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Russian Economy - The Month in Review

Yearbook 1998

Russian Economy - The Month in Review

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

Bank of Finland
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Russian Economy - The Month in Review
Editor-in-Chief **Jouko Rautava**

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Bank of Finland
Institute for Economies in Transition (BOFIT)

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

Russian Economy - The Month in Review 1998

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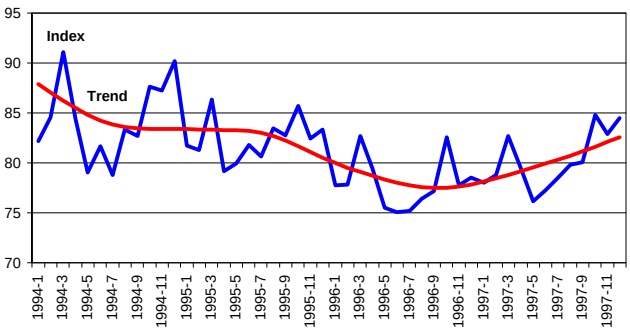
Economic Developments

Output no longer fell in 1997

After declining for seven successive years, Russia's economy showed signs of stabilization in 1997. Real GDP rose 0.4% compared to 1996. In the last two months, production was about 1% higher than in the same period a year ago. Taking into account seasonal variations, there is evidence that industrial output started to recover already in the autumn of 1996, and last year industrial production was up 1.9% (see chart below). Growing industries include the car industry and the metallurgical and chemical sectors. For the first time since 1987 crude oil production also showed some growth (1.3%). Thanks to a good grain harvest, a 28% jump from 1996, there are signs that agricultural output fell much less than in the previous years. Regional differences in growth performance are, however, significant.

Industrial production 1994-1997, Dec 1993 = 100



Consumption up, investment still down

Many indicators show increased consumption. Real average wages were 4.3% higher than in 1996 and data on real disposable income (2.5%) seems to support the view that consumption is increasing. Moreover, for the period January-October, retail trade was up about 1%; and for the period January-November, sales of services was up over 2%.

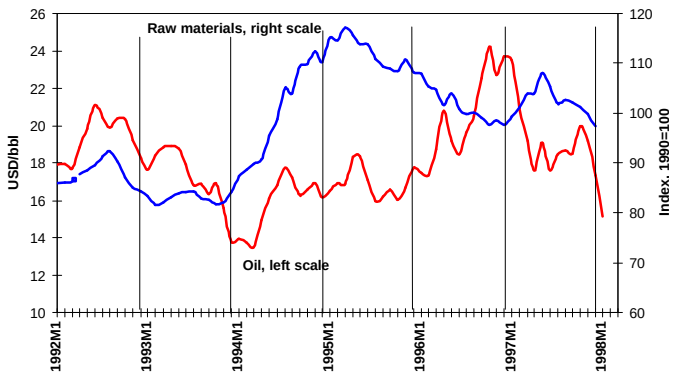
The investment component of aggregate demand continued to decline in 1997. In the first 10 months investment fell by over 6%. However, the rate of decline in investment is probably decelerating as investment dropped much less in the third quarter than during the first half of the year. Despite the decline in investment, aggregate demand was probably higher in 1997 than in 1996.

Low prices threaten export revenues

In January-November 1997, Russia's trade surplus narrowed to USD 18.3 billion from USD 23.5 billion in the same period in 1996. This was the result of increasing imports and decreasing exports. Increase in imports is in line with the above information on increasing domestic demand. Decline in the value of exports, on the other hand, is at least partly explained by the decrease in crude oil prices, which were down by more than 6% compared to 1996.

Towards the end of last year and in January 1998 the price of crude oil declined steeply (see chart below). Currently, Brent crude is selling at around USD 15-16/barrel – about 15-20% below last year's average price of USD 19.15/barrel. Moreover, prices of raw materials other than energy also came down in recent months. Thus, as energy and raw materials count for about 80% of Russia's exports, the outlook concerning export revenues is poor.

Prices of oil and other raw materials, 1992-1997



Russian GDP forecasts, 1998-99

	1998	1999
EIU (Jan. 98)	2.0	4.0
JP Morgan (Jan. 98)	4.0	5.0
OECD (Dec. 97)	3.0	5.0
PlanEcon (Dec. 97)	2.7	-
Russian government (budget)	2.0	-
UBS (Jan. 98)	2.0	4.5

Key economic indicators:

	1992	1993	1994	1995	1996	1997	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-6.0	0.4	
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-5.0	1.9	
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-6.6	10/97
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	
Exports, USD billion	53.6	59.7	67.8	82.6	90.2	41.0	H1/97
Imports, USD billion	43.0	44.3	48.4	60.7	67.4	31.1	H1/97
Current account, USD billion			10.7	10.0	11.4	5.0	H1/97

Sources: Goskomstat, CBR

Budget revenues remain a problem

The revenues of the combined first-through-third quarter budget released by Goskomstat were about 47% of the revenues budgeted for 1997. Expenditures (excluding servicing costs for government debt) in the first nine months amounted to 52% of the year's target. Poor tax collection explains most of the revenue side problems despite the fact that tax collection as a share of GNP is estimated to have slightly improved from the levels of 1996.

The 1998 budget was approved in the second reading at the end of December 1997. The third reading has been postponed to early February. Until approval of the new budget, monthly expenditures have been limited to one-twelfth of the actual spending in 1997.

Public sector wage arrears still unpaid

Despite considerable money transfers to the regions at the end of 1997, public sector arrears were not paid off by the beginning of 1998 as demanded by President Yeltsin last summer. Although precise information on the arrears situation is unknown, the problem of unpaid wages is known to be concentrated in a few regions. The arrears owed to the defence sector are due to be paid off by this summer. At the end of November 1997, estimates on the amount of public sector wage arrears varied from RUB 10 to 26 billion (USD 1.6 - 4.3 billion).

Government debt servicing costs rising

Russia's domestic economic problems and turbulence in global financial markets since late October have slammed stock prices and lifted market interest rates. Starting from under 20% in mid-October, T-bill yields were up to around 30% in January 1998. Due to the growth of domestic debt servicing costs, the government did not do any net borrowing in December and January. At the end of 1997, the Duma passed a bill to raise the level of foreign borrowing from USD 9.8 to 10.9 billion in a second reading. In the near future, the government plans to reduce the term of newly issued government securities in response to a shift in demand towards securities with maturities below 100 days.

The tax reform postponed, again

Comprehensive tax reform, stated as one of the most important targets of the government last year, has been postponed to 1998-99 due to a disagreement between the government and the Duma. The original version of the tax code was approved in its first reading in summer 1997, but then withdrawn from further readings as a concession to the Duma's non-confidence vote in October. The revised version of the tax code is now scheduled to go before the Duma in early February. Before approval of the tax code, some features of tax reform are being pushed through as separate tax laws. At the beginning of January, for example, a law on changes in income tax was approved. The new income tax scale should reduce the tax burden on individuals. Income tax revenues are expected to fall by a fifth. Amendments to value-added taxation were also approved in January in a third reading in the Duma. If implemented, VAT on alcohol, tobacco and luxury cars will increase in February.

Apart from measures concerning changes in tax rates, the government is trying to enhance tax collection. An IMF tranche (EFF) of US$ 670 million, which should have been released November 1997 was delayed because of tax collection problems. Although the revenue situation had not improved markedly by January 1998, the IMF was sufficiently satisfied with the government action plan containing measures to enhance tax collection to release the money. Already in November 1997, a presidential decree outlawing the practice of netting state debts against enterprise tax arrears from the beginning of 1998 was signed as a part of the action plan. In the beginning of December, Russia's Temporary Emergency Commission for Strengthening Tax and Budget Discipline decided on the possible seizure and auctioning off of three large tax debtor enterprises. Also other measures to increase tax revenues, including limiting the availability of oil export quotas to companies that have paid their taxes, are under consideration.

Federal government gross debt (per cent of GDP, year-end)

	1992	1993	1994	1995	1996
Domestic public debt	35.7	26.3	18.9	14.4	19.9
External public debt	132.5	66.9	44.5	33.8	28.4
Total public debt	168.2	93.2	63.4	48.2	48.3

Sources: OECD, BOFIT

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998
Federal government					Q3	budget draft**
- revenues	10.6	13.3	13.6	12.4	10.6	13.1
- expenditures*	21.0	23.0	16.6	15.6	14.2	17.8
- balance*	-10.4	-10.7	-3.0	-3.3	-3.6	
- balance**	-	-11.4	-4.8	-6.3	-7.6	-4.7

* Excludes interest payments on short-term government debt

** Includes interest payments on short-term government debt

Sources: Russian Economic Trends, IMF

New rouble underlines low inflation policy

In 1997, inflation continued to decelerate; at the end of the year consumer prices were only 11.0% higher than a year earlier. Even in December, price developments were modest despite the upcoming nominal currency reform on 1 January 1998. Three zeroes were lopped off the rouble and the new ISO abbreviation for the rouble is now RUB. The 1998 budget draft is based on an inflation forecast of 5.7%.

Changes in exchange rate policy

In addition to the denomination of the rouble, Russia introduced a new foreign exchange policy dedicated to holding the rouble at an average exchange rate of 6.1 roubles to the dollar during 1998. The new system is quite flexible, however; the rouble can vary within broad band of 15% upwards or downwards. For the period 1998-2000, the central rate would be 6.2.

Asian storm hits Russia's markets

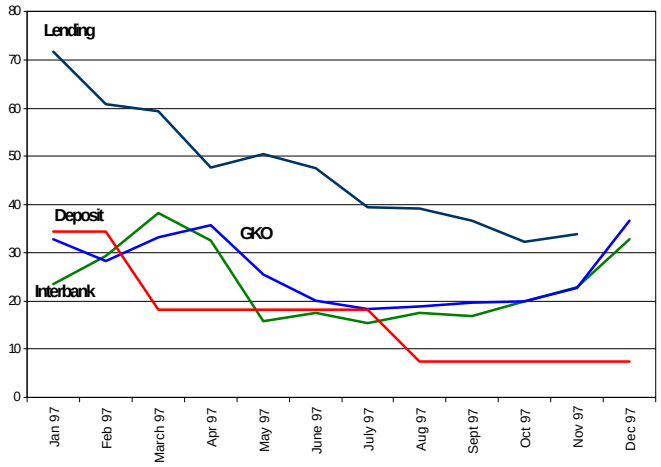
Russia's financial markets have been seriously afflicted by the crisis in Asian financial markets. In addition to distrust of emerging markets, Russia's situation was worsened by fiscal problems related to budget revenues, a bigger-than-planned budget deficit of about 8% of GDP, slow progress of the 1998 budget in the Duma, and concerns related to Mr Yeltsin's health.

Since late October, the Russian stock market has been highly volatile. Daily changes in the Moscow Times index of 50 most-traded shares have varied between -25% and +19%. At the end of January, the MT index was about 50% down from its peak at the beginning of October and only slightly higher than a year ago. After an initial jump in interest rates (GKO yield) from around 20% in late October to around 35% at the beginning of December, yields stabilized at around 30% before they jumped to over 40% in the last week of January. Notably, Russia's 1998 draft budget is presently based on estimates of T-bill (GKO) yields of 12-14 per cent.

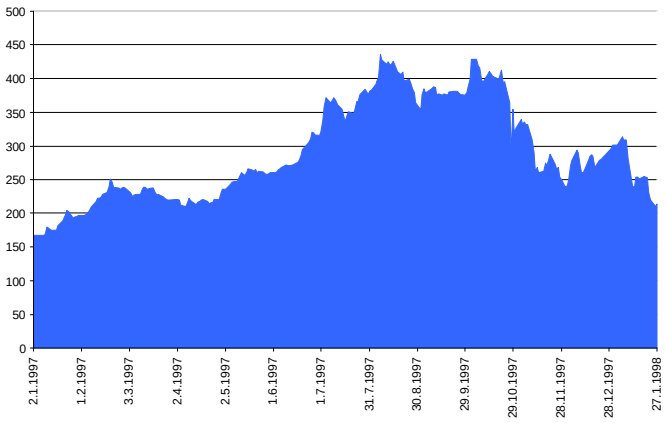
In November, the central bank responded to uncertainty in international currency markets by raising its refinancing rate from 21% to 28% and the minimum hard currency reserve requirements for commercial banks. On 30 January, the central bank said it would raise its key refinancing rate to 42% in the beginning of February. Russian authorities will also limit the amount of foreign loans Russian domestic banks can take to no more than four times their paid-in share capital, or 28% of assets. The limit applies to borrowing from foreign banks and international capital markets. On the other hand, liberalization of Russian markets continues as restrictions on foreign investors buying and selling Russian government securities have been lifted since the beginning of this year.

Recently, the international credit rating agencies Standard & Poor's and Moody's announced that their outlook for Russia has worsened due to concerns over the lack of fiscal consolidation. *Euromoney* also downgraded Russia's ranking in its latest review. In December, Russia's country ranking had fallen from 66th in September to 75th.

Average interest rates in 1997, p.a.



Moscow Times index



Monetary indicators:

	1993	1994	1995	1996	1997	1998 latest	as of
Inflation, %	842	224	131	22	11.5		
M2, %		217	113	33	31.6		
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000		
Interest rates, period average							
- T-bill yield, %			168	86	26.0		
- deposit rate, %			102	55	16.4		
- lending rate, %			320	147	47.1		
Currency reserves, USD billion	5.8	4.0	14.3	11.3	18.4		
RUB/USD, end of period	1247	3550	4640	5560	5960	6.03	1/98

Sources: Goskomstat, CBR

Russian growth is not Polish growth

By Pekka Sutela*

While there is an emerging consensus that Russian economic decline has been halted, statistical uncertainty makes less than fruitful any speculation on whether and how much the Russian economy is actually growing. As a result, medium-to-long-term forecasts vary considerably. At one end, we find negative growth predicted by Russians fearing a deindustrialization process that permanently relegates the country to Third-world status. In particular, we hear this from left-wing opponents of current policy, but it is also a view expounded by prominent Russian academic economists. At the other end, there are respected Western journalists claiming a Russian boom lies ahead and that we can expect growth to accelerate to at least five per cent a year. In more academic exercises such as the *EBRD 1997 Transition Report*, growth rates are forecast to peak at no more than three to four per cent annually.

Perhaps what is needed in the growth discussion is a reference point. Poland, for example, has consistently outperformed Russia in terms of economic growth in recent years. Even so – as we researchers working with the Russian economy are constantly reminded – Russia has vast natural resources, an ample supply of gifted, well qualified brains as well as a tradition of research, development and high-tech production. Why then shouldn't Russian performance be as good as – if not better than – Poland's?

To start with, Polish growth has been based on the twin pillars of new private activities and readjustment of state-owned enterprises. Of course, there is much new activity in Russia, too, especially in service branches such as finance, which were either absent or grossly neglected under socialism. But growth based on such a narrow foundation soon meets up with a balance of payments constraint (and even sooner when there is practically no new enterpreneurship in basic tradable goods).

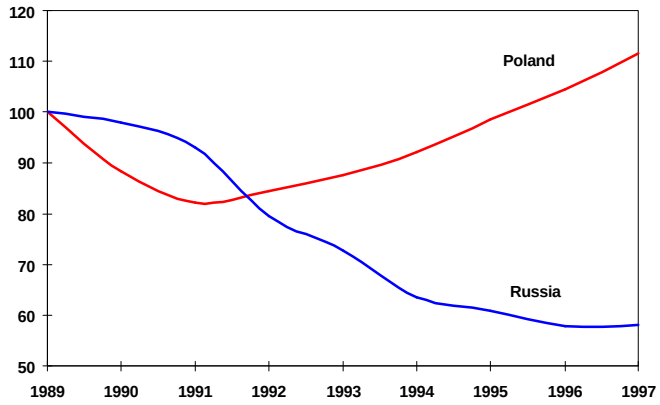
The reasons for this dilemma should be well understood. Comparative studies show that the Russian state has traditionally been a barrier to, rather than a supporter of, entrepreneurial activities. While uneven tax policy, poor regulatory frameworks, prevalence of crime (or at least the absence of law and order) and other problems have been much emphasised, it does not make them any less real. Anyone who has read Gogol or knows anything about socialist traditions very likely understands that the probability of the Russian state supporting growth at any time soon is close to nil.

The preconditions are none better concerning the possibilities of capacity utilization. Surely, the inherited capital stock is not uniformly worthless, but still the picture is sobering. There is now strong evidence that late Soviet investment was increasingly eaten away by hidden inflation and thus left less and less to create new capacity. In the 1990s, most of the capital stock has been little maintained. Additionally, actual (as opposed to statistical) savings and investment ratios are low, perhaps around ten per cent of GDP. Essentially, the economic value of the capital stock was allowed to collapse as planner preferences gave way to market demand, as energy prices and other prices increased dramatically, as transportation costs were introduced, and as the environment assumed an economic value.

To be at all sustainable, Russian growth will have to be based on investment. In other words, the Polish path is not an option. Yet Russia's low actual saving ratios imply that there is no huge stock of savings to be mobilized for investment. In any case, investment financed from savings produces, at most, modest economic growth and there seems to be no basis to believe that Russians would aspire to domestic saving rates at East Asian levels. It takes an even greater leap of faith to believe that Russian growth could be based on foreign savings. That would assume a complete change in the Russian business environment.

Russia's final problem is one of perceptions. The country has yet to come to terms with being smaller and poorer than what the USSR was, or at least pretended to be. In coming times of scarcity, there is strong reason to believe that any redistributable surpluses in production will set off fierce struggles between the forces for investment and those for spending (the military, education and social security).

GDP in Russia and in Poland 1989-1997



** The author is the head of BOFIT.*

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

Editor-in-Chief Jouko Rautava

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Economic Developments

Foreign trade surplus shrinks in 1997

According to the State Statistics Committee (Goskomstat), Russian exports, after growing for a number of years, showed a decline in 1997 in US dollar terms, while the growth in imports accelerated to over 7%. However, export earnings from the CIS countries grew, bringing their share in exports to around 20%. Growth of imports from the CIS slowed, and represented 26% of the Russian market in 1997.

Goskomstat figures put Russia's total exports at USD 87 billion and imports at USD 67 billion in 1997. This includes estimates of trade not recorded by the Russian customs. On a preliminary basis, the share of this "shuttle trade" was estimated to have diminished to around 1% in Russian exports to non-CIS countries and to some 7% in exports to the CIS. For imports from non-CIS countries, the share was judged to have fallen to about one-fifth (from over a quarter in 1996). Shuttle-trade imports from the CIS stayed at about one-fifth.

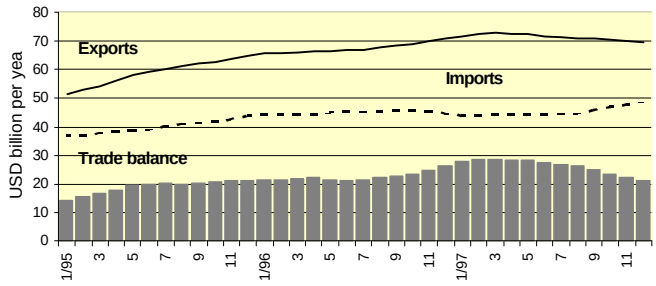
Russia's trade surplus (shuttle trade included) shrank to USD 20 billion from USD 27 billion in 1996. However, due to the uncertain coverage of import statistics and double invoicing practices (whereby invoices are replaced with other invoices upon crossing the border) the actual trade surplus may well be less. Looking back at the Russian balance of payments, imports, though recorded on an f.o.b. basis, have still been higher than suggested by Goskomstat figures. Thus, according to Russia's central bank, the trade surplus in 1996 was USD 23 billion. A recent IMF release puts the figure at slightly over USD 16 billion for 1996.

Exports focus: energy and metals

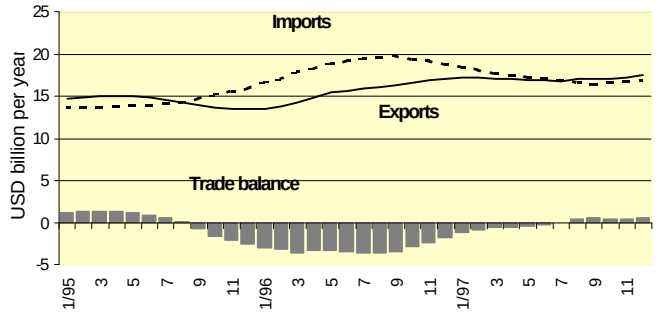
The major sources of Russian export revenue – energy and metals – as well as chemical and forest products were struck by falling prices in international markets in 1997. However, the share of energy and fuels in exports increased slightly to about 47% thanks to more income from gas exports, which climbed to almost 19% of total exports. Unlike in most sectors, prices of Russian gas exports to non-CIS countries rose considerably last year. Total gas deliveries remained at the 1996 level, embodying a switch to the CIS (which took 35% of exports). Export prices of crude oil and oil products dropped about 10%. The volume of crude oil exports grew slightly, going increasingly to non-CIS countries (who took 94% of exports). Metals and metal products increased their share in total exports to 21%. Exports of machinery and equipment to the CIS picked up, and accounted for some 20% of CIS exports. In non-CIS exports, this category stayed at 8%.

Russian imports, as recorded by the customs, saw lively demand in 1997 for non-CIS foods and raw materials (up a third), non-CIS machinery and equipment (up a quarter) and non-CIS chemical products (up a fifth). The share of both food items and machinery in Russia's total imports increased to 26% and 35%, respectively. In Russia's non-CIS imports, the share of machinery reached 39%. However, recalling the magnitude and nature of shuttle imports, Russia actually spends considerably more of its export revenues on consumer durables and clothing.

Russian foreign trade, non-CIS trade (sum for last 12 months)



Russian foreign trade, CIS trade (sum for last 12 months)



Key economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-6.0	0.4	1.3	1/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-5.0	1.9	1.5	1/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0		
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	9.0	1/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7		
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9		
Current account, USD billion			10.7	10.0	11.4	3.0		9/97

Sources: Goskomstat, CBR

1998 budget adoption should happen in March

With the approval of the third reading of the 1998 budget by Russia's lower house Duma (5 Feb), many considered the fourth and final reading would be more or less a formality. It was not. Given President Yeltsin's option to veto the budget unless additional cuts were implemented to make it more realistic, the government suggested further budget amendments to the Duma. These included cutting its expenditures by almost 28 billion roubles (USD 4.7 billion or 5.6% of budget expenditures). Thus, in the fourth reading (20 Feb) the Duma rejected both the version of the draft budget it had approved itself in the third reading as well as the government's new suggested version. Discussions on the budget will continue on the 4 March.

Poor tax collection continued in 1997

Russia's State Tax Service reported that it managed to collect taxes worth about 230 billion roubles during 1997. Taking into account the impact of inflation, this performance was no better than in 1996. The low level of taxes paid in cash is striking – only 58% (RUB 135 billion) of all tax revenues in 1997 were in cash. The rest were paid in the form of non-cash arrangements. Compared to 1996, though, cash tax collection was up by a third. Half of the cash tax revenues came from Moscow. 1997 tax revenues accounted for about 60% of the original 1997 budget and 94% of the revised 1997 budget. Almost 50% of tax revenues came from VAT, 21% from excise taxes, 16% from the profit tax and 5% from taxes on the use of natural resources.

According to the State Tax Service, the debt of Russian enterprises to the state in the form of tax arrears rose during 1997. At the beginning of 1998, the debt amounted over 180 billion roubles (USD 30 billion) and was 50% larger than at the beginning of 1997. If tax penalties are added, the debt rises to 555 billion roubles (USD 93 billion).

Net borrowing halted for the first quarter of 1998

Due to rising government debt servicing costs, President Yeltsin ordered the government to stop taking on additional debt until at least the end of March, when new loans could be considered if interest rates fall back to pre-Asia crisis levels. At the end of February, T-bill yields were still far higher than before the crisis in Asia.

In the second quarter, Russia plans to issue a seven-year Eurobond to cover debt service. At the end of February, the Japanese government announced it was granting Russia a USD 1.5 billion loan. The loan extends over the next two years and is not tied to purchases from Japanese companies.

With the federal government gross debt at about 50% of GNP in the end of 1996, the Russian government has revealed various plans to get control of the debt situation. These plans include restructuring of the estimated RUB 760 billion (USD 125 billion) government debt to defence sector and domestic companies by securitising most of this debt, as well as tighter control on regions and companies taking credits abroad. Tax offsets have been abolished from the beginning of 1998 by presidential decree.

IMF will continue lending program to early 2000

In February, during the visit of IMF managing director Michel Camdessus, Russia and the IMF agreed on a one-year continuation of the USD 10.2 billion Extended Fund Facility arrangement until early 2000. Originally, the agreement covered 1996–1998. Agreement was also reached on Russia's 1998 economic reform program, which is to be signed in the near future. The precise contents of it have not yet been revealed, but the emphasis of the program will be on containing fiscal imbalances and on structural reform. The government amendments to the 1998 budget are in line with the new economic program. Mr Yeltsin's 1998 action plan, which contains 12 priorities, also supports the goals set with the IMF (see below).

Twelve tasks for the Russian government

1. Reduction of taxes
2. Diminishing nonpayments, reduction of budget expenditures
3. Securing prompt payment of wages and pensions to the budget sphere
4. Clearing government debt to defence sector
5. Supporting investments and structural reforms in production
6. Lowering railway and energy tariffs for enterprises
7. Intensifying administrative effectiveness
8. Carrying out land reform
9. Better targeting of social security expenditures
10. Securing apartments for army employees and their families
11. Establishing stipulations on worker relations to comply with market economy conditions
12. Strengthening legal protection of citizens and organisations in the sphere of economy

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998
Federal government					Q3	budget draft**
- revenues	10.6	13.3	13.6	12.4	10.6	13.1
- expenditures*	21.0	23.0	16.6	15.6	14.2	17.8
- balance*	-10.4	-10.7	-3.0	-3.3	-3.6	
- balance**	-	-11.4	-4.8	-6.3	-7.6	-4.7

* Excludes interest payments on short-term government debt
** Includes interest payments on short-term government debt
Sources: Russian Economic Trends, IMF

Interest rates still high, but falling

Continuing crisis in Asian markets and domestic problems related, in particular, to the 1998 budget, have kept alive concerns about Russia's monetary policy and financial markets. Interest rates are still very high, although the Bank of Russia dropped its refinancing rate from 42% to 39% on 17 February. This was the first sign of a turnaround in a trend that saw the key central bank rate hiked from October's 21% to 28% on 11 November, and then to 42% on 2 February in defence of the rouble. The central bank has also dropped the Lombard rate from 42% to 39%.

The reason for the slight fall in interest rates was the return of foreign investors to Russia's government treasuries market: T-bill (GKO) yields have fallen from over 40% at the end of January to about 30% at the end of February. During the latest crisis, however, the share of non-resident holdings in Russian government debt securities had fallen from 31% last September slightly below 25% in January.

Low inflation reduces pressure on the rouble

Before tightening its monetary stance in February, Russia's central bank had drained its total reserves by USD 2.4 billion to USD 15.4 billion in January. Total reserves include gold worth USD 4.9 billion, so the foreign exchange component of total reserves was around USD 10.5 billion at the end of January. This amount is USD 7 billion less than end-October 1997, just before the turmoil of Asian markets hit. During the first two months of 1998, the rouble has lost some 1.8% of its valued against the US dollar.

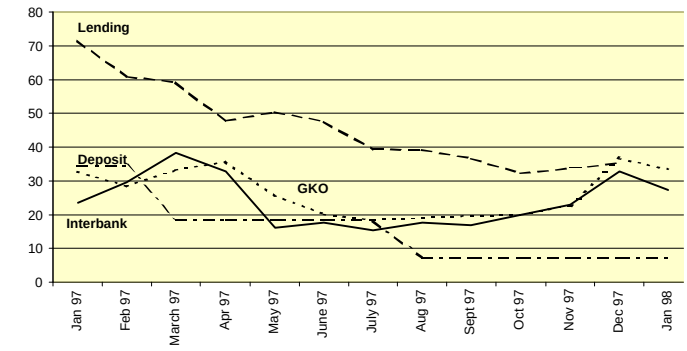
Despite the problems with the budget deficit, inflation is under control. In January, annual inflation was running at 10.1%, which is the lowest figure since the beginning of reforms in 1992.

Shareholder issues also stall equity markets

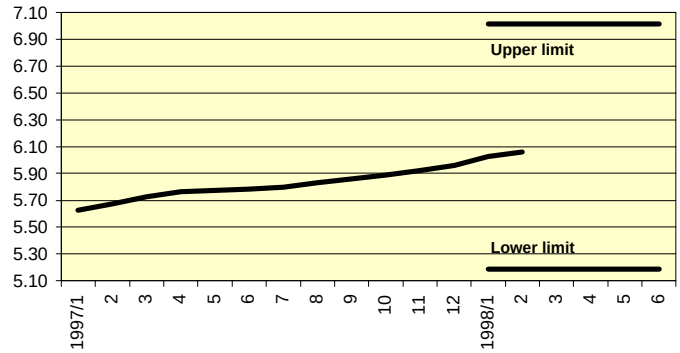
News in January and February also focused on possible violations of shareholder rights by big firms. These problems and the subsequent investigations by the securities authorities have made investors skittish. Thus, there has not yet been any major recovery in share prices. Moreover, downward pressures on oil prices due to the improved situation in Iraq put pressures on Russian oil companies that play a major role in Russia's equity markets.

On the other hand, in mid-February Russia's Federal Securities Commission (FSC) announced that it had annulled the issuance of convertible bonds by one of Russia's largest oil companies on the basis of inadequate information by the company. The FSC's decision was seen as a signal to companies to show greater respect for shareholder rights and more generally, that government agencies would be more willing to intervene in such cases in the future.

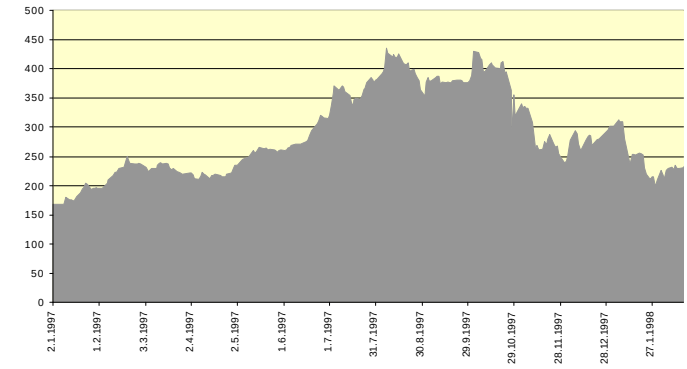
Average annual interest rates



Rouble/dollar exchange rate within the new currency band



Russian share prices
- Moscow Times (US$) index



Monetary indicators

	1993	1994	1995	1996	1997	1998 latest	As of
Inflation, %	842	224	131	22	11.0	1.5	1/98
M2, %		217	113	33	31.5		11/97
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000		
Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	33.4	1/98
- deposit rate, %			102	55	16.4	7.4	1/98
- lending rate, %			320	147	46.2		
Forex reserves, USD billion (excl.gold)	5.8	4.0	14.3	11.3	12.9	10.5	1/98
RUB/USD, end of period	1247	3550	4640	5560	5960	6.07	2/98

Sources: Goskomstat, CBR

How Sustainable Is Russian Fiscal Policy?

By Iikka Korhonen*

The Russian Federation has run large budget deficits since 1992. For most of Russia's transition, local governments and extrabudgetary funds have, on aggregate, run budgetary surpluses. The public sector deficit therefore is mainly a problem of the federal government's inability to balance expenditures and revenues in rapidly changing macro-economic circumstances.

During 1992–1994 the budget deficit was almost exclusively covered with central bank credits. This reliance on central bank financing is perhaps understandable, however, given the circumstances. Domestic securities markets were practically non-existent until 1994, and Russia's private banking sector was too rudimentary and poor to extend large credits to the government. Private banks only began to finance the Russian budget deficit in 1995. Foreign financing of the budget deficit was also almost non-existent in the early years of reform, and new foreign financing was barely enough to cover the repayment on debts inherited from the Soviet Union. Since 1995 increased reliance on market-based financing of the budget deficit has allowed the Central Bank of Russia to tighten monetary policy and this in turn has lead to substantial reduction in inflation. The deficit, however, remains a problem.

The Russian government's debt/GDP ratio decreased drastically during the first years of economic transition. Inflation decreased domestic debt and real appreciation of rouble lowered the ratio of foreign debt to GDP so that by 1995, the debt/GDP ratio had fallen below 50%. At the end of 1996, the ratio was back around 50%, and during 1997 it appears to have crept to approximately 55% of GDP.

One can try to assess sustainability of Russian fiscal policy by simulating the time path of Russian public debt (as share of GDP) under different assumptions. (The changes in debt-to-GDP ratio are calculated with the following formula: $\Delta d = (r-n)d + b$, where Δd is the change in debt-to-GDP ratio, r is the real interest rate, n is the growth rate of real GDP, and b is primary, i.e. before interest payments, balance as share of GDP.)

Three scenarios

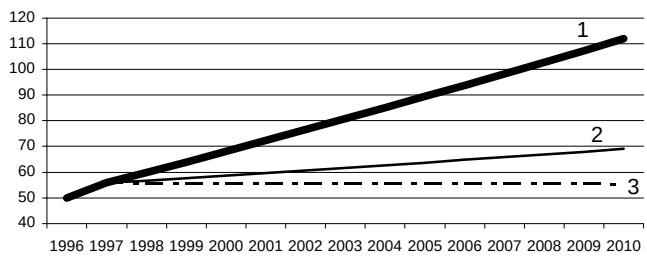
In the scenarios, we assume the present, somewhat hesitant pace of reforms continues, and uncertainty persists as to political processes, and perhaps more importantly, legislative frameworks. These uncertainties hamper investments into Russia, but no major upheavals occur. In this scenario, Russian GDP grows at 4% annually. Of Europe's transition economies, only Poland and the Slovak Republic have been able to maintain growth rates in excess of 4% for several consecutive years. Therefore, this GDP growth can be argued to be slightly on the optimistic side.

The thick solid line in the chart depicts what happens to Russian Federation debt as a share of GDP when the primary deficit of 3.5% of GDP (actual 1997 figure) and pre-Asian crises real interest rate of 5% continue for ten years and economic growth accelerates from 0.4% in 1997 to 4% from 1998 onwards. As can be seen, the government debt increases steadily to over 110% of GDP by 2010 with no sign of stabilization. While some OECD countries presently have public debts of over 100% of GDP, it is arguable whether investors would be willing to give Russia a similar dispensation.

So how much tightening of fiscal policy is needed to stop the debt from growing under the above assumptions? Russian government's budget proposal for 1998 calls for a primary deficit of 0.4% of GDP. If this primary balance can be maintained and the other factors are held constant, the government debt would remain under 70% of GDP. The thin solid line in the chart depicts this scenario.

Even with the primary balance at zero from 1998 onwards, the government debt still rises to approximately 60% by 2010. With a primary surplus of 0.6% to GDP, the debt/GDP ratio would start to decline, albeit very slowly. This scenario is illustrated with the dotted line. Thus, even in a fairly benign macroeconomic environment, the Russian Federation would have to run a primary surplus just to maintain its current debt/GDP ratio. Given the difficulties the Russian Federation is currently experiencing with tax collection and higher real interest rates, this target may be tough to achieve.

Debt-to-GDP (%) ratio in three scenarios



1) Primary deficit 3.5 %, real interest rate 5%.
2) Primary deficit 0.4 %, real interest rate 5%.
3) Primary surplus 0.6%, real interest rate 5%.

** The author is an economist at BOFIT.*

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

Editor-in-Chief Jouko Rautava

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RUSSIAN ECONOMY
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3•1998

Economic Developments

January-February output up 0.9 per cent

In the first two months of 1998, Russia's real GDP was 0.9% higher than in the same period in 1997. At the same time, industrial production increased by 1.4%.

It is very difficult to draw any definite conclusions concerning industry level developments because the situation is still quite unstable and disparities even within sectors seem to be huge. Nevertheless, according to Goskomstat's data, the fastest growing industries in January-February included the graphic industry, metallurgy, pharmaceuticals, textiles and clothing, and machinery. However, production of construction materials, wood and paper, food, electricity and fuel, contracted.

In January-February, production of goods accounted for 35% of GDP and services 54%, while net taxes accounted for the rest. The share of services increased by 2 percentage points from the same period in 1997.

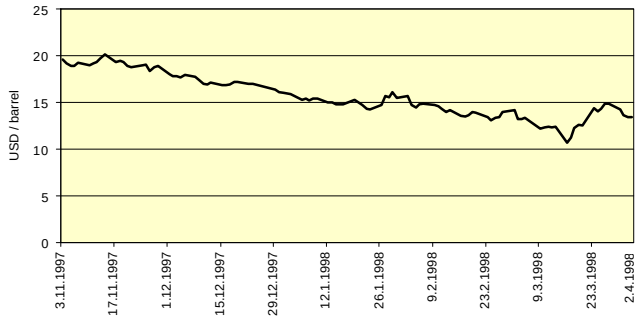
One dollar in oil price means up to one billion in Russian exports

Uncertainties concerning the major oil producers agreement to reduce output have kept oil prices volatile. Benchmark Brent crude varied between USD 11-16/barrel (Russian Urals crude has been some 50-80 cents cheaper than Brent) in March. At the beginning of April, Brent crude was selling at around USD 14.5/barrel. Last year, the average price of Brent was about USD 19.15/barrel.

In 1997, Russia exported 127 million tonnes of crude oil, which accounted for USD 14.8 billion or 17% of total export revenues. In addition to crude oil, oil products (61 million tonnes) brought a further USD 7.2 billion in export revenues. Thus, given the export volumes and taking into account that prices of oil products closely follow crude prices, one can conclude that every dollar/barrel change in the crude oil price changes Russian exports by USD 1.2 billion.

In addition, effective 1 April, Russian authorities decided to eliminate the excise duty on oil transported by pipeline (RUB 3.80/tonne/1000 km) and to halve a fixed transport fee for oil exporters to USD 1.50 a tonne from USD 3.00 to help alleviate the situation in the oil industry. These measures can be estimated to cost the government several hundred million dollars in lost revenues.

Price of oil (Brent), November 1997 – April 1998



EU accounts for a third of Russia's trade

In 1997, the EU's share in Russia's total foreign trade recorded by Russian customs grew to almost 35%. This was largely due to increased imports from Germany, Russia's biggest trading partner which accounted for nearly 10% of total trade. Italy took about 5% and Finland more than 3.5% of the market. Imports from the US grew notably (over 6% of trade).

Among Russia's CIS trading partners (who as a group accounted for 23% of total foreign trade), trade with pro-Russian Belarus increased greatly in 1997 (almost 7% of trade). Imports from Ukraine (8% of trade) and Kazakhstan lost ground.

Trade with Central and East European countries, mainly Poland and Hungary, gained in importance (altogether, about 14% of trade). The same happened with the three Baltic countries (3% of trade). The share of China in Russian foreign trade fell slightly to about 4%.

If imports not recorded by Russian customs (shuttle imports) were added to these country figures, the picture would probably change in favour of most trading partners bordering Russia or close by. In particular, Turkey is the origin for goods imported by Russian shuttlers to the tune of a few billion US dollars annually and thus one of the top suppliers for Russia.

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-4.9	0.4	0.9	1-2/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	1.4	1-2/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-7.5	1-2/98
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	9.1	2/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	11.5	1-2/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	10.6	1-2/98
Current account, USD billion			10.7	10.0	11.6	3.0		9/97

Sources: Goskomstat, CBR

1998 budget approved

The Russian government's proposals for expenditure cuts failed to materialize when the Duma passed the 1998 budget at the beginning of March. Planned revenues (RUB 367.5 bln) and expenditures (RUB 499.9 bln) remained unchanged from the previous budget version. Although revenue and expenditure targets are believed to be unrealistic, the actual budget deficit is to be kept at 4.7% of GDP as the government aims to keep expenditures in line with actual revenues. President Yeltsin has announced that he wants quarterly reports on budget performance and execution of the '12-point plan' (see Russian Economy 2/98).

Budget performance still fragile

Compared to 1996, federal revenues in 1997 fell from 12.5% to 12.1% of GDP. Expenditures declined from 15.8 % to 15.3 % of GDP. The revenues of the federal budget increased towards the end of the year thanks to improved tax collection, but so did expenditures. In the first quarter revenues stood at 9.2% of GDP and expenditures at 13.1% of GDP. In the fourth quarter revenues had risen to 15.9% of GDP while expenditures amounted to 18.1% of GDP.

In comparison to actual revenues in 1997, in the 1998 budget law VAT, profit tax and excises will become more important to the federal budget. Income tax revenues, which have been of minor importance to the federation budget, are left solely to regions. As regards federal expenditures, there are no clear changes in their structure at least in the light of currently available data.

In 1997 Russia's consolidated budget revenues accounted for 25.7% and expenditures 30.1% of GDP. These figures do not include extra-budgetary funds, the revenues and expenditures of which have been about 8% of GDP during recent years and which usually are included in public sector figures. According to data for the first half year 1997, extra-budgetary funds' revenues and expenditures have amounted to approximately 10% of GDP.

The Russian public sector, as measured by the share of revenues or expenditures in GDP has declined considerably since the start of economic reform in 1992. However, the size of the public sector is still relatively high compared to other middle-income countries. According to the World Bank the share of public sector in these countries has been around 25% of GDP during 1983 – 90.

Public sector revenues and expenditures (% of GDP)

	1995	1996	1997
Consolidated budget revenues	26.1	24.7	25.7
- federation	13.7	12.5	12.1
- regions	14.1	14.3	15.5
	1995	**1996**	**1997**
Consolidated budget expenditures	29.4	28.9	30.1
- federation	16.6	15.8	15.3
- regions	14.5	15.2	16.7
Consolidated budget deficit	3.3	4.2	4.4

Source: Goskomstat

Federal government revenues and expenditures (1997 budget performance and 1998 budget law)

Revenues	**1997**	**1997**	**1998**	**1998**
	% of GDP	structure	% of GDP	structure
Value-added tax	4.4	36.4	5.0	38.8
Profit tax	1.2	9.9	1.7	13.2
Income tax	0.1	0.8	0.0	0.0
Excises	1.9	15.7	2.8	21.7
Taxes on foreign economic Activity	1.0	8.3	-	-
Other taxes and payments	0.5	4.1	1.3	10.1
Taxes and payments	9.1	75.2	10.8	83.7
Non-tax revenues	3.0	24.8	2.1	16.3
Revenues	12.1	100.0	12.9	100.0
Expenditures	**1997**	**1997**	**1998**	**1998**
	% of GDP	structure	% of GDP	structure
State administration	0.4	2.6	0.4	2.3
International activity	0.3	2.0	0.5	2.8
National defence	3.0	19.6	2.9	16.5
Law enforcement	1.6	10.5	1.5	8.5
Industry, energy, construction	1.0	6.5	1.0	5.7
Agriculture and fisheries	0.5	3.3	0.4	2.3
Intergovernmental transfers	1.9	12.4	1.8	10.2
Debt servicing	-	-	4.4	25.0
Social policy	-	-	1.2	6.8
Education	-	-	0.6	3.4
Health	-	-	0.3	1.7
Other expenditures	6.6	43.1	2.6	14.8
Expenditures	15.3	100.0	17.6	100.0

Source: Goskomstat, 1998 budget law

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998
Federal government						budget law**
- revenues	14.5	14.1	13.7	12.5	12.1	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	17.6
- balance*	-1.4	-4.0	-2.9	-3.3	-3.2	
- balance**	-6.5	-11.4	-5.4	-7.9	-6.5***	-4.7

* Excludes interest payments on short-term government debt
** Includes interest payments on short-term government debt
*** Estimate

Sources: Goskomstat, IMF. Figures for 1993-94 are not fully comparable with others.

Markets wait for news of a new government

Following its decision to lower the refinancing rate in mid-February from 42% to 39%, Russia's central bank cut the rate further to 36% at the beginning of March. In the first part of March, the situation in the financial market was relatively calm and, consequently, the Bank of Russia cut its refinancing rate further to 30%, effective 16 March. Since then, however, market interest rates have stopped declining and have been fluctuating around 25-27% (GKO yields).

A major factor behind the current market uncertainty is the sudden dismissal by President Yeltsin of the entire Government of Prime Minister Chernomyrdin on 23 March. Yeltsin has nominated former energy minister Sergei Kiriyenko, 35, as Russia's new prime minister, but the nomination needs the approval of the Duma. If the Duma fails to approve the president's candidate for prime minister after three tries, it is possible that the president will appoint the prime minister, dissolve the Duma and call new elections.

Besides creating general uncertainty, the process of appointing a new government has already delayed important economic decisions related to, for example, the continuation of the economic programme agreed on with the IMF. Other factors contributing to current market uncertainty include oil price developments (see page 1).

Foreign investments in Russia USD 3.9 billion in 1997

Foreign direct investment (FDI) in Russia increased from USD 2.1 billion in 1996 to USD 3.9 billion in 1997. Moscow's share of total FDI was, according to Goskomstat, almost 80%. St.Petersburg, for example, managed to attract less than 3% of total FDIs.

Biggest investors (FDI) in Russia, 1997

	USD, mill.	%-share
USA	2099	53.9
UK	340	8.7
Germany	228	5.9
France	203	5.2
Others	1027	26.3
Total	3897	100.0

Differing views from rating agencies

On 10 March, the international credit rating agency Fitch IBCA announced it was keeping its former rating of BB+ long term foreign currency debt for Russia, and that it was withdrawing its negative rating alert. However, the next day Moody's announced it was cutting the ceiling for foreign bonds and notes from Ba2 to Ba3. IBCA's rating for Russia was higher even before Moody's downgrade. International credit rating agencies have followed the development of the Russian economy extremely closely in recent months with concerns about the possibility of having to downgrade.

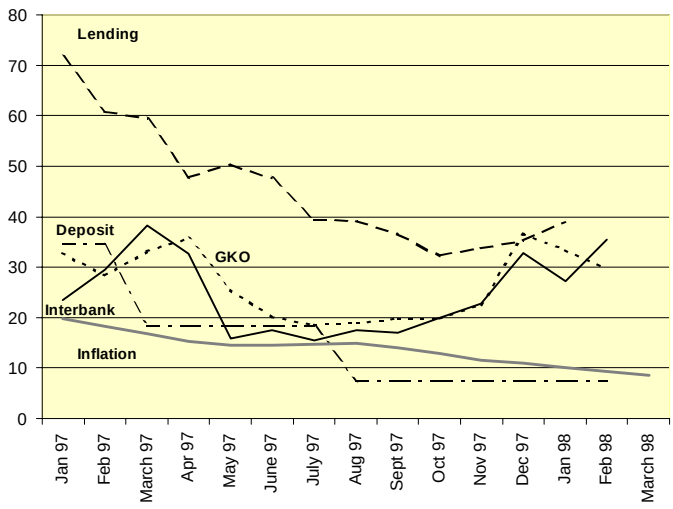
On 24 March, in spite of a debate over an accurate rating for Russia and in the midst of government sackings, Russia returned to the international markets by launching its first Eurobond issue (DEM 1.25 billion, 7 years, priced to yield 475 basis points over German government securities) since the Asian crisis.

Pressure on small banks deepens

According to the Bank of Russia, there are 200-300 'unstable' banks in Russia. However, they only represent about 4% of the assets held by the entire Russian banking system. The assets are concentrated in Russia's 200 largest banks, which in aggregate control 88% of assets. In fact, the top 30 banks account for 75% and the 5 largest banks for almost half of total banking assets.

As of 1 January 1999, the Russian central bank will require all commercial banks in Russia to meet a minimum capital requirement of at least ECU 1 million. The Association of Russian Banks estimates that about 700 of Russia's current 1686 (1 Feb) banks will be unable to meet the requirement. The central bank estimates that new capital requirements will lead to the withdrawal of about 500 licenses. Last year the central bank withdrew the licences of over 300 banks.

Average annual interest rates and 12-month inflation



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M2, %		217	113	33	31.5		11/97
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Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	29.6	2/98
- deposit rate, %			102	55	16.4	7.4	2/98
- lending rate, %			320	147	46.2	38.9	1/98
Forex reserves, USD billion (excl.gold)	5.8	4.0	14.3	11.3	12.9	10.2	2/98
RUB/USD, end of period	1247	3550	4640	5560	5960	6.10	3/98

Sources: Goskomstat, CBR

Enterprises in arrears

By Vesa Korhonen*

Lower inflation has been pursued in Russia by trying to cut the government budget deficit and keeping monetary policy tight since early 1995. Enterprises have seen their subsidies, bank loans and profits shrink, but many of them have not found the means to reform their business in response to the hardening budget constraints. Instead, in order to circumvent the constraints and keep running, enterprises have invented their own financial escapes, engaging increasingly in barter trade, which some regularly conducted barometers of industrial enterprises claim account for a stunning 40-50% of sales. They have also issued bills of exchange (so-called veksels), on a smaller scale, for payment, and allowed overdue payables and receivables to cumulate.

Arrears to suppliers and the budgets equally large

According to Goskomstat bookkeeping of payables overdue, enterprises in four sectors of the economy (industry, construction, transportation and agriculture) have run up considerable payment arrears, equal to 25-30% of annual GDP (figure). These payment defaults are the foremost external source of credit for the enterprises and are composed mostly of arrears to suppliers (11-13% of GDP), the state budget (6%), and extra-budgetary funds (5-6%), the pension fund in particular. The more publicized wage arrears are relatively much smaller in enterprise finances (1.5-2% of GDP), as are their arrears on bank loans (1-4%). By comparison, wage arrears of the public sector currently account for 0.2-0.3% of GDP.

Growth of trade credit between companies can naturally be a normal business promotion device in an emerging market economy such as Russia. Paying trade bills late is not uncommon in the industrialized West either. However, in total trade credit between Russian enterprises the share of trade credit reported by both creditors and debtors as being in arrears has risen to between 55% and 60% in late 1997 and early 1998. The share of all arrears over three months overdue amounts to 40% of total receivables/payables, and arrears to the budget system are about to surpass payment arrears to suppliers.

Bankruptcies: key to the solution?

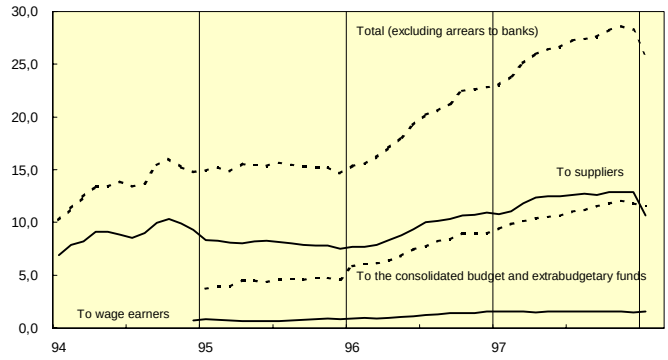
Before 1995, additional incentives to postpone payments in Russia were the high rate of inflation which eroded the value of arrears and a rescue action launched by the state in 1992 (with enterprise arrears cleared and the balances financed from funds of the Central Bank and commercial banks).

Inflation has slowed down considerably in 1996-1997, and the rapid growth of arrears more clearly reflects other old and new aspects of enterprise culture in Russia. The short experience of chasing tax arrears in Russia shows that some of the debtors have genuine problems with profitability and liquidity, while some of those better off channel cash income to other uses that the management finds more attractive, and some do not pay taxes as they are owned by public agencies. The creditors have adhered to Soviet-type survival culture, aiming to maintain deliveries and production and safeguard jobs, or in a more optimistic view, they hope to use the arrears as a time-buffer for modernisation and restructuring. The recent fall in overdue trade credit and total trade credit may signal increasing reluctance of creditors to deliver (see figure).

Through barter trade and arrears enterprises have de-linked themselves from possible monetary shake-ups in the economy, but such freedom may give limited comfort if they fail to improve their real performance through reform. In those cases the enterprises should basically face bankruptcy.

Bankruptcies are an ultimate element of a hard budget constraint to enterprises, but during half a decade of reform a lack of proper legislation and ineffective enforcement of bankruptcies have kept them rather rare in Russia. The new bankruptcy law, in force from 1 March 1998, makes creditors the main initiators of bankruptcies, enabling them to take to court a company with a rather small amount of liabilities over three months overdue. This set-up is apt to shed more light on which debtors are truly in the red and to what extent social, political (especially local) and other constraints might dominate economic grounds in Russia.

Overdue payables of Russian enterprises
per cent of the GDP of last 12 months



Source: calculated from Goskomstat data

** The author is an economist at BOFIT.*

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

Editor-in-Chief Jouko Rautava

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RUSSIAN ECONOMY
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Economic Developments

Output flat in the first quarter

According to Goskomstat, Russia's real GDP in the first quarter was at the same level as a year ago; earlier January-February GDP estimates were revised downwards. The major contributors to the decelerating output growth seem to be transportation (-4.8%) and some other services; industrial output rose 1.3% and agricultural production 1.0%.

As regards the demand side of GDP, both fixed investments (-6.9%) and exports in dollar terms (-15.8% in Jan-Feb) declined during the first quarter. The decline in exports is mainly due to low oil prices. In the first three months of 1998, the level of real disposable income of the population was 6.8% lower than in the same period a year ago, even though the real average wage increased 7.2%.

Three assessments of the Russian economy

In April, the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD) and the United Nations Economic Commission for Europe (UNECE) published their regular reports on world economy. The views of these institutions concerning Russia's economic development and problems are basically similar, although there are some differences on how they emphasise particular topics and how they see short- and medium-term economic development.

According to the IMF's *World Economic Outlook*, the main reason for poor growth performance in Russia is the slow pace of market-oriented structural reforms. Currently, fiscal issues are the main policy challenge because fiscal imbalances have contributed to financial market pressures and disrupted growth in Russia. Russia's fiscal problems include a substantial revenue shortfall, lack of expenditure controls, the inability of the government to pay its own bills, various non-cash budget arrangements and institutional deficiencies. Also, the system of inter-governmental fiscal relations continues to suffer from significant weaknesses.

Both the World Economic Outlook and the OECD's *Economic Outlook* are concerned about the sustainability of Russia's fiscal policies. The reports stress that current high real interest rates and slow economic growth exacerbate the burden of debt servicing. As a result, government debt could potentially spiral out of control unless fiscal imbalances are corrected and growth accelerates. The OECD also emphasized the need for major structural reform. Besides fiscal sector reforms, the OECD highlights the introduction of effective procedures for insolvency and bankruptcy and continued progress in large-scale privatization.

According to the UNECE *Economic Survey of Europe*, Russia is strongly dependent on foreign capital, particularly on short-term portfolio investments to finance the budget deficit. Thus, the stability of financial markets and the behaviour of foreign investors will play a crucial role in Russia's economic development. While the OECD sees a relatively weak link between the current turbulence in financial markets and economic growth in Russia due to a low level of financial intermediation, the UNECE argues that, even in the short term, Russia's recovery depends very much on the situation in financial markets. Moreover, the UNECE reasons that, due to a deep decline in investment, Russia's growth prospects in the medium term are relatively poor. The UNECE projects 1.2-2.0% growth for Russia in 1998 but gives no further forecasts.

GDP, fiscal balance, inflation and current account projections for Russia in 1998-99

	1997	1998	1999
IMF			
- GDP (%-change)	0.4	1.0	1.9
- Inflation*	14.7	8.1	5.0
- Fiscal balance (% of GDP)	-6.8	n.a.	n.a.
- Current account (USD bln)	-1.0	-6.0	-7.0
OECD			
- GDP (%-change)	0.4	2.0	4.0
- Inflation**	11.0	10.0	10.0
- Fiscal balance (% of GDP)	-6.9	-5.0	-5.0
- Current account (USD bln)	4.0	1.0	0.0

* Annual average
** 12-month

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-4.9	0.4	0.0	1-3/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	1.3	1-3/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.9	1-3/98
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	9.1	3/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	11.5	1-2/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	10.6	1-2/98
Current account, USD billion			10.7	10.0	11.6	3.0		9/97

Sources: Goskomstat, CBR

Tax code draft approved in first reading

The tax reform process began a new round after the tax code draft was suddenly approved in the Duma's first reading in mid-April. The version of the code accepted by the Duma was initiated by the government, and according to preliminary reports, contains no radical changes. The number of taxes will be diminished and fixed for the federal, regional and local levels (see Table 1). Regions are granted leeway in deciding which taxes they will introduce. However, maximum tax rates for certain taxes are stipulated. If a region decides to introduce the real estate tax, taxes on property and land will cease to exist. The revenues from certain federal taxes will be divided between the centre and regions (e.g., the majority of profit tax revenues will go to regional budgets, although the tax is considered federal).

The key taxation principles and sources of tax revenue will remain unaffected. The main changes include reducing corporate profit tax from 35% to 30% and greater deduction possibilities for enterprises. Tax allowances will gradually be reduced.

Table 1. Federal, regional and local taxes, duties and payments in the tax code draft

Federal taxes	Regional taxes	Local taxes
1. VAT	1. Tax on property of legal entities	1. Land tax
2. Excise taxes	2. Real estate tax	2. Tax on individual property
3. Federal profit tax	3. Road tax	3. Tax on advertising
4. Tax on capital income	4. Traffic tax	4. Gift and inheritance tax
5. Income tax	5. Sales tax	5. Local license payments
6. Tax on the use of land	6. Game business tax	
7. Tax on the use of minerals and raw materials	7. Regional license payments	
8. Tax on extra income from extraction of hydrocarbon		
9. Tax on hunting, fishing,etc.		
10. Forest tax		
11. Water tax		
12. Ecology tax		
13. State duties		
14. Customs duties and payments		
15. Federal license payments		
16. Payments to extra-budgetary funds		

According to some optimistic views, the tax code would come into force at the beginning of 1999. However, as previous years have shown, the most striking disagreements will occur in the forthcoming readings. The Duma and the government have different views on how to proceed with the handling of the tax code. The Duma supports the approval of the general part of the tax code separately, followed by approval of individual sections of the special part. The government wants the entire tax code to be approved at once.

Share of debt service grows to 30%

The budget approved by the Russian Duma in March was initially condemned as unrealistic, mainly due to over-optimistic projections on tax collection. Even though the Russian State Tax Service reported tax receipts in the first quarter equalling the budgeted amounts, serious doubts have been raised about meeting the targets in the second quarter. In particular, low prices for crude oil (at the end of April Brent crude sold for about USD 14.4/barrel) could pose a serious threat to the Russian budget. Since the ceiling for the budget deficit is fixed at 4.7% of GDP, falling revenues will force the government to cut public spending later this year. The only single item in the budget that cannot be left in arrears is debt service. Debt service for both internal and external sovereign debt amounted to 24% of all budget expenditures in 1997. The figure is expected to exceed 30% this year.

Decree on restructuring tax debts of enterprises

In April, the government approved a decree on restructuring the tax and other debts of enterprises to the federal budget. The decree aims at stabilizing federal budget revenues. Enterprises are compelled to either pay their debts or agree on a plan to restructure them by the beginning of 1999. Once the restructuring process is initiated, the enterprise must pay off its old tax debts according to an agreed schedule while meeting its current liabilities to the federal budget. Bankruptcy proceedings will be initiated by the federal authorities, unless the decree's requirements are met.

The government has also taken steps to improve fiscal relations between the centre and regions. According to preliminary information, the government has approved in principle a plan that allows federal authorities to control expenditures in regions with big budget deficits. Regions have also been advised to give up offsets and restructure their mutual debts.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998
Federal government						budget law**
- revenues	14.5	14.1	13.7	12.5	12.1	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	17.6
- balance*	-1.4	-4.0	-2.9	-3.3	-3.2	
- balance**	-6.5	-11.4	-5.4	-7.9	-6.5***	-4.7

* Excludes interest payments on short-term government debt
** Includes interest payments on short-term government debt
*** Estimate

Sources: Goskomstat, IMF. Figures for 1993-94 are not fully comparable with others.

Lower interest rates given top priority by Kiriyenko government

On 24 April, the Duma confirmed Sergei Kiriyenko, 35, as Russian prime minister. The nomination of a new prime minister had no major effects, either in stock or money markets. At the end of April, in the midst of the naming process of the new government, stock market indices were below the level of pre-confirmation of Kiriyenko and T-bill (GKO) yields were still close to 30%. Mr Boris Nemtsov, deputy prime minister candidate for the Kiriyenko cabinet, outlined the top priorities of the new government. The basis for future work will be a 1998 action plan (see BOFIT 2/98), which contains 12 priorities that include reducing the tax burden on enterprises. The new government aims at lowering yields on state treasury bonds by about 15 percentage points.

More flexibility for foreigners in forex markets

On 23 March, the Duma passed a law that allows non-residents to open currency accounts, not only as clients to Russian banks, but as full trading and clearing members of the Moscow Interbank Currency Exchange (MICEX). In April, the Chicago Mercantile Exchange became the first exchange outside Russia to offer rouble-denominated futures and options. Rouble futures differ from other futures in the market in that currency is not physically delivered on the expiry date, but netted according to an exchange rate (RUB/USD) set by the MICEX. The new currency accounts enable non-resident market makers in rouble futures and options to operate on both markets. The Russian central bank said it does not plan to lift the remaining convertibility restrictions on the rouble in the near future.

As a result of increased participation, the turnover on the MICEX has increased. Non-residents account for 20% of volume.

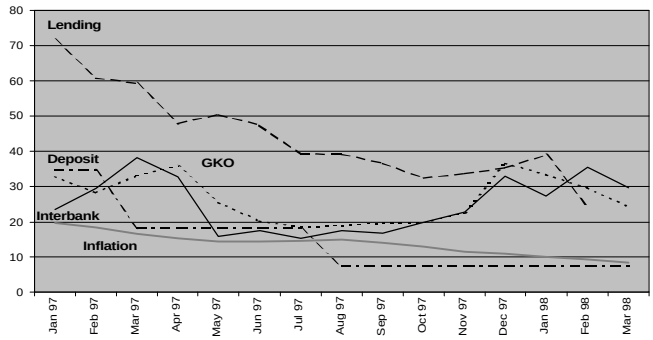
New rules to protect minority shareholders

In response to recent cases where majority shareholders have been abusing minority shareholders by keeping them poorly informed and even diluting their shares, Russia's Federal Securities Commission (FSC) has introduced new regulations, effective 1 May. On 22 April, the Duma also approved the second reading of a law on the Rights of Minority Shareholders. The law aims to increase the enforcement power of the FSC.

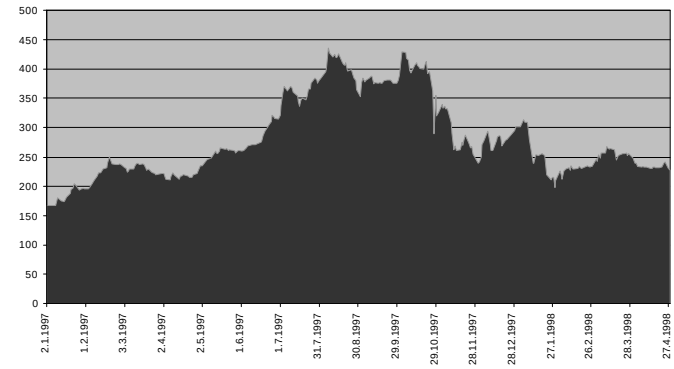
The new regulations by the FSC compel the companies to disclose more information on planned share issues to their shareholders. The information has to be submitted to shareholders at least a month before the prospectus on the new share issue is handed in to the FSC for registration. The decision to issue new shares has to be made at a general meeting of shareholders – it cannot be decided solely by majority shareholders, as was previously the case. If the issuer has more than a thousand shareholders, an independent valuation of the share issue where the issue price is set must be done before the meeting. These measures are intended to give minority shareholders a chance to lodge complaints with the FSC before subscription of the issue actually begins.

According to Dimitri Vasiliev, chairman of the FSC, the new regulations are fiercely opposed by Russia's powerful business magnates. Nevertheless, the new regulations could help improve Russia's reputation for mistreating minority shareholders.

Average annual interest rates and 12-month inflation



Moscow Times index



Monetary indicators

	1993	1994	1995	1996	1997	1998 latest	As of
Inflation, %	842	224	131	22	11.0	8.5	3/98
M2, %		217	113	33	31.5	21.9	1/98
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1085	3/98
Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	24.4	3/98
- deposit rate, %			102	55	16.4	7.4	3/98
- lending rate, %			320	147	46.2	24.4	2/98
Forex reserves, USD billion (excl.gold)	5.8	4.0	14.3	11.3	12.9	11.9	3/98
RUB/USD, end of period	1247	3550	4640	5560	5960	6.13	4/98

Sources: Goskomstat, CBR

Russia's pension system needs radical reform

By Merja Tekoniemi*

The pension systems of the countries comprising the former Soviet Union were, and still for the most part are, based on a pay-as-you-go (PAYG) scheme. Under this scheme, current pensions are financed by contributions of the current working population and sometimes supplemented by budget transfers. Although pension reforms have not gained momentum in most of the countries (Kazakhstan and Latvia being the exceptions), the need for such reforms is acute. In transition economies, the typical problems of PAYG systems are connected with problems inherited from socialist era and those resulting from economic reform (see Table 1).

Pension expenditures moderate at the moment

Since 1992, public sector pension expenditures as a share of GDP in Russia have declined noticeably. According to the IMF, they were 4.5% of GDP at the end of 1996, which compares to 5.8% on average for the former Soviet Union area, and 6.7% of GDP for the major industrial countries. Russia's average monthly pensions (USD 66) have already been lower than official subsistence levels for several years. The average replacement rate (ratio of the average pension to the average wage) in Russia was about 28% at the end of 1996. On the other hand, the situation is not grim for all pensioners. Privileged pensioners (about 20%) enjoy much higher benefits. Further, if a pensioner works, it does not decrease their pension.

Unlike in many ex-socialist countries, and particularly Poland, where reducing the aggregate level of pension expenditures is the main problem, the difficulty in Russia seems to lie more with reforming the structure of the pension system itself. Since employees only contribute 1% of their wages to the national Pension Fund (PF), Russia's present pension system relies extensively on employers who must pay 28% of their wage bill to the PF. Not surprisingly, employer pension contribution arrears at the end of 1997 had already risen to about RUB 88 billion (USD 14 billion). The role of federal budget transfers in aggregate public pension expenditures has been quite modest, but is bound to increase should the pension reform delay.

Under the PAYG system, the dependent ratio (the ratio of pensioners to working population) is of crucial importance. In Russia it is currently about 1:2, but is estimated to increase to 1:1 by the middle of next century at latest. Given the above problems, we can assume that without radical pension reform, public pension expenditures could increase to unsustainable levels well before the middle of the next century.

The shift to a partly funded system

The latest reform plans are based on a government program approved in December 1997 and preliminarily confirmed by the president in April 1998. Since February 1998, state pensions have been determined mainly on the basis of individual coefficients, which depend on the length of service and on the amount of wages. The other parts of the program are intended to come into force in 2000, when a three-pillar pension system will be introduced. After that, pensions will be provided by the state (social pensions) and by the PF on the basis of individual's mandatory contributions on their own account. These sources will be complemented by an increasing number of private pension funds. The plan does not include changes in the current retirement age (55 for women and 60 for men). One significant improvement will be the indexing of pensions to wages rather than inflation.

A funded system needs time

The funded pension system has many advantages, which are especially important for transition economies. This system is not linked to dependent ratios, as people's savings serve as a source of their future pensions. It allows for lower contributions due to interest earned on savings and does not encourage informal activities. The funded system also reduces the financial burden on enterprises, and the savings can serve as a source of industrial finance. However, funded systems require developed financial markets. Otherwise, it may be difficult to protect pensioner investments against high inflation or the risk of fund collapse. Perhaps the most pressing question, however, is how to build up a funded scheme while continuing to pay current pensions.

Top 10 barriers to pension reform in transition economies

1. Eroded revenue bases
2. High contribution rates
3. Complex structure of benefits
4. Low retirement age
5. Lack of clear relation between years of contribution and pension benefits
6. Increasing dependency ratios
7. Inefficient collection systems
8. Unequal distribution of benefits and costs across generations
9. Financial instability of PAYG system, arrears
10. Reduced incentives for private saving

Source: IMF

** The author is an economist at BOFIT.*

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

Editor-in-Chief Jouko Rautava

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RUSSIAN ECONOMY
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Economic Developments

Poor growth prospects for 1998

According to Goskomstat, Russia's GDP in April was only 0.2% more than a year ago. In the first quarter of 1998, GDP showed no growth at all. Taking into account the persisting uncertainty in Russia's financial markets along with extremely high interest rates and their immediate impact on public expenditures and investor confidence, an output recovery in 1998 seems increasing unlikely.

In industry, the rates of increase have been constantly falling since the beginning of year – from 1.5% in January to only 0.8% in April. During January-April industrial output was 1.2% higher than in the same period last year. In the first four months of 1998, the biotechnology industry, the medical industry and the printing industry grew over 10% compared to January-April 1997. Other healthy growth industries (4-10%) included non-ferrous metals, glass and porcelain, light manufacturing and the food industry. Output has fallen in chemicals and petrochemicals (-3.6%), ferrous metals (-1.6%) and the fuel industry (-1.1%). In forestry and pulp-and-paper industries, the output decline has apparently bottomed out, with production running at the same level as last year.

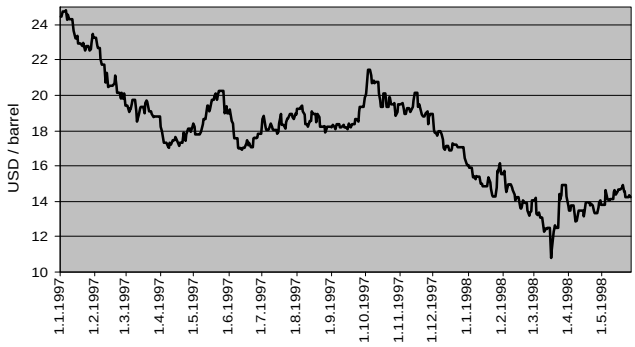
Trade balance deteriorating

Low oil prices and the resulting damage wreaked upon Russia's external balance partly explain the current crisis in Russia's financial markets. As the following figure on Brent oil price shows, there has been a slight recovery in prices since March. Even so, oil prices are still well below the 1997 average of over USD 19/barrel. Moreover, in the first four months prices of raw materials other than energy have been some 8% lower than last year.

Thus, in the first quarter of 1998, the dollar value of Russia's exports (USD 17.9 billion) was some 16% lower than in the same period a year ago. At the same time, imports (USD 15.9 billion) were up 5%. Thus, in the first quarter of 1998, the trade balance showed a surplus of USD 2 billion, or USD 4 billion less than a year ago.

Recently published data on Russia's balance of payments show that the current account surplus in 1997 was still over USD 3 billion (see table).

Price of Brent crude in 1997-98



Russia's balance of payments in 1996-97, USD billion

	1996	1997
Current account	**12.1**	**3.3**
Trade balance	23.1	17.3
Exports, f.o.b.	90.5	88.7
Imports, c.i.f.	-67.4	-71.3
Services	-5.7	-5.2
Exports	12.9	13.5
Imports	-18.7	-18.7
Investment income	-4.9	-8.1
Received	4.2	4.1
Paid	-9.1	-12.1
Other items, net	-0.4	-0.7
Capital and financial account	**-6.8**	**5.7**
Capital Account	-0.5	-0.8
Received	3.1	2.1
Paid	-3.5	-2.9
Financial account	-6.3	6.5
Direct investment in Russia	2.4	6.2
Portfolio investment in Russia	9.8	46.2
Other items, net	-18.5	-45.9
Net errors and omissions	**-8.1**	**-7.3**
Change in reserves ('-' growth, '+' decline)	**2.8**	**-1.8**

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.5	0.8	0.2	4/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	1.2	1-4/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-5.8	1-4/98
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	9.2	4/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	17.9	1-3/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	15.9	1-3/98
Current account, USD billion			10.7	10.0	11.6	3.3		

Sources: Goskomstat, CBR

Wage arrears still growing

The unsolved wage arrears problem was again brought to light as striking coal miners demanded unpaid wages estimated to amount to RUB 3.7 billion (USD 600 million). According to Goskomstat, only about a third of this sum is considered purely as state debt; the rest is classed as debt of coal enterprises to miners. As a partial solution, a law diminishing expenditures of government, parliament, president and state auditors by 25% was suggested to the Duma by the prime minister Kiriyenko. If passed, the estimated RUB 500 million (USD 80 million) would be used exclusively to pay coal miner wages.

Overall, the total wage arrears from budgets of different levels amount to about RUB 9 billion (USD 1.5 billion), of which arrears to industry account for some 15%. Although the coal miner wage arrears has aroused the most heated discussion, the Russia state's wage arrears to the social sphere (education, health, culture etc.) have been rising rapidly during recent months. At the beginning of April, they amounted to RUB 6.5 billion (USD 1.1 billion) and thus, formed the greatest share of total public wage arrears. The figure does not include state debts to off-budget funds, of which debts to the Pension Fund are reported to be growing.

Restraining the state debt becomes priority target

The May warnings of central bank chairman Sergei Dubinin that debt service costs constitute an overly high share of budget expenditures were reiterated by prime minister Kiriyenko, who stated that the reduction of both domestic and foreign debt is one of the main tasks of the government. On the other hand, Mr. Kiriyenko was also reported to have said that rouble-denominated domestic loans should be eliminated by increasing long-term borrowing in hard currency. At present, Russia's total foreign debt is estimated to be about USD 120–123 billion and domestic debt USD 60–80 billion. The finance ministry forecasts that debt servicing costs will decrease from over 35% (5% of GDP) in Q1 this year to 27% of budget expenditures (3.5% of GDP) in 2001.

Federal budget execution in the first quarter of 1998

The estimates on budget execution for the first three months of 1998 vary greatly due to 1) slight differences in published figures, and 2) different points of comparison. Compared to the first quarter of 1997, the federal budget *revenues* rose from 9.2 to 10.7% of GDP. Thanks to a presidential decree abolishing tax offsets from the beginning of 1998, the share of cash revenues was also up. Tax revenues comprising over 80% of federal budget revenues increased from 7.5% of GDP in Q1/1997 to 8.8% in Q1/1998. Non-tax revenues were clearly lower than a year ago (0.6% compared to 1.4% of GDP in Q1/1997) due to decreases in revenues from foreign economic activity (low oil prices) and sales of state property. Compared to Q1/1997, *expenditures* decreased from 13.1% to 11.3% of GDP. The budget *deficit* came to 3.5% of GDP (3.7% in Q1/1997). In January, the deficit was 4.4% of GDP and in February 2.3%.

As regards to budget execution as a share of the 1998 targets, revenues amounted to 17% and expenditures to 16% of those budgeted for the all of 1998. In Q1/1997, the equivalent figures were 17% and 19%.

Federal government budget execution in Q1/1998

	RUB million	% of total	% of GDP
Revenues	**60 768**	**100.0**	**10.7**
Tax revenues	***49 949***	***82.2***	***8.8***
of which			
Profit tax	6561	10.8	1.2
Taxes on goods and services incl. licenses	35146	57.8	6.2
Taxes on foreign economic activity	6662	11.0	1.2
Property tax	137	0.2	0.0
Payments on the use of natural resources	874	1.4	0.2
Other taxes	569	0.9	0.1
Non-tax revenues	***3022***	***5.0***	***0.5***
of which			
Revenues from foreign economic activity	1035	1.7	0.2
Revenues from selling state or municipal property	465	0.8	0.1
Revenues of earmarked budget funds	***7386***	***12.2***	***1.3***
Other revenues	***411***	***0.7***	***0.1***
Expenditures	**80 795**	**100.0**	**14.2**
of which			
National defence	10 856	13.4	1.9
Debt servicing	28 456	35.2	5.0
Social policy	7505	9.3	1.3
Intergovernmental transfers	7969	9.9	1.4
Education	2533	3.1	0.4
Expenditures of earmarked budget funds	4851	6.0	0.9
Loans	1994	2.5	0.4
Other expenditures	16 631	20.6	2.9
Budget deficit	-20 027		-3.5
Nominal GDP Q1/1998	568 800		

Source: Ministry of Finance

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998 Q1	1998 budget law**
Federal government							
- revenues	14.5	14.1	13.7	12.5	12.1	10.7	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	14.2	17.6
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* Excludes interest payments on short-term government debt
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Sources: Goskomstat, IMF. Figures for 1993-94 are not fully comparable with others.

Central bank raises key interest rates to 150%

By mid-May, pressures on the rouble had again intensified and financial markets in Russia became very nervous. To calm the market and stem devaluation fears, the Bank of Russia raised its Lombard rate from 30% to 36% on Friday 15 May. However, by the following Monday the continued loss of investor confidence had forced the central bank to raise both its refinancing and Lombard rates to 50%. Even these measures did not convince the markets, so key rates were raised to 150% on 27 May.

During the last six months, the central bank has used the interest rate weapon three times (October 1997, January 1998 and now) to defend the rouble. The huge interest rate hikes occurred in the midst of crashing share prices. Since the beginning of the year, Russian share prices have lost over 50% of their value (see figure).

Too many domestic problems

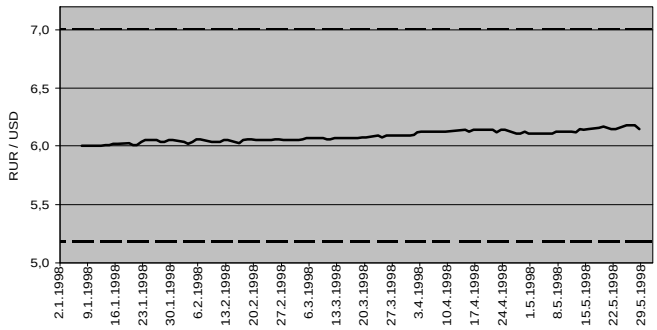
Recent developments in Indonesia and the overall distrust of emerging markets have contributed to Russia's troubles. However, domestic economic and political problems are clearly the major reason for lasting and deepening crisis in Russia. Topping the list are: 1) the president's decision to suddenly change governments, followed by a protracted nomination process for the new government, 2) serious problems in budget execution and unsustainable growth of public debt, 3) low oil prices that diminish the benefits of privatizing energy companies, while simultaneously impairing Russia's external balance, 4) the ominous decision to limit foreign ownership to 25% in United Energy System (UES), 5) the placement of a major bank, Tokobank, under temporary management due to illiquidity, and 6) lasting problems with wage arrears and related strikes of coal miners.

IMF welcomes fiscal tightening

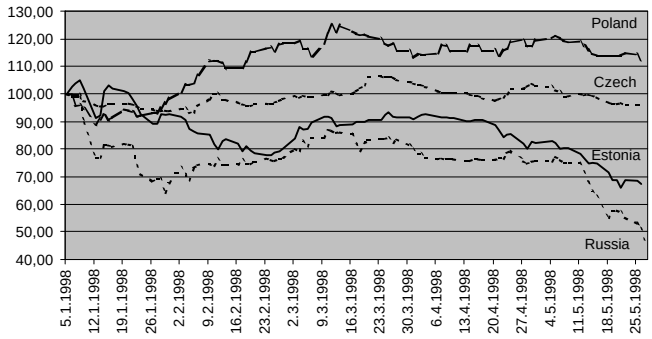
At the end of May, the government agreed on further measures to balance state finances. On the expenditure side, the government seeks to cut RUB 40 billion (USD 6.5 billion) from the budget by, e.g., limiting government bureaucracy, cutting state energy bills and eliminating subsidies to industry. As regards budget revenues, the new plan aims to increase budget revenues by some RUB 10–14 billion (USD 1.6–2.3 billion). This time, the government will focus on tax arrears, customs duties, alcohol taxes, as well as reorganization of the tax authority.

New measures by the Russian authorities to bring the fiscal situation under control were well received by the IMF. At the end of May, the IMF released a statement indicating that a recommendation will be made to the IMF's Executive Board to release a loan tranche of USD 670 million that is part of the current Extended Funds Facility (EFF) arrangement between the IMF and Russia. The IMF has denied rumours of any additional loan arrangements.

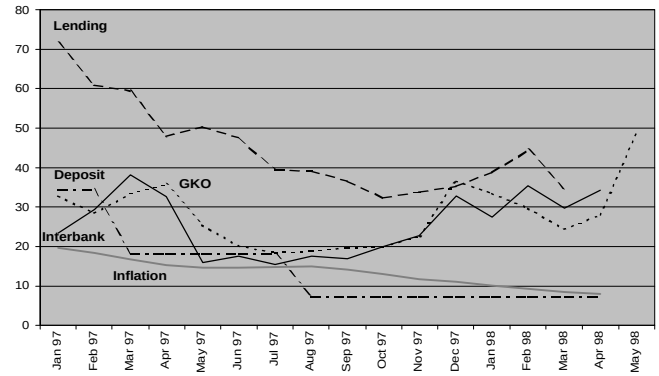
Rouble/dollar exchange rate and the currency band



Development of stock prices in transition economies in 1998



Average annual interest rates and 12-month inflation



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RUB/USD, end of period	1247	3550	4640	5560	5960	6.16	5/98

Sources: Goskomstat, CBR

Kiriyenko's policy priorities

By Pekka Sutela*

A deep shift has taken place in official Russian policy rhetoric. The self-satisfied remarks of former-prime minister Viktor Chernomyrdin repeatedly pointed out the indisputable achievements of monetary stabilisation, first signs of economic growth and, up to autumn 1997, falling interest rates and fast rising stock valuations. By contrast, current prime minister Sergei Kiriyenko portrays a much more sombre image. Not only is his Russia a "relatively poor country," he also seems to hold few illusions concerning the seriousness of current problems.

In a sense, Mr Chernomyrdin is correct when he argues that the problems he helped to handle during the last five years were more fundamental than anything Mr Kiriyenko now has to face. Still, while such comments might help the previous prime minister's meagre possibilities in the forthcoming presidential campaign, from the policy point of view all that really matters is winning current battles and those ahead. Fighting past wars, emphasising how far Russia has already come, is part of the problem, not the solution.

Asian flu?

Neither does it help to blame the current crisis on "Asian flu." Obviously, Russian financial markets are part of emerging markets – and trouble elsewhere does tend to transmit – but the fact is that Russia still has too many of the underlying fundamentals wrong. In particular, this concerns the budget deficit. After having varied between five and almost ten per cent of GDP in recent years, we still see no decreasing trend. Though accumulated rouble-denominated debt is still modest relative to GDP, it is also quite short term and ominously equal to the rouble money stock. Moreover, debt servicing – even with interest rates much lower than today – is clearly the largest single expenditure item in the federal budget. Finally, foreigners hold perhaps 30–40 per cent of rouble debt. As they withdraw, there is simply insufficient domestic demand to compensate for the shortfall. Interest rates surge and stock values nosedive, while currency reserves dwindle in relation to short-term foreign debt (even without large-scale interventions). This basically describes the situation at the end of May.

Devaluation not the solution

In any monetary crisis, the natural first reaction of many actors and commentators is to call for devaluation. A few Russian economists have long argued that the rouble is grossly overvalued. At the extreme, they have called for a whopping 50 per cent devaluation, citing Dutch disease and de-industrialisation. It may be that a lower exchange rate would have improved Russian manufacturing competitiveness in the CIS area, but in major markets the problem has surely been the lack of real, not price, competitiveness. If one assumes that the current low oil prices eating into Russian earnings are temporary, then devaluation would surely be the wrong medicine. Also, one has to remember the extent to which the Russian economy is dollarized. Many sectors, and several banks in particular, have uncovered currency positions; the last thing they need is a shock to the existing precarious equilibrium.

What is more, even unfounded rumours of a possible devaluation may be already driving up interest rates, and thus feeding a vicious fiscal spiral. Not only debt servicing, but also other government commitments may be under immediate threat. As oil and stock prices are low, little privatization revenue can be expected. With considerable pressure to pay wage arrears and parties in power losing widely in recent regional elections, Mr Kiriyenko's cabinet failed to get the hundred days' window of opportunity that has come to be expected in Russian politics.

Though the current cabinet has better rhetoric and greater homogeneity than its predecessor, Mr Yeltsin's decision to sack Mr Chernomyrdin must be judged a monumental mistake. It took six weeks to get a new team in place. The process itself – though it was importantly played according to the constitution – raised serious questions about the Russian political process. Once again, we all could witness the true extent to which parliamentarism is lacking in Russia, and once again, Mr Yeltsin's persona is under scrutiny. Though the long overdue reform of the central administration structure is now underway, it could not have incapacitated large parts of the regime at a worse time.

The short view and the long view

The underlying problem is the need to gear emergency measures so that they do not conflict with the structural needs of the economy. Restructuring short-term domestic debt to longer-term foreign debt may be necessary, but that would then worsen the outlook for debt servicing after 2002. Cutting government expenditure, while a must, needs to be made in a transparent way in line of a definition of the future role of the state. How does one motivate a population to accept the measures to be taken, when the same population is just discovering its political voice, as shown in last weeks? Elections lie ahead, and a crisis consciousness is conspicuously lacking. Fortunately perhaps, because it means there is as yet no political opposition. In any case, Mr Kiriyenko must surely be recalling his predecessor's fate as contemplates the tall order he has been asked to fill.

** The author is the head of BOFIT.*

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

Editor-in-Chief Jouko Rautava

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
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6•1998

Economic Developments

GDP growth turns negative in May

The modest GDP growth at the beginning of this year turned negative in May, when GDP contracted at a rate of 1.2% compared to a year ago. In the first five months of 1998, GDP growth was 0.2% lower than the same period in 1997. May industrial output was also 2.1% lower than a year ago. ILO-defined unemployment was up from 9.2% in April to 9.3% in May, and corresponded to 6.7 million unemployed persons.

Goskomstat has revised its 1996 GDP estimate downwards, so that GDP grew by 0.8% in 1997 rather than the 0.4% as reported earlier. The new GDP figures are based, e.g., on revised, yet-to-be-released, production figures of industrial branches.

In June, the reliability of Goskomstat data became officially suspect after the arrest of a number of employees including the head of Goskomstat. The group is accused of altering the production figures to help companies evade taxes, as well as selling confidential information to competitor firms.

Developments in wages, pensions and other incomes

Goskomstat divides money incomes into three groups: wages, social transfers and others including dividends and incomes from entrepreneurial activity. The importance of wages has decreased markedly since 1992, while social transfers have retained their positions and other non-wage sources of income have gained in importance (see Table 1.)

Table 1. The structure of money incomes, %

	1992	1997
Money incomes	**100.0**	**100.0**
Wages	69.9	42.9
Social transfers	14.0	14.8
Other (incl. dividends, income from entrepreneurial activity)	16.1	42.3

Source: Review of the Russian Economy, 2/97, Institute of Economies in Transition

As a result of stricter monetary and fiscal policies, both real wages and incomes fell significantly in 1995, compared to 1994. In 1996, real wages and pensions recovered, while real incomes remained at the 1995 level. Wage growth was especially brisk in the public sector before the 1996 presidential elections. On the other hand, wage and pension arrears also grew markedly in 1996.

In 1997, real wages and incomes continued to grow. Wage arrears grew only slightly, and even fell towards the end of the year. The decrease in the real level of pensions was partly compensated by the intensive reduction of pension arrears.

The preliminary Goskomstat data from January-May 1998 compared to the same period in the previous year suggest that real incomes decreased by 7.9%. However, there is no comparable data for wages. In the first two months of this year, wages and pensions seemed to pick up clearly from 1997. Correspondingly, the arrears situation again has deteriorated during 1998, and has led to further worker unrest, including strikes by coal miners and other groups.

The pension/wage ratio was 28% in 1992. During 1995–1997 it varied in the range of 34-38%. By February 1998, it had risen to 41%, a level last seen in the late 1980s.

Table 2. Real wage, income and pension, index 1995=100

	Real average wage	Real income	Real average pension
1995	100.0	100.0	100.0
1996	106.0	99.8	109.0
1997	109.9	103.3	103.6

Sources: Goskomstat (Voprosy statistiki 3/98), Bank of Finland

Economic indicators

	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**as of**
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.5	0.8	-0.2	1-5/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-2.1	5/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-5.8	1-4/98
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	9.3	5/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	22.3	1-4/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	20.9	1-4/98
Current account, USD billion			10.7	10.0	11.6	3.3		

Sources: Goskomstat, CBR

IMF approves EFF loan tranche

As part of the USD 9.2 billion Extended Fund Facility (EFF) loan initially approved for Russia at the end of March 1996, the latest USD 670 million tranche is tied to implementation of measures and achievement of targets agreed with the IMF in a separate economic program. The IMF tracks the implementation of the program regularly.

The recent delay was not the first time the IMF has postponed release of a tranche due to Russia's fiscal problems. However, this time IMF board also decided that the EFF loan program, which originally covered 1996-1998, would be prolonged through early 2000.

Government's "anti-crisis" program submitted to Duma for approval

The broad lines of the "anti-crisis" program drawn up by the Kiriyenko cabinet are, for the most part, quite familiar (e.g., see the 12-point plan reviewed in issue 2/98). The program is also in line with the measures agreed upon with the IMF. The program aims to end the financial market crisis and assure economic growth. Interest rates, e.g., will have to be reduced from 60% to 20-25% by the end of the year. The main points of the program include adoption of new tax and budget legislation, VAT reform, reduction of tax relief and exemptions, cutting of subsidies from the federal budget, payment of wage and pension arrears, increasing revenues from privatization sales and speeding up of reforms in bankruptcy procedures (see Table 1).

The reactions of the main Duma factions to the program were mixed. While many deputies admitted that the program included necessary measures, they felt it was generally too tough to be implemented. The Duma is scheduled to begin the discussions on the program in early July.

President Yeltsin appealed to Duma members to approve the program before parliament adjourns for summer holidays in mid-July. If the Duma refuses to approve the program, Mr Yeltsin can still push it through by presidential decrees. He can also threaten to dissolve the Duma. Given mounting wage and pension arrears, Mr Yeltsin warned the Duma of serious social and political consequences should it delay approval of the new reform plan.

Request for new loans

Russia is also seeking new loans, perhaps USD 10–15 billion. At least some money is expected to be provided under the IMF's Supplemental Reserve Facility (SRF). The rest would come from other international institutions, western commercial banks and foreign governments.

The IMF introduced the SRF loan last year as a way to provide short-term financing relief to countries suffering from Asia's financial crisis. The loan terms are much stricter and payback times shorter than loans intended for structural reforms. According to prime minister Sergei Kiriyenko, the additional aid is needed mainly to boost confidence in the rouble and improve the central bank's position in fending off speculative attacks.

The request for new loan arrangements has not been fully supported by the state Duma, where Mr Yeltsin's recently tapping of Anatoly Chubais to conduct negotiations on international loans has been severely challenged. For this year, the parliament has set limits on borrowing. These limits could be exceeded if the planned loan arrangements are approved.

Table 1. Main measures of the anti-crisis program

1. Raising revenues
* Increase privatization revenues
* Strengthen customs control and control of participants in foreign economic activity
* Withdraw certain goods from CIS free-trade regime to prevent re-export
* Establish a state joint stock company to administer alcohol plants; intensify control over illegal alcohol production
* Increase the land tax

2. Fair and comprehensible tax policy
* New tax and budget legislation, VAT reform
* Reduce the tax burden on law-abiding enterprises
* Introduce new income tax scale with lower rates, but extended to all types of income
* Grant regions authority to introduce a sales tax of 5–10%

3. Reduction of state expenditures
* Reduce tax reliefs and exemptions
* Cut number of state employees
* Restructure the state system for remuneration of labour
* Liquidate certain extrabudgetary funds
* Decrease direct state supports for agriculture and transport

4. Ensuring financial stability
* Reduce budget deficit
* Regulate regional loans and use of funds; stimulate of regional tax collection
* Reduce attraction of funds through the issue of short-term T-bills

5. Active industrial policy
* Reduce tax burden of enterprises
* Lower transport tariffs and wholesale prices for gas and electricity for companies that pay in cash
* Speed up bankruptcy procedures
* Promote Russian exports

6. Protecting investors' rights
* Move to international auditing standards
* Guarantee rights of minority shareholders

7. Targeted social policy
* Payment of wage and pension arrears
* Grant benefits only to those living below subsistence level
* Stabilize financial position of national pension fund
* Intensify tax take from well-off citizens

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998/1-4	1998 budget law**
Federal government							
- revenues	14.5	14.1	13.7	12.5	12.1	10.9	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	15.3	17.6
- balance*	-1.4	-4.0	-2.9	-3.3	-3.2		
- balance**	-6.5	-11.4	-5.4	-7.9	-6.5	-4.4	-4.7

* Excludes interest payments on short-term government debt
** Includes interest payments on short-term government debt
Sources: Goskomstat, IMF. Figures for 1993-94 are not fully comparable with others.

Financial markets volatile, illiquid

The high volatility in Russian financial markets persisted throughout June. Fear of devaluation has kept investors wary and markets quiet. The Russian central bank lowered its refinancing rate from 150% to 60% on June 5 but had to raise it again to 80 % on June 26 (see table 1). Preceding the rate hike the rouble weakened outside the daily band set by the central bank. In June the Ministry of Finance had difficulties in finding enough acceptable bids at its weekly auctions. Investors stayed on the sidelines awaiting the IMF's decisions on the disbursement of the USD 670 million tranche of its current USD 9.2 billion EFF loan and a new credit package of USD 10 – 15 billion discussed currently with Russia's international finance negotiator, Anatoly Chubais. The decision on the disbursement of USD 670 million was made on June 25.

According to the Bank of Russia's first deputy chairman, Sergei Alekshenko, foreign investors have withdrawn USD 1.2 billion from the short-term government paper market (GKO) since the beginning of May. The market value of the GKOs is currently USD 54.3 billion (June 19), of which foreign investors hold USD 16.8 billion (31%).

At the beginning of May 1998, total reserves amounted to USD 16 billion, of which USD 11 billion was in foreign currencies and USD 5 billion in gold. The total reserves peaked at USD 24.5 billion in July 1997.

Table1. Refinancing rate of the Russian central bank

Date	Refinancing rate, %
Feb. 97 – Apr. 97	42
Apr. 97 – Jun. 97	36
Jun. 97 – Oct. 97	24
Oct. 97 – Nov. 97	21
Nov. 97 – Feb. 98	28
Feb. 98 – Feb. 98	42
Feb. 98 – Mar. 98	39
Mar. 98 – Mar. 98	36
Mar. 98 – May 98	30
May 98 – May 98	50
May 98 – Jun. 98	150
Jun. 98 – Jun.98	60
Jun.98-	80

Russian debt and currency ratings lowered

On May 29, the international credit rating agency Moody's lowered its rating for Russian government long-term debt from B1 to Ba3. The change meant that Moody's sees palpable investment risk instead of only a possible negative development. The main arguments for the downgrading were the weakness of the state finances, political uncertainty, lack of credibility and a poor atmosphere for foreign investors. Two weeks later, Standard & Poor's and Fitch IBCA both lowered their ratings for Russian currency debt. Standard & Poor's argued that the solvency of Russia had deteriorated as the state has been running deficits the last few years and tax collection has not improved.

Russian government launches two Eurobonds

The Russian government raised USD 3.75 billion in total from the international debt markets in June. The country's first 5-year bond worth USD 1.25 billion was issued 3 June. It yielded 650 basis points (bp), or 6.5%, over the US Treasury bill with a similar maturity. In spite of the turmoil on the Russian financial markets the international demand for the Eurobond was good. The second USD 2.5 billion bond, maturing in 2028, was issued on 18 June. The bond includes an option at ten years, whereby the owner of the bond has the right to sell it back to the Russian government in 2008. The bond was placed at 753 bp over US Treasury bills. According to a finance ministry statement at the end of June, Russia has no intention to issue additional eurobonds in the near future.

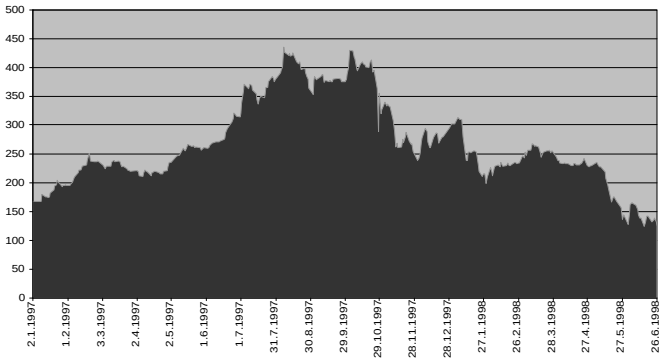
The June bond issues were costly for the government in comparison to previous bonds. In October 1997, a Russian 5-year dollar-denominated Eurobond was issued at 334 bp over US treasury bills; in July 1997, a 10-year bond was issued 375 bp over the US treasury bills.

Rosneft stake back on the block

With May's failed attempt to sell 75% plus one share of the oil company Rosneft for USD 2.1 billion plus USD 400 million in further investments, the government has now re-offered the stake for USD 1.6 billion plus a further USD 65 million investment. The tender closes on July 16.

The Federal Property Fund also plans to announce tenders for oil companies LUKoil and Slavneft as well as the telecom company Svyazinvest forthcoming autumn.

Moscow Times index



Monetary indicators

	1993	1994	1995	1996	1997	1998 latest	As of
Inflation, %	842	224	131	22	11.0	7.5	5/98
M2, year-to-year growth, %		217	113	33	31.5	16.8	4/98
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1054	4/98
Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	54.8	5/98
- deposit rate, %			102	55	16.4	7.4	5/98
- lending rate, %			320	147	46.2	36.3	4/98
Forex reserves, USD billion (excl.gold)	5.8	4.0	14.3	11.3	12.9	11.0	4/98
RUB/USD, end of period	1247	3550	4640	5560	5960	6.19	6/98

Sources: Goskomstat, CBR

When Regions Compete

by Laura Solanko*

Many Russian regions and localities have introduced tax breaks and other enticements to attract foreign direct investment (FDI) to their jurisdictions. The aggressiveness of competition for FDI, especially between neighbouring regions, seems to be heating up. In northwestern Russia, for example, St. Petersburg and the city's surrounding Leningrad *oblast* are engaged in rival transportation infrastructure projects. Both continue to issue ever-more innovative tax concessions in an effort to outdo their neighbour.

Not far down the road, we find raging competition for foreign investors between the ancient city-states of Novgorod and Pskov. The situation highlights how fast regions can abandon old policies, just to get into the game. As a result of the 1996 gubernatorial elections, the two regions have followed distinctly different economic approaches. Novgorod strove to attract FDI with tax breaks and liberal administration; Pskov took a more xenophobic line by banning export of raw materials produced in the region and restricting import of goods produced outside the region. Even so, it was simply too much for members of Pskov's business community and many public officials to idly watch the inflows of FDI next door. Taking Novgorod as the proper model for reforming their region, Pskov passed a law on investments this March that bears an uncanny resemblance to its Novgorodian counterpart.

How should an observer of transition economies react to increased fiscal competition between regions? Is it a boon or disaster-in-the-making? Standard economic theory suggests that fiscal competition between sub-federal units may be harmful to the economy as a whole. Instead of tax competition to attract mobile capital to regions, the optimal strategy to raise the general welfare would be to centralize tax policy decisions.

China and theory

Most models conclude that tax levels end up too low in a competitive, non-cooperative equilibrium. However, an often-neglected aspect of such modelling is that the fiscal competition affects both the revenue side of local budgets and the composition of public expenditure. In the presence of mobile capital, this fiscal competition leads to relative over-provision of public inputs in infrastructure and relative under-provision of items that directly affect consumer welfare such as social services. In models where the economy would otherwise be in optimum, this would appear to be a clear drawback of fiscal competition. Yet, in a country starting from centrally planned socialist optima, this may in fact be a blessing in disguise.

In China, local governments have long competed for FDI by providing better local infrastructure. Recent observers have noted that some of China's provinces have offered inefficiently high levels of infrastructure. Nevertheless, this misguided obsession seems to have helped local governments become more fiscally prudent. By preferring to allocate funds to infrastructure that might lure FDI, local governments forego expenditure on social projects such as bailing out loss-making state-owned enterprises (SOEs). Indeed, if we make the natural assumption that regional governments are operating under relatively hard budget constraints already, promotion of competition between sub-national units in a transition country may also harden the budget constraints of local enterprises. This, in turn, may be highly beneficial for restructuring and the transition process as a whole.

Bigger pie

During the Soviet period, the main source of investments was the federal treasury. Regions concentrated on competing for federal funds. Now, regions like Novgorod have found it makes better sense to shift their efforts to competition for FDI. Given the ongoing problems with the federal budget, regions have realized that it is unlikely in the foreseeable future that federal investments will supply the main share of investment funding needed. Rather than waiting around to fight over how the existing pie should be divided, many regions see attracting new private investments (both domestic and foreign) as a more feasible way to make their slice of the investment pie bigger. The increase in competition among regions hints that this kind of development is slowly under way. However, substantial differences in attitudes towards investments persist. Novgorod trusts in its ability to attract private investments; Pskov still, for the most part, clings to hopes for federal funding.

Assuming that the negative connection between attracting FDI and financing SOEs is valid for a wider spectrum of public expenditure, regional competition in Russia should be welcomed as good news. If fiscal competition is beneficial for the restructuring process and simultaneously helps to increase the amount of badly needed investments, is it not best to let the regions compete? The role of the federal government in fostering competition should not, however, be neglected. The federal government's role here should be to ensure a level playing field for all. That assured, the federal government must then further resist the impulse to bail out loser regions automatically to avoid creating moral hazard conditions.

* *The author is an economist of BOFIT.*

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

Editor-in-Chief Jouko Rautava

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RUSSIAN ECONOMY
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Economic Developments

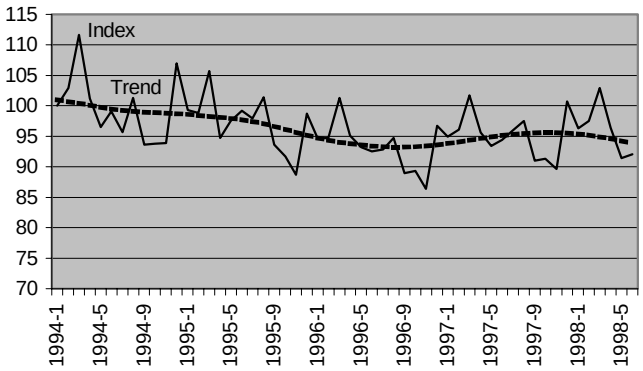
GDP shrank in the first half of the year

In the first half of 1998, GDP declined 0.5% compared to the same period in 1997. In June GDP was 1.6% lower than a year ago.

Industrial output growth was only 0.1% in the first half of the year. In the first quarter industrial output still grew 1.3%, but started to decline in the second quarter. In June industrial output was 2.5% lower than the year before. The long-run trend component in the chart below indicates that the earlier modest industrial growth started to decelerate already in the latter part of 1997 and the long-run output growth turned negative around the turn of the year.

Also the outlook for economic growth looks rather bleak as, for example, the situation concerning investments seems to be worsening again. In January-May fixed investments declined 6% and, given the current uncertainties related to fiscal policy and financial markets, there are no signs of a change for the better in this statistic. The Russian Economic Ministry now forecasts that GDP will decrease 1% in 1998.

Industrial production, 1994-1998, Jan 1994=100



Sources: PlanEcon vol. XIV, BOFIT

Trade balance falls

Russia's trade surplus in May was USD 0.3 billion, down from USD 1.1 billion in May 1997. In January-May the value of imports grew 6.5%, while the value of exports declined 15.2% compared to the same period a year ago. As a result, the trade surplus fell from USD 9.5 billion in the first five months of 1997 to USD 2.7 billion in 1998.

One of the main reasons for the deteriorating trade balance is low oil prices. The price for Brent crude has been on average USD 5/barrel lower than in 1997. In January-May Russia's crude oil exports grew 8.6% in volume, but declined 22% in value compared to the same period a year ago. Average export contract prices have fallen some 28% from January-May 1997.

As a part of the latest stabilization programme, Russia is to impose a temporary special customs duty of 3% on all imports. The new duty will be effective from 15 August until the end of 1999 and will not apply to goods originating from Customs Union countries (Belarus, Kazakhstan and Kyrgyzstan).

Role of services in Russia's economy growing

According to Goskomstat's recently revised GDP statistics, the share of services in Russia's GDP increased from about 54% in 1996 to 55% in 1997. Accordingly, the share of goods' production declined by 1 percentage point from 46% to 45%. No data is available on the share of net taxes and subsides in GDP.

Official GDP statistics seem to indicate that the services sector grew on average about 1.5%, while the production sector declined some 0.7% in 1997.

Structure of Russia's GDP, 1996 and 1997, %

	1996	1997
GDP	100	100
Production of goods	46.3	45.2
- Industry	29.9	28.6
- Agriculture	7.3	7.1
- Construction	8.2	8.6
- Other goods	0.9	0.9
Production of services	53.7	54.8
- Transport and communication	13.3	12.4
- Trade	15.9	16.0
- Non-market services	13.4	13.8
- Other services	11.1	12.6

Source: Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-0.5	1-6/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	0.1	1-6/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.2	1-5/98
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	11.5	6/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	29.6	1-5/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	26.9	1-5/98
Current account, USD billion			10.7	10.0	11.6	3.3		

Sources: Goskomstat, CBR

A rescue package of USD 22.6 billion for 1998-1999

International financial institutions agreed to provide Russia with a USD 22.6 billion loan package to strengthen the rouble and to stabilize Russia's public finances. The agreed loan package would bring Russia a total of USD 14.8 billion from the IMF, World Bank and Japan this year and another USD 7.8 billion next year. Loans are conditional on implementation of several reform measures, which primarily aim at bringing Russia's federal budget back into balance. Russia has already received the first loan tranche of USD 4.8 billion, which was used to strengthen the central bank's reserves.

The second disbursement of the IMF loan is scheduled for September. The World Bank's board approved a USD 1.5 billion structural adjustment loan for Russia on 6 August.

Table 1. Composition of the loan package

Lender	sum, billion USD	of which new commitments
IMF	15.1	13.8
World Bank	6.0	5.2
Japan	1.5	1.5

Source: Reuters

Anti-crisis program approved – government still under pressure

Approving the measures of the anti-crisis program (e.g. see Table 1 in issue 6/98) was a major precondition for disbursements of the new IMF lead loan package. The State Duma failed to pass all the laws proposed by the government before leaving for vacation. Consequently president Yeltsin was forced to override the Duma and implement some of the anti-crisis measures by decree. As a result the IMF board reduced the first loan tranche approved 20 July by USD 800 million. The remaining anti-crisis measures were approved by government resolutions, and Prime Minister Kiriyenko declared that all stabilization measures, increasing budget revenues by RUB 105 billions this year, had been taken.

This however does not guarantee easy times for the Russian government. The legislative changes are focused on boosting tax collection and increasing cash tax revenues. The measures aimed at cutting government expenditure were, for a large part, not approved. Also the most important parts two and three of the new Tax Code, which deal with tax levels and the division of taxes between federation and regions, were not approved. The Duma approved only the first part of the Code, which defines general principles of taxation but means little if any changes in practice.

The Duma, angered by president Yeltsin's vetoes, is likely to be even more reluctant to approve new propositions in the autumn. This indicates that Russia will face serious difficulties in reducing the budget deficit to 2.8% of GDP next year as agreed with the IMF. Furthermore, the many of the measures taken will have their full positive effect on government tax revenues only in 1999.

Despite the successful swap of short-term rouble-denominated bonds for long-term dollar-denominated bonds in July, debt servicing costs are to remain high. About USD 18.5 billion of short-term rouble bonds will mature by the end of this year. In addition the government may need roughly the same amount for interest payments this year. To ensure this, the government has taken tight measures to crack down on large tax evaders and to squeeze revenues from the regional governments.

As part of the measures to raise additional revenues, the government intends to sell about 5% of its stake in the natural gas monopoly Gazprom. This would reduce the state's stake in Gazprom to 35% but bring up to USD 1.5 billions to state coffers. The Rosneft auction, which should have brought in USD 1.6 billion, has been postponed till October.

The problem of wage arrears is constantly growing and it is putting extra pressure on the government's stabilization efforts. Striking miners in several regions in the Urals as well as in the Far East are demanding immediate payment of all wages in arrears. In all cases, workers, managers and regional governments have appealed to Moscow for cash to solve their arrears problems.

Table 2. Main measures of the anti-crisis program:

1. Passed by both houses in final reading
* The first part of new Tax Code
* Reduction in profit tax from 35 to 30%
* Introduction of regional sales tax
* A minimum tax for small business
* Reduction in oil excise taxes
* Tightening regulation on alcohol production and sales
* A 1% tax on purchase of foreign currency

2. Vetoed by Yeltsin
* Reduction in profit tax
* Reduction in oil excise taxes

3. Rejected by Duma but approved by decrees
* Uniform 20% VAT rate and VAT payments on delivery
* A fourfold increase in land tax

4. Other measures taken
* 3% increase in duties on imports from outside CIS
* Additional 2% income tax earmarked for Pension Fund
* Swap of GKOs for long-term dollar-denominated bonds
* Massive hike in sugar import duties

5. Measures not taken
* New income tax law
* Parts II and III of the new Tax Code
* Reform of the system of intergovernmental transfers

Source: BOFIT

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998/1-5	1998
Federal government							budget law
- revenues	14.5	14.1	13.7	12.5	12.1	10.8	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	15.4	17.6
- balance	-6.5	-11.4	-5.4	-7.9	-6.5	-4.6	-4.7

* Figures for 1993 – 1997 excludes interest payments on short-term government debt

Sources: Goskomstat, IMF. Figures for 1993-94 are not fully comparable with others.

IMF deal did not reassure markets

During July the developments in Russian financial markets have been very much governed by actions of the International Monetary Fund and expectations related to those actions. During the first week of the month, equity prices continued their downward slide and the Moscow Times $-index reached its lowest level this year on 9 July when its value (97.77) was only one-third of that at the beginning of the year. After the deal with the IMF was more or less certain, stock prices rebounded by over 30% in mid-July. However, the boom proved to be short-lived, as the Duma didn't approve large parts of the government's anti-crisis package, many investors sold their stocks and the prices decreased again. At the end of July, the Moscow Times $-index ended up around 110, roughly the same level as at the end of June.

Interest rates have continued to be very high. Average treasury bill (GKO) yields were approximately 90% at the beginning of the month. After the announcement of the IMF deal, yields decreased considerably. The rally in the short-term debt market was also helped by the swap of GKOs for long-term dollar bonds. On 24 July, decreased yields allowed the Central Bank of Russia to lower its refinancing rate to 60% from 80%. But as with equities, the improvement of the situation in the debt market was short-lived, and the yields went up again. The 6-month-to-maturity GKO yield at the end of July was about 48%, down from 77% at the end of June.

In July, also the pressure on the rouble continued and it depreciated to the weaker edge of the central bank's miniband. During the month, the central bank has widened somewhat the miniband it uses to regulate daily fluctuations in the RUB/USD rate.

Russian government aims to lengthen its debt maturity

In order to reduce its debt-servicing costs, the Russian government offered a chance for the investors to swap their short-term (i.e. under 12-month) GKOs for dollar-denominated bonds with maturities of seven and twenty years. This offer was prompted by the sharp rise in the yields on rouble debt. All in all, GKOs with market value of USD 4.4 billion and nominal value of USD 6.4 billion were exchanged into long-term bonds. The Russian government was also able to place additional bonds worth USD 500 million. The yields on the dollar-denominated bonds were 940 basis points over corresponding US Treasuries. Thus, the risk premium attached to Russian debt has increased considerably since June when Russia launched two Eurobonds with a spread over US Treasuries of 650 basis points. On 21 July, the market value of all outstanding GKOs was USD 36.8 billion.

Russia's Ministry of Finance has also shifted its borrowing in roubles to longer maturities. In July, three GKO auctions were cancelled and the MoF auctioned only bonds with maturities longer than one year.

On 30 July, Fitch IBCA, the international rating agency, cut Russia's long term foreign currency rating from 'BB' to 'BB-'. The agency is worried in particular about political confrontation over the 1999 budget.

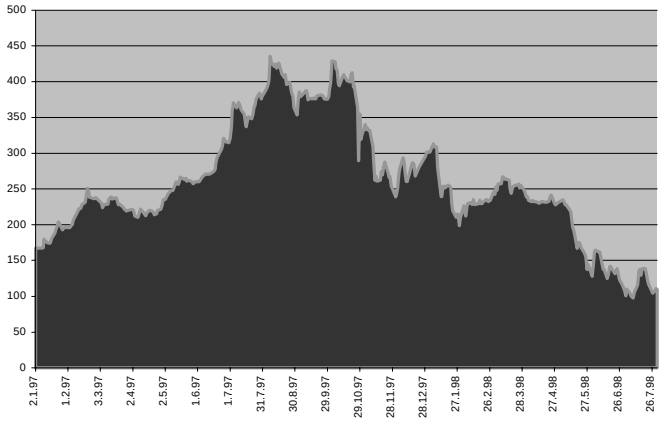
Menatep to rescue Tokobank?

Menatep Bank has announced a plan to restructure the liabilities of Tokobank. According to the plan, creditors of the bank would e.g. extend the maturities of their loans, and some of the loans would be converted into Menatep's long-term bonds. If Menatep gets the deal, it will receive 50% plus one share in Tokobank. Both the Central Bank of Russia and Tokobank's foreign creditors have accepted Menatep's scheme in principle. Recently, however, also Uneximbank and the state investement corporation Gosinvest have shown interest to participate in Tokobank's rescue.

Tokobank was placed under the central bank's temporary administration in May after it experienced liquidity difficulties. Earlier this summer Moskvy Bank proposed a smaller scheme for Tokobank's restructuring, but Moskvy Bank decided to withdraw from the venture when it became apparent that Tokobank's losses were significantly greater than anticipated.

The Central Bank of Russia has announced that it will back a possible restructuring deal with liquidity support.

Russian share prices in 1997-98
- Moscow Times $-index



Monetary indicators

	1993	1994	1995	1996	1997	1998 latest	As of
Inflation, 12-month, %	842	224	131	22	11.0	5.6	7/98
M2, year-to-year growth, %		217	113	33	31.5	12.7	5/98
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1060	5/98
Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	65.1	6/98
- deposit rate, %			102	55	16.4	7.4	6/98
- lending rate, %			320	147	46.2	41.3	5/98
Forex reserves, USD billion (excl.gold)	5.8	4.0	14.3	11.3	12.9	11.2	6/98
RUB/USD, end of period	1247	3550	4640	5560	5960	6.24	7/98

Sources: Goskomstat, CBR

Russia's crisis in the light of early warning indicators

by Iikka Korhonen*

The past few months have been filled with speculation about the impending devaluation of the Russian rouble, the possibility of a large-scale exodus of foreign investors from the Russian stock and especially debt market, and the emergence of a full-blown crisis in Russian financial markets caused by these factors.

Can we predict currency crises?

Experiences in Mexico and later on in South East Asia have spurred research on the causes of the crises as well as on discovering early warning indicators of such crises. Here the rationale is that if we could obtain a reasonable set of indicators which would forecast a currency crisis with reasonably high probability in advance, then policies could perhaps be changed to avert the crisis. In a working paper published last year economists of the IMF surveyed 25 empirical studies on such indicators (G. Kaminsky, S. Lizondo & C.M. Reinhart: Leading Indicators of Currency Crises, IMF Working Paper 79/97). Kaminsky et al. conclude that an effective warning system should be based on *a broad variety of indicators.* The variables that seem to be the most robust indicators of currency crises are *international reserves, real exchange rate, credit growth, credit to public sector, and domestic inflation.* Also *trade balance, export performance, money growth, M2/international reserves, real GDP growth, and fiscal deficit* seem to have some predictive power.

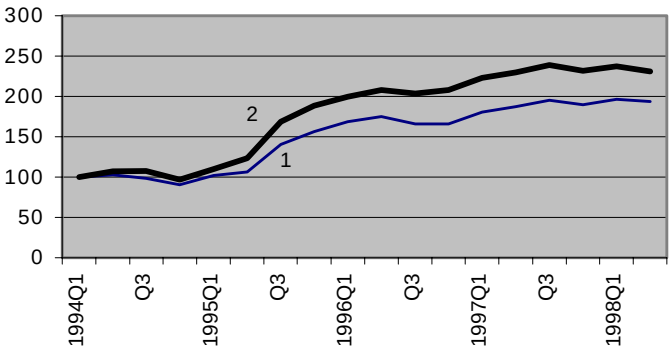
After surveying results of previous research, Kaminsky et al. study which variables have been the best "signals" for their definition of currency crises. They find that the most reliable leading indicator of currency crises within a time period of 24 months is the deviation of the real exchange rate from its trend. The next two strong "signals" were exports and the stock market index.

The notion that a rapid appreciation of the real exchange rate might bring about a sharp reversal (i.e. currency crisis) later is certainly not very novel. Neither is it very surprising that declining exports could lead to changes in the exchange rate. If declining exports indicate loss of competitiveness, then exchange rate realignment is what sometimes happens. Stock prices were found to be an important indicator of currency crises also in an earlier study on such crises (B. Eichengreen, A. Rose & C. Wyplosz: Exchange Market Mayhem: The Antecedents and Aftermath of Speculative Attacks, Economic Policy, Vol.21).

What do the indicators say in Russia?

Can these studies shed any light on the Russian case? What have the indicators been signalling during the last year or so? The chart below on the rouble's real effective exchange rate shows that the rate has indeed appreciated quite remarkably from the beginning of 1995. But has it deviated from its long-term trend? Unfortunately this question remains open, as it would be quite hazardous to say what exchange rate would be consistent with both external and internal equilibrium in the medium-term.

Real effective exchange rate, 1994Q1=100
1. CPI-based index
2. PPI-based index



Sources: BIS and own calculations

The export indicator, on the other hand, is not so ambiguous. The value of exports has declined as the prices of oil and other raw materials have decreased. During the first five months of this year, the value of Russian exports decreased by 15% from a year ago. In the same period, the value of imports increased by over 6%. These developments point to problems in Russia's external sector, although they do not necessarily indicate major problems in Russia's price competitiveness and, moreover, Russia's current account is still roughly in balance.

Last year Moscow's equity markets boomed, but then have slumped to levels last seen in 1996. This clearly reflects investors' perceptions about the Russian economy, including their assessment of the future external value of the rouble.

Thus, of the three 'strongest' early warning indicators, at least stock prices and perhaps export performance, could be viewed as indicating that there are considerable risks related to the rouble. An interpretation of real exchange rate developments seems to be more complicated.

Naturally, one should remember that each country has its own unique features. In Russia, government finances have played a larger role in past economic difficulties than in many other countries. It remains to be seen whether the policies of the Russian government will be sufficient to restore confidence in the fixed rouble.

** The author is an economist at BOFIT.*

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

Editor-in-Chief Jouko Rautava

BANK OF FINLAND
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RUSSIAN ECONOMY
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Economic Developments

Output falls, political crisis deepens

Even before the dramatic events of late August, output in Russia had turned negative. First-half real GDP was 0.5% lower than a year ago. However, industrial production (0.1%), agriculture (0.6%), as well as many services, were still slightly above the 1997 level. Transportation was down (-3.9%) and presumably construction, since fixed investment declined some 7% compared to the first half in 1997.

The fall in output seems to be accelerating. In July, GDP was 4.5% and industrial production 9.5% lower than in July 1997. Moreover, the August collapse of economic policy makes the short-term outlook for Russia very poor.

Unemployment figures revised up

The unemployment figures have recently been revised, causing a two-percentage-point rise in the officially published unemployment rate. Thus, the unemployment rate in July calculated by the ILO methodology was 11.4%. The comparable figure a year ago was 10.9%. The number of people without work is currently 8.3 million; the active working population is 72.7 million people.

Reliability of Russian trade statistics

In 1994-96, Goskomstat revised import figures in Russian custom statistics upwards by USD 10-15 billion to include, in particular, the "shuttle trade," which includes goods brought into the country by travellers. In 1997, however, the difference between foreign trade statistics published by Goskomstat and by Russia's custom administration was negligible. According to both offices, Russia's trade surplus was USD 20 billion.

Despite the similarity of figures, however, there is strong evidence the Russian foreign trade statistics are specious. A comparison to Finnish custom statistics reveals that the reliability of Russian foreign trade statistics is probably as poor as ever. In 1994-95, both Russian (unrevised customs statistics) and Finnish customs data gave a similar view concerning Russian-Finnish trade and trade balance (see table and figure). In the following years, even though Russian officials were working to increase the reliability of data collection, the disparities widen strikingly. Thus, while the Finnish data shows Russia's trade balance steadily deteriorating, Russian customs statistics indicate a huge improvement. The difference is mainly due to Russian figures on imports to Russia, which are 30% to 40% lower than the corresponding figures stated by the Finnish Customs Board. One important factor behind this is practice of double billing, whereby the Russian importer, in order to circumvent taxes, demands that the transport company presents Russian custom officers with documents that understate the value of the imported goods. Meanwhile, the Finnish custom authorities are given documents showing actual billing values.

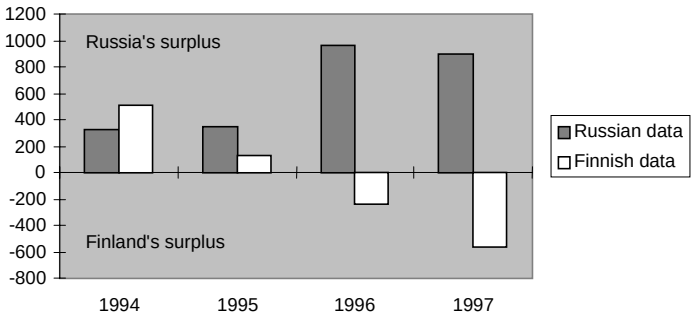
Naturally, there are also other (and perhaps even more significant) factors behind the differences in Russian and western foreign trade statistics. However, in response to the poor reporting of imports, the Bureau of Economic Analysis in Moscow has also called for an upward revision of Russia's import figures by some 20-30% for recent years.

This evidence calls into question whether Russia's external balance is as good as is generally believed. If not, other estimates, for example, on capital flight should correspondingly be revised downwards.

Russian-Finnish trade according to Finnish and Russian customs statistics, USD million

	Russia's exports to Finland		Russia's imports from Finland	
	Russian data	Finnish data	Russian data	Finnish data
1994	1950	2042	1628	1531
1995	2386	2062	2041	1932
1996	2638	2229	1675	2463
1997	2770	2413	1869	2979

Russian-Finnish trade balance, USD million



Sources: Finnish and Russian custom statistics

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-1.1	1-7/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-1.3	1-7/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.3	1-6/98
Unemployment, % (end of year)	4.9	5.5	7.5	8.2	9.3	9.0	11.4	7/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	29.7	1-5/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	28.8	1-5/98
Current account, USD billion			10.7	10.0	11.6	3.3		

Sources: Goskomstat, CBR

Economic crisis turns political, decision-making systems paralyzed

An anti-crisis program and a USD 22.6 billion loan package in July were not enough to convince investors that Russian economy was on course. The economic crisis turned political as August wore on. On Sunday 25 August President Yeltsin disbanded Sergey Kiriyenko's five-month-old government, and named Viktor Chernomyrdin as his candidate for prime minister.

The majority of Duma deputies have initially opposed Mr Chernomyrdin's nomination, claiming that he was responsible for the current crisis. Thus, in the Duma's first vote on 31 August, only 94 Duma members supported Mr Chernomyrdin's nomination, while 253 were opposed. If the Duma rejects Mr Chernomyrdin three times, Mr Yeltsin can disband the Duma and nominate Mr Chernomyrdin as the prime minister, or name a new candidate.

The ultimate target of Duma critics is naturally Mr Yeltsin. The majority of Duma members openly demand the president's resignation or at least diminishing his powers to the benefit of parliament. Although the current situation resembles the government crisis five months ago, this time Mr Yeltsin appears weaker, and the Duma stronger, than before.

Compared to advanced transition economies, an important difference is that there has never been the same political commitment to reform in Russia as in the more advanced transition economies. In particular, the Duma has openly opposed reforms. Unfortunately, given the current political structures and plans, it is difficult at this point to see how the situation could change for the better. On the contrary, the comments by Mr Chernomyrdin and several Duma leaders imply that Russian politicians are still reluctant to make the necessary fiscal and structural reforms.

Russia ended August without any executive power in place.

Public debt hits 50% of GDP

The inability of Russia to manage its internal debt – treasury bills (GKO) and bonds (OFZ) – was a main reason behind the August financial crisis. Russia reacted with too little too late after it became apparent that its short-term debt had become an excessive burden to the budget. As a share of budget expenditures, debt servicing costs had risen from approximately 25% in 1997 to 35% by mid-1998. The bulk of the rise was due to the increase in internal debt and domestic interest rates. Internal debt rose from RUB 385 billion at the end of 1997 to RUB 436 billion in mid-1998 (see table below).

Of Russia's USD 141 billion foreign debt, about USD 90 billion consists of debt inherited from the Soviet Union. The majority of this debt (over USD 70 billion) was rescheduled through agreements with the Paris and London clubs in 1996–1997. Both agreements start with grace periods during which only interest is paid. The amortization of the loan capital of both loans commences in 2002. The loans must be paid back by 2020.

The overall outstanding public debt before the August crisis equalled about 50% of GDP.

While the government's default on GKO and OFZ debt alleviates Russia's immediate debt servicing problems, challenges remain. According to Fitch IBCA, about USD 4.5 billion in public external debt payments will fall due before the end of this year. In 1999, payments will rise to USD 18 billion including repayments to the IMF (USD 7 billion), interest on Eurobonds and Soviet-era debt (USD 5.1 billion) and payments to other official and private creditors (USD 6 billion).

Table. Federal government external and internal debt in 1995-1998

Federal government external debt				
end of period	**1995**	**1996**	**1997**	**1998/7**
as % of GDP	33.8	28.4	26.7	34.1
bln USD	120.4	125	123.5	141
Of which				
Multilateral creditors	11.4	15.3	18.7	25
Bonds	1.1	1.1	4.6	15.9
Official creditors	68.6	69.8	64.5	NA
Commercial creditors	39.3	38.8	35.7	NA
Federal government internal debt				
end of period	**1995**	**1996**	**1997**	**1998/6**
as % of GDP	14.1	18.9	14.8	16.8
Of which				
GKO's	4	9	10.5	10.8
OFZ's	0.7	1.5	4.3	5.9
OVVZ's	2.2	2.7	NA	NA
Other	7.2	5.6	NA	NA
bln new RUB	230	427	385	436

Sources: OECD, JPMorgan, Fitch IBCA, BOFIT, Goskomstat

Debt to official creditors includes bilateral government credit and official export credits.
Debt to commercial creditors includes London club creditors and uninsured trade credits.

Fiscal indicators (per cent of GDP)

	1993	**1994**	**1995**	**1996**	**1997**	**1998/1-6**	**1998**
Federal government							budget law
- revenues	14.5	14.1	13.7	12.5	12.1	10.8	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	14.7	17.6
- balance	-6.5	-11.4	-5.4	-7.9	-6.5	-3.9	-4.7

* Figures for 1993 – 1997 exclude interest payments on short-term government debt

Sources: Goskomstat, IMF, Minfin. Figures for 1993-94 are not fully comparable with others.

Rouble down 40%, government defaults

On Monday 17 August, Russian authorities announced that the rouble would be allowed to float within a wider band between 6.0 and 9.5 roubles to the dollar. At the same time, the government essentially declared itself insolvent due to its inability to honour obligations related to rouble-denominated debt maturing before 1999. Moreover, the new crisis package included capital controls as the government and central bank declared a 90-day moratorium on foreign debt servicing by Russian banks and firms. A week later, President Yeltsin disbanded the government, setting off a heated political dispute that focused on the division of power between the president and the parliament.

The above measures paralyzed Russia's already fragile financial markets. The GKO market was closed down and trade in the rouble on the MICEX virtually ended. The lack of confidence in the financial system also led to runs on banks. At the end of August, the rouble was trading in thin markets at between 10 and 11 roubles per dollar, implying a 40% devaluation of the rouble in two weeks.

To stop the run on banks, the authorities promised a 100% guarantee for the deposits of private citizens.

Investors lose big time in debt restructuring…

On 25 August, the Russian government gave an indication about the terms of the restructuring of rouble-denominated debt securities maturing before the end of 1999. The arrangement affects RUB 292 billion of debt (with a nominal value of USD 46 billion before devaluation, but less than USD 30 billion at end-August), a quarter of which is in the hands of foreign investors. When the current GKO and OFZ issues come due, they will be swapped into a package of three new bonds (OFZ) of 3-5 years yielding 30% for the first three years, 25% in the fourth year and 20% in the fifth year. Alternatively, investors that exchange their old paper for 3-5 year bonds before the old paper matures will receive 5% of the old paper's nominal value in cash. Investors also have the option to convert 20% of the nominal value of their rouble investment into dollar-denominated debt with a maturity of eight years and annual yield of 5%. Dollar bonds will be offered at par for the rouble debt and converted to dollars at 7.15 roubles per dollar.

The full details of the debt swap have yet to be published. Nevertheless, in light of current interest rates in Russia and the huge risk premium attached to Russian dollar loans, these conversion conditions spell major losses for investors in Russian T-bills. Some estimates foresee investors getting back about 30 cents on the dollar.

…but so does the Russian government

The response of the international financial community to Russia's latest announcements, in particular to the forced public debt restructuring and a 90-days moratorium on most foreign commercial debt repayment, has been blunt. All major rating agencies downgraded their ratings for Russia. Standard & Poor's, for example, noted that the government's measures have hurt the credit worthiness of both Russia's public and private sectors for a long time to come.

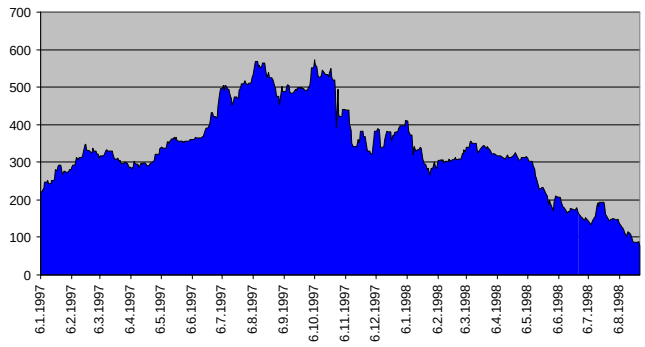
Shakeout in banking sector

Although a general restructuring of the Russia's banking industry is undoubtedly underway, the outcome of the process is still unclear. Uncertainties related to the overall economic situation and, consequently, to the banking sector, are so huge that the latest news concerning mergers and other arrangements between banks should be treated with caution. Two things are sure: the number of banks will decrease dramatically, and even the biggest banks will be affected. The change will happen through liquidation and mergers.

The following examples illustrate recent developments in the Russian banking sector:

- Uneximbank, Menatep and Mostbank have announced they will form a joint holding company that would control 51% of the banks' shares.
- Natsionalnyi Rezervnyi Bank (NRB) and Inkombank have announced a share swap to establish an integrated banking group.
- The operations of SBS-Agro Bank, Russia's third largest deposit bank, and Imperial bank have been suspended by the Central Bank of Russia.

Russian share prices in 1997-98
RTS index



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Forex reserves, USD billion (excl.gold)	5.8	4.0	14.3	11.3	12.9	13.8	7/98
RUB/USD, end of period	1247	3550	4640	5560	5960	9.3	8/98

Sources: Goskomstat, CBR

Russia: Where do you want to go today?

by Pekka Sutela*

The current Russian economic crisis should surprise no economist. The intermediate underlying factors – the debt accumulation caused by the budget deficit – were evident for years. The absence of sustainability in its policies was also clear more than a year ago. Last May, we ourselves wrote that the timing of the decision to sack Viktor Chernomyrdin from his post of prime minister was "a monumental mistake." The move destroyed whatever confidence the markets might have had in Russian policy. The collapse of the economic policy regime was a predictable outcome.

Happy scenarios

Several analysts have sketched rational, even charitable, interpretations of what is taking place. For example, the political scientist Andranik Migranyan published his scenario already in July. In it, Mr Yeltsin announces that he is not a candidate in 2000, perhaps on the grounds of deteriorating health. Then, or perhaps even earlier, the oligarchs decide that Mr Chernomyrdin is, after all, the best alternative they have. He is made prime minister and he assumes power through a soft transition. Mr Yeltsin remains as a figurehead until the end of his term.

Migranyan's scenario contains the consoling thought that, in spite of everything, rationality and even planning will prevail in Russian politics. Consequently, international financial aid continues. Mr Chernomyrdin is a well-known figure, a symbol of reliability, stability and established order.

Perhaps some people are deliberately implementing this scenario, but if they are, they are guilty of several major oversights. They assume that Mr Yeltsin will step down voluntarily (or will lose all his mental faculties). They assume that there is only one game in Moscow, the struggle of the oligarchs. They assume that these oligarchs are united and unanimous players. They assume that a pro-Chernomyrdin coalition is in the best political interests of the opposition. They assume that Mr Chernomyrdin is able and willing to manage the economic crisis in a popularly acceptable way. They assume that the elections can be postponed. They assume that there is a Grand Plan. Relax any of these assumptions and the picture becomes much more muddy, arbitrary – and realistic. There is no reason to believe in an easy shortcut out of the current political crisis.

Economic sands continue to shift

Meanwhile, economic sands continue to shift under the creaky foundations of Russian politics. Understanding this is hardly helped by the current debate on "Who Lost Russia?" (Who ever had Russia in the first place?). Prominent individuals have blamed the likes of George Soros and Helmut Kohl – seemingly the current symbols of wrong action and equally wrong inaction – for having overturned the boat at the very moment when it seemed that Russia might just navigate the dangerous waters.

The point is not whether such arguments are self-serving or not. The point is that they are not consistent with the facts. In the last two weeks, there was no speculation against the rouble – unfortunately. The loss of confidence in Russia was so complete that its markets have been moribund. Nobody would sell foreign exchange for any price. Thus, the volumes traded underlying currency depreciation and the stock market crash have been negligible. In this light, there seems to be no end to what the markets will demand before confidence is restored.

The debt rescheduling scheme adopted hardly helped. We are witnessing not just massive political uncertainty, but actual policy mistakes in the making.

One thing that we know for sure is that any forthcoming government will face an uphill struggle. Time and practical success will be needed before either private or (perhaps especially) public foreign finance will be available. Given Russia's track record, the conditions to be applied will have to be far stricter than before.

The choices ahead are few. With deficit and debt as the intermediate problems, only two alternatives are available. Either there is an immediate, credible and irreversible reduction in public expenditure by several percentage points of GDP, or the authorities can start monetizing the deficit and inflating the debt away. The former alternative would hit many, and it seems to have been completely abandoned politically. The latter alternative would hit almost everybody, depending on the ultimate rate of inflation unleashed. During the first week of Mr Chernomyrdin's acting premiership, almost everything he said was consistent with preparing people for a "soft inflation" alternative with some rationing. But given the state of the markets, steps in that direction are sure to be punished immediately. In fact, Russian policymakers must always keep returning to the start of path of prudent economic policies until they commit to taking that path. They must always return, but each time with far worse initial conditions.

** The author is the head of BOFIT.*

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

Editor-in-Chief Jouko Rautava

BANK OF FINLAND
Institute for Economies in Transition

RUSSIAN ECONOMY
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9•1998

Economic Developments

Output falling

Production has been hampered by Russia's ongoing financial crisis and general uncertainty over economic policy. While the situation was deteriorating before the mid-August events, the fall in output has since accelerated. For August, Goskomstat reports GDP was down 8.2% compared to August 1997, and industrial production was down 11.5%. In the period January-August, GDP contracted 2.1% and industrial production 2.6% compared to the same period of 1997. For January-July, investments were 5.5% less than in the same period a year ago.

Drought and floods hit agriculture

Agricultural production in January-July fell 3% from a year ago. Both drought and floods have affected large areas of cultivated land, which is expected to reduce the grain harvest by tens of million tons. At latest estimate, the grain harvest this year is only 43-46 million tons, or about half of the 1997 figure of 89 million tons. Earlier estimates this year still foresaw a harvest of 56-67 million tons. Although the country has 20 million tons of grain in reserves from last year, the bad harvest means Russia must import grain this winter.

In 1997, agriculture employed around 5.4 million people and accounted for 7% of Russia's GDP. Nearly a third of Russia's unemployed come from the agriculture sector.

Devaluation and government measures alter foreign trade environment

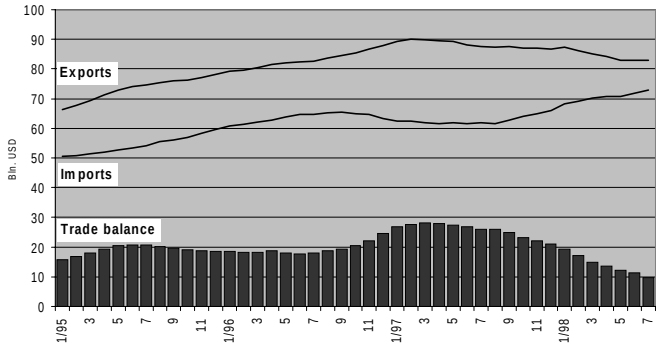
The foreign trade figures of Goskomstat for the first seven months of 1998 show a USD 0.9 billion trade surplus for Russia. This compares to USD 11.7 billion surplus in the same period in 1997. For January-July, the value of exports declined 11.1% and the value of imports rose 15.3% compared to the same period a year ago.

At the beginning of October, the rouble traded at around 16 roubles per dollar. This implied a 60% devaluation of the rouble from mid-August. In addition, Russian import possibilities have been hit by general uncertainty, a paralyzed payments system and a halt in foreign financing. Their impact on Russian import volumes, the structure of imports, and the trade balance is still unclear. For example, the importance of imported foodstuffs to Russia's economy is not clear.

Information on border traffic between Finland and Russia as well as the records of Finnish transportation and forwarding companies indicate that export shipments to Russia in August and September may been declined as much as 50% from a year ago. Even so, a recent business survey shows that Finnish firms hope to sustain their trade volumes to Russia in 1998-99 at around the same level as in 1997. Interestingly, Finnish custom statistics show that the *value* of Finnish exports to Russia rose 28% in the first half of this year compared to the same period in 1997.

Preliminary information indicates the Primakov government plans to introduce a number of measures to tighten custom procedures and restrict purchase of foreign currency by firms in order to restrict capital flight. Instead of a current 50%, exporters may be obliged to sell 70% of their foreign currency revenues. The operations of raw material exporters may be targeted for strict control. As regards importers, the plans include measures to ensure that declared import prices reflect realistic prices so that correct taxes are paid.

Russian foreign trade (12-months moving sum)



Sources: Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-2.1	1-8/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-2.6	1-8/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-5.5	1-7/98
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.5	8/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	42.3	1-7/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	41.4	1-7/98
Current account, USD billion			10.7	10.0	11.6	2.9	-1.5	1-3/98

Sources: Goskomstat, CBR

Economic policy lines slowly take shape

After a majority of Duma representatives twice opposed the nomination of Viktor Chernomyrdin as Russia's prime minister, compromise was found through the appointment of ex-foreign minister Yevgeny Primakov to lead the new government. The formation of a new government and preparation of a plan to deal with the economic crisis have both moved ahead slowly, however.

Initially three groups were delegated to prepare the government's economic program. The group lead by the communist first deputy prime minister Yuri Maslyukov has been dealing with identifying the strategic questions for 1998-99. This group includes leading economists from the Russian Academy of Sciences (i.e. Abalkin, Petrakov and Lvov) who have published their own program to reform the Russian economy. According to the preliminary information, the program would restrict capital flight, tighten foreign currency controls and implement a more tightly regulated banking system. Domestic industries would also get greater government support. A crucial assumption of the plan is that the effects of printing money to finance these measures can be kept under control.

Up his resignation, former first deputy prime minister Anatoli Shokhin briefly led a second group seeking concrete proposals on ways to extricate Russia from its current crisis. The third group headed by prime minister Primakov has no stated mission. It is assumed that at least the work of first two groups must be integrated into a comprehensive program.

CBR chairman Viktor Geraschenko has also drawn up his own anti-crisis program, highlighting the role of the CBR in the current struggle. Russia's leading central banker calls for printing roubles in limited amounts and increasing state regulation in the banking sphere and currency markets. The program has much in common with the ideas of Maslyukov's team.

None of the schemes under consideration appear to comprise coherent economic programmes. In particular, they lack a coherent macroeconomic framework and explicit targets for economic policy.

Tax revenues in critical stage

Russia's budget revenues have fallen dramatically. Tax revenues have dropped from about RUB 18 billion in July to RUB 11 billion in August. Tax revenues could amount to less than half of budgeted RUB 24 billion for September and only 30% of what is needed to cover the month's expenditures.

Preliminary information from Minfin shows that both revenues and expenditures in January-August were less than half of those budgeted for the whole year. The crisis has evidently deteriorated the weak revenue position even further. It has paralyzed the banking system and slowed the payment of taxes as the system of tax collection in Russia relies largely on banks. Rising inflation has increased state expenditures faster than revenues. Russian regions and enterprises are also increasingly less inclined to pay taxes to the federal centre. Even the state's main taxpayer, Gazprom, has not paid its taxes according to an agreement made with Kiriyenko government and is planning to cut tax payments even more.

Privatization revenues have also fallen as many of the planned privatization sales have been cancelled. For the period January-August, privatization revenues were a meagre 16% of those budgeted for the whole year.

It also appears that the draft program of Maslyukov's team mentions few concrete proposals to tackle the problem of diminishing tax revenues. According to preliminary information, the program suggests that VAT should be cut from 20% to 15%, that incomes should be taxed at two rates (15% and 30%) and that profits should be taxed at 30%.

State makes headway in paying down arrears

Wage and pension arrears have grown steadily this year. According to Goskomstat, total wage arrears in the beginning of 1998 stood at RUB 53 billion. By September, they had risen to RUB 84 billion. Pension arrears began to accumulate this year after pensions were raised twice in the end of 1997 and again in February 1998.

At the beginning of October about RUB 2 billion was paid to the army and coal industry. Arrears owed to students are also reportedly paid off. Apparently, this has been accomplished by increasing money emission.

The draft economic program of Maslyukov's group suggests that all state wage and pension arrears will be paid by the turn of the year and no new arrears will be allowed. According to the program, the government would index wages, pensions and other welfare benefits to inflation from the beginning of next year.

Table 1. Wage and pension arrears (as of 1 Sept -98)

	Total	Of which govt share	Of which govt share
	RUB bln	RUB bln	%
Wage arrears	**84.0**	**18.6**	**22.1**
* to industry and agriculture	63.9	3.1	4.9
* to social spheres	20.1	15.6	77.6
Pension fund arrears	**23.8**	**10.0**	**42.0**

Sources: Goskomstat, State pension fund
Notes: Goskomstat data for wage arrears do not include arrears to the military. The government share includes local and federal wage arrears. In the case of pension arrears, the government share indicates federal arrears only.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998/1-6	1998
Federal government							budget law
- revenues	14.5	14.1	13.7	12.5	12.1	10.8	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	14.7	17.6
- balance	-6.5	-11.4	-5.4	-7.9	-6.5	-3.9	-4.7

* Figures for 1993 – 1997 exclude interest payments on short-term government debt
Sources: Goskomstat, IMF, Minfin. Figures for 1993-94 are not fully comparable with others.

Inflation back in headlines

Inflation has been a good indicator of Russia's economic policy stance throughout the 1990s (see figure below). Monthly inflation figures readily reflect crisis periods and turnarounds in policymaking. However, tight monetary and exchange rate policies after 1995 brought inflation down to such low levels that most economists lost interest in the policy indicator aspects of monthly inflation.

However, with the events of mid-August, attention has become again riveted on monthly inflation as an indicator of Russian developments.

In August, monthly inflation picked up to 15% and annual inflation to 23%. This contrasts sharply to the 12-month inflation rate of 6% in July. Moreover, in the first three weeks of September, consumer prices rocketed 45%. This accounts already to 77% 12-month inflation.

Rouble stays volatile

In September, the value of the rouble seesawed between 8 and 21 roubles per dollar. In the last two weeks of the month, the exchange rate was relatively stable floating around 16 roubles per dollar (see the figure below). There were several indications that the central bank has been exerting a strong direct influence on the currency markets. There was an unexpected strengthening of the rouble just before the rouble forward contracts of the Russian banks fell due in mid-September and an immediate collapse thereafter. The central bank also restricted or halted trade in the MICEX on several occasions. Moreover, from 6 October, trading on the MICEX will be split into separate sessions for different actors to give the authorities better control over the foreign exchange market.

CBR calls for more money and more regulation

Without a well-functioning government and a coherent economic program, there seems to be little basis for sound monetary policy to manage price developments and the banking crisis. On the other hand, this blurry situation seems to give more room for the central bank's own moves. On 24 September, Russia's central bank chairman Viktor Geraschenko outlined his plans out of current crisis.

The plans by the central bank rely heavily on increase of state control in the financial system and printing money as a means to pay off government debt and revive the ailing banking sector. In particular, currency controls should be tightened to ensure that new money related to budget financing and banks' liquidity are not used to buy foreign currencies, which would threaten the rouble. Moreover, the central bank is ready to increase its role in controlling the economy by getting stakes in the major banks and through its credit policies.

In the short-run, there seems to be no alternative for the government to stick with its promises and pay off pension and wage arrears, as well as revive the necessary payment system, than printing money. The problem is, however, that Russia presently has no credible framework or economic program to deal with its fiscal and monetary policy problems. The measures proposed by the central bank do not constitute such a framework. Consequently, there is a danger that measures and policies aimed to be temporary will turn to be an inescapable practice.

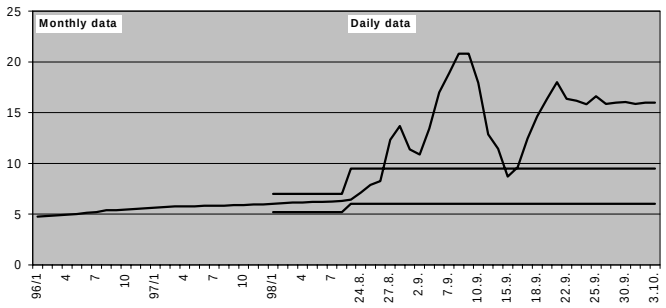
Russia defaults on external debt

At the end of September, Russian government defaulted on USD 400-600 million in interest payments on its restructured Soviet-era debt.

As of 30 September, details concerning the earlier announced forced restructuring of Russia's rouble-denominated GKO and OFZ debt were not yet available. Due to the fall of the rouble, the nominal value of the debt held be investors had decreased from USD 46 billion in mid-August to less than USD 20 billion at the end of September. A quarter of this short-term state debt is held by foreigners.

Monthly inflation in Russia, Feb. 1992 to Sept. 1998 (3rd week)

Rouble/dollar exchange rate



Monetary indicators

	1993	1994	1995	1996	1997	1998 latest	As of
Inflation, 12-month, %	842	224	131	22	11.0	77.0	e 9/98
M2, year-to-year growth, %		217	113	33	31.5	-1.2	7/98
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1122	7/98
Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	135.3	8/98
- deposit rate, %			102	55	16.4	26.1	8/98
- lending rate, %			320	147	46.2	51.5	7/98
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	8.2	25.9.98
RUB/USD, end of period	1247	3550	4640	5560	5960	16.06	9/98

Sources: Goskomstat, CBR

Russia's trade policy searches for direction

by Matti Anttonen*

The reforms of the past years have opened the Russian economy in a unprecedented way. Liberalization of foreign trade was one of the first moves of the reformers. Consequently, the ratio of exports to GDP has risen to around 20%.

In the Soviet Union, exports and imports were planned by Gosplan and the actual trade was carried out by specialised state owned foreign trade firms. Customs duties had no role in influencing trade flows. There was no need for a trade policy.

In the new circumstances this could not continue. A customs tariff was introduced and a customs service created. The customs service presently collects a substantial share of government income (customs duties and VAT on imports). Formulating a trade policy has been more difficult as the role of foreign trade has changed. There is no consensus of Russia's role in international division of labour and inconsistency in Russia's industrial and agricultural policies.

Problems related to the structure of Russia's trade

Although the recent decline of trade surplus is partly explained by increased imports, the main cause for the growing imbalance is due to declining export prices. Russia is a major exporter of energy and semifinished goods (e.g. metals and chemicals) prone to rapid and unpredictable price fluctuations. In spite of rouble's devaluation, the structure of exports will remain the same for the near future. The picture on the import side is more blurred. It is extremely difficult to assess how much domestic production can compensate for imports. The present halt of trade is mostly a consequence of disruption in banking system and we have to wait for some time before any reliable assessments can be made of more permanent changes of volumes and structure of imports.

Due to its structure, Russian exports face generally low tariff barriers. Thus, Russian trade policy has concentrated on anti-dumping measures aimed at Russian producers. The price competitiveness of Russian exports will be considerably increased by the devaluation of the rouble, making it even more difficult to assess production costs. Capital costs are already impossible to calculate as the owners of most firms acquired their firms free of charge or at a minimal price.

WTO membership before EU-Russia free trade

In principle, WTO membership is the number-one goal of Russian trade policy. In practice, things have moved slowly. While the accession working party held its first meeting in summer 1995, Russia only submitted its tariff offer on goods in spring 1998. The services offer was promised for this autumn. The tariff negotiations proper have hardly started. As Russia would like to keep its tariff protection on a high level, the negotiations will likely take time. In order for the negotiations to proceed, Russia needs a credible positions covering industry, agriculture and services. The negotiating partners must understand the reasoning behind Russian requests. This is impossible without credible policies.

The European Union is by far the most important trade partner of Russia. It accounts for around 40% of Russia's foreign trade. This figure will climb to over 50% after enlargement. Indeed, enlargement will be highly beneficial specifically to Russia as it means that the acceding countries must lower their tariffs and to abolish quantitative restrictions. The dynamic effects of the enlargement process will also benefit Russia.

EU-Russia trade relations are based on a partnership and cooperation agreement that provides for mutual most-favoured nation treatment (MFN). The agreement sets an EU-Russia free trade agreement as one of its goals. However, it is not feasible to think about a free-trade area before Russia has been accepted into the WTO. When taking into account the apparent unwillingness of Russia to lower its tariff protection in WTO negotiations, it is clear that it will take a long time before European goods will be imported into Russia without import duties.

Fiscal goals vs. trade policy goals

Foreign trade is the financial lifeline of Russia's state budget. The exporting energy and other giants and the importers of consumer goods answer for a substantial share of state finances. In the discussions with international financial institutions, questions concerning foreign trade have had a central role. The export duties were abolished two years ago. This year a 3% import surcharge was introduced. The international community well understands that Russia has to finance its state budget. It further understands that Russia needs to do it in a non-discriminatory way with minimum damage to Russia's trade relations with outside world.

So far the new government has said very little about its foreign trade policy. It is clear that the outside world hopes that the policies aiming at Russia's full integration into the world economy will be continued.

** Director, Unit for Russia, Ministry for Foreign Affairs, Finland.*

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

Editor-in-Chief Jouko Rautava

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RUSSIAN ECONOMY
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Economic Developments

Fall in output accelerates

Russia experienced its largest decline in output since 1994 in September. GDP shrank 9.9% and industrial output 14.5% compared to September 1997. In the period January-September, GDP fell 3% and industrial output 3.9% compared to the same period last year. Output has been falling in almost all sectors of industry. The biggest declines in the first nine months of the year were registered in chemicals and petrochemicals, iron and steel production, and engineering and metal processing. Declines in all these sectors exceeded 6%.

The outlook for agriculture is even more worrying. Agricultural production in January-September fell 9.4% compared to the same period in 1997. At end-September the grain harvest amounted to only 47 million tons – 47% less than a year ago.

Financial crisis drives people below poverty line

In September, the number of people living below the "subsistence minimum" lurched to 44 million – over 30% of the population. The number in August was 22%.

In the first nine months of this year, real incomes dropped 12.4% compared to the same period in 1997. In September, the average per capita income was RUB 940 (USD 56).

Foreign trade down

Goskomstat reports that Russia's foreign trade turnover in the first eight months of the year was down 6% compared to the same period in 1997. The foreign trade surplus for January-August was USD 1.2 billion. During the same period in 1997, Russia's trade surplus was still USD 10.7 billion. In January-August 1998, the value of exports fell 13.9% while the value of imports increased 3.7% compared to the same period a year ago. The consequences of mid-August events can now be seen in trade statistics. The State Customs Committee's figures show the volume of imports falling 45% in September from the August level.

Production sharing regains popularity

Politicians and oil companies are showing renewed interest in production sharing as a means to attract foreign investment. In the first half of 1998, foreign direct investments (FDI) in Russia amounted to only USD 1.5 billion, or 46% less than in the first six months of 1997. In the wake of recent events, a pick up in FDI seems unlikely. Thus, production sharing agreements (PSAs), that is contracts between the government and investors, are seen as workable answer. Investors get the right to develop natural resources, and the contract determines how production will be shared between the government and the investors beforehand. Presently, there are only three production sharing agreements in force: Sakhalin oilfields 1 and 2 and Kharyaginsk oilfield. These resources represent only 1.4% of Russia's known oil reserves. While controversy has surrounded the production sharing discussion for years, traditional opponents may be warming to the idea. In October, the Duma received three draft laws concerning production sharing designed to clarify existing legislation. If the amendments are accepted, new production sharing legislation could be passed before the end of this year.

Revised GDP and inflation forecasts

The current financial crisis has led to substantial revision of GDP forecasts for 1998–99. For example, the September issue of the IMF's *World Economic Outlook* revises the forecast for Russia downwards by 7 percentage points from the figure given in the May issue. The 1999 forecast was lowered by 7.9 percentage points. The present GDP forecast is 6% contraction for both 1998 and 1999. Russia's Economy Ministry forecasts a 5% decline in GDP for 1998, which is also 7 percentage points less than originally projected in this year's budget. Annual inflation estimates range from the *World Economic Outlook*'s 48% to the Economy Ministry's 100% and Finance Ministry's 110 – 130%.

Russian GDP forecasts, 1998 – 99

	1998	1999
EIU (Sept. 98)	-4.0	-7.0
PlanEcon (Aug. 98)	-2.5	-4.0
Russian Economy Ministry (Sept. 98)	-5.0	-
World Economic Outlook (Sept. 98)	-6.0	-6.0

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-3.0	1-9/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-3.9	1-9/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.8	1-9/98
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.5	9/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	48.2	1-8/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	47.0	1-8/98
Current account, USD billion			10.7	10.0	11.6	2.9	-6.0	1-6/98

Sources: Goskomstat, CBR

Draft of long-awaited economic program published

Two months since the nomination of Yevgeny Primakov as prime minister, the new government finally came up with a draft economic program. The slowness in compiling the program was widely interpreted to indicate disunity among government members and unwillingness to compromise. If so, the future work of the government may prove difficult.

The draft program seeks to strengthen the regulatory role of the state, and concentrates on restructuring the banking sector, supporting domestic enterprises, defending the rouble, revising the tax system and easing the import of essential goods (see Table 1). The suggested measures would be implemented by mid-1999.

Still no coherent plan to cover the budget deficit

The original projections for September tax revenues proved overly optimistic – actual revenues were a mere RUB 9.3 billion, and down from RUB 11 billion in August. The state tax service estimates that October tax revenues will rise to RUB 11-13 billion. The actual result will greatly depend on the willingness of the state's main taxpayer, Gazprom, to stick to its agreement to pay some RUB 8 billion by the end of the year. More than RUB 2 billion fell due in October. Similar agreements have been made with other major taxpayer firms.

Privatization revenues also continue to fall short of 1998 goals. Of the budgeted revenues for January-September 1998 of almost RUB 12 billion, only RUB 1.4 billion were realized (11% of target). This was due mostly to cancelled privatization sales of Rosneft and Svyazinvest. Hopes remain that at least 5% of Gazprom shares could be sold during this year.

Preliminary Minfin information shows that in January-September the federal budget deficit amounted to 3.1% of GDP, which is actually lower than in the first half of 1998 (3.9% of GDP). However, the deficit accounted for a quarter of budget expenditures and was almost totally covered by foreign sources.

The "agreed in principle" emergency budget for the fourth quarter of 1998 foresees a budget deficit of RUB 65-75 billion. Together with the deficit from the three first quarters, this would mean a deficit of 4.7-5.1% of GDP (under the Minfin definition) for the 1998 provided that GDP remains at the 1997 level for the rest of the year.

The government has not announced a coherent plan to cover the deficit. The draft economic program includes few measures that could – at least in the short term – increase state revenues. The program limits the money issuance to maximum RUB 60 billion, or an over 30% increase in the monetary base. There are also plans to use about USD 3 billion (RUB 51 billion) of CBR reserves to service Russia's external debt this year. Some funds are anticipated to come from increased state control of the production and distribution of alcohol, from improving the management of state property and from fighting corruption. While the IMF loan tranche would help cover the deficit, initial comments from the IMF on the government's proposed draft were critical, making the release of a tranche this year highly unlikely.

Table 1. Main measures of the government anti-crisis program draft

1. Taxes
* Lower profit tax from 35% to 30% (19–22 % to regions)
* Eliminate profit tax on profits reinvested in industry
* Set property tax at 0.5% of property's market value
* Higher penalties for tax violations
* Reduce VAT gradually

2. State debt
* Restructure frozen T-bills and resume secondary trading
* Establish a unified system to monitor and manage Russia's state debt

3. Rouble, banks
* Float the rouble with short-term fluctuations governed by interest rates and the money supply
* Allow the CBR to introduce temporary compulsory reserve requirements for commercial banks in the event of speculative attack
* Introduce administrative measures against banks launching speculative attacks on rouble
* Restructure commercial banks with introduction of strict controls on hard currency operations
* CBR credits to banks with realistic programmes for restoring operations
* Rescind licenses of under-capitalized banks (capital less than 1 million ecus) and non-bank credit institutions (less than 100,000 ecus) from the start of 2001

4. Foreign trade
* Eliminate additional 3% import duty on essential goods
* Reduce import duties on seven groups of essential goods
* Raise obligatory hard currency sales by exporters from 50% to 75%
* Shorten hard currency repatriation period for certain sectors

5. Support to domestic producers
* Reduce tax burden of enterprises
* Create state agency for insuring and guaranteeing credits for investments in the real sector. In particular, manufacturers of essential goods would receive support.
* Create a state development bank to fund real sector projects
* Cut rail freight tariffs for essential goods by 50%

6. Wages, pensions, social security
* Guarantee full payment of current wages and pensions and continue paying back arrears from October
* Set tax on second income at 20%
* Alleviate shortages of medicines and food
* Introduce price controls or freeze cost of certain services such as utilities and heating at least until January 1999

Sources: Kommersant daily, Reuters 27 October 98
Note: Headings used in table are not included in the program

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998/1-9**	1998 budget law
Federal government							
- revenues	14.5	14.1	13.7	12.5	12.1	10.2	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	13.3	17.6
- balance	-6.5	-11.4	-5.4	-7.9	-6.5	-3.1	-4.7

* Figures for 1993 – 1997 exclude interest payments on short-term government debt
** Preliminary Minfin information
Sources: Goskomstat, IMF, Minfin. Figures for 1993-94 are not fully comparable with others.

Situation stabilizes

Both the rise of consumer prices and the value of the rouble stabilized somewhat in October. During the first two weeks in October, consumer prices rose only 0.8%.

Price stability, in turn, reflects a relatively stable rouble. While the exchange rate fluctuated between 8–21 roubles to the dollar in September, the rate settled down to around 15–17 roubles to the dollar in October. The rouble strengthened temporarily in mid-month with the expiry of dollar-denominated forward contracts of Russian commercial banks.

The money supply continues to grow. The monetary base (which includes cash in circulation and commercial banks' deposits at the central bank) has increased 13% during the year, a modest increase in comparison to early prognoses on the impact of the crisis. No information concerning broader money, M2, has been released since the beginning of August.

The future exchange rate will depend on what happens to the money supply. Printing money will probably cover a substantial part of the deficit in the emergency budget.

Regulated foreign exchange market

As of October 6, foreign exchange trading has been organized into two separate sessions at the Moscow currency exchange (MICEX). CBR chairman, Viktor Geraschenko, however, has indicated that the two-session approach may be ending soon.

Under the CBR's rules, the morning session is where exporters are required to sell 50% of their hard currency earnings. Only the central bank and banks with contracts from importers are allowed to buy currency in the morning trade. In the afternoon, banks may conduct their usual interbank trade. The official central bank rouble rate is based on trading in the morning session.

The system enables the central bank to strengthen the rouble artificially. With restricted participation to buy currency, the rouble should stay firmer in the morning session. At the outset, this was indeed the case. However, by the end of the month, the difference has almost completely vanished. Apparently, the banks discovered ways to get around CBR rules and participate in both sessions.

The government's draft economic program comprises further regulatory measures such as raising the obligatory sales of hard currency earnings by exporters to 75% and imposing temporary reserve requirements during speculative attacks. In principle, though, the rouble would be allowed to float.

The government's attempts to regulate the forex market are telling. One main reason the two-session system is likely to be abandoned is the ability of the banks to circumvent the regulations. Future attempts to impose regulatory measures on markets could very well suffer from similar problems.

Bank sector restructuring

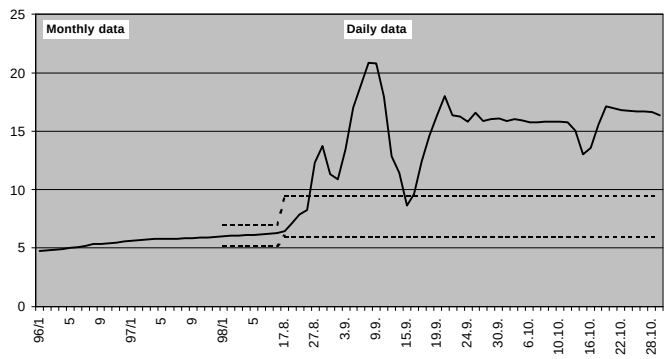
In October, the CBR submitted its bank-restructuring program to the State Duma. It comprises measures to liquidate a fifth of Russia's 1,550 banks and considerably increase of central bank's power over banks.

The plan divides banks into four classes. The first consists of stable banks that do not need significant amounts of extra finance. The central bank aims to support their liquidity but may impose temporary restrictions on them. The second group comprises liquid, mainly regional banks, in which the central bank intends to acquire stakes. The third group includes 14 banks that are illiquid but too big to fail, that is, the threat that closing their doors might set off a general run on banks is too great. These banks require individual restructuring. The fourth group consists of small unprofitable banks slated for liquidation.

The draft economic program also proposes establishing a state development bank to boost domestic industry. The extent to which public deposits will be guaranteed is unclear.

Analysts worry that the restructuring program is too vague on the conditions that govern which banks get bailed out. In any case, Russia's inefficient banking sector must consolidate further to serve the financial needs of the economy.

Rouble/dollar exchange rate



Monetary indicators

	1993	1994	1995	1996	1997	1998 latest	As of
Inflation, 12-month, %	842	224	131	22	11.0	52.2	9/98
M2, year-to-year growth, %		217	113	33	31.5	-8.5	8/98
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1077	8/98
Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	n.a.	8/98
- deposit rate, %			102	55	16.4	16.1	7/98
- lending rate, %			320	147	46.2	52.3	7/98
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	8.8	9/98
RUB/USD, end of period	1247	3550	4640	5560	5960	16.33	10/98

Sources: Goskomstat, CBR

The effects of corruption on economic policy

by Jukka Pirttilä*

Recent weeks have witnessed a flourish of suggestions for economic policy in Russia. If there is a common feature among them, it probably is a trend towards a larger role for government in economic policy through regulation. Those suggesting such measures include well-known economists (Abalkin, Lvov et al) from the Russian Academy of Science.

Despite the lively dispute over the virtues of various programs, the ability of authorities to implement the policies has received little attention. Yet there are good reasons to believe that precisely the implementation of such programs is decisive for their success. The old wisdom in welfare economics tells us that if a market failure exists (as in Russia presently due to the market shakeout), there is a potential role for the government to correct such failure. But only potential, when the government failure is more serious than the market failure itself. Certainly one of the most serious sources of a failure in Russian government policy today is corruption. Thus, it is worth considering what are its consequences, if any, on anti-crisis policies.

Why is corruption so widespread?

As other countries of the former Soviet Union, Russia suffers from endemic corruption. For example, Russia's score in a regional corruption study conducted by the UK-based Economist Intelligence Unit was 4, the highest possible corruption rating. Transparency International, a NGO that aims to reduce corruption, also gives Russia a score of 2 on a scale from 0 (most corrupt) to 10 (least corrupt). While corruption is admittedly difficult to measure, it is hard to infer from such figures that Russia is corruption-free.

The EBRD 1997 Transition Report points out that corruption in CIS states is partly a response by firms to hedge against unpredictable and discretionary government policy. If rules and regulations are too complicated and open to interpretation, enterprises can seek to avoid difficulties with regulation by bribing the authorities.

Empirical evidence corroborates that heavy bureaucracy creates a demand for corruption. For example, Frye and Shleifer (1997, American Economic Review) show that Moscow-based small enterprises encounter considerably more bureaucracy from their local government than similar firms in Warsaw, Poland.

Moreover, there is supply side corruption. Low public sector wages encourage officials to seek additional income from offering services to willing bribers.

Finally, cultural factors may explain certain corruption behaviour in Russia. An IMF working paper by Vito Tanzi (1994) argues that corruption is more likely to occur in countries where personal relations are important in doing business. It appears that the socialist era, when enterprises used parallel markets through their networks to overcome shortcomings of the planned economy, still influences how transactions are handled in post-communist economies.

Empirical evidence from cross-country studies (e.g. Tanzi, 1998, IMF Working Paper) confirms the intuition that corruption is harmful for economic growth. It encourages rent seeking, as opposed to socially beneficial behaviour, and reduces investments. It also increases poverty and inequality by its detrimental impact on the effectiveness of social policy. Indeed, the mere threat of corruption requires that institutions must employ safeguards to deter it. Such measures often impair the ability of public administrators to carry out their primary duties.

Any economic policy must suffer

It is not plausible that any economic policy, and its implementation, would be immune to the severe consequences of corruption. Indeed, it has been a popular practice to point out several instances of rent seeking and corruption in the liberalization policies in Russia in 1990s. Prominent examples are the accusations regarding the Russian privatization program. Market-oriented reforms have therefore suffered from the illness of corruption. Some even regard corruption as one of the underpinnings of the current economic crisis in Russia.

The presently proposed anti-crisis programs calling for a return to greater regulation are even more exposed to corruption than liberal programs. Some of the contents of these programs coincide with factors that promote corruption. Thus, regulation of the foreign exchange market or a discretionary bank bailout program can create fertile conditions for corruption. A key question emerges: Can regulation in Russia work well enough to offset, and hopefully outweigh, the probable costs of corruption? The above discussion suggests that, in any case, corruption is such a widespread phenomenon in Russia that it should not be ignored in policy analysis.

Experiences from various other countries such as Portugal and Singapore suggest that it is possible to cut corruption drastically by reducing the state's powers to intervene in the economy. Such a reduction would deliver a win-win outcome for both consumers and producers in Russia. More to the point, it would improve the efficacy of any economic policy, even the regulatory aspects.

**The author is an economist at BOFIT.*

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

Editor-in-Chief Jouko Rautava

BANK OF FINLAND
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RUSSIAN ECONOMY
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Economic Developments

No stabilization in the real sector

According to Goskomstat, Russia's industrial output fell 11.1% in October from the same month in 1997. Thus, industrial output has fallen over 10% in three successive months. In January-October industrial production was down by 4.6% from the same period last year. Output has been declining in almost all sectors of industry. The worst drop was registered in light industry, where output fell 30%.

Starting from September, Goskomstat publishes only quarterly reports on GDP. In the first three quarters (January-September), Russian GDP was down by 3.0%.

Real incomes hit hard

In October, the real money income of the Russian population dropped by 27% compared to October 1997, although it was up by 7% from September. For January-October, real money income was down by 14% from the same period last year. Real monetary income includes post-tax income adjusted to inflation.

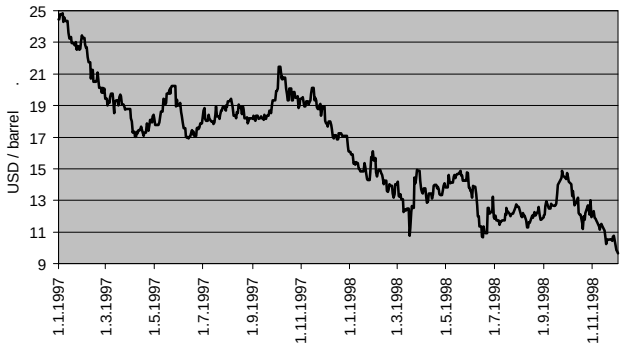
The average wage in October was 1065 roubles a month. So, in dollar terms the average wage is about 70 dollars a month, down from 170 dollars before the August crisis.

Oil export volumes up, revenues down

Russia's September exports amounted to USD 5.7 billion, 17% below September 1997. Imports to Russia were valued at USD 3.0 billion, a decline of 48% from the same month a year ago. Thus, the September trade surplus came to USD 2.7 billion, making the total surplus so far this year USD 4.0 billion. The current account deficit for the first half of 1998 amounted to USD 6 billion (see table).

In January-September, the volume of oil exports was 102 million tonnes, which is 8% more than a year ago. However, receipts from oil exports dropped by 27% to USD 8.1 billion. In the late October and beginning of December the price of crude oil (Brent) hit a record low of less than USD 10 a barrel (see figure). Although Russia's more sulphurous Urals blend trades currently at about 60 cents a barrel less than Brent, Russian exporters remained eager to export every drop possible as the rouble devaluation pulled the average domestic price down to some USD 3 a barrel. Moreover, in domestic markets oil companies get cash payments for only about 25% of crude oil sales.

Price of crude oil (Brent) in 1997 – 98



Russia's balance of payments in 1996-98H1, USD billion

	1996	1997	1998 1-6
Current account	**12.1**	**3.3**	**-6.0**
Trade balance	23.1	17.6	2.2
Exports, f.o.b.	90.6	88.9	36.5
Imports, c.i.f.	-67.5	-71.3	-34.4
Services	-5.9	-5.2	-2.5
Exports	13.0	13.9	6.1
Imports	-18.8	-19.1	-8.7
Investment income	-4.9	-8.2	-4.9
Received	4.2	4.0	3.2
Paid	-9.2	-12.2	-8.1
Other items, net	-0.2	-0.3	-0.2
Capital and financial account	**-6.5**	**5.7**	**7.0**
Capital Account	-0.5	-0.8	-0.3
Received	3.1	2.1	0.8
Paid	-3.5	-2.9	-1.2
Financial account	-3.2	4.5	8.9
Direct investment in Russia	2.5	6.2	1.1
Portfolio investment in Russia	9.9	45.6	8.0
Other items, net	-15.6	-47.3	-0.2
Net errors and omissions*	**-8.4**	**-7.1**	**-2.7**
Change in reserves	**2.8**	**-1.9**	**1.7**
('-' growth, '+' decline)			

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-3.0	1-9/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-4.6	1-10/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-5.1	1-10/98
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.6	10/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	54.0	1-9/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	50.0	1-9/98
Current account, USD billion			10.7	10.0	11.6	2.9	-6.0	1-6/98

Sources: Goskomstat, CBR

No clarification in economic policies

The economic program submitted by the government and the CBR was approved and published in mid-November. The final version of the program closely matched draft versions leaked to the press earlier, and contained the main features previously criticised by outside experts. Rather than being a comprehensive program, it is essentially a list of aims and wishes. The program is divided into four parts: protecting living standards of the population, stabilising the monetary system and restructuring the banking sector, improving the tax system and enhancing foreign direct investment. It also calls for a clearer division of power among federal, regional, and local authorities.

Besides lacking coherence, the program is short of details on how its stated goals would be reached. Further, the aims often contradict each other. Measures are proposed that would bring about a considerable increase in budgetary spending without indicating where the necessary funds would come from. For example, starting October 1998 pensions and state sector salaries would be paid on time and accrued arrears would be paid off by the end of 1999. Further, budget sector salaries would be gradually indexed and the poorest segment of population would receive compensation for price increases. The state would support selected producers; certain troubled banks would receive stabilisation credits; and a system will be formed to offer credits and guarantees for Russian exporters. Certain measures in the program increase state revenue in the short run, while others, such as tax cuts, would reduce it. The program also permits offsetting of debts with food products in the case of food companies. Such measures fuel the use of barter in the enterprise sphere and limit possibilities for collecting taxes in cash.

The program calls for several extensive reforms to improve the functioning of markets, including effective control over monopolies, enhanced banking supervision and tax administration, and improved customs control. All these measures are long overdue, but it is doubtful whether the Russian state is in any better position at this stage than previously to carry them out.

No improvement in fiscal situation

The deficit of the federal budget continues to grow as tax collection remains poor. Russian companies are highly adept at finding ways to evade taxes. In one recently revealed scheme, firms took advantage of tax rules set for "closed administrative-territorial formations." These special zones may contain, e.g. military bases or nuclear power complexes, so they have been granted special tax advantages to create jobs. Many firms registered in such zones, however, are registered solely for the benefits. They are actually sited elsewhere.

Given the current circumstances, the IMF has been unwilling to approve disbursement of further tranches of the loan it granted to Russia last summer. No further foreign financing is expected during this year. Moreover, the CBR is reportedly unwilling to buy state bonds at the full amount as proposed by the Ministry of Finance. Thus, Russia's only way out of this impasse appears to be further expenditure cutting. Due to the already difficult situation, pension arrears, which amount to RUB 35 billion presently, will not be paid by the previously announced deadline of 1 January 1999. Governmental sources now say they will be paid by 1st July 1999. The government did pay, however, pensions and budget sector wages for November on time.

The 1999 budget still open

The budget law for 1999 should be presented to the State Duma sometime in December. The Ministry of Finance assumes the average exchange rate in 1999 will be 21.5 roubles to the dollar and inflation at year's end to be at 30%. Further, it assumes the deficit would amount to RUB 105 billion, or 2.75% of GDP. Over half the deficit (RUB 55 billion) would be covered by foreign financing, i.e. borrowing and debt rescheduling.

However, as a number of crucial factors remain unresolved such as decisions on 1999 tax rates (profit tax and VAT) and the debt rescheduling negotiations with the Paris and London clubs, the final outcome is unclear. Moreover, any strong reliance on the availability of foreign financing in current circumstances appears to be unrealistic.

Tax cuts proposed

At the end of November, the government reached agreement on a renewed tax system and new tax rates to be applied from the start of 1999. The general idea behind the reform is to ease the tax burden of producers, stimulate production, and increase payment discipline. Under the decision, VAT will be cut from 20% to 14% in 1999 and further to 10% in 2000. Enterprise profit tax will be lowered from 35 to 30% and payments to social funds from 39 to 32% as of January 1999. The government would like to see these amendments to be approved by the State Duma in December. According to governmental sources, as a result of these changes, tax revenue could fall somewhat during the first quarter of 1999, but would pick up later on. Some fear that tax revenue could be reduced over in longer term as well. A crucial question is how to improve tax discipline.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998/1-9**	1998
Federal government							budget law
- revenues	14.5	14.1	13.7	12.5	12.1	9.7	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	14.1	17.6
- balance	-6.5	-11.4	-5.4	-7.9	-6.5	-4.4	-4.7

* Figures for 1993 – 1997 exclude interest payments on short-term government debt

** Preliminary Minfin information

Sources: Goskomstat, IMF, Minfin. Figures for 1993-94 are not fully comparable with others.

Rouble slide continues

There were no major changes concerning consumer price developments. In November, consumer prices went up 5.7%, making 12-month inflation 67%. October inflation was 4.5%.

After strengthening briefly, the rouble started to weaken in the first part of November. The rouble ended October at 16.33 roubles to the dollar; in early December it was approaching a rate of 20 to the dollar.

The stock market recovered somewhat as the RTS index rose from under 50 at the beginning of November to around 70 at the beginning of December. Daily trading volumes have still been less than 7% of the pre-crisis daily average of USD 50-60 million.

Moratorium end reveals payment problems

The 90-day debt repayment moratorium announced by the Russian government in mid-August expired in the mid-November. The moratorium mainly affected western commercial banks that had loaned USD 2.5 billion to Russia, as well as at least USD 6 billion in rouble/dollar forward contracts. Although Sberbank reported that it has fully repaid on time a USD 225 million one-year syndicated credit, due December 1, most of banks apparently were in talks with their foreign partners on debt restructuring. Many banks have since announced that have they reached rescheduling agreements.

Further debt negotiations in the pipeline

On November 25, the Russian authorities and the London Club agreed on rescheduling the December's payment, which is worth of USD 724 million. Nevertheless, further defaults and/or restructuring deals are expected.

Russian authorities told London Club and Paris Club creditors that Russia would be unable to meet its debt servicing obligations in full next year. Of scheduled payments worth some USD 17.5 billion, Russia said it could pay less than USD 10 billion. Russia is due to pay Paris Club lenders USD 6.1 billion and London Club lenders USD 1.1 billion. Russia inherited from the Soviet Union about USD 40 billion in sovereign debt, as well as USD 33 billion in commercial debt, which it has arranged to repay the two creditor clubs over the next 25 years.

At the moment, Russia's Soviet-era debt paper is trading at around seven cents on the dollar. Russia's country ranking by *Euromoney* dropped from 78 in December 1997 to 129 in September 1998.

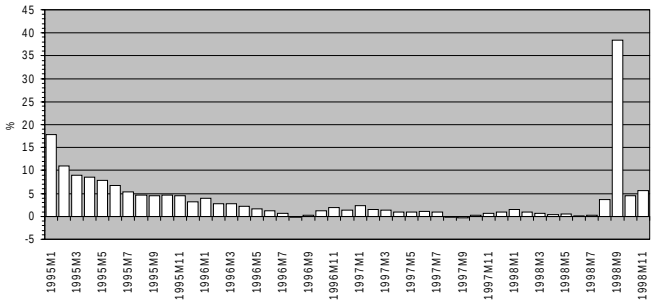
Agreement on GKO/OFZ rescheduling

Talks to restructure rouble-denominated repayments on short-term government paper (GKOs and OFZs) seem to be over for both domestic and foreign investors. According to earlier information, investors would exchange 70% of their nominally valued rouble-denominated paper for four to five-year rouble bonds, which would pay 30% during the first two years. Another 20% of the value of the debt would be paid in zero-coupon bonds. 10% would be paid in cash roubles. According to the plan, both the Russian and foreign investors would be treated equally in the future.

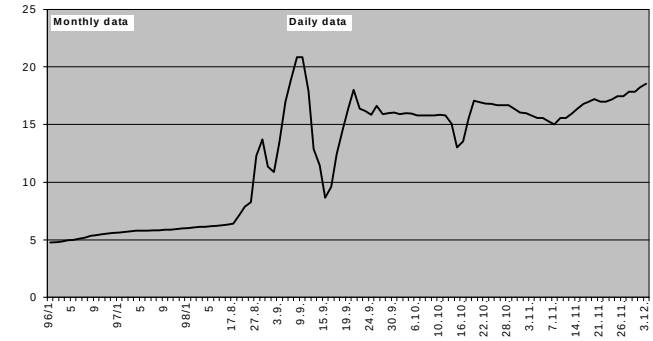
ARCO aims at banking reform

Russia's government and the central bank have founded an Agency for the Restructuring of Credit Organizations (ARCO) to restructure Russia's ailing banks. The duties of the Agency include helping bankrupt insolvent banks, injecting liquidity into salvageable banks, assisting banks in restructuring their debts and improving their assets. ARCO's share capital of RUB 10 billion (USD 550 million) is minuscule considering its vast mandate.

Monthly inflation in Russia, Feb.1992 - Nov.1998



Rouble/dollar exchange rate



Monetary indicators

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Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1065	10/98
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Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	9.7	10/98
RUB/USD, end of period	1247	3550	4640	5560	5960	17.88	11/98

Sources: Goskomstat, CBR

China and Russia – two very different stories

by Tom Nordman*

Russia's dismal economic trends are often compared against China's robust growth. Why has the economic performance of these two major economies in transition been so different? Since reforms were initiated in 1978, the Chinese economy has produced annual growth around 7.5%. The Russian economy, on the other hand, has contracted by some 6.5% per annum since 1992. Various commentators have therefore suggested that Russia should adopt the Chinese reform model. Does this make sense? Would it even be possible?

Some sobering facts

By any measure, China and Russia are very different countries. Despite its recent growth record, China remains a poor agricultural country. Russia is an industrialised country, even if the value of much of its industrial stock may be questionable. But the relative position of the two countries has been changing very fast in recent years. A recent OECD study (*Chinese Economic Performance in the Long Run*, Angus Maddison) contains some interesting comparisons between China and other countries including Russia.

China and Russia:
Comparative Levels of Economic Performance

	1952	1978	1995
	GDP (billion 1990 US dollars)		
China	305.7	935.9	3196.3
USSR/Russia	512.6	1715.2	648.7
	GDP per capita (1990 US dollars)		
China	537	979	2653
USSR/Russia	2928	6565	4383
	Share of World GDP (per cent)		
China	5.2	5.0	10.9
USSR/Russia	8.7	9.2	2.2

China's GNP exceeded the USSR's around 1990. Now China's economy is the second largest in the world, measured at purchasing power parity exchange rates. However, GNP per capita in China is still only slightly more than half of Russia's. Over half of employment in China is still in agriculture, compared with about 15% in Russia, where agriculture was always neglected at the expense of manufacturing. Manufacturing provides employment for only 17% of the Chinese labour force, compared to almost 30% in Russia. However, if GNP per capita in China were to continue growing at, say, 4.5% per annum, China would exceed Russia's 1995 GNP per capita well before the end of the first decade of the next millennium.

Chinese gradualism and Russian collapse

Under the guidance of Deng Xiaoping, China embarked on gradual reform of its economy in 1978. Reforms were begun in agriculture, where collectivisation was scaled back and farmers under the family responsibility system were increasingly free to decide what to grow and at what prices to sell their produce. This policy was highly successful, as agricultural output recovered from the setbacks of the Cultural Revolution. Economic reform got a good name at the outset and is supported by the general public. Subsequently, the emphasis of reforms shifted to industrial production and exports. Liberal economic policies were first pursued in special economic zones, where foreign investors were invited to participate in the process. Successful reforms were then gradually adopted on a countrywide scale. Between 1978 and 1996, the share of state enterprises in industrial output fell from close to 80% to less than 30%. This was not a result of privatisation, but the expansion of new industries owned privately, by local cooperatives or joint ventures. So far, there are no serious disequilibria in China. Investments are financed by private domestic savings, foreign trade is well diversified and in surplus, the fiscal deficit is moderate and inflation is under control. Further down the road, the ability to sustain progress in reform of state-owned enterprises and state banks will be critical.

China enjoys full political commitment to reform. In Russia, reform has always been half-hearted and never accepted by the general public. China never pretended it was an advanced economy, and there has been no hesitation or impediment to borrowing ideas and practices from other countries. In Russia, the old economic model has failed, but there is no agreement on what to put in its place. Large parts of state industry have been privatised under dubious circumstances, but the new owners show little interest in investing in new capacity or even maintaining existing capacity, which remains in pretty much its pre-Russian state. Incentives for new investment are weak or non-existent. For the public at large, economic reform and market economy are tantamount to criminal activity.

Could Russia adopt the Chinese model? Probably not, or at least not without significant modifications. The initial conditions between the two countries differ sharply. China is committed and determined. Russia is much better endowed with natural resources, and its labour force is better educated – but is it motivated?

**The author is a Senior Adviser with BOFIT*

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

Editor-in-Chief Jouko Rautava

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RUSSIAN ECONOMY
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Economic Developments

Real sector output continues to decline

The Russian economy continues to shrink with industrial output falling in November by 9.1% compared to a year ago. Some of the biggest declines were recorded in light industry (-28%), pharmaceuticals (-24%), and printing (-19%). In the period January-November, industrial production declined by 5% from the previous year. During the same period, fixed investments were down 6% according to Goskomstat estimates.

Russia's foreign trade also declined further, with exports decreasing in dollar terms by 16% and imports by 11% in January-October from the previous year. According to information from the fuel ministry, the volume of Russia's oil exports in 1998 was 6% higher that in 1997.

Economic difficulties were reflected in the fact that foreign direct investments fell by almost half from close to USD 4 billion in 1997 to an estimated USD 2 billion in 1998, according to advance information from the economy ministry.

Living standards fall

The situation of Russian consumers has worsened together with the overall decline of the economy. In November 1998, real disposable money income was down by a quarter from November a year before, and from October 1998 it had decreased by almost 4%. Real wages had fallen even more; they were more than a third lower in November than a year earlier.

The number of unemployed in November increased slightly from October to 8.5 million, i.e. 11.7% of workforce.

Production sharing law amended

The law on production sharing adopted in 1995 has been widely criticized as overly restrictive towards foreign investors, and Russia largely failed to attract the investments in its mineral and hydrocarbon extracting sectors as hoped. Now the attitudes in the State Duma towards foreign investment seem to have become more favourable. On 9 December, the Duma approved several amendments to the law.

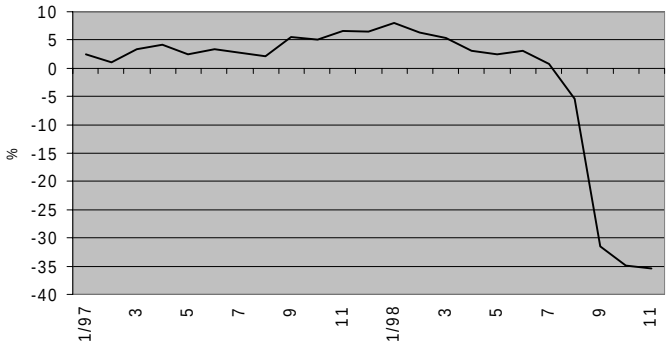
The amended law stipulates that the utilization of small oil fields no longer requires approval by the Duma; approval of federal and local governments is now sufficient. The new law limits the amount of Russia's natural resources that can be exploited under production sharing schemes to 30%. Further, at least 80% of employees and 70% of equipment used in production sharing projects must be Russian.

A set of related legal amendments was adopted by the Duma on 17 December, changing other laws that were in conflict with the renewed production sharing law.

Prime minister Primakov has promised that other improvements in the position of foreign investors in Russia are coming, including amendments to customs and tax legislation. A further measure would be the establishment of a special state-owned insurance agency whose duties would include protecting foreign investments.

A sign in the opposite direction was, however, given by the State Duma on 23 December, when it rejected a new draft of the Land Code which had been prepared taking into account President Yeltsin's recommendations when he vetoed the previous version of the Code. The question at issue is whether or not to allow free sale of agricultural land, which the Duma opposes. The latest rejection of the draft represents yet another delay in a process of preparing land legislation that has already taken several years.

Monthly real wages, 12-month change, %



Economic indicators

	1992	1993	1994	1995	1996	1997	1998	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-3.0	1-9/98
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.0	1-11/98
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.2	1-11/98
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.7	11/98
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	60.0	1-10/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	52.5	1-10/98
Current account, USD billion			10.7	10.0	11.6	2.9	-5.6	1-9/98

Sources: Goskomstat, CBR

1999 budget proposal goes to Duma

The government submitted its long-awaited proposal for the federation budget to the State Duma, which passed the proposal in its first reading on Christmas Eve. The budget envisages spending equal to 575 billion roubles, revenues of 474 billion roubles and a deficit of 101 billion roubles, or 2.5 % of GDP.

The Duma has already shown green light to some of the tax changes contained in the budget proposal. These include a reduction in the VAT rate from 20% to 15%, a profit tax cut from 35% to 30% and a unified flat tax on small businesses.

This year's fiscal plight was partly alleviated by the announced sale of 2.5 % of Gazprom shares to a German gas company, Ruhrgas, for USD 660 million. Next year, the government intends to privatize a further 2.5% stake of the company.

Tough on expenditure side

The following table compares the 1999 budget plan to budget performance in 1998.

The Russian 1999 Budget Plan			
	RUB	USD	% of GDP
Expenditures	575	28	14.4 %
Revenues	474	23	11.9 %
Deficit	101	5	2.5 %
Primary surplus	68	3	1.7 %

The Russian 1998 Budget Law				Estim. '98 Budget	
	RUB	USD	% of GDP	RUB	% of GDP
Expenditures	500	82	17.6 %	418	14.7 %
Revenues	368	60	12.9 %	263	9.3 %
Deficit	132	22	4.7 %	155	5.4 %
Primary surplus	-18	-3	-0.6 %		

Sources: Reuters, Russian Economic Trends. The exchange rate used for 1999 budget plan is 21.5 and for 1998 budget law 6.1 roubles to dollar. Amounts are in billions.

As the table shows, the budget proposal is tough on the expenditure side. Outlays in real terms decrease from the present level, meaning that the budget plan does not fully compensate the public sector for inflation. The plan also includes an ambitious increase in tax revenues from this year's figure. The tax revenue target may be difficult to implement because of the tax cuts and problems in tax collection.

Measured in terms of foreign currency, the federation budget is small (e.g. smaller than the Finnish state budget). The funding needs of the total public sector in Russia are much larger than the federation budget. Indeed, regional budgets and extra-budgetary funds outweigh the size of the federation budget. No information is yet available on 1999 regional budget proposals, but assuming they remain roughly at the present level, the funding needs of the entire public sector would be about 35% of GDP.

Caveats remain

Bearing in mind that one of the main reasons for the Russian financial crisis has been unsustainable public debt accumulation, the toughness of the budget proposal is welcome news. There are, however, a number of serious concerns on the reliability of the budget.

First, the proposal assumes an annual inflation rate of 30% and a GDP decline of 3%. The envisaged exchange rate is 21.5 roubles to the dollar. Analysts argue that these predictions are far too optimistic, given that the current exchange rate is already 20.6 roubles to the dollar, and that the IMF, for example, forecasts Russian GDP will decline over 8% in 1999. If the GDP declines much more than the government expects, budget balance is seriously undermined.

Second, several factors increase the uncertainty that the budget will be implemented as proposed. The parliamentary elections in December 1999 could increase expenditure pressure. The proposed bank restructuring program also contains an expansionary risk. Either additional expenditures financed via monetary emission, or tax revenues short of plan, could push inflation beyond the baseline rate.

Third, the budget plan assumes that further foreign finance, particularly from the IMF, and debt restructuring will be forthcoming. This assumption is still largely open.

Regional issues still ahead

The budget proposal does not seem to have much in common with some of the ideas in the government's economic program, which many analysts feared to contain a clear reversal of the reform course. The main threat in the budget proposal now is whether it is sustainable, so that excessive money printing can be avoided. As the federation outlays are already quite small, the key, for the federation, is now to reach the revenue target. Due to the steep decline in the value of the rouble, the deficit is now around USD 5 billion. That is equivalent to only about a fifth of the July 1998 rescue package put together by the IMF.

Finally, the budget proposal shifts the attention to the regional side. As the share of regional contributions to overall funding of the public sector increases, it becomes a top priority to reconsider regional expenditure and to clarify the fiscal links between the centre and the regions.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998/1-9**	1998
Federal government							budget law
- revenues	14.5	14.1	13.7	12.5	12.1	9.7	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	14.1	17.6
- balance	-6.5	-11.4	-5.4	-7.9	-6.5	-4.4	-4.7

* Figures for 1993 – 1997 exclude interest payments on short-term government debt
** Preliminary Minfin information
Sources: Goskomstat, IMF, Minfin. Figures for 1993-94 are not fully comparable with others.

Inflation still high

The monthly consumer price growth accelerated markedly in December, reaching 11.6%, while it was 5.7% in November. During the whole of 1998, inflation amounted to 84.4%.

Following that trend, the rouble continued to weaken in December, and its rate exceeded 20 roubles per dollar during the first half of the month. On December 31, the rate against the dollar was 20.65 roubles.

The Moscow stock market continued to be depressed with prices at extremely low levels and changing only slightly. At end-December, the RTS index hovered around 59, down from 70 a month earlier. Trading volumes also remained low. For the year, the RTS index lost 85% of its value.

Debt negotiations continue

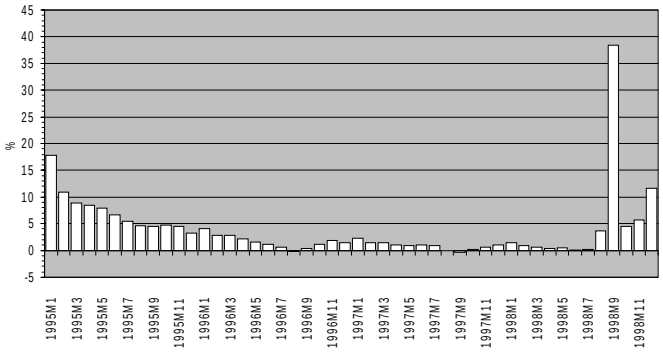
In spite of announcements by Russian authorities that a rescheduling deal has been concluded with foreign creditors on short-term government papers (GKOs and OFZs) frozen in August, negotiations in fact continue. The process has been rather blurred, and Western counterparts have criticized the Russian side for trying to unilaterally impose rescheduling terms. The deal proposed by the Russian authorities splits the debt into three parts: 70% of the value of the paper would be swapped for four-to-five-year variable coupon bonds, 20% would be swapped for three-year zero-coupon investment bonds, and 10% would be exchanged for cash, discounted at 50% and paid in three tranches.

According to currently available information, foreign creditors can use the three-year investment bonds for buying shares of Russian banks, but not those of other companies. However, in response to sharp criticism from foreign creditors, the government may consider allowing the sale of shares of other companies as well. The CBR will organize monthly auctions of dollars for the repatriation of proceeds from restructuring deals. The rouble/dollar rate at the auctions will be pre-determined by the central bank.

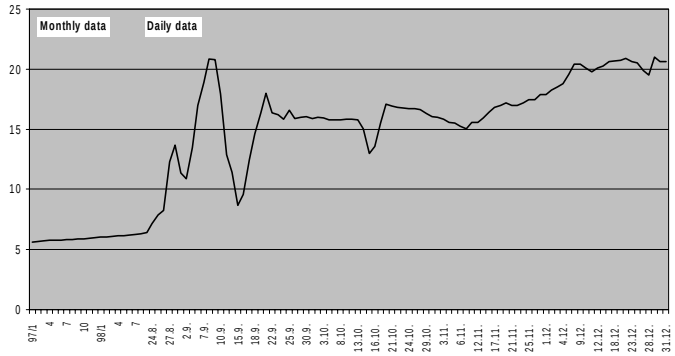
Russia will also have to renegotiate with the Paris and London clubs of official and commercial creditors its payment obligations for 1999, related to debts inherited from the Soviet Union. These negotiations have yet to start. According to government sources, Russia can pay only 9 billion dollars out of its foreign debt due in 1999, which amounts to 17 billion dollars.

On December 29, Russia failed to make an important interest payment to the London Club on renegotiated Soviet-era debt. In November, Russia had asked for restructuring the tranche so that settlement with creditors could be made in new government paper rather than cash. However, by the acceptance deadline only 72% of creditors had agreed to the deal, instead of the required 95%. Opinions vary between Russia and the London Club over whether Russia should be regarded as being in default.

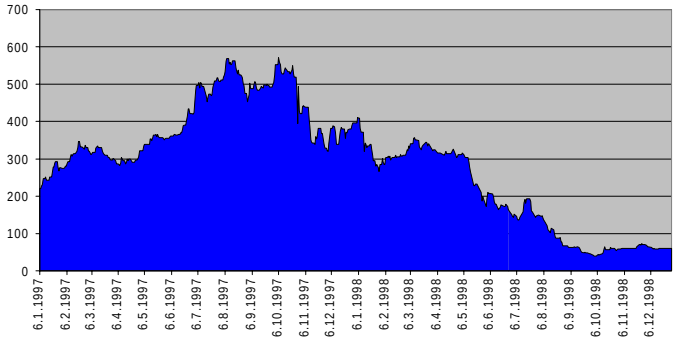
Monthly inflation, Jan. 1995 - Dec. 1998



Rouble/dollar exchange rate



Share prices, RTS index



Monetary indicators

	1993	1994	1995	1996	1997	1998	as of
Inflation, 12-month, %	842	224	131	22	11.0	84.4	12/98
M2, year-to-year growth, %		217	113	33	31.5	-0.4	10/98
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1113	11/98
Interest rates, period average							
- T-bill (GKO) yield, %			168	86	26.0	n.a.	8/98
- deposit rate, %			102	55	16.4	16.7	9/98
- lending rate, %			320	147	46.2	42.0	9/98
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	8.2	11/98
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	12/98

Sources: Goskomstat, CBR

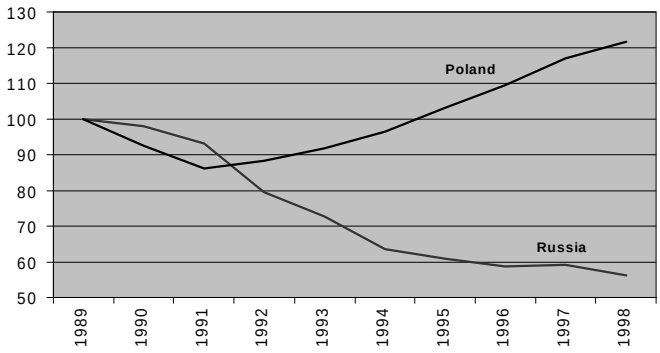
Small enterprises: The missing engine of growth

by Jouko Rautava*

The figure below illustrates the severity and extent of the decline in Russian GDP. In 1998, Russian GDP fell 5-6%, which means that, with the exception of 1997, production declined every year this decade. The level of Russian production today is down 60% form the start of the 1990s. By contrast, Poland's production started to recover within two and half years of the launch of radical reforms.

Granted, the conditions prior to reforms in Russia and Poland differed considerably. However, these factors have gradually lost their power in explaining the huge difference in economic performance of these two countries.

Real GDP in Russia and Poland, 1989=100



Missing small business sector

In all transition economies, the engine of growth has been new private enterprises. Thus, as large state-owned enterprises decline, shedding labour and other resources, new enterprises have absorbed and realized the potential.

The poor development of a new enterprise sector in Russia is evidenced by Goskomstat's information on small enterprises in Russia (see table). At end-1997, there were 861,000 small enterprises, or about 6 small enterprises per 1000 people. Regional differences are also remarkable. St. Petersburg and Moscow led with 21 small enterprises per 1000 inhabitants; northern regions had only 3 small enterprises per 1000 inhabitants.

Goskomstat's data on small business offers interesting details. In 1997, for example, the Novgorod region had only 3 small enterprises per 1000 inhabitants, in spite of region's fame for its benign attitude towards entrepreneurs and ability to attract foreign investors.

Small business in Russia (in thousands)

	1996	1997
Number of small enterprises	842	861
Number of workers	6269	6515
Per cent of total employment	9.4%	9.9%

Source: Goskomstat

Due to Russia's large shadow economy – itself an indicator of a difficult business environment – these figures probably seriously underestimate the actual number of small enterprises in Russia. Nevertheless, Russian figures contrast sharply to those of developed market economies and many other transition economies. In Poland, there are more than 50 small enterprises per 1000 inhabitants. Russia's small-business sector employs some 6.5 million people, which account only for 10% of total employment. In most industrial and even transition economies, small business employs well over half the workforce. In Russia, development of the sector plods ahead slowly; there was only a slight increase in the number of small enterprises between 1996-97.

Backward-looking policies

Numerous business surveys and comparisons underscore the troubled business climate in Russia. Factors conspiring against the survival of a legitimate small business include bad economic policies, excess red tape, and the sweeping discretionary powers of authorities. To date, interest groups such as industrial and agricultural lobbies and financial-industrial groups have exerted a strong influence on economic decision-making in Russia. Indeed, the insinuation of powerful interests into current economic and political structures has led to a situation where policy focuses on yesterday's problems, rather than tomorrow's prospects.

The tragedy here is not that Russia still lacks an engine of growth, i.e. a strong and dynamic small-business sector. Rather it is the lack of any important pressure group capable of shifting the focus of policymakers to the future.

**The author is an economist at BOFIT*

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

Editor-in-Chief Jouko Rautava