GDP, or slightly more than last autumn. Contained in credit, lending to households continued to boom, with the credit stock doubling in the past year. In January-August, the net flow of bank loans to households corresponded to over a third of the net flow to firms. While banks drained their reserves at the CBR significantly since spring, they scaled back their government debt portfolios throughout the summer.

Claims of banks on firms and households, % change of the stock in real terms from a year earlier



Source: CBR

Firms continue to attract foreign loans in large proportions

Foreign loans now play a rather important role in Russian enterprise finance. Despite ample liquidity in the domestic banking sector, firms in Russia have increased their direct borrowing from foreign sources since 2002. This is due in part to the structure of the economy. Large firms, even some of those with good liquidity from their own cash flow, go for foreign borrowing in relatively large sums compared to domestic bank financing. This reflects insufficient capabilities of Russian banks to engage in corporate lending (e.g. organising large syndicated loans to share the risks).

Indeed, while Russian firms' net borrowing from banks in Russia amounted to $14 billion in 2002 and $23 billion in 2003, their net borrowing from foreign financial markets and foreign companies (excluding portfolio investments and subsidiary loans from foreign parent companies) exceeded $8 billion in 2002 and $15 billion in 2003 (foreign gross borrowing in 2003 was $34 billion, with $26 billion in long-term loans). In 1H04, domestic net borrowing was $14 billion and foreign net borrowing $7 billion. Despite the fact that loaning from abroad is a more recent course of action for Russian firms, the stock of foreign loans was almost $50 billion in mid-2004 compared to $119 billion in debt owed to domestic banks.

Interest rates on deposits and loans entail high margins

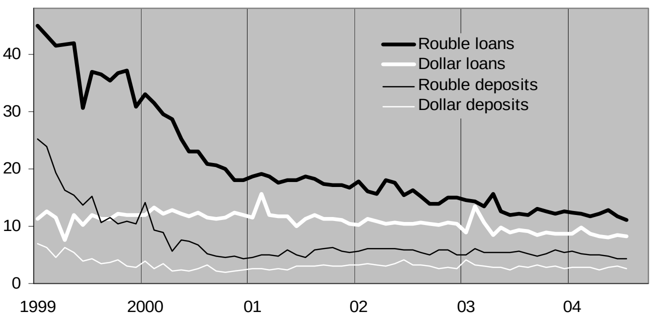
Interest rates on bank deposits and loans in Russia have gradually declined, although this year the decline came to a virtual halt. Partly this stemmed from the acceleration of inflation in summer to around 11 %.

Interest rates on household rouble deposits follow their customary track of staying much below inflation, at 4–5 % on average for all maturities. Household forex deposit rates average 2–3 %. These low averages partly result from 0.5-1 % interest rates on demand deposits, although all the longer household rouble deposits also carry below-inflation interest rates, i.e. 8–10 %, while longer forex deposits fetch 5–7 %. Other banks seem to pay better than Sberbank for deposits over one year. Such deposits already account for over half of household rouble and forex deposits.

Interest rates on rouble loans to firms continuously average about 11–12 %, a pittance in real terms. The rates hardly rise with maturity, although this likely reflects differences in borrower risks so that riskier firms only get shorter loans. Forex loans average 8 %, with longer maturities at 9 %. Other banks charge more than Sberbank for loans over a year, which constitute 30 % of rouble loans and 55 % of forex loans, although different borrowers may be part of the reason.

The low rates on rouble lending to firms compared to inflation reflect the ample liquidity in Russia, while banks are apparently unwilling to accept lower rates, given borrower risks and the need to try to maintain asset values. Rather high rates on domestic forex loans for their part encourage large export-oriented firms, with forex income to ease the loan exchange rate risk, to seek foreign loans. Margins between deposit and loan interest rates are high, which suggests banks have potential to improve their efficiency.

Interest rates on household deposits and loans to firms (all maturities), %



Source: CBR

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.5	9/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.2	8/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	236	8/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.3	8/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.6	8/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	95.1	9/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	29.22	9/04

Source: State Statistical Service, CBR.

What could Russia do with its external financial surplus?

by Tapio Korhonen*

Current account surplus drives the financial surplus

Energy exports have created a huge external financial surplus for Russia. This surplus may be used for real investments and consumption domestically, or for investments abroad. A strong investment outflow from Russia has given rise to discussion about "capital flight." Capital exports is seen as a negative phenomenon, and likely excessive in Russia's case considering the low level of real investment.

On the other hand, investments abroad can serve various purposes. Such investments from Russia have been made possible by surprisingly large external surpluses. Uncertainty related to world energy prices, difficulties in controlling growing domestic liquidity and prevention of the rouble's excessive appreciation well justify such investments.

Russia's capital flight is usually referred to as the items in the set of statistics "Net outflow of private sector capital" published by the CBR. The set contains data on flows of foreign assets and liabilities of enterprises, the financial sector and households, including net errors and omissions of the balance of payments statistics. In the first half of 2004, this private sector net outflow was \$8 billion. Preliminary data show this outflow shrank in the third quarter.

In a way, "capital flight" from Russia is inevitable. The country has a current account surplus, which has been as high as some 10 % of GDP. The very logic of the balance of payments is that an economy's total net assets abroad grow according to the current account surplus.

Private sector capital exports represent less than half the total

The private sector has not driven most of the increase in Russian investments abroad in 2003–2004. Most worrying is that private capital exports have not been recorded properly in official statistics as they have been largely illegal. Defectively recorded capital export items are estimated to account for about a third of the current account surplus in recent years. On the other hand, private capital flows recorded in the statistics – foreign loans of enterprises, foreign direct investments and portfolio investments – have usually been directed from abroad into Russia.

More recently, there has been talk about capital flight caused by problems related to Yukos and certain banks. The Yukos discussion seems to have affected investments in certain periods, but as a whole private sector capital flows have been unexceptional this year. Outside defectively recorded items, capital exports have flowed mainly via banks, probably reflecting loose liquidity in Russia's financial markets.

State capital exports

Part of Russia's external financial surplus has been applied to paying the state's foreign debt. The debt repayments have corresponded to about a quarter of the current account surplus in recent years. This year, funds of the state oil fund (stabilisation fund) have also been invested abroad. This may be a prudent way to help Russia deal with possible tough times ahead.

Central bank as major capital exporter

The CBR foreign exchange reserve has grown from \$10 billion after the 1998 crisis to over \$90 billion. Over a third of the current account surpluses have thus accrued to the reserve. From this standpoint, private sector "capital flight" has not been a problem.

The CBR's interventions on the foreign exchange market, which increase the reserve, have dampened the rise of the rouble exchange rate considerably. If the CBR had stayed away from the market, earners of foreign exchange in Russia would have had to find enough buyers of foreign exchange in the private sector. In that case, sellers of foreign exchange would have had to offer a higher price for roubles. Private sector capital exports would have been larger by the amount that the CBR's foreign exchange reserve has actually grown or the current account surplus would have been smaller. This stems from the fact that if the current account balance remains unchanged, there are no private capital net exports when the exchange rate is freely floating.

Capital imports could create liquidity problem

Hopes have been voiced in Russia for private investment flows to turn into Russia. However, it is tricky for an economy with a large current account surplus to absorb investment flows, since the resulting liquidity growth is difficult, if not impossible, to manage without large disturbances to the economy's balance, e.g. inflation problems. Such investment flows can materialise only if the central bank intervenes to the extent that growth of its foreign exchange reserve corresponds to the current account surplus and private capital net imports. Of course, liquidity would also shrink if the state exported capital, but this is hardly possible to any significant degree.

In practice, Russia cannot be a net importer of private capital as long as its current account shows such a surplus. This does not mean that e.g. foreign direct investments could not be made into Russia to expand production capacity, but then corresponding capital exports would also have to take place. In principle, Russia does not need foreign finance, since it has ample domestic liquidity. However, the domestic financial markets function weakly, especially in supplying long-term financing.

Real investments in Russia should increase. A higher investment rate would show up as a smaller current account surplus and less capital exports. However, investments depend, inter alia, on the country's investment climate. Blaming capital exports helps little in increasing investment.

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Economic Developments

Major data revision – oil exports did not shrink

Last summer's strange gap in Russia's official data on oil production and oil export volumes suggested that oil production continued growing at 8-9 % y-o-y (although growth slowed slightly), while the export volume fell around 15 % y-o-y every month from May onwards. A large jump in Russian oil consumption and stock-building might have in principle explained the sudden gap, but both were very unlikely. Russia's oil imports are almost nil, so no drop was possible. A sudden jump in illegal oil exports was suggested.

The Federal Customs Service has now produced fresh figures with a stunning upward revision of oil exports. The earlier figures published in early October still suggested Russia's exports of crude oil averaged 4.4-4.5 million barrels a day (mbd) in January-August. The revised data are 20-25 % higher for the amount of crude oil exported in April-August, which lifts January-September average to 5.1 mbd. Customs figures for exports of oil products were also raised some 20 % for April-August. The corrected on-year growth figures testify that Russia's crude oil exports did *not* stall and oil product exports did *not* fall 6 % as suggested by the earlier January-August data. Instead, crude oil exports rose 14 % in January-September and exports of oil products were up 2-3 %. In September, crude oil exports increased 8 % y-o-y.

The corrections affect other data. The CBR has already raised its figures for total export earnings (which are based mainly on customs data) by $3 billion for April-August, bringing the January-September figure to $129 billion. Russia's current account surplus will also be larger, as will the perceived net private capital outflow from Russia (i.e. the net errors and omissions item in the balance of payments will be more negative). In the national accounts data concerning GDP demand components, the correction (equal to over 0.5 % of the annual GDP) will result in higher export figures (and diminish the residual statistical discrepancy). Total GDP data, however, should remain unaffected since oil production data remained unchanged.

The oil export data revision eliminates the notions that Russia could not boost oil exports to capitalise on high world oil prices, or that Russia may have attempted to constrain its oil exports to support high oil prices – although the earlier uncorrected oil export data might have had some such effect. The revised data suggest that Russia's peak in oil production and exports may culminate quite smoothly.

All current medium- and long-term projections about Russian oil are cautious and foresee the growth of Russian oil production slowing considerably.

Income growth feeds consumption

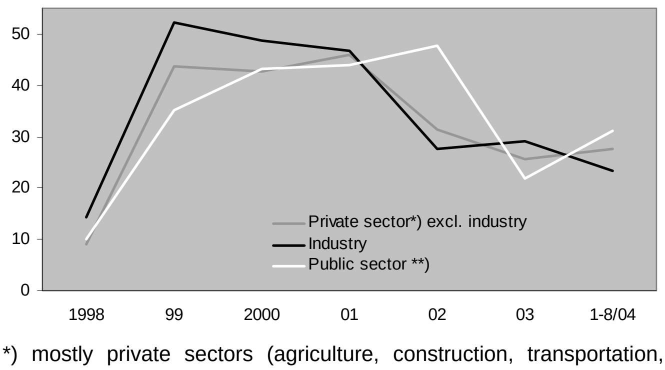
In addition to oil exports and fixed investments, private consumption has been a major driver of the Russian economy for almost four years now, accounting for about half of GDP. In recent months, growth in investment and oil exports has cooled slightly while the volume of private consumption has steamed ahead, increasing over 12 % y-o-y in 1H04 (tentative figures indicate this pace was also maintained in 3Q04). The consumption boom is driving import growth.

The consumption surge has been supported by an over 25 % y-o-y increase in nominal wages in 2003 and January-September this year. It is so far unclear from national accounts and household money income data, which include estimates of wages paid under the table (about a quarter of total wages in 2003, or 11 % of GDP), whether the trend away from under-the-table payments in recent years (2001-03) to declared payments is still estimated to continue.

Wage growth in industry (under 30 % of the economy's total wage sum) slowed this year, while wages in other sectors dominated by private employers (over 40 % of the wage total) rose more briskly, especially in protected, low-wage agriculture. Wages in the public sector (30 % of the total) received substantial hikes in 2002 and this year mainly as the low wages in health care and education were raised.

Rapid wage growth and a relatively stable rouble will boost the Russian private consumer market by about €30 billion this year to an annual volume of over €220 billion, even if private consumption per capita in Russia is still only about €1500 per year (when using the nominal exchange rate) and monthly wages (including the under-the-table slice) average some €270.

Nominal wages, % change from a year earlier



*) mostly private sectors (agriculture, construction, transportation, communication, trade, finance)

**) mostly public sectors (housing, health care, education, culture and arts, science, administration)

Source: State Statistics Service

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.4	H1/04
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	6.2	1-10/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	11.6	1-9/04
Unemployment, % (end of period)	9.3	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.4	9/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9	129.1	1-9/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4	66.6	1-9/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	35.9	1-9/04

Source: State Statistics Service, CBR.

Proposals concerning stabilisation fund resources

Last month the representatives of various ministries actively participated in discussions on how to spend the stabilisation fund "surplus", i.e. the amount exceeding the 500-billion-rouble (over $17 billion) ceiling. The excess money may be used for purposes other than covering budget deficits. It is estimated that the fund will surpass its ceiling in about one month. The stabilisation fund collects revenues from export tariffs on oil and oil products, as well as oil extraction taxes, when the price of Urals-grade crude oil is above $20 a barrel. With the prevailing high oil prices, the fund has been growing very fast (chart).

As most ministries indulged in mainly suggesting investment projects related to their own areas of specialisation, the finance ministry made a special effort to coordinate the suggestions. The joint proposition reached at the beginning of November has now been submitted to the government. The guiding principle is that any stabilisation fund "surplus" should be solely used for paying down foreign debt. Next year, however, financing of the pension fund shortfall would also be allowed under the 2005 budget draft. From 2006, the pension fund deficit (the result of cuts in the unified social tax next year) would be financed directly from the federal budget. However, to support investments, the ministries suggest lifting the fund's threshold oil price from $20 to $21 per barrel. If approved, the change would take effect from the beginning of 2006, and would leave more resources to the budget. The money and any savings from early paying down of foreign debt from the fund would be used for investments as a separate budget item. Under the proposition, at least RUB 60 billion (0.4 % of current GDP) would be available annually for this purpose.

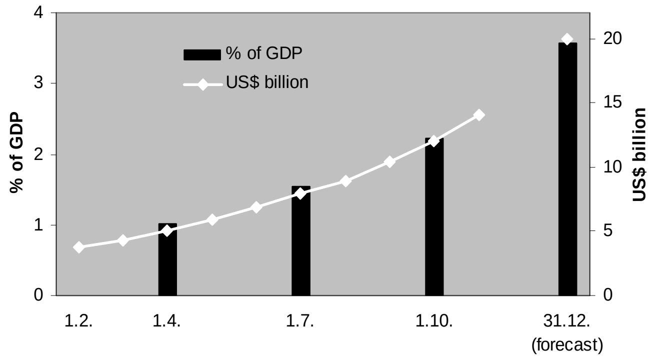
Next year, Russia plans to use RUB 167 billion ($5.6 billion) for total foreign debt repayment and RUB 74 billion to cover the pension fund shortfall. The finance ministry wants to concentrate on paying down non-market debt, i.e. Russia's $40-billion-plus debt to Paris Club creditors. Russia hopes to swap this debt into eurobonds or pay it back faster than originally scheduled. The finance ministry estimates Russia will thus save about two billion dollars in interest payments over the next two to three years.

The joint proposal also included a plan to link the size of the stabilisation fund to GDP. Within a couple of years, the present 500-billion-rouble ceiling will be too low to guarantee financing of necessary expenditures in the event of a drop in oil prices. The present ceiling equals some 3 % of forecast GDP for 2004. Finance minister Kudrin would like to raise it e.g. to 4.5 % of GDP.

Government approves stabilisation fund investment rules

Under the budget code, stabilisation fund resources are held in the finance ministry's account at the central bank. Although never done, the law permits investment of these funds in foreign government securities. At the start of October, the government finally agreed on a list of countries offering securities that can be considered trustworthy. Thus, at the instruction of the finance ministry, the CBR can invest in securities of 14 countries denominated in dollars, euro or pound sterling. The issuer countries include the US, Great Britain, Germany, France and Finland. All issuers must have the highest possible investment rating from at least two international credit rating agencies. The finance ministry will decide the shares of each currency in the loan portfolio. It remains unclear what share of the fund will be placed in securities.

Stabilisation fund resources



Source: Minfin

Budget 2004 amended, budget 2005 proceeds

The original 2004 budget severely underestimated the average oil price for Urals crude in 2004 at $22 per barrel. Already in 2003 the average price exceeded $27 a barrel. During January-August this year, it averaged $32.50. In the amended 2004 budget, accepted by the Duma in three back-to-back readings, revenues are now expected to exceed the original budget by 19 % and expenditures by 4 %. The additional revenues (RUB 500 billion, equal to over 3 % of GDP) come mainly from mineral extraction taxes and export duties. These revenues are both boosting this year's budget surplus to about 3 % of GDP and resulting in additional spending equal to 0.7 % of GDP. Most spending hikes affect transfers to regional and local budgets, international activities, agriculture and road maintenance.

The second reading of 2005 budget was passed in mid-October, with the Duma making only slight changes to the draft. Revenue and expenditure estimates were approved in the first reading in September. The next reading is scheduled for end-November, when the Duma will decide on various revenue and expenditure categories.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2004 amended budget law	2005 draft budget
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.2	1-8/04	20.1	17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	15.6	1-8/04	17.0	16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.6	1-8/04	3.1	1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	25.2	3/04		
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	117.9	3/04		

[1] *Since 2002 social tax is included in the federal budget.*

Source: Budget: IMF 1996–2000, State Statistics Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

Rise of different direct investment flows

Readily available figures on foreign direct investment (FDI) flows are often relied on to judge the relative attractiveness of different economies, which results e.g. from cost advantages, market appeal and the investment climate.

FDI flows to Russia have during the past decade corresponded to slightly over 1 % of the GDP on the average. In the past two years, FDI inflows have risen to $7-9 billion per annum, or 1.5-2 % of GDP. Still, the figure in many of the more advanced transition economies in Central, Eastern and Baltic Europe has ranged between 5 % and 10 % over the past decade.

Moreover, changes in small FDI flows can easily result from relatively large new acquisitions of firms or their shares but also from variations in other FDI sub-flows (which are recorded as FDI as they contain an owner's risk). Indeed, while money and other assets transferred to Russia as equity were a large component of FDI for most of the past decade, it appears (at the aggregate flow level, at least) that the FDI surge into Russia in the very recent years consisted largely of FDI resources going to existing foreign-owned companies, rather than new companies. Data from the CBR and State Statistics Service suggest that in the last five years 35-40 % of FDI flows to Russia, and even more in 2003-04, consisted of loans from foreign companies to Russian companies they owned either wholly or partly. Moreover, using standard balance-of-payments statistics practices, the CBR data suggest that, as part of FDI, earnings reinvested by foreign-owned companies leaped sharply in 2003 and were also relatively large in 1H04.

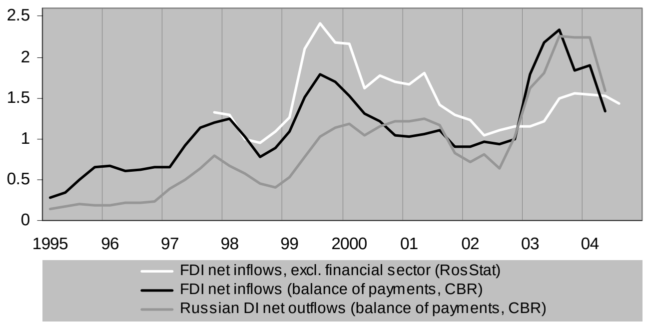
Direct investments from Russia, in turn, surged in the past year as well, reaching $8-10 billion. While undoubtedly more difficult to trace than FDI inflows, Russian DI outflows also appear to be a mixture of changes in placements in equity abroad, loans from Russian owners to their firms abroad and reinvested earnings. This particular type of private capital outflow may partly reflect situations where some companies engaging in foreign businesses feel they get pushed abroad by difficult operating conditions in the home country. On the other hand, especially large Russian companies engaged in oil, gas and metals may be rather pulled by the prospects abroad to reach out to new markets.

Foreign companies in Russia as employers and investors

FDI flows naturally do not give the full picture of the role of foreign companies that can have various positive effects in the host country such as bringing and spreading competition, technology and management skills, which are hard to capture in an assessment. However, some basic indicators suggest the impact of foreign companies in Russia is not negligible. The number of fully or partly foreign-owned companies in Russia, while still small by international comparison, has gradually grown to more than 11,000 companies (the latest data, unfortunately, are for 2002 and include companies with any share of foreign ownership). As of mid-2004, Russia had about 7,000 foreign-owned large or medium-sized companies (defined as companies with at least 100 employees in industry, construction and transportation, 30 employees in retail trade or 50 employees in wholesale trade). Almost 2,000 of these firms were involved in the industrial sector, while 2,600 operated in the trade sector. The total of 11,000 firms employed 2.8 million people and the narrower group of 7,000 firms about 2.3 million people, or 3-4 % of all employed in the economy. The 1.7 million industrial employees in the second group represented over 10 % of industrial-sector workers.

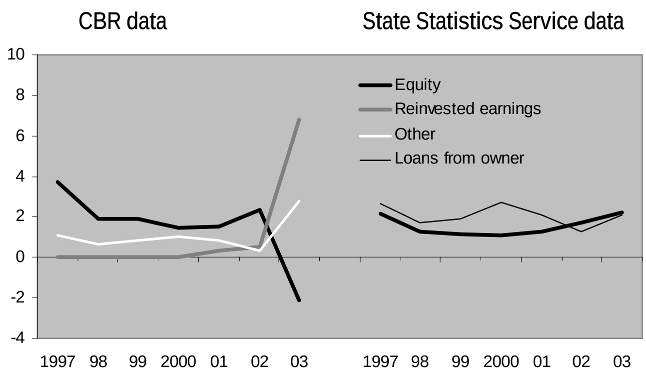
State Statistics Service data further reveal that companies partly owned by foreigners accounted for 11-12 % of total fixed investments in Russia in 2000-03 (excluding investments by small firms). The share of fully foreign-owned companies rose from 2-3 % in 1998-2001 to almost 6 % in 2003.

FDI inflows to Russia and Russian DI outflows, four-quarter moving sum, % of GDP



Source: CBR, State Statistics Service

Components of FDI inflows to Russia (excluding financial sector), US$ billion



Sources: CBR, State Statistics Service

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
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Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.5	9/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	107.3	10/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	28.77	10/04

Source: State Statistics Service, CBR.

Why they, why not we? Explaining Russia's poor competitiveness
by Antti Helanterä and Simon-Erik Ollus*

At first sight, comparing Finland and Russia sounds unreasonable, as the two countries appear to have little in common. However, several reasons justify such comparison.

First, back in the mid-19th century, Finland and Russia lagged behind their industrialising neighbours in Europe and North America. Indeed, Finland was part of the Russian Empire. Second, scholars often attribute Russia's backwardness and underdevelopment to geography. Finland did not necessarily enjoy a better geographic position. Thus, we can test the argument of whether unfavourable geographical conditions explain Russia's slow development. Third, economic growth in both countries in the post-war era was partly based on extensive investments in industry.

In our larger study we compare the historical and present development of both countries to identify differences in competitiveness, and more specifically, with a view to explaining Russia's recent poor record of competitiveness. Key differences included the role of the State, internationalisation and stability.

The State and stability
International competitiveness rankings (e.g. World Economic Forum) note that some of Russia's major weaknesses are rooted in its poorly functioning public sector. In contrast, stable institutions, which constitute the foundation of a market economy, have allowed Finland to adapt at critical historical turning points. Finland already possessed the necessary institutions before industrialisation. Thus, Finnish enterprises were able to adapt and the fundamental institutions remained untouched by the political system even during the stormiest periods.

In Russia, stability has been (and still is) perceived differently. Stability is something each new leader should provide; it is not inherited and passed on to successors.

The systemic crises in Finland and Russia in the late 1980s and early 1990s shook the foundations of both systems. The Finnish system became more competitive, while the Russian system collapsed. Finland's structural changes in the 1990s demonstrate that systemic crisis can provide opportunity to reform and become more competitive. Notably, the state played an important role in structural reform.

Russia has always resisted that kind of large-scale change as it requires the State apparatus to learn new ways of functioning. The State should support economic actors and create favourable conditions for them to act, mainly by enforcing law and order. Instead, virtually all actors in Russia are focusing on short-term benefits. It seems that the stability pursued by increased control has not succeeded in ensuring that economic actors invest in or think about long-term benefits.

Internationalisation and diversification
Investments abroad and specialisation on global markets were important in restoring the competitiveness of enterprises in Finland in the 1990s. The allowing of foreign enterprises to compete on the domestic market also helped improve competitiveness and efficiency. While investment flooded into Finland, foreign enterprises have remained cautious about investing in Russia's unstable environment.

Russia remains highly dependent on natural resources, yet to raise its competitiveness, diversification of the economy is essential. To accomplish this, Russia needs to develop its SME sector and promote innovation, which, in turn, requires stability and long-range thinking. Diversification also implies that the State surrenders control of the enterprises driving wealth creation.

An authoritarian government, however, cannot tolerate the dictation of resource allocation by an "invisible hand" market mechanism. And even if it could, the mere ability to tolerate economic success beyond the competence of the State is not in itself sufficient to create a diversified economy.

Naturally, a state can encourage internationalisation through its foreign policy. For decades, and even centuries, Finland's foreign policy has sought integration with the West. Finland has always been clear that it could not dictate the rules of the game. In contrast, Russia has hardly ever shown much interest in integration with Europe or any other continent. Its foreign policy has typically stressed either isolation or geopolitical expansion. What Russia needs to strengthen its competitiveness is a willingness to integrate under the same rules as any other country.

The Finnish model shows that creating competitiveness is basically a question of a close cooperation between the state and enterprises. State supports through policy, while enterprises must learn to compete in the global economy. Russia still lacks decent policies supporting enterprises and integration in the global economy. The record of internationalisation by Russian private enterprises is modest.

Finally, Russia's planned administrative reform is indeed an effort required to tackle some of the problems related to strengthening the State. However, the experience of simultaneous efforts to accelerate growth and establish new institutions is not encouraging. A more competent state apparatus is certainly required, but, again, in Russia reform is always dictated from the top down. In the long term, Russia requires stable institutions and a state apparatus that continue after the leader goes.

** The authors recently published a report named "Why they, why not we - an analysis in competitiveness of Finland and Russia", Sitra, 2004. The report is available at* http://www.sitra.fi/Julkaisut/Raportti46.pdf

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Economic Developments

Economic growth slowed, consumption surges ahead

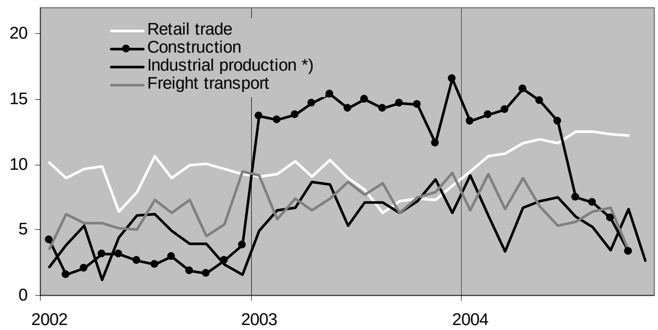
Like last year, GDP growth slowed notably from 7.5 % y-o-y in 1H04 to 6.4 % in 3Q04. The latter pace is still robust, while the economy ministry tentatively notes that GDP growth slowed further in September-October (to 4.5-5 %) but rose in November (to almost 7 %). Assessments vary as to whether some economic activity, feeling pressure from the authorities, has moved into the shadow economy or vice versa. This could make statistics differ from actual growth. The apparent slowdown indicated by the statistics gives some cause for concern since the economy should currently be enjoying the income-boosting effects of higher export prices (that were up last year and this year) while other factors would in that case be yielding slower growth. The income effect may though be weakened by increased net outflow of private capital from Russia.

GDP demand components show some departure from broad-based growth. Growth of investments and exports eased this autumn, while private consumption continued to steam ahead. The investment growth of 8-9 % y-o-y recorded for September and October is still good, and although investments in crude oil production fell, most industrial branches and other sectors have increased investments briskly. However, at the current pace of investment growth it would still take around a decade for the investment-to-GDP ratio to reach 25 % (assuming GDP grows at an annual rate of 4-5 %), which is a level often found to be virtually minimal if an economy is supposed to grow fast over many years.

The boom in private consumption has obviously helped retail trade and services, which grew at a record pace in 3Q04 (12 % and 9 %, respectively). Growth was led by durable goods and telecom services, hallmarks of modern consumer society. While a good harvest helped agriculture improve performance in 3Q04, growth in other sectors abated. Industrial output growth slowed from almost 7 % in 1H04 to 4.5 % in August-November as high growth in different manufacturing branches ebbed and growth of crude oil production eased to 7-8 %. Increases in freight transport also slowed in 3Q04 and October, due mainly to oil and gas pipeline volumes. Slowing investment growth dampened the construction boom that started in early 2003.

Projections for Russian growth next year have become slightly more cautious in recent weeks, although the world market price for oil is generally expected to decline more slowly than in the earlier forecasts. The latest projections of the economy ministry, the OECD, the EBRD and consensus forecasts anticipate GDP growth of 5.5-6 % in 2005.

Volume of activity in the main sectors of the economy, % change from a year earlier



*) adjusted for the difference in the number of working days

Source: State Statistics Service

Expansion of exports may slow, room for import growth

Russia's export income in dollar terms soared 35 % y-o-y in 2Q04 and 40 % in 3Q04. This includes the Russian customs' revised export figures for April-August, which added about 20 million tonnes of crude oil (about 1 million barrels per day) and 5-6 million tonnes of oil products, equal to 7-8 % of the annual export volumes. A major boost in 2Q and 3Q came from export prices that were up 40 % y-o-y for crude oil, about 35 % for oil products and even more for Russia's major export metals. Gas export prices have remained rather flat. The gains for Russia were slightly moderated by the declining dollar. Thus, export revenues in 2Q and 3Q rose about 30 % measured in the currency basket of Russia's main trading partners. Export volumes also increased. For January-September, crude oil exports were up 14 % y-o-y (although not so much in autumn), while gas exports increased 9 %.

Imports to Russia continued to climb over 25 % y-o-y in 3Q04 in dollar terms or 20 % in terms of the currency basket. The share of machinery and equipment (not counting the boom in passenger car imports) in imports recorded by the Russian customs rose to one third for January-September.

Over the past three years, Russia's export earnings have expanded 80 %. Both higher export prices (over half of the rise) and larger export volumes, especially oil, have played significant roles. As a participant in global trade, Russia now compares in size to countries such as Sweden. Going forward, Russia's export development faces new challenges as it is hard to count on the world market prices rising continuously and growth of energy exports likely abates. The economy ministry's most recent projection foresees crude oil exports rising 5-7 % in 2005 and slower thereafter, while gas exports are foreseen to jump in 2007.

Macroeconomic indicators

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004,**	**as of**
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.0	1-9/04
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	6.2	1-11/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	11.2	1-10/04
Unemployment, % (end of period)	9.3	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.5	10/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9	145.9	1-10/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4	75.1	1-10/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	35.9	1-9/04

Source: State Statistics Service, CBR.

2005 budget passes easily

The passing of the 2005 federal budget proceeded smoothly and rapidly, with budget debates carried out behind the scenes. The fourth and final Duma reading took place at the start of December and was soon followed by the Federation Council reading.

Federal budget parameters, % of GDP unless otherwise noted

	2005 budget	2004 actual Jan-Sep	2004 budget	2003 actual
Revenues, excl. UST	16.3	17.3	15.1	16.7
Expenditures, excl. UST	14.9	12.5	14.5	15.0
Non-interest expenditures	13.5	11.0	12.6	13.3
Surplus	1.5	4.8	0.5	1.7
Average exchange rate (roubles per dollar)	30.0	28.9	31.1	30.7
Inflation (year-end, %)	7.5-8.5	11.4	8-10	12.0
Average oil price, Urals grade (dollars per barrel)	28.0	33.0	22.0	27.2
GDP (RUB billion)	18,720	12,164	15,300	13,285

Source: Russian government

Compared to the initial 2004 budget, 2005 revenues and expenditures are higher (excluding monies from the unified social tax (UST) that merely pass through the federal budget to the pension fund). However, the picture changes when compared to this year’s budget outcome, which reflects stronger-than-expected revenue performance due to high oil prices. 2005 revenues are anticipated to decline *if* the oil price falls from this year's actual level as assumed in the budget. Expenditures, and particularly non-interest expenditures, will rise substantially from this year when only part of the extra revenue was used to increase expenditure. Thus, the budget surplus would shrink from this year’s 4-5 % of GDP to about 1.5 % of GDP. Accordingly, the stabilisation fund is projected to grow to, but not exceed, 4 % of annual GDP at the end of 2005.

The first distinctive feature of the 2005 federal budget is its focus on reducing the tax burden and diversifying the economy. From the start of 2005, the maximum UST rate will be cut from 35.6 % to 26 %, which, together with a smaller share left for channelling via the federal budget to the pension fund, would halve the federal budget’s UST revenues (as a share of GDP, i.e. reduce revenues by 1.5 % of GDP).

Second, even as VAT continues to generate the largest single revenue stream (one third of revenues), the dependence of revenues on natural resource extraction fees and export duties continues to rise. Fully one-third of revenues are expected to derive from these two sources (after the 1998 crisis they accounted for only 10-15 % of federal revenues). As long as high oil prices prevail, taxation of oil companies will further increase from the start of 2005. Next month the basic mineral extraction tax on oil (MET) rises 15 %. Already last August, the oil export duty was increased from 45 % to 65 % on the share of Urals-grade oil price above $25 per barrel. Export duties on non-energy commodities will be significantly reduced, although the fiscal impact will be small. Import duties are budgeted to remain at this year’s level.

The new budget also includes changes in the allocation of taxes mainly between federal and regional budgets. The most important of these from the fiscal point of view is the increase of the federal share of profit tax revenues. While still leaving the lion’s share to regional budgets, the federal budget’s share of the 24 % profit tax will rise next month to 6.5 percentage points from the present 5 percentage points.

On the expenditure side, declining interest payments will allow great spending on other items. Reflecting recent global and domestic developments, the weight of expenditures on defence, law enforcement and security will grow to over 30 % of 2005 federal budget expenditures. Spending on education (which in the federal budget consists mainly of higher professional education), health care and social policy (mainly pensions of the military and providers of security and law enforcement) will slightly decline. Regarding support functions for the national economy, transport networks figure relatively high on the government's budget agenda. Transfers to regions will not change much as a share of GDP or federal budget expenditures.

Main revenue and expenditure categories of 2005 and 2004 initial federal budgets

	2005 % of GDP	2004 % of GDP	2005 %	2004 %
Total revenues	**17.8**	**17.9**	**100**	**100**
Total (excluding UST)	16.3	15.1	92.0	84.0
VAT	*6.0*	*6.5*	*33.7*	*36.0*
Export duties	*3.3*	*2.3*	*18.6*	*12.8*
Natural resource fees	*2.5*	*1.8*	*14.0*	*10.2*
Profit tax	*1.4*	*1.1*	*7.8*	*6.0*
Import duties	*1.3*	*1.2*	*7.5*	*6.6*
Total expenditures	**16.3**	**17.4**	**100**	**100**
Total (excluding UST)	14.9	14.5	91.3	83.5
Interest payments	*1.4*	*1.9*	*8.3*	*10.8*
Non-interest payments (excluding UST)	13.5	12.6	82.9	72.7
Defence	*2.8*	*2.7*	*17.4*	*15.6*
Security	*2.1*	*2.1*	*13.1*	*11.9*
General administration	*1.3*	*1.1*	*7.7*	*6.4*
Transport,production etc.	*1.3*	*1.4*	*7.7*	*8.0*
Education	*0.8*	*1.0*	*5.1*	*5.9*
Health care	*0.4*	*0.5*	*2.7*	*2.8*
Social policy	*0.9*	*1.0*	*5.6*	*5.8*
Transfers to regions	*2.0*	*2.1*	*12.1*	*11.9*
Balance	**1.5**	**0.5**		

Source: Budget figures after the third Duma reading

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2005 draft budget
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	19.9	1-9/04	17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	15.1	1-9/04	16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.8	1-9/04	1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	25.2	3/04	
Foreign currency debt, $ bn	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	117.9	3/04	

[1] *Since 2002 the unified social tax is included in the federal budget.*

Source: Budget: IMF 1996–2000, State Statistics Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

Government debt over corporate stocks

Russia's state finances have been in a solid shape for several years now, with a sturdy budget surplus, declining debt ratios and even plans to pay down some foreign debt early. The Russian state also received its second upgrade to an investment rating from a leading international rating agency this autumn. The market prices and yields of Russian government debt paper (rouble and foreign-currency) have remained relatively stable during the past year. On the other hand, continuous improvements have been restrained, and in late spring the prices for government foreign debt papers declined. This autumn, prices moved up again, with yields and yield spreads compared to US government paper declining back to the best-ever levels of autumn 2003 (slightly above 2 percentage points for the spread as an aggregate).

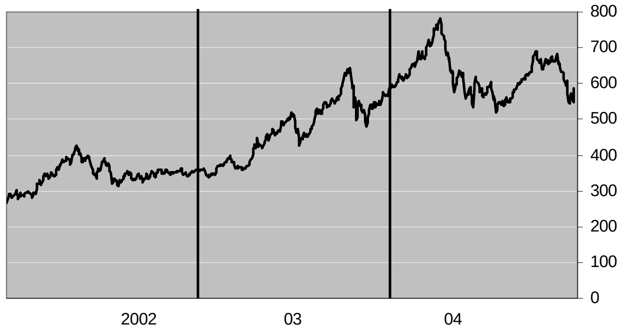
While the Russian state has been unambiguously successful in improving its own standing, it has met shakier success in its stated efforts to advance trust in the Russian corporate sector. Growing production and sales volumes and high export prices for energy and metals are reflected in improved performance of Russian companies – their net profits increased one-third in real terms in January–August (excluding small firms, agriculture and banks, and noting uncertainties relating to profit/loss figures). Even so, uncertainty about the official policies towards companies has eroded the attraction of the corporate sector among financial investors.

Thus, the main company stock index, RTS, while generally on a path of recovery since the 1998 crisis, has gone through major upward and downward shifts in the past year. The major drops, between 15 % and 25 %, reflected specific steps in the state's process against Yukos, earlier Russia's largest private oil company. Following the arrests of Yukos directors last year, the first tax court ruling against Yukos this spring and the authorities' announcement in summer about their intention to sell Yukos core production entity (Yuganskneftegaz), the latest drop of almost 20 % in the RTS stock index came in November and early December when other oil companies and telecom firms received claims for back taxes (although the claims were far less than the claims against Yukos). Extra uncertainty prior to Yuganskneftegaz's auction on December 19 may have also played its role in dragging down the RTS as the index revived after the auction and currently has recovered to last summer's levels.

The structure of the stock market has also changed. Yukos stock has evaporated to 10 % of its value in October and 3 % of the value in April. All other major RTS stocks also fell 15–30 % since November, before this week´s recovery. The capitalisation of the RTS continues to be concentrated in few companies. It is currently dominated by Lukoil (30 % of RTS capitalisation) and Surgutneftegaz (almost 25 %), followed by Norilsk Nickel and Sberbank (each around 7 % and 8 %). Gazprom, Russia's largest stock (over double the Lukoil stock) is not listed in the RTS, but it has also fallen lately.

The authorities face a tricky challenge in trying to keep balance between enforcing, in principle, the same rules for all firms and avoiding real spreading of acts that could be deemed by the market as attacks. The situation will keep investors watchful and many of them will remain sensitized.

RTS company stock index



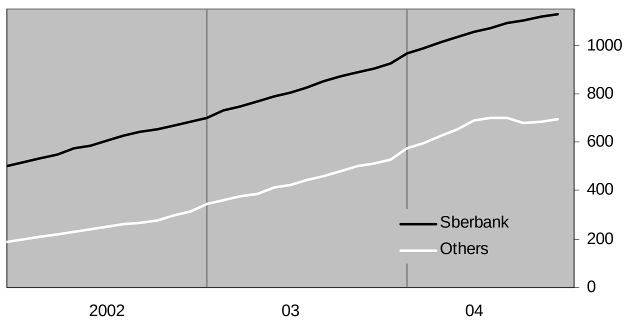
Source: RTS

Commercial banks start to recover from summer deposit drop

Last summer's turbulence around certain banks helped reaffirm state-owned Sberbank's dominant position as its share of household deposits jumped to 62 %. Sberbank and other major state banks, supported by their exclusive state deposit guarantee, were able to continue deposit growth, whereas deposits to a varying degree fled other banks in all size categories, resulting in losses of market share and declines of deposits in absolute terms.

Thanks to the express deposit guarantee enacted in July for all other banks not covered earlier, the situation has now somewhat normalised. Deposit growth overall recovered to 18 % y-o-y in real terms in October. Banks in nearly all size categories were again able to attract new deposit money from households in August-September, while Sberbank's market share stopped growing.

Household deposit stocks in Sberbank and other banks, 1 Jan 2002 – 1 Oct 2004 (monthly), RUB billion



Source: CBR

Monetary indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	11/04
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	37.5	10/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	245	10/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	10/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	13.0	10.9	10/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	117.4	11/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	28.24	11/04

Source: State Statistics Service, CBR.

Is Russia all that different from its emerging market peers?
by Tuomas Komulainen *

Daniel Treisman and Andrei Shleifer (*Foreign Affairs*, 2004) recently articulated the view that Russia is a normal country given its income level. Some Russia followers responded (e.g. Rosefield, BOFIT Discussion Paper 15/2004) that the country is basically different, since it degrades human welfare more than others and remains undemocratic. Today, of course, we have the Yukos case (and possibly the Vimpelcom case), where the state has interfered radically with private enterprise. Nevertheless, it can still be argued that the country is basically similar to other emerging economies, i.e. Russia is a market economy and we should analyse it as such.

Similar economic indicators

It may be easily forgotten that Russian enterprises are privately owned and they react to price changes and profit opportunities. Free elections are also held in due course. Moreover, recent economic developments and many current indicators are quite similar to those of other emerging economies. For example, gross national income per capita in Russia in 2002 was US$7,820 (as calculated by the World Bank in purchasing power parity terms) which is lower than in Poland $10,130 and Mexico $8,540, but higher than in Brazil $7,250 and Turkey $6,120. The high income inequality encountered in Russia is quite common in emerging markets - the Gini coefficient for Russia is 0.46, similar to Thailand's 0.43 but lower than Brazil's 0.58 or Mexico's 0.55. The financial system is quite small in Russia (the ratio of bank assets to GDP is around 40 %), yet quite in line with most Latin American countries. Even Russia's exchange rate policy - fear of floating - and some of the current problems with capital inflows are common issues in many emerging markets. The volatility of GDP growth is comparable to most developing economies, and the volatility of capital flows is actually lower than in most Latin American and Asian countries. Using these and other indicators, the Russian economy can easily be classed with a sub-group of over 30 emerging economies (for further comparison, see Shleifer and Treisman, *Journal of Economic Perspectives*, forthcoming 2005).

Does economic growth in Russia, then, depend on the intervention of authorities or is economic growth determined by the usual economic variables? After 1998 crisis, the rouble's real exchange became highly competitive and raw material prices climbed. Macroeconomic stability was achieved and the profits of enterprises increased substantially. Thus, economic growth since 1999 seems generally to be a natural response to macroeconomic stability and profit opportunities. A similar growth pattern following the 1997–2000 financial crises has been seen in many emerging market countries. In some respects (e.g. strict fiscal policy), the economic policies of Russia have actually been better than in many other emerging economies and so has the economic performance (admittedly, high raw material prices have played a big role as well). Clearly, this economic growth has benefited the average Russian citizen. Private consumption has increased in real terms at 8-9 % per annum since 1999. Hence, as in all market economies, Russian economic development seems to depend more on economic variables and conditions than on politics or the whims of certain authorities.

What about those government interventions?

In the Yukos case government-controlled Gazprom or Kremlin-friend Surgutneftegaz seem to acquire 19 % of the Russian oil sector. Unfortunately, if the persecution and nationalisation continue, Russian economic growth may depend more on political outcomes than economic variables. Russia stands alone in this regard; nationalisation of a major industrial asset has hardly occurred in any emerging market since 1990. Of course, in most emerging economies, e.g. Mexico, Venezuela and the Arab states, most or all of the oil and natural gas sector is still owned by the state enterprises. Relatively speaking, Russia is still ahead of many of its peers in privatisation.

Undoubtedly, the Yukos (and Vimpelcom) case constitute a setback for economic growth. Private Russian enterprises will react to the deterioration in business environment. Indeed, there is already some evidence of such reaction. After enjoying rapid growth since 1999, the increase of industrial production decelerated this autumn. Investment growth has also slowed and equity markets are narrow. This is the price Russians are now paying for government interventions.

In addition, in developing or emerging economies productivity and investments of state enterprises in raw material industries are usually lower than in private enterprises. This is partly because corruption is often higher in state enterprises in such countries than in private firms. It is hard to see how Gazprom or Surgutneftegaz can do more for productivity, transparency or investment in Yuganskneftegaz than Yukos did.

So what should we expect from the Russian economy during the rest of president Putin's second term? The relatively strict fiscal policy and flexible monetary policy will continue. Hence, the macroeconomic stability should continue. Moreover, few analysts predict that raw material prices will drop substantially. Also Russian membership in the WTO should become reality before 2008. But we might also see less structural reforms, more state interference and more powerful state enterprises. Given these fears, all decisions by the Russian authorities will hold the rapt attention of markets and enterprises.

Economic variables will thus continue to favour economic growth in Russia, but state interference could discourage private investment. In sum, economic growth will continue but with slower pace.

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