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Russian Economy - The Month in Review

Yearbook 1999

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
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Russian Economy - The Month in Review 1999

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RUSSIAN ECONOMY
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Economic Developments

GDP down by 4.6% in 1998

According to Goskomstat's preliminary figures, Russia's nominal GDP was RUB 2680 billion (USD 280 billion) in 1998. Industrial production declined by more than 5% compared to 1997 and agricultural production by 12%. Along with decline of production of goods, many indicators concerning services also reveal deterioration of the economic situation in Russia. Of the demand indicators, fixed investments were down by over 6%. This means that Russia's GDP has declined over 40% this decade.

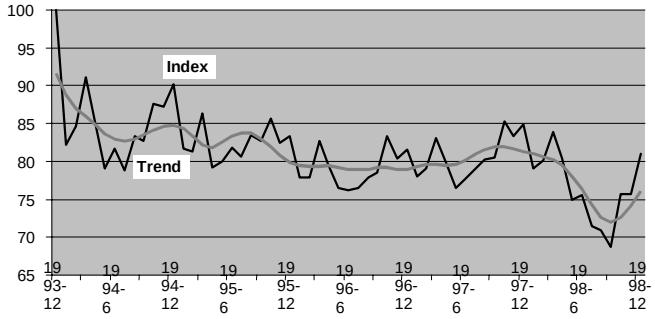
As regards various industrial sectors, the most significant decreases were recorded in light industry (-12%), ferrous metallurgy (-8%), mechanical engineering and metal processing (-7%) and in the chemical and petrochemical industries (-7%). The car industry, which some time ago was a source of some cautious optimism, was down by 12% last year. The forest industry was the only major industrial sector which matched its 1997 production level.

Has devaluation already induced industrial growth?

At the moment, there seems to be a consensus that Russia's GDP will decline 6-8% in 1999. Thus, against this background and given the current problems related to the Russian economy and politics, it is somewhat counter-intuitive that a long-run trend component in the chart below indicates that a turnaround in industrial production has already taken place. On the other hand, after the rouble's huge depreciation (over 70% against the dollar) since mid-August, one might expect an eventual positive impact on domestic production. Devaluation has helped many firms competing with imports as dollar-denominated imports were down by some 40-50% in September-November compared to the same period in 1997. Moreover, a weak rouble has also helped export industries grappling with low energy and raw material prices.

However, the view given by the long-run trend indicator is highly tentative as it seems to be rather sensitive to changes in monthly production figures. Only the coming months will show whether industrial production has actually started to recover. One might even ask whether growth on a sustainable basis is possible, given the government's current difficulties in developing and implementing sound economic policies.

Russia's industrial production, Dec. 1993 = 100



Russia's balance of payments in 1996-1998 (Jan-Sept), USD billion

	1996	1997	1998 1-9
Current account	**12.1**	**3.3**	**-5.6**
Trade balance	23.1	17.6	6.6
Exports, f.o.b.	90.6	88.9	54.5
Imports, c.i.f.	-67.5	-71.3	-47.9
Services	-5.9	-5.2	-3.3
Exports	13.0	13.9	9.9
Imports	-18.8	-19.1	-13.2
Investment income	-4.9	-8.2	-8.1
Received	4.2	4.0	3.7
Paid	-9.2	-12.2	-11.8
Other items, net	-0.2	-0.3	-0.8
Capital and financial account	**-6.5**	**5.7**	**6.7**
Capital Account	-0.5	-0.8	-0.4
Received	3.1	2.1	1.4
Paid	-3.5	-2.9	-1.8
Financial account	-3.2	4.5	7.1
Direct investment in Russia	2.5	6.2	1.5
Portfolio investment in Russia	9.9	45.6	7.2
Other items, net	-15.6	-47.3	-1.6
Net errors and omissions	**-8.4**	**-7.1**	**-5.3**
Change in reserves	**2.8**	**-1.9**	**4.2**
('-' 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	-4.6	
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	65.8	1-11/98
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	55.5	1-11/98
Current account, USD billion			10.7	10.0	11.6	2.9	-5.6	1-9/98

Sources: Goskomstat, CBR

Progress on the budget

The draft budget for 1999 was approved by the State Duma in its second reading on 19 January and in its third reading on 29 January. The two readings form the main basis for discussions and modifications of the budget in the Duma. In the second reading, the division of expenditure between the large spending categories is decided, while in the third reading, the detailed allocation within each category is fixed. The surprisingly swift passage of the draft budget indicates a willingness by Duma members to work with the government that has been absent in recent years. Like in previous years, however, thousands of amendments were proposed to the draft budget.

On 5 February, the budget was approved by the Duma in its fourth and final reading. After that, the budget goes to the Federation Council, the upper chamber of the parliament, which consists of regional leaders. If approved, the budget goes to the president, who signs it into law or sends it back to the Duma.

Chances for a fast adoption of the budget seem good. The Federation Council signalled its support for the budget after a part of budget revenue was reallocated in favour of regions. The biggest uncertainty may thus be final approval from the president. In the third reading, the Duma increased cuts in spending for Kremlin administration to 20% (originally 40%) of last year's level, which may provoke a reaction from the president.

In spite of the large number of proposed amendments, no major changes have been made in the basic parameters of the draft budget during readings in the Duma. Hence, the draft retains its optimistic assumptions, including the availability of further foreign financing and agreements on new debt restructuring deals with Western creditors. Moreover, the budget proposal assumes an annual inflation rate of 30% and an exchange rate of 21.5 roubles per dollar, both of which seem highly unrealistic from today's perspective.

New tariffs to balance tax cuts

The government stuck to its plan to cut the VAT rate from the current 20% to 15%. The tax law package, which also contains other tax cuts including a reduction in profit tax from 35% to 30%, is currently in the State Duma awaiting its second reading.

In order to boost tax revenues and to recover part of the windfall gains enjoyed by exporters after the collapse of the rouble, the government introduced export tariffs for the first time since 1996. In the beginning of January, a 5% tariff was established on exports including natural gas, coal, fuel oil and certain minerals. The tariff applies to exports to non-CIS countries and will be in force for six months. A crude oil export tariff, also valid for six months, was introduced later in January. Its rate is fixed at EUR 2.5 per tonne within an oil price range between USD 9.80 and 12.30 per barrel. Below that price range, no tariff will be levied and above it, the tariff will double. Due to tough resistance from the fuel and energy ministry, the finance ministry had to back down from its original plan, which proposed a flat tax rate of EUR 10 per tonne irrespective of the price of oil.

Foreign debt remains a major burden

In the draft budget, revenue is set at RUB 474 billion (USD 21 billion) and expenditure at RUB 575 billion (USD 25 billion). The deficit would amount to 2.5% of GDP, far more than what the IMF seems ready to accept.

Russia's foreign debt currently totals roughly USD 145 billion. Of that, USD 103 billion dates back to the Soviet period. Debt servicing obligations for the current year amount to about USD 17.5 billion. The table below gives their breakdown.

Russia's debt servicing obligations 1999, USD billion

Total debt servicing payments	17.3
Principal	
IMF debt	3.7
Paris Club debt, non-rescheduled	1.4
Official bilateral credit	2.4
Trade credits etc.	0.4
MinFin bonds	1.3
Total principal	9.2
Interest	
IMF and World Bank loans	1.3
Eurobonds	1.7
Paris and London Club debt, rescheduled	3.9
Trade credit	0.7
Bilateral credit	0.5
Total interest	8.1

Sources: Reuters, Financial Times

In the draft budget, only USD 9.5 billion has been allocated for debt servicing. Even so, debt payments would make up some 38% of budgetary expenditure. Russian authorities have factored into the draft budget a roll-over of the debt owed to the IMF, as well as restructuring of obligations to the Paris and London clubs of creditors.

According to some recent statements by Russian officials, even a smaller sum may actually have been reserved for debt servicing in the budget. The finance ministry considers debt servicing obligations of some USD 4.6-6 billion to be absolutely necessary, while they hope to be able to restructure the rest. This contradicts the often repeated assertion that Russia intends to honour all its obligations that relate to debt taken on after 1992.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998/1-11**	1998
Federal government							budget law
- revenues	14.5	14.1	13.7	12.5	12.1	9.6	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	14.0	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.

High inflation continues to hurt rouble

In January, monthly consumer price inflation was 8.5%. In December inflation was 11.6%. To get an idea of the impact of small changes in monthly inflation figures, note that 5% monthly inflation translates into 80% annual inflation. Correspondingly, 10% monthly inflation results in an annual increase in prices of over 210%.

Along with inflation, the official rouble exchange rate has depreciated by over 10% since the end of 1998 to 23.14 roubles to the dollar on 5 February 1999. Thus, inflation and exchange rate developments show no stability and indicate that the situation is out of control. This conclusion contradicts the popular view that, at least so far, the government still has a handle on macroeconomic developments.

The Russian stock market continued to be depressed with low prices and trading volumes (daily volumes only USD 1-2 million). At the beginning of February, the RTS index was 55.09, down from 59.39 at the end of 1998.

Bond market reopening fails to generate interest

After a five-month suspension, trading in rouble-denominated GKO T-bills and OFZ bonds reopened 15 January 1999. A third instrument available in rouble debt market at the moment is central bank OBR bonds. The trading volumes have been very small partly because the central bank has set a 120% ceiling on yields on GKO T-bills and OFZ bonds. Also Western investors remain cautious as the question as to whether non-residents will be allowed to acquire shares in Russian enterprises as part of the restructuring of frozen GKO and OFZ debt is still open.

Severe debt servicing problems at every level

It is clear that the Russian State lacks the money to meet its present obligations to foreign creditors this year, so further negotiation of loan terms seems inevitable. However, discussions with Paris Club representatives on sovereign debt could only begin after Russia and the IMF agree on an economic plan. In practice, the same also applies to the London Club of private creditors. At the end of December, Russia failed to make a scheduled interest payment to London Club on restructured Soviet-era debt.

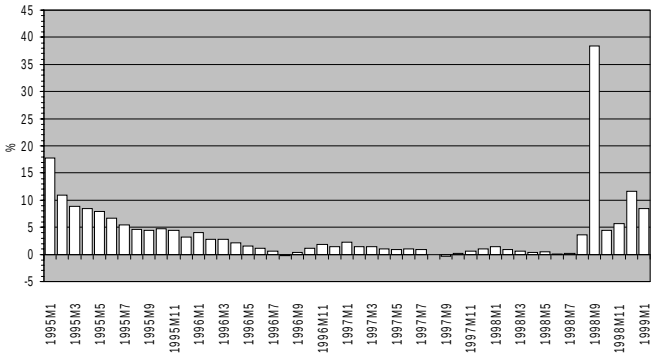
In addition to the government's debt problems, Russian companies also face increasing difficulties in meeting their foreign debt obligations. At the beginning of February, it was reported that Uneximbank missed a USD 12 million interest payment due on 1 February. If so, the bank would become the first Russian borrower to default on a eurobond. More disconcerting is the fact that other Russian banks with similar obligations could follow suit as well.

Restructuring in the energy sector

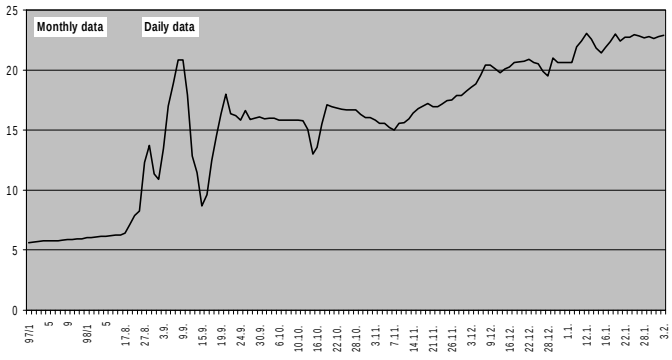
The Russian government has been rather passive in promoting further privatization or restructuring in the enterprise sector. However, on 25 January the government announced that three state-owned oil companies (Rosneft, Slavneft and ONAKO) would be combined to form a single national oil company. The state holds stakes of 100% in Rosneft, 75% in Slavneft, and 89% in ONAKO. The state plans to retain 75% of the shares in the new company. If the merger gets final approval, the new creation would be Russia's fifth largest oil company.

The merger was driven by the current economic situation as lousy earnings had forced the government and other owners to find more profitable ways to organize domestic oil production. Although Russia's crude oil export volumes rose about 10% in 1998, revenues declined by about USD 4 billion compared to 1997. In addition to oil companies, Gazprom also fell into difficulties last year as a result of the rouble's devaluation and low world prices for natural gas. Gazprom is expected to show a loss for the 1998 financial year. Some analysts predict that Gazprom could lay off as much as 10% of its workforce of 350,000.

Monthly inflation, Jan. 1995 – Jan. 1999



Rouble/dollar exchange rate



Monetary indicators

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	97	1/99
M2, year-to-year growth, %		217	113	33	31.5	11.1		11/98
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1390		
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.		8/98
- deposit rate, %			102	55	16.4	22.3		11/98
- lending rate, %			320	147	46.2	44.8		11/98
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8		
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	22.60	1/99

Sources: Goskomstat, CBR

Will the Russian Federation fall apart?

By Laura Solanko*

The August crisis has had at least two effects on federal-regional relations in Russia. First, after the default on GKOs and the forced devaluation of the rouble, regional leaders found it convenient to accuse the federal government of bankrupting the entire country through the conduct of disastrous economic policy. The centre defaulted first, not the regions. With no acting federal government and a president in the sanatorium, the regions gained relative importance with respect to the historically powerful centre.

Second, regions and localities have had to bear the brunt of socio-economic consequences from the crisis. Whereas federal authorities are preoccupied with foreign creditors and banking sector problems, the regions are directly faced with falling real wages and production, rising inflation and food shortages. Consequently, regional administrations have felt compelled to find ways to protect their people.

Both effects have fuelled demands by regions for greater fiscal and political independence. Since August, several regions (Mari-El is the most recent example) have banned exports of local foodstuffs. The Saha region announced its intention to put federal gold mines under direct regional control. The president of Kalmykia has even demanded complete independence from Russia. During the final days of January, Federation Council chairman and the governor of Orel region Yegor Stroyev threatened to block passage of the 1999 budget unless regional interests are given higher priority. These "innovative" and mostly anti-market-oriented measures, together with the centre's inability to pay wages and transfers on time, have raised concerns about the future of Russia as a federation. Could a new Time of Troubles (*smutnaya vremya*) cause the Russian Federation to break apart?

Fragmenting, but not collapsing

Such fears may be premature. One reason is that nearly all of Russia's 89 regions are simply too economically insignificant to survive on their own. Assuming a 1998 GDP of USD 280 billion, the average Russian region would have 1.7 million inhabitants and a nominal GDP of about USD 3.1 billion (about 10% of the Helsinki metropolitan area's GDP for 1996). Further, the legacy of central planning has left most regions totally dependent on a handful of large enterprises to provide the region with tax revenues and employment.

Only about a dozen Russian regions pay more taxes to the central government than they receive back in transfers. The rest are more or less dependent on federal transfers to finance their public expenditure. Even the few donor regions presently rely on centralized supply of electricity, gas and oil – probably even more than former Soviet republics. No Russian region today has the economic, political or administrative capacity to operate as an independent state.

On the other hand, Russia is clearly becoming more fragmented. Practically every region has imposed its own local export controls, import tariffs, specific regulations on licensing, anti-monopoly requirements etc. Thus, it is highly doubtful whether Russia can any longer be called a single market space. The widespread use of non-monetary means of payments aalso contributes to greater internal barriers within Russia's domestic markets. The promissory notes that local enterprises issue to pay their debts are not universally acceptable outside their respective region, so, in a sense, regions have already been creating local money of their own. On the other hand, in some regions over half of regional budget revenues are derived in non-monetary form. For example, the renovation of local school might be substituted for a tax payment. As such payment practices cannot be used to buy commodities from other regions (or anything else), the basis for trade cooperation among regions suffers.

Need for a comprehensive solution

The fragmentation of Russian markets however, is nothing new. Since 1991, most regions have been active in pursuing their own policies, preferably at the expense of the federal centre. The Kiriyenko government was planning a radical reform of federal transfer schemes that would have forced regions to cooperate according to uniform standards. Russia's current prime minister, Yevgeny Primakov, has constantly stressed the importance of getting federal-regional relations "in order". Not surprisingly, Mr Primakov's proposals about nominating governors instead of electing them and allocating more tax revenues to the federal centre have found little support. As long as federal-regional relations are in a state of flux (as they have been for the last ten years) every region as well as the federal centre will concentrate its efforts on securing its own position.

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Economic Developments

Turnaround of industrial production looks likely

While industrial production still decreased 4.9% in January compared to a year ago and 7.2% from the previous month, the large changes in monthly figures may be misleading. January is a major holiday season in Russia, so the drop in output does not necessarily mean reversal of a long-run trend. This can also be seen in the chart below, where the slope of the seasonally adjusted trend is still positive. Apparently, the rouble's large depreciation has had a positive impact on reviving industrial production.

Living standards collapsed in 1998

The August crisis led to a 31% decrease in real disposable income in December 1998 compared to December 1997. The real average wage fell by 40%. The number of people living below the subsistence minimum grew by 4.3 million to 35 million, or 24% of the population. The subsistence minimum at the end of 1998 was RUB 717.

The unemployment rate calculated by ILO standards was 11.8% at the end of December 1998. The number of unemployed was quite stable in the second half of last year amounting approximately to 8.5 million persons.

In February, the Duma approved the first reading of a bill to raise the minimum wage from RUB 84 to RUB 200. Minimum wage is mostly used as a benchmark in calculating numerous charges and entitlements. The government opposes the bill due to a lack of funds. If accepted, the new minimum wage would come into effect on 1 July. The average nominal wage in January was RUB 1,200 (USD 53).

Russia maintains significant trade surplus in 1998

According to Goskomstat, Russia's trade surplus in 1998 amounted to USD 14.4 billion, only slightly down from 1997 trade surplus of USD 14.8 billion. However, the value of foreign trade turnover fell by 17.6% to USD 133.4 billion. Value of exports amounted to USD 73.9 billion, which is 16.4% less than in 1997. The value of imports decreased by 19.1% to USD 59.5 billion. The geographical structure of Russia's foreign trade remained unchanged last year; 21% of Russia's trade was with CIS countries (22% in 1997) and 79% with non-CIS countries (78% in 1997).

Low prices for oil and non-ferrous metals have hurt Russian exports. In 1998, oil exports grew 8% in volume, but declined 30% in value compared to 1997. The average export price for crude oil and oil products in November 1998 was down by 45% compared to the same period year ago, and for non-ferrous metals 13 – 39%.

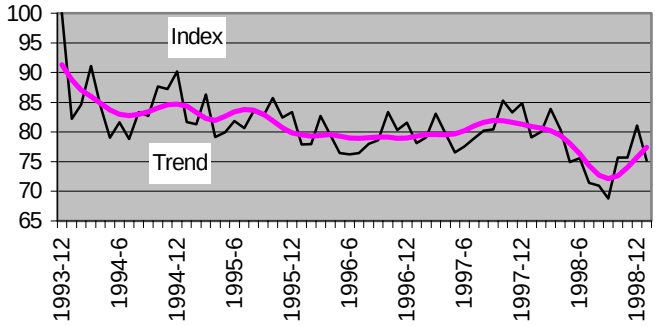
The value of imports began to decline in September as a consequence of the rouble's devaluation in mid-August. The drop was largest in consumer goods and pharmaceuticals.

Production sharing moves ahead

In February, the Duma approved the first reading of two production-sharing lists. The lists consist of eleven oil and gas fields to be developed on the basis of production-sharing agreements. On 10 February, president Yeltsin signed into law amendments to the production-sharing law and twelve related laws.

The production-sharing agreement with the French Total and Norwegian Norsk Hydro on use of the Kharyaga oilfield went into force in February. The Kharyaga oilfield in the Nenets autonomous area will be the first deposit where production sharing leads to commercial production. The two other agreements currently in place (Sakhalin 1 and Sakhalin 2) have reached the implementation phase. Total signed its agreement in 1995. Norsk Hydro said major investment was only possible after Russia adopted workable production sharing legislation. Commercial production of crude oil is expected to commence in autumn this year.

Russia's industrial production, Dec. 1993 = 100



Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	-4.9	1/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7		
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	12.4	1/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9		
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5		
Current account, USD billion			10.7	10.0	11.6	2.9	-5.6		1-9/98

Sources: Goskomstat, CBR

1999 federal budget approved

The draft budget for 1999 was signed to law by president Yeltsin on 20 February. The budget process, which involved four readings in the Duma, approval by the Federation Council and signing by the president, was fast by Russian standards. In addition, the willingness of all parties to work together was welcomed.

The budget foresees revenues of RUB 474 billion (USD 21 billion), expenditures of RUB 575 billions (USD 25 billion) and primary surplus (excluding interest payments) of 1.7% of GDP. As the table below shows, the budget law assumes revenues and expenditures relative to GDP equal to 1998 final figures.

Russian budgets, % of GDP

	1998 realized	1999 budget law
Federal expenditures	14.5	14.4
Federal revenues	11.3	11.9
Deficit	3.2	2.5
Primary surplus		1.7

Source: Reuters, MinFin

Even though the budget is extremely tight (and measured in foreign currency terms amazingly tiny), it is widely believed that the revenue-side forecasts on which the budget is based are still overly optimistic. Hence, as in previous years, it seems unlikely that the budget offers a realistic framework for fiscal policy in 1999.

Foreign debt remains an open question

The IMF mission left Moscow on 9 February with no visible progress in its talks with the Russian government. The unresolved issues centered around the 1999 budget. Without an approved IMF program, Russia has little hopes to advance in debt restructuring negotiations with the Paris and London clubs of creditors.

Russia's debt servicing obligations this year amount to USD 17.5 billion, which is equal to 80% of budgeted expenditures of the 1999 federal budget. Only USD 9.5 billion (38% of total budget expenditures) has, however, been allocated to debt servicing in the current budget law. This supposes further IMF credit and restructuring of the USD 103 billion Soviet-era debt.

The ratio of Russian federal foreign debt to GDP in 1998 was 51% and 28% for federal domestic debt. Consequently, debt servicing costs will remain high in the coming years and, given the current difficulties in managing fiscal policy, further restructuring of old debt seems inevitable. However, before any talks on restructuring, Russia's ability to service its debts should be analyzed in a coherent framework. This, again, implies a realistic economic program, which takes into account Russia's improved balance of payments situation after the huge devaluation of the rouble.

Structure of government debt, end of period

	1995	1996	1997	1998
% of GDP	34	28	27	51
USD bill.	120	125	124	145
Of which				
Multilateral creditors	11	15	19	22
Official creditors	69	70	65	67
Commercial creditors	39	39	36	41
Eurobonds	1	1	5	15
Domestic debt				
% of GDP	14	19	15	28
USD billion	50	83	67	79
RUB billion	230	427	385	756
Of which				
MinFin bonds			…	308
GKO and OFZ			…	280

Source: MinFin, Troika, BOFIT

Uncertainty about taxes and tariffs continues

Duma approved a tax law package including e.g. a cut in VAT rate from 20% to 15%. The government asked the Duma to postpone the law's introduction until first of July, instead of 1 April as originally planned. A new 5% regional sales tax has already been implemented in about half of Russian regions.

A 5% export tariff on natural gas to tax windfall gains from devaluation was imposed on 16 January only to be dropped on 24 February. The Russian government gave no explanation for this move, but it is evident that Gazprom was the main beneficiary. Export tariffs on crude oil and oil products remain in force, but will not be collected for March due to the low oil price.

A new 5% export tariff on non-ferrous metal exports outside the CIS was also introduced on 1 March. Oddly, aluminium exports are exempted.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998**	1998 budget law
Federal government							
- revenues	14.5	14.1	13.7	12.5	12.1	11.3	12.9
- expenditures*	15.9	18.1	16.6	15.8	15.3	14.5	17.6
- balance	-6.5	-11.4	-5.4	-7.9	-6.5	-3.2	-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 stable, inflation slowing?

Based on reported weekly data, inflation should slow from 8.5% in January to 3.5%-4% in February. Inflation for the first three weeks of February was 2.9%.

Russia's central bank (CBR) has pursued fairly tight monetary policy during the two first months of 1999, with M1 increasing only slightly. This trend might, however, be reversed during the spring as the budget assumes RUB 33 billion in CBR credits this year. The official rouble exchange rate was surprisingly stable in February, varying between 22-23 roubles to dollar.

The CBR's gold and forex reserves are their lowest levels in three years. On 2 February, the central bank reported reserves equivalent to USD 11.4 billion.

Rumours lift stock markets

Under the deal spelled out by the government last year, investors holding frozen short-term government paper (GKOs and OFZs) would be paid 10% of face value as cash. The original plan, however, forbid the conversion of receivable roubles into foreign currency, raising general criticism against the restructuring plan. Comments from the finance ministry indicated that foreign investors, who hold some RUB 68 billion (USD 3.0 billion) in frozen government rouble debt, might be allowed to put part of their reimbursed roubles into the Russian stock market. The news, coupled with more positive market sentiment, lifted the Moscow stock exchange's RTS index by 30% in mid-February. On Feb 28 RTS index was 70, still far below pre-crisis levels of 100-200 last August. Daily trading volumes have risen from around USD 2 million to USD 12 million – the highest volumes since the August crisis.

All quiet on the bank restructuring front

The Communist-dominated Duma is effectively blocking passage of a law to create a new agency for restructuring of credit institutions, ARCO. So far, the agency that was supposed to start operations 1 January has only one permanent staff member and no policy plan on banking sector restructuring.

While waiting for the CBR and the government to resolve their plans, the banks themselves have been active in cleaning up the playground. Several troubled banks have established new debt-free banks that have inherited VIP customers and assets from the original bank. Given the rampant asset stripping and lack of political consensus, there may not be much left to restructure when ARCO finally gets to work.

Central Bank independence discussed

The CBR's independence is also under threat. The State Duma is currently discussing amendments to the central bank law. Many experts, including the IMF, fear that the proposed amendments will jeopardize the CBR's independence in policymaking.

The whereabouts of Russia's exchange reserves

Recently there has been an intense public discussion combined with accusations of mismanagement or worse of the central bank's exchange reserves. The discussion has focused on FIMACO, a company located in the Channel Islands and apparently owned by Eurobank in Paris. Eurobank, a Soviet-era legacy inherited by the CBR, is today a CBR subsidiary. As a rule, central banks do not have foreign subsidiaries.

The CBR has now been accused of "hiding" part of its reserves in FIMACO, although it is not clear what hiding means in this context. If reserves have been invested in FIMACO by the CBR, they would still be on the CBR's balance sheet. Just taking foreign assets off the central bank's balance sheet would be more difficult. A more plausible alternative is that the CBR has tried to keep its reserve assets out of the reach of Russia's creditors, which in some countries could use legal means to impound Russian-owned assets, including the central bank's reserves. But there are many places where this would not be possible, including the Channel Islands. Some funds invested through FIMACO could conceivably have ended up with Eurobank, which may find it difficult to raise funds in the market. This would be a way of propping up Eurobank. If the CBR has been motivated by these considerations to invest through FIMACO, then it is an understandable, albeit unorthodox, way of managing reserves. But Russia's situation is also somewhat unusual. Central banks of other countries facing similar problems have been known to resort to similar tactics.

Typically, central banks invest their foreign exchange reserves in securities and deposits in major currencies with central banks and prime commercial banks. The CBR's approach to acquiring such assets is unusual and open to the possibility of irregularities. However, the mere fact that reserves have been invested through FIMACO, and perhaps similar entities, is no proof of irregularities.

Monetary indicators

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	97	1/99
M2, year-to-year growth, %		217	113	33	31.5	39.5		
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1200	1/99
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.		8/98
- deposit rate, %			102	55	16.4	22.3		11/98
- lending rate, %			320	147	46.2	44.8		11/98
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8		
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	22.86	2/99

Sources: Goskomstat, CBR

The Challenge of Restructuring Russian Banks

By Tuomas Komulainen*

Even before the crisis, a distinctive feature of the Russian banking sector was its smallness. Today the entire assets of Russian banks amount to less than those of MeritaNordbanken, Finland's largest bank. Moreover, the Russian banking sector does not perform its role as financial intermediator. Bank credits granted to the private sector are around 5% of the GDP, compared to around 20% in Poland and 60% in the Czech Republic.

The current banking crisis manifests the government's default on GKOs and a huge depreciation of the rouble. Banks had extensive GKO holdings, and were in effect financing the federal budget deficit. The several Russian banks that underwrote rouble forward contracts to foreign investors are today in no position to honour those contracts.

Confused authorities

The CBR oversaw transfer of deposits in 4-6 troubled banks to state-owned Sberbank, which now holds about 85% of the personal deposits. The move stemmed a run on the banks. In November, the CBR announced a program revamp the banking sector into four types of banks, i.e. those owned by the state, solvent private banks, regionally important banks and foreign banks. Banks classed as regional banks would be selected in cooperation with regional authorities. An individual restructuring plan would be implemented for unhealthy banks whose closure was seen as too costly to the economy. The basis on which such candidates for salvation would be is still unclear.

The program includes relatively strict measures to tackle the crisis, such as liquidations and converting creditor claims into shares. However, more lax and doubtful measures are also included. The CBR announced it gave RUB 20 billion (USD 1 billion) in stabilization loans to banks and that government bonds could be exchanged to banks shares.

The mission of the agency for Restructuring Credit Organisations (ARCO) is to acquire controlling stakes in decapitalized banks, manage bad assets, initiate and supervise bankruptcy undertakings. However, both ARCO and the CBR lack skilled personnel and resources to supervise bankruptcy undertakings. ARCO, with charter capital of only RUB 10 billion (USD 450 million), debuted with the poorly managed handling of the Tokobank insolvency.

Russian banks have engaged in widespread asset stripping against foreign creditors in favour of certain clients, shareholders and management. Bank managers transfer liquid assets to a branch or to a new bank. In Menatep, for example, assets are transferred to Menatep St. Petersburg, in Uneximbank to Rosbank, in SBS-Agro to Gold and Platinum Bank.

Experience from bank restructurings elsewhere shows that rapidly implemented strict measures make the restructuring less costly overall and restores the intermediation capacity of the banking sector faster. Closures, mergers, loan workout units, privatization and new equity by the owners have been used in the "fast track" countries. In "slow track" countries, the central bank is typically the only agency for restructuring, and its sole measure is liquidity support (Dziobek and Pazarbasioglu, IMF WP 97/161).

The role of foreign banks

Currently, foreign banks are not allowed to own more than 12% of the aggregate capital of the Russian banking system. Several reasons speak for dropping this restriction. For one, foreign banks could encourage domestic savings. After several banking crises and two bouts of hyperinflation, Russian enterprises and citizens have learned to trust foreign banks over domestic ones. The experience from other emerging markets (e.g. Poland, Estonia and Argentina) shows that foreign banks with banking knowledge improve the performance of the banking sector and increase lending to private sector. Foreign banks may also better enable the badly needed foreign investments to Russia.

Unfortunately, foreign banks face a challenge finding viable lending targets. With the possible exception of the equity market, there are few investment possibilities in Russia. Indeed, the legal fog and arbitrariness of Russian law enforcement, courts and public administration are enough in themselves to make any investor cautious.

Four policy implications

1) Any restructuring program Russia embarks on needs to be as tough as possible – and implemented with tough enforcement. Russia's banking system will not die without the CBR's liquidity support. Even now some banks are able to manage their operations and service their foreign debts.
2) A restructuring program for Sberbank has to be formulated. Given the experiences in Poland and Hungary, it may be efficient to find a foreign strategic owner for Sberbank.
3) To grow the banking system, domestic savings have to be encouraged and the limitations on foreign ownership should be reconsidered.
4) The infrastructure for bond and equity markets already exists in Russia. These markets may become more important mediator of foreign capital to enterprises than the weak Russian banks.

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Economic Developments

Positive trend in industrial output

Industrial production grew 1.9% in February from the previous month, but compared to February 1998 it declined 3.7%. However, the chart on the right indicates growth in industrial output since the August devaluation.

Russia's Economy Ministry said in March that it expects GDP to shrink by 7% in the first quarter of 1999. The Ministry had earlier forecasted a 9% drop in first quarter GDP.

Oil prices up in March

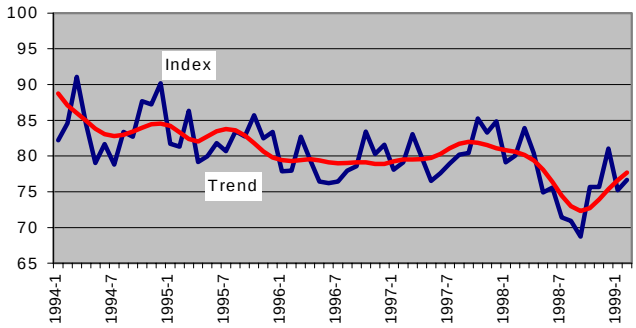
On 6 April, Brent blend traded at around USD 14.50 a barrel. The price of Russian Urals crude is currently almost a dollar below the benchmark Brent price. Oil prices rose with an agreement among OPEC members to cut their total oil production by 1.7 million barrels a day. Non-OPEC countries Mexico, Norway, Oman and Russia also agreed to reduce oil production by 0.4 million barrels a day. The world's total daily oil production is 73.4 million barrels.

According to energy minister Sergei Generalov, Russia will reduce oil exports by 100,000 barrels a day in the second quarter of this year. Russia promised last summer to cut its exports by 100,000 barrel a day, but last year's oil exports ended up at the highest level since 1991. Russia's crude oil exports have been running at about 2.3 million barrels a day. Thus, on an annual basis, one dollar change in crude price means directly up to USD 840 million in export revenues. Given the fact that the prices of crude, oil products and gas are closely related, the overall impact is naturally more.

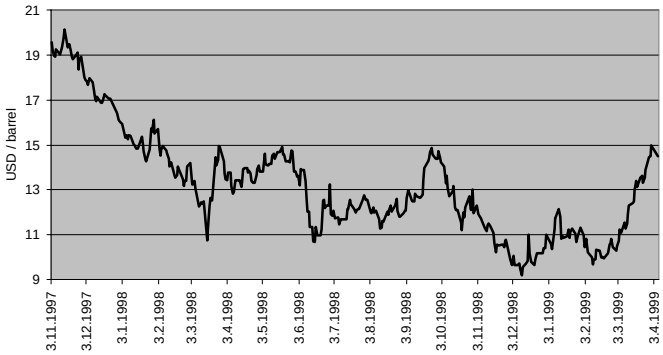
In 1998, oil and petroleum products accounted for only about 19% of the value of Russia's exports. In 1997, the share of oil and petroleum products in total exports was 24%. Fuel and energy resources, which in addition to oil and petroleum products consist of natural gas, coal and electricity, accounted for 40% of total exports. The share of metals in total exports remained at 17%.

Foreign trade turnover fell 15% last year and has continued to decline in January. This is illustrated by the chart below, which shows Russian foreign trade as a 12-month moving sum.

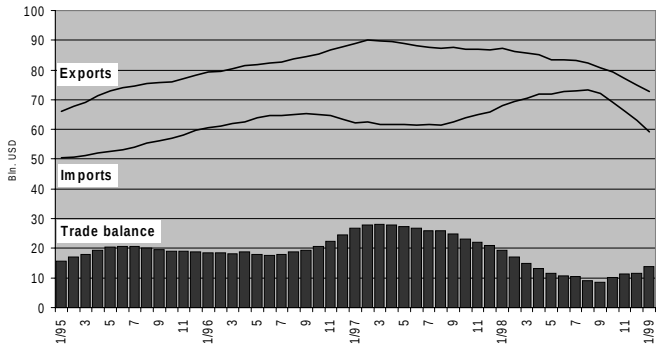
Russia's industrial production, Dec. 1993 = 100



Price of crude oil (Brent) in 1 Jan 1997– 6 Apr 1999



Russian foreign trade (12-month moving sum)



Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	-4.3	1-2/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	-9.3	1-2/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	12.4	2/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	4.8	1/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	2.9	1/99
Current account, USD billion			10.7	10.0	11.6	2.9	2.4		

Sources: Goskomstat, CBR

Russia and the IMF

While the Nato strikes in Yugoslavia that started 23 March have complicated Russia's relations with Western nations, prime minister Yevgeny Primakov and IMF managing director Michel Camdessus reached an informal agreement on 29 March which paves the way to talks on new lending to Russia. While no details were discussed, the parties were reported to agree on new target of 2% of GDP for Russia's primary budget surplus (i.e. without debt servicing costs). This year's budget originally set a primary surplus of 1.6%; the IMF had earlier wanted to see a primary surplus of 3.5% of GDP.

The IMF mission returned to Moscow on 7 April to discuss details of Russia's economic program with the government and the central bank. Although the size of new credits will not be discussed until later, there has been wide speculation that the new loan arrangement would be at least enough to cover Russia's USD 4.4 billion in debt payments to the IMF this year. Moreover, as Russia has defaulted on its external obligations, the IMF arrangement would make it possible to start negotiations concerning rescheduling of Russia's foreign debt and, hence, alleviate the overall external situation.

Confusing tax figures

Tax minister Georgy Boos announced that federal tax revenues (including income from the federal road fund) were RUB 20.4 billion (USD 900 million) for January and just RUB 15.6 billion (USD 680 million) for February. The preliminary figure for March is RUB 19.5 billion (USD 850 million), which exceeds a stated target of RUB 18.1 billion.

Although the authorities can claim they reached the target in March, a simple calculation based on 1999 budget figures gives a totally different view. The 1999 budget assumes overall tax revenues of RUB 399 billion (USD 17 billion), which means that Russia should on average take in RUB 33.3 billion (USD 1.4 billion) monthly. Even assuming the above first-quarter figures refer to tax revenues excluding custom duties and export taxes, the average monthly tax collection should be some RUB 25 billion. Thus, on the basis of the January-March data, it seems that the country is falling at least 20% short of its budget goals.

The good news is that the share of cash revenues in total tax revenues has exceeded 90% in recent months.

Russia's realized 1998 federal and regional budgets

	Federation			*Regions*		
	RUB bln.	**% of budget**	**% of GDP**	**RUB bln.**	**% of budget**	**% of GDP**
Revenues	302.4	100.0	11.3*	397.7	100.0	14.8
Taxes	236.0	78.0	8.8	308.1	77.5	11.5
VAT	104.7	34.6	3.9	51.8	13.0	1.9
Personal income taxes	0.1	0.0	0.0	71.1	17.9	2.6
Profit taxes	34.9	11.5	1.3	61.5	15.5	2.3
Excises	52.5	17.4	2.0	15.3	3.8	0.6
Customs duties	36.5	12.1	1.4	-	-	-
Other taxes	7.3	2.4	0.3	108.4	27.3	4.0
Foreign operations	15.4	5.1	0.6	0.1	0.0	0.0
Sale of property	15.2	5.0	0.6	9.2	2.3	0.3
Other revenues	35.8	11.8	1.3	80.3	20.2	3.0
Expenditures	388.9	100.0	14.5*	407.1	100.0	15.2
Administration	9.7	2.5	0.4	20.3	5.0	0.8
Law enforcement and security	30.7	7.9	1.1	11.9	2.9	0.4
Industry, energy and construction	11.3	2.9	0.4	10.9	2.7	0.4
Agriculture	3.3	0.8	0.1	16.2	4.0	0.6
Social and cultural expenditures	57.2	14.7	2.1	181.7	44.6	6.8
Defence	56.7	14.6	2.1	-	-	-
Transfers to regional budgets	45.2	11.6	1.7	-	-	-
Debt service	106.6	27.4	4.0	-	-	-
Other expenditures	68.2	17.5	2.5	166.1	40.8	6.2
Balance	-86.5		-3.2*	-9.4		-0.4

*Using the IMF definition, 1998 federal budget revenues were 9.0%, expenditures 13.9% and the deficit 4.9% of GDP.
Source: Goskomstat, Minfin

Fiscal indicators (per cent of GDP)

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**1999**
Federal government								budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0		11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9		14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9		-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

Rouble hits record low, inflation falls

On 25 March, the Russian rouble fell in afternoon trading to a record low of 27 to the dollar. Since then it has recovered slightly and is trading in the range of 24-26 to the dollar. In the restricted morning sessions where the central bank intervenes, the exchange rate has been more stable. The sharp fall in the rouble's exchange rate was driven by the war in Yugoslavia, higher liquidity in the Russian money market and uncertainty over the outcome of Russia's discussions with the IMF.

Consumer price inflation in March was 2.8%, down from 4.1% in February. As it is widely believed that the Central Bank of Russia (CBR) has started to issue credits for the Ministry of Finance, the inflationary pressures may rise in April, especially if the rouble declines further.

During the first quarter of 1999 the CBR's forex reserves were used to service Russia's foreign currency-denominated loans, causing the CBR's reserves to fall to new lows. On March 30, the central bank reported forex and gold reserves equivalent to USD 10.6 billion.

More headaches for minority shareholders

Yukos, Russia's second largest oil company, continued to dilute minority shareholder rights through special share issues to company insiders. Three Yukos production subsidiaries (Samaraneftgaz, Yuganskneftgaz and Tomskneft) held extraordinary shareholder meetings in late March after barring foreign minority shareholders from the meetings. The participants at all three meetings voted to issue new controlling stakes to be sold to offshore companies controlled by the parent Yukos.

Meanwhile, BP Amoco, which owns 10% of the oil company Sidanko, continues to fight to retain its investment. Bankruptcy proceedings against Sidanko were started in February, but a local court postponed the insolvency hearings to mid-May. In the interim, the company is managed by an alleged ally of Interros, the company that holds a controlling interest in Sidanko. BP Amoco has now called for a new shareholders' meeting to remove the incumbent management.

New measures to tackle capital outflows

The Russian government and the CBR have resorted to a variety of administrative measures to control the uncontrollable – capital outflows from Russia. For example, during March the CBR ordered importers to deposit a rouble equivalent of any advance payments for goods to be received from abroad and raised the compulsory reserve requirements for commercial banks. Moreover, a number of minor banks have temporarily been barred from the exchange market altogether. The requirement to repatriate 75% of export earnings is still in force, but for a majority of export firms the limit has effectly been lowered to 50%.

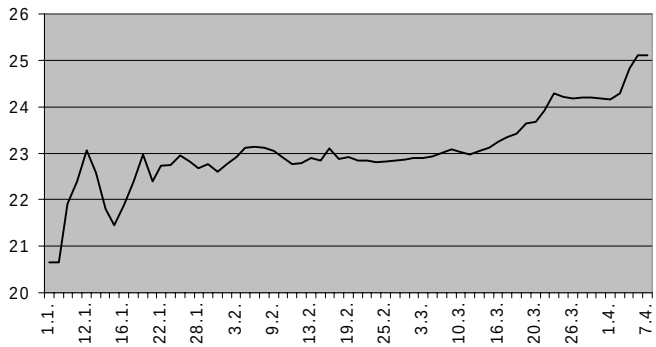
In addition to the measures imposed by the CBR, the Russian government has proposed to the Duma a series of amendments on existing legislation to curb cash outflow. The proposed amendments include a USD 5,000 limit on cash that individuals can take out of the country.

All quiet on the bank restructuring front

There was little to report on bank restructuring in March. The high point was the founding of a new committee for structural reform of the banking system (MKK). The new committee comprises representatives from the cabinet, CBR, parliament and office of the president, as well as IMF, EBRD and World Bank representatives. The committee is chaired by CBR deputy chairman Tatyana Paramonova. The committee's tasks include development of banking legislation, prudential supervision, and accounting regulations.

CBR chairman Viktor Geraschenko revised his earlier estimates by predicting that only about 30% of Russia's 1400 banks will close their doors as a result of the banking reform process. ARCO, the organization supposed to be in charge of restructuring process, lacks sufficient funds and political will to implement the necessary reforms.

Rouble/dollar exchange rate in 1999 (daily)



Monetary indicators

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Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1201	2/99
Interest rates, period average								
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- deposit rate, %			102	55	16.4	25.7	24.2	1/99
- lending rate, %			320	147	46.2	41.7	45.5	1/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	7.3	2/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	24.18	3/99

Sources: Goskomstat, CBR

Are Russians Different?

By Alexander Bukhvalov*

Economists sometimes use peculiar assumptions about the Russian mentality in their analyses of the anomalies of Russian transition processes. But as economic growth has continued to elude Russia, the public perception has shifted from that of a people blessed with the richness and depth of the Russian soul to a chaotic society with widespread corruption and criminality. Is this perception shift really the consequence of deviant behaviour by economic agents or is there another explanation?

X-efficiency and legal frameworks

When writing about Russia, theorists regularly employ the notion of *X-efficiency* coined by Harvey Leibenstein in 1960s. Mainstream economics assumes that economic agents are rational to the extent of their resources and capacities. Thus, consumers seek to maximize their utility and producers seek to maximize their profits. This fairly describes the function of most developed economies. However, Leibenstein qualified his definition with the corollary that when competitive pressures are light, neither individuals nor organisations work as hard or effectively as they could.

For simplicity, one might argue that in the modern world X-efficiency emerges in the absence of a *proper legislative environment and consistent enforcement*. Accordingly, when legislative vacuums or loopholes appear, the resulting X-efficiency has nothing to do with whether the soul in question is Russian or American. Rather, the difference lies in the fact that Russian legislation and enforcement procedures consist of huge gaps, while such gaps are rare in the mature US framework.

X-efficiency and the Russian soul

The notion of X-efficiency provides a formal opportunity to assign any value you want to the Russian soul. The Russian soul can be held responsible for wage and tax arrears, collectivist behaviour at the job, tiered corruption, the spread of barter, and so forth. Of course, theoretical modelling of this stuff is rather sophisticated, and one quickly wonders why the problem needs to be so complicated. After all, souls in developed economies obey simple rules.

Under normal developed economy conditions, everyone is rational in a traditional sense. The economy is more or less predictable and thus possible to regulate. Rational behaviour here assumes that economic agents have a clear idea of their goals and the constraints determined by the institutional environment of the economy. Such frameworks result when there is a unity of *legislation and enforcement.*

After a decade of legislative development, Russia has a reasonable set of laws based on the recent Civil Code. There are still some gaping omissions such as the lack of a law on land ownership. Even so, the real disaster is the lack of enforcement procedures. Russia's new bankruptcy law, introduced in 1998, provides a telling example through its unsuitability to banking and the needs of society.

Bank as an example of legal problems

While the insolvency of a Russian bank surely may seem like a disaster to its depositors, legally speaking the event is little more than a footnote. Typically, all the bad things have already happened by the time a bankruptcy is announced. Troubled banks may hide their assets or dump them at arbitrary prices before the bankruptcy announcement, so that any debt subordination rules laid down in the law have little meaning. In numerous instances, bankers have boldly suggested "take it or leave it" deals to depositors, arguing that since the bank is in trouble they must agree to discounting of their accounts. They add that since the "train is leaving," any depositors who do not agree to their terms immediately will get nothing later. A troubled bank may announce, for example, that only accounts with balances of less than $1,000 will be reimbursed. Who makes such arbitrary rules? The law mentions nothing. Under the current paradigm, troubled banks are allowed to operate outside the law for long periods. When the law finally does intervene, any liquid assets are long gone.

Indeed, there are not even clear rules pertaining to the liabilities of a bank and its branches. Thus, it is quite possible that the St.Petersburg branch of a bank closes its doors to clients, while the Moscow headquarters still pays clients with a Moscow residence stamp in their passports. Again, there is no legal basis for the rule.

The inadequacy of legal and enforcement structures in Russia is readily evidence in the outcomes of most bank restructuring. Many banks have gone bankrupt, but very few bankers have. Entire branch may be bought by a former subsidiary for a song. After the crash of 17 August 1998 many banks froze accounts and announced multi-year restructuring schemes similar to those to deal with default on other securities. Given these realities, is it any wonder that people keep money under their mattresses or businesses hide currency abroad?

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RUSSIAN ECONOMY
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Economic Developments

GDP down by 4% in the first quarter

According to Goskomstat's preliminary information, Russia's GDP declined 4% in the first quarter of 1999 compared to the same period in 1998. The situation concerning production of services, on the one hand, and goods, on the other, seems to be relatively uneven. In particular, retail trade (-16%) and other consumer services are still having major difficulties.

Although industrial production in the first quarter contracted 2% from the same period a year ago, in March output was already 1.4% higher than in March 1998. Month-on-month figures indicate that industrial output has been increasing since last autumn. The factors behind the turnaround in output are the rouble's weakening and, recently, higher energy prices, which have given a boost to Russian export industries and domestic industries competing with imports.

In the first quarter, according to Goskomstat, the best performing industrial branches were wood and paper (8%), chemical and petrochemical (6%), construction materials (5%) and non-ferrous metals (2%). For example, production of paper and cellulose was up by about one-fifth from the previous year. On the other hand, output declined on an annual basis, e.g. in energy sector (-2%), ferrous metals (-3%) and food industries (-1%). It is interesting to note that, despite the weaker rouble, the official figures for the light industry sector still shows a dramatic decline (-17%), although the situation varies considerably within the sector.

Of the demand indicators, fixed investments were down by 11% in the first quarter compared to the first quarter of 1998. Moreover, while real wages on average rose 5% in March from February, they are still 42% below the March 1998 level.

Current account surplus USD 2.4 billion in 1998

Due to the floating of the rouble and its consequent depreciation after the August crisis in 1998, Russia's monthly imports were down by almost 50% from the pre-crisis level. This has led to a substantial improvement in Russia's external balance in the latter part of 1998. Thus, according to the central bank's balance of payments information, Russia's trade balance (goods) surplus was over USD 17 billion in 1998, while the half-year figure in June was only USD 2 billion. Despite the deficit in trade of services and major interest payments by Russia, the overall current account was USD 2.4 billion in surplus in 1998.

As the information concerning the financial account shows, direct and portfolio investment flows to Russia dried up in 1998. Moreover, despite the improved situation concerning the trade balance, Russia's international foreign exchange reserves decreased alarmingly by over USD 5.3 billion to less than USD 8 billion at the end of 1998.

In 1999, Russia's current account situation has improved further due to the recent oil price increase, which will lift Russia's export revenues. However, the overall balance of payment situation will stay dire. Russia is unable to service a significant part of its foreign debt, its currency reserves are very low, and the unsatisfactory business climate has increased capital flight while discouraging investment inflows into the country.

Russia's balance of payments in 1996-1998, USD billion

	1996	1997	1998
Current account	**12.0**	**4.0**	**2.4**
Trade balance	22.9	17.4	17.3
Exports, f.o.b.	90.6	89.0	74.8
Imports, c.i.f.	-67.6	-71.6	-57.4
Services	-5.7	-4.7	-3.2
Exports	13.0	14.2	12.9
Imports	-18.7	-18.8	-16.1
Investment income	-4.9	-8.1	-11.2
Received	4.2	4.1	4.0
Paid	-9.2	-12.2	-15.2
Other items, net	-0.3	-0.6	-0.5
Capital and financial account	**-6.2**	**5.7**	**0.2**
Capital Account	-0.5	-0.8	-0.4
Received	3.1	2.1	1.7
Paid	-3.5	-2.9	-2.1
Financial account	-5.8	6.5	0.5
Direct investment in Russia	2.5	6.2	2.2
Portfolio investment in Russia	8.9	45.6	8.0
Other items, net	-17.2	-45.3	-9.7
Net errors and omissions	**-8.6**	**-7.8**	**-7.9**
Change in reserves	**2.8**	**-1.9**	**5.3**

('-' growth, '+' decline)

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-4.0	Q1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	-2.0	Q1
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	-10.7	Q1
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	12.4	3/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	9.7	1-2/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	5.7	1-2/99
Current account, USD billion			10.7	10.0	12.0	4.0	2.4		

Sources: Goskomstat, CBR

Russia and the IMF aim at USD 4.5 billion stabilisation arrangement

At the end of April, the IMF and Russia reached a tentative agreement on an economic program that is likely to serve as a basis for a coming Stand-by Arrangement. Besides an economic program, the 18-month arrangement includes USD 4.5 billion in new loans to cover Russia's payments to the IMF during the program period. The program focuses on fiscal and banking sector consolidation as well as structural reforms. While some program measures are still under discussion, Russia has been by the IMF asked to raise taxes on alcohol and gasoline, to postpone the planned VAT cut, to make changes in its legislation concerning bank restructuring and bankruptcies, and to relax restrictions on foreign exchange. Moreover, before the IMF board will consider Russia's request for a new Stand-by Arrangement, Russian authorities must provide the IMF with a full explanation how the CBR has managed its reserves and what happened to earlier IMF loans.

Thus, instead of a more demanding medium-term economic program, the IMF aims at a short-term stabilization program to get the Russian situation under better control and to lay down a foundation for a possible longer-term program after the December parliamentary and June 2000 presidential elections. Besides alleviating risks related to Russia's economic situation, a new IMF-arrangement allows Russia to start – in all cases inevitable – debt rescheduling negotiations with its creditors. This opens the door to an orderly management of Russia's disastrous debt situation. Also, the coming arrangement will save both Russia and the IMF from the mutually embarassing event of Russia defaulting on the IMF.

If the Stand-by Arrangement is approved by the IMF board, Russia will also get new financing from the World Bank and Japan so that the overall loan package is expected to rise to some USD 7.5 billion.

No basis for debt write-offs

International creditors have understandably not been facinated by deputy prime minister Yuri Maslyukov's ideas about massive debt forgiveness for Russia. Such talks are clearly premature as Russia's overall debt situation can be analysed only in the framework of a comprehensive economic program.

In general, the current talks on debt write-offs concentrate to the so-called HIPC group (Highly Indebted Poor Countries), which comprises the world's 32 poorest countries with yearly GDP per capita levels below USD 695. Thus, in spite of severe problems, Russia with its nominal GDP per capita close to USD 2,000 is still far from qualifying to HIPC arrangements.

The Soviet-era debt Russia now claims to be unable to service, has already been restructured once in this decade. Originally, Russia agreed to service Soviet debts in exchange for all Soviet property abroad. Thus, talks about a massive write-off of the Soviet debt is likely to raise angry voices not only among Western creditors, but also among ex-Soviet republics.

The problem is more in the short-term structure of Russia's debt and its inability to no longer service old loans by taking new ones. This applies even more to domestic than foreign debt. Nevertheless, after the new IMF-program has been approved, serious talks about restructuring of all of Russia's debts are in line.

Assessing the amount and structure of Russian domestic debt is a troublesome task, and thus the figures below should be viewed with caution. The GDP figure used to calculate the table's figures is the 1998 figure of USD 280 billion. The rouble exchange rate used is the official rate for 30 December, 1998, whereby one dollar equals 20.65 roubles. The director of the domestic debt department of Russia's finance ministry Bella Zlatkis stated recently that after major restructuring, Russia's domestic debt has now fallen to RUR 550 billion. Even if some of the old GKO papers have indeed been repaid, a RUR 200 billion reduction in the debt stock sounds confusing.

Russian government's debt as of December 1998, estimate

	% of GDP	nominal, billion	
Total	65	USD	181
Foreign, including	52	USD	145
- multilateral (IMF, WB)		USD	25
- eurobonds		USD	15
Domestic, including	13	RUR	750
- frozen GKO/OFZ		RUR	280
- MinFin bonds		USD	11

Source: MinFin, BOFIT

First quarter federal budget deficit 2.1% of GDP

Russia's finance ministry released preliminary January-March figures on the federal budget deficit: RUB 20.6 billion (USD 840 million), or about 2.1% of the GDP estimate used in the 1999 budget act. The act allows for a total budget deficit this year of RUB 101 billion, or 2.5% of a Russia's predicted 1999 GDP of RUB 4 trillion.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Jan.	1999 budget law
Federal government								
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	10.7	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.3	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-4.6	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

Rouble stable despite low forex reserves

CPI inflation has remained relatively low despite the increased liquidity in the banking system and growing money stock. The modest inflation may be explained by the deep economic recession and by the stability of the exchange rate.

The rouble's exchange rate has remained relatively stable for the month of April, staying at around 24.5 roubles to the dollar. The restrictions on currency operations (see Russian Economy 3/99) and improved trade balance have evidently started to affect the markets. The stock market experienced growth as the RTS index increased from 78.7 in 1 April to 103.5 in 5 May. Trading volumes, however, remained modest and thus a couple of large deals may change the index considerably.

During the first four months of 1999, the CBR's gold and foreign exchange reserves have fallen from USD 12.2 billion on 1 January to USD 10.9 billion as of 23 April. As the value of gold reserves is USD 4.1 billion, liquid currency reserves are only adequate to cover about two months of imports.

Debt problems concern all types of debt

Eight months after the devaluation and effective default of the Russian government's rouble-denominated debt (GKO/OFZ paper) the tricky restructuring saga seems to be close to an end. According to finance ministry officials, a large majority of the frozen GKO/OFZ stock has now been submitted to restructuring and the ministry seems willing to forget the mainly foreign investors that still hold some of the frozen paper. Those who agreed to the terms proposed by the Russian government will receive 10% in cash, 20% in interest-free short paper (new GKOs) and the rest in long-term Russian government papers (new OFZs). The first of two new GKO series has already been repaid and hopes are high that the second one maturing in July will also be honoured in full.

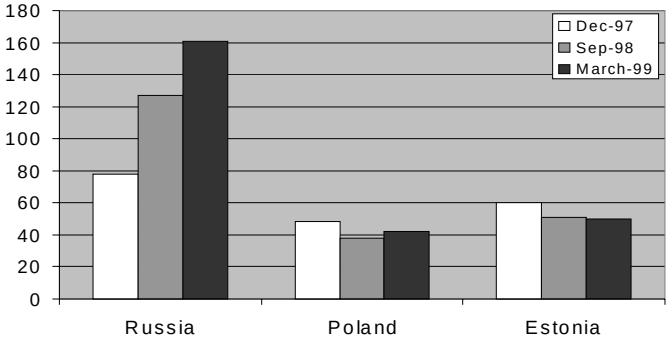
The GKO story is hardly an example of a well-managed restructuring scheme, and unfortunately may set a precedent for major restructuring negotiations ahead. In April, Russian officials announced that the dollar-denominated MinFin bonds would not be honoured in full, leaving little hope for those waiting for payments scheduled for mid-May. The markets have, however, anticipated the move as especially MinFin Series 3 bonds have long traded at default levels. Russia's already once restructured Soviet-era debt instruments (PRINs and IANs) are not doing much better. There seems to be very little confidence in Russia's willingness to service its debt at all. The best papers, Russian eurobonds, trade at around one-third of their face value.

April

	day of maturity	Average price % of nominal	YTM % per year
GKO 21133	16.07.99	97.0	23.8
GKO 25014	15.03.02	18.5	114.7
MinFin 3	14.05.99	-	-
MinFin 4	14.05.03	5.0	96.7
MinFin 6	14.05.06	9.0	48.3
IAN	15.12.15	6.6	89.6
PRIN	15.12.20	6.3	45.1
EURO (05)	24.07.05	37.0	32.9
EURO (18)	24.07.18	36.7	29.7

Sources: VEDI, KD

According to *Euromoney*, an international financial magazine that issues country-risk rankings every half year, Russia has fallen to the rank of 161 among the 180 countries surveyed. Russia 's creditworthiness fell from 78 in December 1997 to 127 in September 1998, falling further to 161 in March this year, behind such countries as Sudan and Chad.



Source: Euromoney

Debt servicing is not a problem of the federal government alone. The financial boom also encouraged regional governments to borrow on the international bond markets, but now they find it increasingly difficult to cope with their foreign debts. Recently, the Leningrad region and the City of Moscow have announced that they will not be able to service their debts according to original schedules. Experts note that the City of Moscow, considered to be one of the best performers, has borrowed over USD 1 billion from international lenders that must be paid off between 1999 and 2001.

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	108	3/99
M2, year-to-year growth, %		217	113	30	29.5	36.3		
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1295	3/99
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.	33.4	2/99
- deposit rate, %			102	55	16.4	25.7	22.7	2/99
- lending rate, %			320	147	46.2	41.7	44.0	2/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	6.7	3/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	24.23	4/99

Sources: Goskomstat, CBR

From real to virtual economy – a one way street?

By Juhani Laurila*

The Russians pretend to run a much larger economy than they really do. This illusory economy is dubbed by American economists Gaddy and Ickes as a "virtual economy." According to them, almost every important economic parameter such as prices, sales, wages, taxes and budgets described by the official statistics present a misleading over-sized facade. Behind this facade hides the midget that is Russia's real economy. One of the main conclusions the authors draw is that this virtual economy is "beyond bailout." By assisting this alleged "market economy" the West only supports the inertia of old approaches in economic administration; a command system replaced with barter, arrears and offsets. The Russian economist Illarionov called this system in his recent article in the Nezavisimaya Gazeta (13 April, 1999) "the populist-socialistic economy."

Survival kit of the Russian manufacturer

A neat, internally consistent accounting-algorithm illustrates how Russian manufacturers destroy economic values. Their cash sales do not cover their production costs in cash. Thus, instead of adding to the value of GDP, they subtract from it. In the real world, such behaviour would to get their operations terminated. Instead of going bankrupt, however, they continue to operate by propping up their losses with inflated barter deals and bills of exchange (*veksels*), tax offsets and other “instruments” having fairly liquid secondary markets. Competition also pushes liquid firms, which would be able to settle their bills in cash, to act the same way. They, too, economise cash to increase their liquidity and solvency.

Any effort to rewind development in Russia is now doomed to fail simply because it runs against every sector’s interests. The survival technique comprising the neglect of the hard budget constraint is a perfect way for the Russian economy to protect itself from the market economy, economic growth and accompanying welfare. However, the sources of rent gained through barterisation (surrogates for credits and subsidies) are bound to dry up sooner or later. Eventually, however, the value subtractors must face the real hard budget constraint and real bankruptcy. Again, the Russian economy will have to cope with yet another crisis.

Who is to be blamed?

The Russian government has never been able to commit itself to implement market reforms fully and consistently. On the contrary, by accepting tax offsets and barter payments to settle tax debts, the government has started to run a nationwide clearinghouse enabling it to postpone structural reforms. This centralisation and multilateralisation of clearing arrangements reduces transaction costs of barters and thus promotes the avoidance of the hard budget constraint and causes the expansion of non-monetary economy, which already has reached amazing dimensions in Russia. According to an EBRD survey (Commander-Mumssen 1998) of 350 Russian firms, more than half of industrial sales took place in barter form. More than half of the tax revenues to the federal budget took place in non-monetary – and relatively illiquid – form in 1998, accounting for almost 30 per cent of consolidated budget revenues.

Diagnosis and prescriptions

There are number of reasons (for instance, the failure of the Russian financial sector to generate savings), which alone would suffice to explain why the Russian economy is not growing. However, the term "value destruction" may best describe the rapid demonetisation of the Russian economy, whereby an increasing amount of economic actors are centrifuged or centripetalled into the use of surrogate money, surrogate credits and surrogate subsidies. Non-compliance with the hard budget constraint and the high transaction costs of barter lend the virtual economy its inflated face value.

The current virtual system also deludes Russian politicians into believing that, at least for the time being, there exists a specific “Russian road” between the market and command economy that leads to economic prosperity.

Ultimately, only Russia can help itself, no matter whether international assistance is made available or not. A serious commitment by the Russian government to the implementation of structural reforms and the imposition of a hard budget constraint is the only way to halt the value-destroying process. This calls for actual restructuring of formally privatised companies. It calls for creation of a credible financial sector able to convert short-term money into credits and equity capital necessary to finance economic growth. It demands removal of Russia's cumbersome and predatory tax system as well as the tax authorities’ right to get information about balances in bank accounts (a major factor undermining the credibility of the Russian banking). Enforcement of law and order in general, and ownership and contract laws in particular, will assist those firms willing and able to return to solid ground.

By failing to introduce these time-consuming, and in the short-run politically unrewarding reforms, Russia's politicians and authorities have opted to stay on a one-way street for some time to come.

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RUSSIAN ECONOMY
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Economic Developments

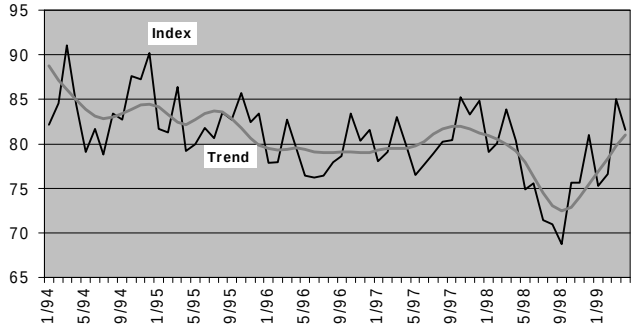
The real economy: 1995 versus 1999

In this issue of Russian Economy, we will compare Russia's current situation to that of spring 1995. The motivation for such comparison arises from recent events: The August 1998 crisis, the subsequent rise of an anti-market political stance, and finally the swing back to Stepashin's more market-oriented government. In essence, Russia faces similar dilemmas to those four years ago. In this respect, the ongoing IMF negotiations on a new stabilisation (stand-by) arrangement are particularly interesting. In spring 1995, the IMF and Russia agreed for the first time on a short-term stabilisation package. Thus, it might be both interesting and useful to contrast the situation in certain sectors of the Russian economy in the mid-1990s to the situation today to identify possible similarities as well as differences.

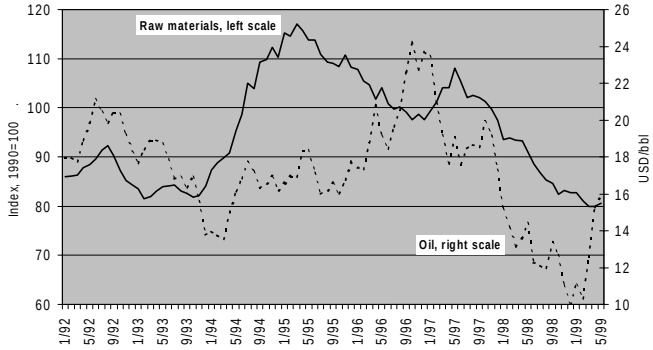
As regards production, GDP declined by 4% in the first quarter of 1999. Hence, the big picture concerning output developments corresponds well to that of 1995. However, due to the huge devaluation of the rouble since last August, industrial production today shows relatively strong signs of growth; the situation in this respect was not so promising in 1995 (see chart). Moreover, in spite of slow reforms, there have been changes in the structure of Russian GDP. For example, since the end of 1994 the share of services in GDP has increased by almost 5 percentage points to 53%, while the share of production of goods has decreased respectively to less than 40% (the rest comprise net taxes). Naturally, there have also been many changes within sectors.

However, the one-sided, underdeveloped structure of Russian production persists. Tellingly, Russia's foreign trade has not seen the introduction of new export products during the 1990s – it is as vulnerable as ever to changes in energy and raw material prices. In this respect, the current situation is more demanding than it was four years ago because raw materials in particular are much cheaper today than they were in the mid-1990s (see chart). In dollar terms, trade today is somewhat larger and the trade balance is improving rapidly thanks to the weak rouble. In any case, Russia needs a strong trade balance to compensate for today's significantly higher interest payments in the current account as compared to 1995.

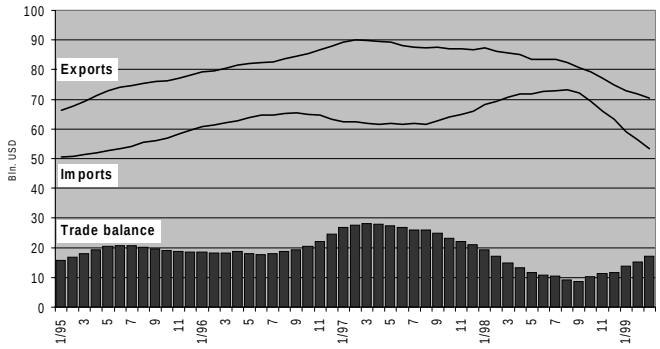
Russia's industrial production, Dec. 1993 = 100



Prices of oil and raw materials, 1994-99



Russia's foreign trade (12-month moving sum)



Sources: Goskomstat, Bank of Finland

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-4.0	Q1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	-0.5	1-4/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	-2.2	1-4/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	14.2	4/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	15.6	1-3/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	9.4	1-3/99
Current account, USD billion			10.7	10.0	12.0	4.0	2.4		

Sources: Goskomstat, CBR

Policy in the fiscal arena: 1995 versus 1999

As mentioned on page one, our comparison closely relates to the current negotiations between the IMF and Russia. Thus, the graph below on monthly inflation well illustrates both the starting points for IMF negotiations in 1995 and 1999, as well as the urgent need for a stabilisation package. Besides the need for curbing inflation, there are several other interesting features in the political and fiscal fields that justify a comparison between 1995 and today.

In spring 1995, there were two important elections ahead (parliamentary elections in December 1995 and presidential elections in summer 1996) and the war in Chechnya, which started in December 1994, added to the instability in the political field. Thus, as far as elections and wars are concerned, the situation today is oddly similar to that of four years ago, only this time the war is in Kosovo. Moreover, the deep confrontation between the Duma and the president and the overall uncertainty related to Mr. Yeltsin's political manoeuvres remain the same as in 1995. Also from the viewpoint of political commitment to reforms, the situation seems almost as uncertain as it was in the mid-1990s.

Nevertheless, while a budget deficit is still a major problem, there have been important changes in the field of fiscal policy since 1995. Perhaps one of the most important developments in this sense is the decline of real public revenues and expenditures measured as a share of GDP (see graph). Consequently, today the question of scaling down state functions is not as urgent an issue as it was earlier, so it is easier to focus on other fiscal issues such as revenue collection. Also an important learning process has gone on in recent years, meaning that today there is a wider understanding on numerous issues related to fiscal policy and the links among various policy sectors. For example, the leftist government of Mr. Primakov well realised the dangers related to excessive budget deficits and the links between loose fiscal policy and inflation.

An important change has occurred also in the external environment and overall sentiment concerning Russia. Due to the Asian crisis and Russia's defaults on both domestic and foreign debt, the international community now demands determined measures by Russia as a condition for further assistance and cooperation. This contrasts sharply to the situation four years ago, when for many people conditionality of financing held only secondary importance.

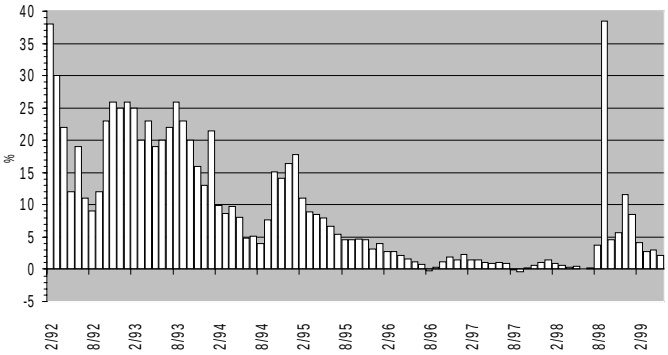
Government reshuffled again

The most recent governmental crisis was initiated 12 May when president Boris Yeltsin dismissed prime minister Yevgeny Primakov from the post that he had occupied for 8 months. The publicly stated reason for the dismissal was the slow pace of reforms, but according to commentators, a power struggle within the Kremlin was a more plausible explanation.

On 19 May, Sergei Stepashin, who has made his career in the ministry for internal affairs, was appointed as prime minister. His cabinet includes several members of the previous government, but is more reform-minded than its predecessor. Viktor Khristenko became first deputy prime minister in charge of budget and macroeconomic policy. The other first deputy prime minister, Nikolai Aksyonenko, was distinctively president Yeltsin's choice. Mikhail Kasyanov was appointed as finance minister; Andrei Shapovaliants is the new economy minister.

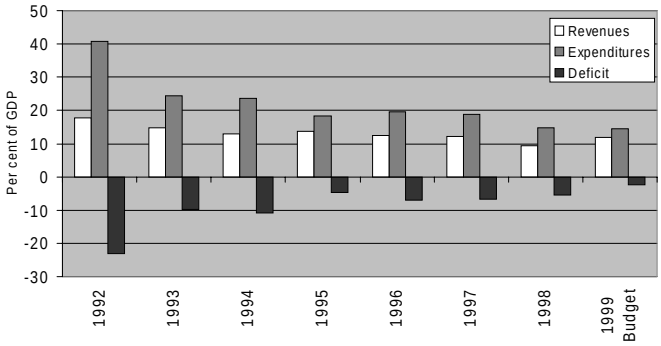
Mr. Stepashin has declared that the new government will implement the IMF agreement. The Duma has already started to discuss the related package of laws. It approved on 2 June in the first reading a bill on restructuring credit organisations – a move also considered crucial by the IMF. Further banking and tax laws are currently under discussion.

Monthly inflation in Russia, 1992-99



Source: Goskomstat

Federal budget in 1992-99, per cent of GDP



Source: MinFin, BOFIT

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	1999
Federal government							Jan.- March	budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	11.4	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	16.4	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-5.0	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

Financial markets: 1995 versus 1999

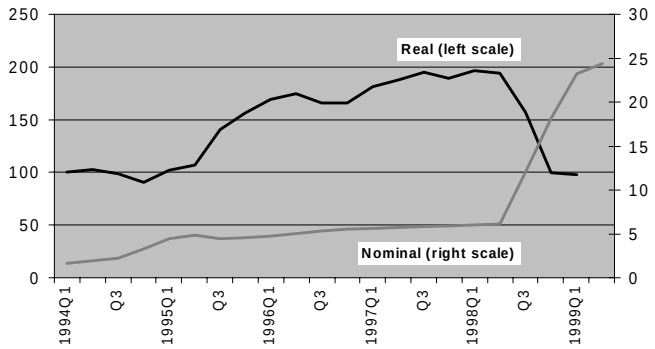
In the spheres of monetary policy and financial markets there are also interesting similarities and differences between the situation in spring 1995 and early summer of 1999. In addition to the problems related to controlling inflation (see the graph on the previous page), another important semblance concerns the real exchange rate. With the rouble's devaluation of over 70% since August 1998, its real value has declined to about the same level as it was in spring 1995 (see graph). As a result, an average monthly wage in dollars has declined from USD 170 before the August crisis to less than USD 60 today. At the beginning of 1995, an average wage was about USD 100 per month. Due to the August crisis and subsequent problems related to economic policy, the current situation concerning stock prices and sale volumes compares well to that in 1995 (see graph).

However, from the stabilisation point of view the situation concerning inflation and exchange rate policy is this time perhaps somewhat easier than four years ago. Today, despite high current monthly inflation rates, inflation is lower and there is less inflation inertia than in 1995. Thus, the chances of getting inflation under control by reasonable stabilisation policies without sharp appreciation of the real exchange rate are better today than in the mid-1990s.

On the other hand, Russia's debt situation today is much worse than it was in 1995. Russia's foreign debt has increased from USD 120 billion at the end of 1994 to about USD 150 billion (see graph). Moreover, because of recent defaults on both domestic and foreign loans, Russia's creditworthiness today is even lower than it was before the first IMF stand-by arrangement in 1995. In *Euromoney*'s March 1999 country-risk list, Russia was given the dark rank of 161 among 180 countries surveyed. Not surprisingly, perhaps, investors are more sceptical about Russia and demand more from the Russian side than ever before.

There have been several improvements since 1995 concerning structure and institutions of the financial sector. These include financial market legislation and corporate governance. The situation is still unsatisfactory in many respects, though. The Russian banking sector is currently in the midst of full-blown banking crisis; in mid-1995, such a crisis was only a future eventuality. Thus, there is presently an urgent need to deal with banking sector restructuring. This is likely to be especially challenging from the fiscal standpoint.

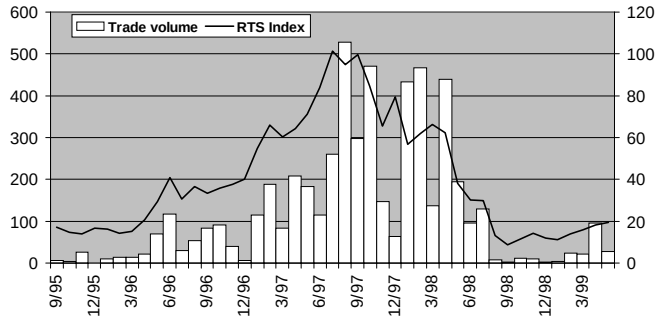
Rouble's nominal and real effective exchange rate, 1994-99



Source: BIS, BOFIT

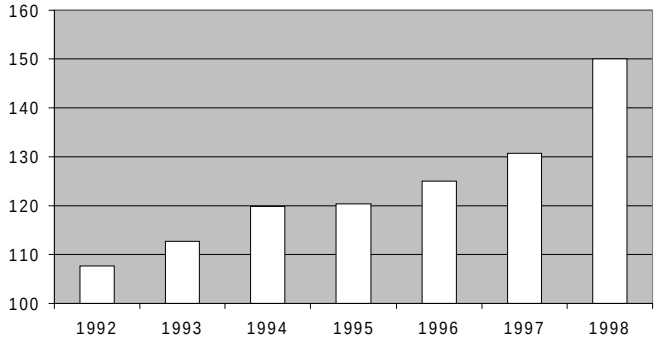
Russia's stock market in 1995-99

- data on the last day in each month



Source: RTS

Russia's foreign debt in 1992-98, USD billions



Source: Institute of Economy in Transition

Monetary indicators

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	116.6	4/99
M2, year-to-year growth, %		217	113	30	29.5	36.3	31.5	3/99
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1370	4/99
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.	27.4	4/99
- deposit rate, %			102	55	16.4	25.7	18.9	3/99
- lending rate, %			320	147	46.2	41.7	47.5	3/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	8.1	5/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	24.44	5/99

Sources: Goskomstat, CBR

Russia online and the researcher

By Päivi Määttä*

As most academics were raised on the slogan "Publish or perish," the current explosion in the quantity of academic literature comes as no surprise. As a result, however, most journals serve only a small number of readers. Limited circulation, however, usually raises costs to subscribers. This phenomenon can be readily seen also among publications dedicated to issues related to economies in transition. The number of publications increases, subscription prices rise and readerships dwindle. This trend keeps information markets very unstable and constantly changing. It has become quite common to see a new journal get into trouble within a couple years from its first issue. At that point, the publisher is faced with ending the publication altogether, merging it with another publication, or in the most recent trend, moving completely to an online format (e.g. the Czech journal *Transitions* is now www.ijt.cz). This new way of publishing changes business models so much that e.g. the process of making journal subscriptions (once supported by booksellers) no longer applies. Because of the present confusion on the Web, various parties (publishers, vendors, booksellers, libraries, and self-publishing authors) in the information market are seeking to define their roles and business models, establish territory, and ultimately find an audience.

Whether we like it or not, publishing is moving to electronic formats. But as the Internet itself as the means of disseminating information is constantly evolving, the research community must constantly reevaluate their publishing channels. The maturing of electronic publications is constantly creating new possibilities in communicating and distributing scientific information.

New delights

In the case of information about Russia, the advantages of electronic publishing are especially pronounced. Subscribers no longer have to depend on slow, unreliable delivery of surface mail. Among the types of email information available to economists are publication announcements, economic surveys (e.g. by research institutes and investment banks), news summaries (e.g. BOFIT's Week in Review and RFE/RL Newsline). There is also information about what is happening in Russia's regions (e.g. EWI/Russian Regional Report and RFE/RL Russian Federation Report). Johnson's Russia List is probably the best known discussion newsletter.

Also on the Internet you can find a wide range of news services, Russian-language newspapers, statistical data, who's who information, research, surveys, electronic journals and books. Information is offered by commercial firms, public agencies, banks, research institutes and international organisations. The Central Bank of Russia's own website (www.cbr.ru) deserves mention in this regard. Subscription-based *Russian Economic Trends* and the *Review of the Russian Economy* both publish monthly updates that can be viewed free-of-charge. Another welcome development is the increasing practice among Russian research institutes of publishing their working or discussion papers on their sites. The situation could be summarised by saying that the Internet has made it easier to obtain access to information sources related to Russia.

New headaches

Online publication is a mixed blessing, however, because electronic publishing also creates problems. For example, online access to journals is often limited to recent issues; the older material is not available in electronic format. A question facing libraries is what access and storage policies apply when a for-pay publication goes entirely online. If archive access depends on having a subscription, why should cancellation of a subscription necessarily prevent access to archive material when the subscriber has, in principle, paid for the information? Also if the journal ends or is merged, why does it follow that the archives should be lost (unlike in traditional libraries)? Even if libraries are allowed to store files of journals to which they subscribe, what assurances are there that the data will even be readable five years from now? This question is unavoidable because the computer programs and formats are developing so rapidly.

One particularly nasty problem is the use of online publications as references. URLs not only expire, they may link to other links, making the problem of tracking an original reference rather tedious. An online article with many hypertext references can be quite problematic. For the researcher coming back to an article years later, it is a virtual certainty that many links will no longer function. Indeed, entire publication may no longer exist and there may be no library files anywhere to verify the reference!

In the future, we can expect academic rigour to reassert itself so that quality and verifiability of information including references again become the cornerstones of leading journals. In the meantime, there is little to do but realise that anybody can maintain a site that includes unsubstantiated information in ways that even the site host is difficult to identify. Clicking from one link to another, one has to carefully check who is the original producer of the information. More than ever, researchers dealing with economies in transition need to be aware that the information processes by which they get their information are also in transition.

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RUSSIAN ECONOMY
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Economic Developments

Sustainability of growth under discussion

According to Goskomstat, Russia's industrial production grew in January-May 1999 1.5% compared to the same period in 1998. In May, production was reported to be as much as 6.1% higher than in May 1998. However, doubts have been raised related to the reliability of the latest figures. Using Goskomstat's figure for on-month change in May (-6.4%) gives an on-year growth figure of 1.9% for May rather than reported 6.1%. A possible explanation for this inconsistency is that Goskomstat has revised its 1998 figures.

In addition to problems related to consistency of data, there are wider doubts concerning the sustainability of growth in Russia. While Russian industry experienced growth after the rouble's devaluation, it is now necessary to ask whether the possibilities created by the devaluation have already been exploited. The extremely poor performance of domestic demand indicators underscores the importance of additional demand from import substitution to Russian industry. For example, real average wages are still 38% below the May 1998 level, although they recovered 1% from April. In the first five months of 1999, the volume of retail trade was 15% lower than a year ago.

Moreover, a lack of production capacity could prevent further benefit from devaluation. As with most of demand indicators, fixed investments have been declining in spite of devaluation-led industrial growth. Although the rate of decline in investment has decelerated, fixed investments were still down 2% in January-May compared to the same period in 1998.

While import substitution has had a substantial short- to medium-term effect on domestic production, it apparently has not led to any fundamental changes in the economy. The problems with the business environment and behaviour of firms are essentially the same as before the devaluation. Consequently, once the import substitution effect passes, there is a real danger that the current positive trend in industrial output will end. All these issues emphasise Russia's need to focus economic policy on supply-side problems (e.g. taxation, liberalisation) to promote sustainable growth in Russia.

USD 5 billion current account surplus in Q1

Due to the weak rouble, Russia's monthly imports were down by 47% in January-April compared to the same period last year. Thus, while the dollar value of exports were down by 10% as a result of low energy and raw material prices, Russia's external balance showed substantial improvement from the previous year.

According to the central bank's balance of payments information (see table), Russia's trade balance for goods surplus was USD 6.5 billion in the first quarter of 1999. Despite the deficit in trade of services and net interest payments by Russia, the overall current account was USD 5.1 billion in surplus in January-March 1999.

Russia's export situation has improved recently with a rise in oil prices since the beginning of June. In the first week of July, the price of Brent crude soared to an 18-month high of USD 18 per barrel.

Russia's balance of payments in 1997-1999, USD billion

	1997	1998	1999Q1
Current account	**4.0**	**2.4**	**5.1**
Trade balance (goods)	17.4	17.3	6.5
Exports, f.o.b.	89.0	74.8	15.6
Imports, c.i.f.	-71.6	-57.4	-9.1
Services	-4.7	-3.2	-0.4
Exports	14.2	12.9	2.2
Imports	-18.8	-16.1	-2.6
Investment income	-8.1	-11.2	-1.1
Received	4.1	4.0	2.2
Paid	-12.2	-15.2	-3.2
Other items, net	-0.6	-0.5	0.0
Capital and financial account	**5.7**	**0.2**	**-5.2**
Capital Account	-0.8	-0.4	-0.1
Received	2.1	1.7	0.2
Paid	-2.9	-2.1	-0.3
Financial account	6.5	0.5	-5.1
Direct investment in Russia	6.2	2.2	0.6
Portfolio investment in Russia	45.6	8.0	-0.5
Other items, net	-45.3	-9.7	-5.2
Net errors and omissions	**-7.8**	**-7.9**	**-0.9**
Change in reserves	**-1.9**	**5.3**	**1.0**
('-' growth, '+' decline)			

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-4.0	Q1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	1.5	1-5/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	-2.0	1-5/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	14.2	5/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	22.1	1-4/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	13.0	1-4/99
Current account, USD billion			10.7	10.0	12.0	4.0	2.4	5.1	Q1

Sources: Goskomstat, CBR

Russia's road towards new IMF credit

In late April, Russia and the IMF reached tentative agreement on an economic program aiming at a USD 4.5 billion Stand-By Arrangement. The program focuses on short-term stabilisation to get the Russian situation under better control and open the door for negotiations about debt rescheduling with Western creditors. The program is based on forecasts of a 2% GDP drop, 50% inflation and a current account surplus this year amounting to 8% of GDP.

The agreement included a list of prior actions that the IMF demanded Russia take before the IMF board would discuss a new loan arrangement. The prior actions cover a wide range of legal initiatives to raise federal budget revenues, promote orderly management of bank restructuring and relax foreign exchange restrictions imposed after the August 1998 crisis. Russia must also provide a thorough accounting of the activities of FIMACO, a CBR foreign subsidiary allegedly used to "hide" part of the central bank reserves.

The State Duma proved to be surprisingly cooperative in passing the majority of the proposed acts and amendments before it adjourned for summer holidays in late June. The law on restructuring credit institutions was passed and is now waiting for approval by the Federation Council and the President. The law provides a clear legal basis for the operation of the new state agency for restructuring of credit organisations, ARCO, which to date has played only a modest role in restructuring Russia's troubled banking sector. Another important legal change was an amendment to the law on central bank granting the CBR the right to issue its own bonds.

In addition, the government and the central bank have been busy paving the way for the new stand-by arrangement. From June 29, the two forex trading sessions on the currency exchange were unified. All other restrictions on foreign currency operations remain in place, however. Exporters are still required to repatriate 75% of their foreign currency earnings and importers must deposit a rouble equivalent for any advance payment. The CBR also seems more willing to withdraw banking licences, even those of large insolvent banks. The CBR's actions in this matter have not been fully consistent with those of ARCO.

An IMF mission visited Moscow 28-30 June. Several observers noted the discussions had been fruitful. Mikhail **Zadornov**, Russia's lead negotiator in the IMF talks, further announced that the two parties agreed on the text of a Letter of Intent outlining the economic policies that would form the basis of a new stand–by agreement.

Some open questions remain

The Federal Tax Service has reportedly been able to collect increasing amounts of taxes during the first six months. Moreover, due to increased world market prices, revenues from customs duties are high and covering a third of federal budget revenues. Nevertheless, the target primary surplus of 2% of GDP looks as distant as ever. As expenditures have also risen, the federal budget ran a primary deficit of 0.5% for January-April. Not only did major oil companies lag far behind their agreed payment schedules, the Duma voted down a proposed tax on gas stations. A proposal to raise alcohol taxes never even made it before the Duma. So far, the government appears to lack a clear plan on how to compensate for the revenues these taxes would have generated.

The IMF board may decide upon the agreement as early as mid July. If the proposed agreement were approved, Russia would receive USD 4.5 billion over the next 18 months. The money would go exclusively to covering the main part of Russia's debt servicing costs to the Fund. In all likelihood, the money will never make it to the CBR's coffers.

The IMF approval would also free financing from the World Bank and Japan, increasing the overall loan package to some USD 7.5 billion. The London and Paris clubs of creditors holding some USD 100 billion (de facto defaulted) Soviet-era debt also consider an IMF agreement as a precondition for any negotiations on debt rescheduling. The agreement should help with orderly management of Russian economic policy until the Duma elections in December 1999 and the presidential elections in June 2000.

Some of the IMF's requested prior actions

1. Increasing budget revenues
* postpone VAT cut from 20% to 15%
* raise taxes on alcoholic beverages
* introduce taxes on luxury cars and gasoline stations
* enforce better tax collection from large oil companies

2. Bank restructuring
* pass bank restructuring and bankruptcy legislation
* strengthen ARCO
* withdraw licences of banks to be liquidated
* authorise to the CBR to issue its own debt paper

3. Foreign exchange restrictions
* abolish the two-tier foreign currency market
* lift restrictions on foreign bank participation in the forex market

Source: PlanEcon, BOFIT

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Jan.- April	1999 budget law
Federal government								
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	12.4	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	16.9	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-4.4	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

CBR eases currency restrictions

The new unified currency trading session at the Moscow Interbank Currency Exchange (MICEX) launched on 29 June. Previously only exporters were permitted (and obligated) to repatriate their hard currency earnings in a special morning session by selling to importers and the Central Bank of Russia (CBR). Now every bank with a license for foreign currency operations (approx. 650 banks) may take part in the hour-long session. The CBR sets the official daily rouble rate based on trading during the session.

Although trading volumes in the new session were considerably higher than previously, the rouble managed to keep its value in the early days of the new regime, trading just above 24 against the dollar.

The new law allowing the CBR to issue new short-term debt (OBRs) aims to cool high liquidity in the banking sector. Under the new law, OBRs would be sold exclusively to banks and the total amount of OBRs on issue could never exceed 20% of the total liabilities of Russian banks. Russia's interbank market also needs new liquid instruments since the government defaulted on its short-term papers (GKOs). No OBRs have yet been issued.

Equity market gains 45% in a month

On Tuesday 6 July, the RTS index closed at 146.61, or almost 45% higher than just a month ago (see chart). The Russian equity market has benefited from higher oil prices and the possible disbursement of new IMF money. Falling eurobond yields, high liquidity in the banking sector and a more stable rouble also helped push the leading RTS index to levels not seen since before last year's mid-August devaluation.

Equity market volumes have also been rising. The average daily volume in the RTS in June was USD 13 million, considerably up from an average of USD 1.5 million in January this year. Even so, these new volumes are still low compared to 1997 levels. Moreover, smaller firms quoted on the RTS 2 list are rarely traded.

Although the equity market has been rapidly growing, the market capitalisation of the approximately 200 enterprises listed in Russia (USD 30 billion) only amounts, for example, to about 30% of the market capitalisation of Nokia, Finland's largest firm.

Since 23 June, foreign investors have been allowed to invest their money from the GKO restructuring process in six MICEX securities. Nevertheless, MICEX volumes were relatively unchanged in the first days of July.

Progress on banking sector reform

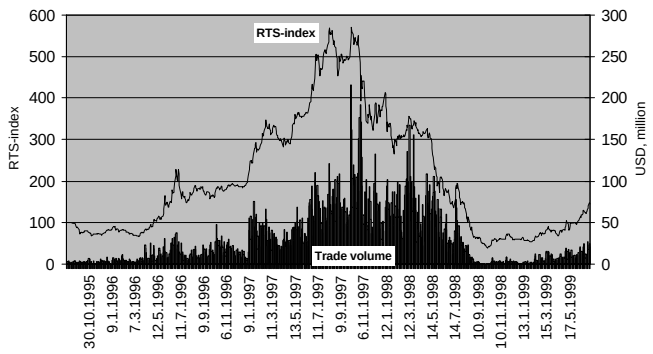
The new law on restructuring credit organisations provides a clear legal basis for the operation of the Agency for the Restructuring of Credit Organisations, ARCO, which to date has played only a modest role in restructuring Russia's troubled banking sector. The law makes it possible to swap bank liabilities for bank equity, sell controlling stakes in troubled banks to ARCO, set the charter capital requirement equivalent to a bank's net assets, restructure by merger and place moratoria on liabilities.

On 30 June, the CBR revoked the licenses of four large commercial banks: Uneximbank, Promstroibank, Mosbiznesbank and Mezhkombank. Earlier, the CBR revoked the licenses of MENATEP, Unikombank and Tokobank. At the end of June, the total number of licenses revoked during this year stood at 52. The number of banks still operating is just under 1,400.

The recent CBR moves were criticised by ARCO, creditors and bank clients. ARCO had just promised a RUB 3.1 billion restructuring loan for Promstroibank. Mosbiznesbank had already received a RUB 1 billion loan for stabilisation.

Nevertheless, few dispute that Russia needs proper banking laws and a tough, functional supervision body, particularly if Russia expects to attract foreign investment in the future. Even if change is forthcoming, it will be too late to help creditors today seeking solutions with troubled banks. In numerous cases, the liquid assets have been transferred out of the troubled bank to a new bank owned by the managers of the old bank.

Russia's stock market in 1995-99, RTS-index Sep 95=100



Source: RTS

Monetary indicators

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	120.5	6/99
M2, year-to-year growth, %		217	113	30	29.5	36.3	38.5	4/99
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1465	5/99
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.	20.2	5/99
- deposit rate, %			102	55	16.4	25.7	14.6	4/99
- lending rate, %			320	147	46.2	41.7	44.1	4/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	8.2	6/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	24.22	6/99

Sources: Goskomstat, CBR

Slavic Brotherhood or Botherhood? Belarus, Russia and Ukraine

By Rupinder Singh *

A decade into transition, where are the three former Soviet Republics on the road from Plan to Market and what can be expected in the near future?

The three economies retain considerable cross-border trade and enterprise links inherited from the Soviet-era. Moreover, unlike countries to the immediate West, these economies have pursued gradualist reform strategies, in part due to a lack of sufficient "ownership" for reform, of sufficient political stability and consensus for a fast-track transition to market. Consequently, each country remains 30-40 percent below its economic level in 1990.

The key macro-picture for Belarus, Russia and Ukraine.

	Belarus		Russia		Ukraine	
	1997	1998	1997	1998	1997	1998
Real GDP	10.4	8.3	0.8	-4.6	-3.2	-1.7
Industrial production	17.6	11.0	1.9	-5.2	-1.8	-1.9
CPI	63.1	181.7	11.0	84.4	15.9	10.6
Gov. balance % of GDP	-2.1	-3.0	-7.4	-5.3	-5.6	-3.0
Trade balance % of GDP	-10.1	-10.1	4.3	5.1	8.8	3.7
Current Account balance % of GDP	-6.0	-6.8	0.9	1.9	-2.7	-2.3

Sources: EBRD, BOFIT, BET, UET.

Spillovers from the Russian crisis

The existing close economic links between the three countries suggested that after August 1998 both Belarus and Ukraine would suffer economic repercussions through (i) a decline in external demand; (ii) contagion in the financial markets due to spillovers from the rupture of the payment and settlement systems in Moscow during the summer 1998 crisis, and; (iii) a decline in external appetite for sovereign Slavic risk making external financing more difficult.

The doomsday scenarios of a Russian economic policy returning to the edicts of command economy under the Primakov government and hyperinflation have proved unfounded and if anything the Russian economy has benefited from the twin gifts of a rising oil price that raises export revenues and compression of imports on the back of RUR devaluation which has also raised the competitiveness of the Russian real sector, at least in the domestic market. However, inflation has risen, the banking sector remains moribund and the external debt overhang remains pending.

By contrast, Ukraine has avoided a return to high inflation and ruptures with the international financial community, though there remain medium-term concerns, particularly on the sustainability of the external account. The policy of high interest rates, imposition of currency controls and trade restrictions have prevented the domestic currency from rapid devaluation, and helped keep inflation in check.

Unlike her two Slavic sisters, Belarus has in effect been isolated from external finance both because of the backtracking of the reform effort under the Lukashenka-regime and its international outcasting. This has meant that no multilateral funding has been forthcoming since 1994, locking out the release of bilateral and other private-sector funding. Thus, whilst Belarus escaped the direct effects of the international financial contagion borne from the Russian crisis, the indirect effects are likely to be more prevalent. The redirection of trade towards Russia and Ukraine has meant that the real sector contagion has been more pronounced. With little restructuring undertaken, exporters cannot look realistically for new markets, unlike the pattern being observed for the real sectors in the Baltic economies. Without external finance, the Belarusian 'miracle' has been based on use of central bank financing, which in turn has fuelled a rapid surge in inflation, particularly on the black-market exchange rate, and seen in growing shortages and arrears to both Russia and Lithuania for energy imports.

Short-term horizons

Each of the three countries has a series of elections in the offing until the Russian Presidential elections in the summer of 2000. This means that a faster shift to market is not likely. Secondly, the international community can be expected to be more accommodating to ensure no default before the elections, to ward against the elections of a more leftist and less reform-minded legislatures and presidents.

The mutual reinforcement of these two themes set against the current economic environment does mean that neither Russia nor Ukraine are likely to move toward a substantive pre-election spending spree, beyond rhetoric á la Yeltsin in 1996.

The Belarusian economic model has a finite time horizon. Even with continuing energy subsidies from Russia, the fear of a return of hyperinflation may give way to one of slumpflation, as in the Albanian and Bulgarian crises. Output rises have been based on edict, financed by cheap credit, leading to unwanted stocks or until recently bartered to pay for Russian energy. Stabilisation would imply a cut in credits and a decline in 'bubble' output. The release of the monetary overhang would therefore see a simultaneous one-time spike in inflation.

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RUSSIAN ECONOMY
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Economic Developments

Industrial production up 3% in first half

According to Goskomstat, Russia's industrial output increased 3.1% during the first six months of 1999 as compared to the same period last year. The best performing sector was the tiny microbiological branch (up 24%). It was followed by more traditional sectors: chemicals and petrochemicals (14%), pulp and paper (11%) and non-ferrous metals (7%). The food industry also seems to be enjoying devaluation benefits with an on-year production increase of 7% – a remarkable achievement given a 1% decline in food industry output in 1Q99. Perhaps too remarkable, however, for the validity of the data has been questioned (see RM 6/99). On an annual basis, output declined in electrical energy (-1%), printing (-8%) and light industries (-5%).

The resource-intensive energy, metallurgy, fuel, pulp and paper, and chemical sectors together amounted to 60% of the industrial production in 1H99. Machine building with 18% had the single largest share for an industrial sector. It was followed by the food industries with a 15% share of total industrial output.

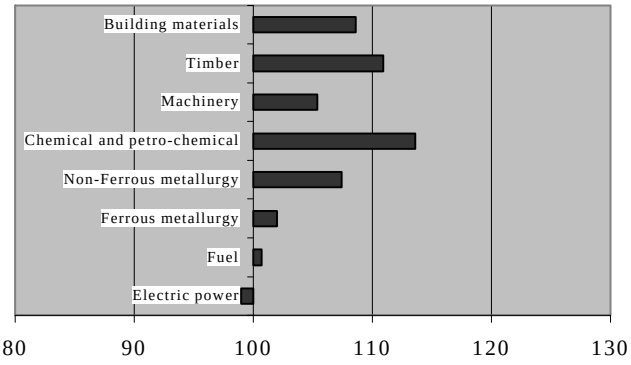
Oil exports up, too

According to preliminary data from the Ministry of Fuel and Energy, Russia's exports of crude oil outside the CIS have increased slightly from 58 million tonnes in 1H98 to 63 million tonnes in 1H99. The level of crude production, however, stayed at around 150 millions tonnes – the same level as a year ago. Thus, increased exports come at the expense of domestic consumption. Additionally, exports of oil products into and outside the CIS have risen substantially. According to Ministry of Trade estimates, oil product exports to CIS were up by 40% during the first five months of this year. Meanwhile, Russia's domestic production of gasoline and fuel oil decreased 8% compared to the same period last year.

The situation has inflamed government sentiments, forcing leaders to stress satisfying domestic needs over exports. The government has even urged oil companies to increase production by the end of the year. Unfortunately, higher crude production fits badly with last March's promise to OPEC to cut exports by 100,000 bpd. Moreover, analysts note that rapid increases in the production are technically unfeasible. Paradoxically, the efforts to sustain a price freeze on domestic fuel prices as part of the government's price stabilisation measures (and thereby ensuring that domestic fuel prices are not even held in line with inflation), creates stronger incentives to divert production away from domestic users to exports.

Improvements in the performance of Russian oil companies (see page 3), a stronger trade balance and higher government revenues from customs duties all reflect the current rise in oil prices. Russia's exports in January-May 1999 were valued at USD 27.3 billion. Of this, the energy sector accounted for a third of the total value. During the same period, Russia's trade surplus according to CBR data was USD 11.6 billion. For January-May 1998, the figure was only USD 834 million. At current price levels, the government collects an export duty of 5 euros per ton. If exports continue at current levels in the second half, it would add some USD 300 million to government revenues.

Industrial production, change in 1H99 as percentage of 1H98



Source: Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-4.0	Q1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	3.1	1-6/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	-1.7	1-6/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	14.2	6/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	27.3	1-5/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	16.1	1-5/99
Current account, USD billion			10.7	10.0	12.0	4.0	2.4	5.1	Q1

Sources: Goskomstat, CBR

IMF approves USD 4.5 billion credit for Russia

On Wednesday, 28 July, the IMF board approved a 17-month, USD 4.5 billion stand-by credit designed to support the government's economic program for 1999-2000. The first tranche, worth USD 640 million, was released immediately. The IMF board is expected to consider the next loan tranche in late September, and five more thereafter. In an exceptional move, the credit will be used exclusively to service Russia's former IMF credits.

The main focuses of the economic program are on restoring fiscal balance and structural reforms. Fiscal balance is the most pressing issue, but structural reforms also offer formidable challenges. To date, Russians have been lax in implementing structural reforms (including bank restructuring), improvements in fiscal management, and accountability of natural monopolies.

Challenges in fiscal policy

On the fiscal side, the IMF program targets the goal of a primary surplus of 2% of GDP of the federal budget and 5.1% of GDP total budget deficit this year. The total deficit is projected to decrease in 2000, but a balanced budget is nowhere in sight. Even if the Russian government sticks to the program guidelines, substantial borrowing will be needed to cover expenditures, including debt servicing, in the coming years. It is not entirely clear how the Russian government will achieve the 2% primary surplus target by the end of this year, as the figure for the first five months was 0%. All things equal, this would require a decrease in spending of about RUB 60 billion (USD 2.8 billion) – a little over 30% of the budgeted non-interest expenditure in the second half of the year. However, such reductions seem quite unlikely, given the upcoming Duma elections in December.

A more attracting alternative, naturally, is to increase budget revenues. As the increasing tax collection figures are insufficient to fill the gap, Russian authorities are considering selling stakes in several state-controlled oil companies. A 9% stake in Lukoil and several tiny blocks of Gazprom may be sold by the end of the year. Authorities have also mentioned that the government's larger stakes in three other oil companies, Slavneft, Rosneft and Tyumen Oil may be put on sale.

Doors open for debt negotiations

While the IMF agreement offers no fresh money for the government, the agreement with the IMF was a prerequisite for both other creditors to resume their lending program and for re-opening the negotiations on rescheduling Soviet-era debt. The World Bank and Russia agreed in principle on loan programs of USD 2.3 billion for the next two years. Russia is expected to receive USD 1 billion from Japan to complement how the World Bank has handled funding of programs.

The negotiations on debt rescheduling with the Paris club of sovereign creditors started immediately after the IMF deal was confirmed. Russia owes some USD 38 billion in Soviet-era debt to its creditor countries. Of that, approximately USD 8 million in interest payments fall due on 1999-2000. The country with greatest exposure to Soviet debt, Germany, has repeatedly excluded any discussion of debt-forgiveness. It is thus only expected that an agreement on rescheduling of interest payments in 1999-2000 will be reached, postponing inevitable hard decisions for a couple of years. The negotiations with the London club of private creditors are likely to be even more difficult and time-consuming. The Russian authorities have indicated that they may seek restructuring of all London club debt, which amounts to approximately USD 35 billion, not only the payments falling due in 1999-2000.

Some program targets specified in the Governor's Statement of Economic Policies

1. Basic economic developments
* GDP drop of 2% in 1999
* 12-month inflation of 50% by December 1999
* Current account improvement of 8% of GDP
* International reserves in the amount of USD 2bl in 1999

2. Fiscal policy in 1999
* Federal government primary surplus of 2% of GDP
* Overall deficit of the federal and the extended governments of 5.1% of GDP
* Move to full cash tax payments by oil companies by November
* Reduction in non-interest government spending

3. Exchange rate and trade policy
* The market helps determines the exchange rate.
* Elimination of deposit requirement for prepayment of imports by the end of September 1999
* Further steps to liberalise trade and foreign investment regimes

4. Structural reforms
*Improving fiscal management by transferring all budgetary entities, including the Minister of Defence, to the Treasury system.
* Enhanced transparency and public disclosure of information on CBR and government activities.
* Passage of additional laws facilitating orderly management of bank restructuring.
* Non-payments must be seriously addressed in 1999: the government intends to meet its own spending obligations in full.

Source: www.imf.org/external/np/loi/1999/071399.htm

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Jan.- May	1999 budget law
Federal government								
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	12.5	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	16.9	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-4.4	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

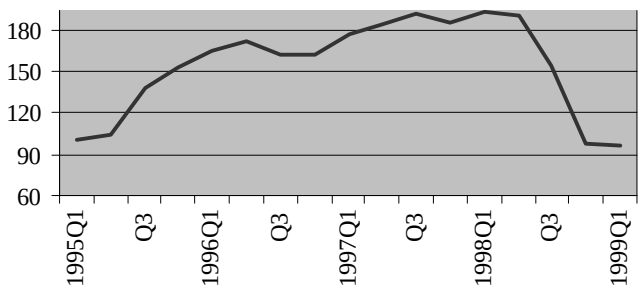
Sources: Goskomstat, IMF, MinFin. Figures for 1993-94 are not fully comparable with others.

Devaluation boosts earnings of large firms

While the turnover of major Russian firms fell in dollar terms after last August's crisis, their costs showed a vast drop. The real effective exchange rate has dropped nearly 40% since the devaluation. As a result, the earnings reports for the last quarter of 1998 and the first quarter of this year have improved.

For example, in 1Q99 Gazprom's revenues dropped 21% y-o-y to USD 2.3 billion, while operating profit before taxes was up 88 % to USD 466 million. During the same period, oil producer Lukoil saw its turnover fall 57% to USD 1.1 billion, but nevertheless saw its operating profit before taxes rise 111% to USD 211 million. The 1998 turnover of non-ferrous metals producer Norilsk Nickel fell 17% from 1997. Even so, the firm managed to reduce its operating loss before taxes from USD 578 million in 1997 to USD 68 million. While the social costs that have burdened Norilsk Nickel were considerably reduced, the firm also incurred over USD 300 million in exchange rate losses due to the rouble's devaluation. The blessings of improved profitability from the devaluation, however, have been limited mainly to exporters and firms competing directly with foreign imports. For example, power producers and telecoms have not seen improved results this year. The above corporate results were formulated in accordance with Russian accounting standards, which differ somewhat from internationally accepted accounting practices.

Rouble/USD real exchange rate 1995-1999



Source: BOFIT

Sovereign eurobonds serviced in full, but banks face difficult times

The government agent for external debt servicing, Vnesheconombank, reported that it transferred a total of USD 320 millions for coupon payments due 24 July on eurobonds maturing in 2018 and 2005. Both bonds were issued in July 1998 in a swap of short-term GKOs to longer dollar-denominated debt. These payments mark a temporary respite for Russia after a heavy external debt servicing period. Russia paid approximately USD 320 million in July, USD 450 million in June and USD 530 million in May. These figures exclude payments to the IMF and to the London and Paris clubs of creditors. The next eurobond coupon payment falls due in October.

As expected, SBS-Agro Bank failed to pay its USD 26 million Eurobond coupon falling due on June 22. It thus became the third Russian commercial bank to default on a eurobond. SBS-Agro, once among the country's five largest banks, has received several billions roubles in soft loans from the government and the CBR since the August 1998 crisis. It is feared that the bank's assets are being moved to a new entity. Another Russian bank, Alfa, however, successfully met a USD 18.2 million coupon payment on its 2000 eurobond. Alfa further noted that on 16 July it had agreed with creditors on restructuring of the bank's USD 77 million commercial paper. The National Reserve Bank was also reported to have repaid on 26 July USD 14 million of its 3-year syndicated loan.

Modest demand for new rouble corporate bonds

Three large Russian companies recently issued rouble-denominated corporate bonds targeted primarily at foreign investors wishing to reinvest their rouble returns from the GKO restructuring. According to various estimates, foreign investors may have up to RUB 20 billion available in their accounts (USD 830 million to buy specified shares and corporate paper in MICEX. These particular corporate bond issues, however, have not been runaway successes.

Already in June, Russia's biggest oil producer Lukoil issued a rouble-denominated corporate bond with a nominal value of RUB 3 billion. Both coupons and repayments on the principal of this four-year bond will be indexed to the rouble-dollar exchange rate. Lack of interest, however, forced the company to request an extension of the subscription period to late August. A second corporate bond issuer, Gazprom, announced RUB 2.5 billion (USD 100 million) had been raised from its RUB 3 billion issue held between 6 and 12 July. The terms of this issue were similar to those of the Lukoil issue with payments indexed to the official exchange rate. The lack of interest in the issue was apparent as, according to estimates, the underwriters themselves subscribed to about 40% of the bonds offered. Tyumen Oil Company is placing the first tranche of its oil-exports-backed RUB 2.5 billion issue on 91.2% of the face value.

Monetary indicators

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	120.5	6/99
M2, year-to-year growth, %		217	113	30	29.5	36.3	38.5	4/99
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1619	6/99
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.	16.0	6/99
- deposit rate, %			102	55	16.4	25.7	14.6	4/99
- lending rate, %			320	147	46.2	41.7	44.1	4/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	8.2	6/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	24.19	7/99

Sources: Goskomstat, CBR

Towards a New Theory of Reform

By Victor Polterovich *

There is little doubt that the use of neoliberal recipes failed to deliver their intended results in many economies in transition. This happened for several reasons. The neoliberals ignored the massive costs of institutional transformation. They believed that the creation of a legal framework for markets was sufficient for the formation of efficient institutions. They disregarded the possibility of "institutional conflicts" when institutions are transplanted from one culture to another, and they neglected the need for an effective state. Understanding these failures does not imply an attempt to return to older views. Work still remains before we understand what should and could be done in the future.

Up to the 1970's it was customary to think that the state should play an important role in the economy. A radical socialist theory of transition from capitalism was based on a simple and seemingly obvious recipe: "Set up a good plan and enforce it". Practice showed that this recipe could not be implemented since nobody knew what a good plan was and how to enforce it. Theories of rent seeking and corruption were developed to explain the roots of government failures. Instead of the old slogan, a new one, as simple and obvious, was widely embraced as a recipe for reforming developing and centrally managed economies: "Create market institutions and enforce their efficient functioning". This was misleading again since nobody knew what market institutions were and how they should be designed to be efficient. More specifically, there were five main mistakes.

First, the size and distribution of transformation costs were forgotten. In practice, these costs turned out to be huge. Most former Soviet republics suffered drops in GDP of around 40 per cent, and welfare differentials surged. There are three basic sources of transformation costs. Resources have to be diverted from traditional objects of investment to the riskier business of building up new institutions. Disorganisation prevails while the old system is dismantled before the new one can function efficiently. Economic agents need to learn a lot, and the learning processes are expensive.

The transition from the old systemic equilibrium to a new one takes years, and many mistaken decisions are made before a new balance is found. Of necessity, many barriers to free movement of resources exist, and each offers somebody the possibility of earning rent revenue. Under central management, the crucial sources of rents were differences between wholesale and retail prices as well as domestic and world market prices. Such rents should disappear in transition, but in fact the process of liberalisation offers huge possibilities of earning income just by being "in the right place at the right time". This process creates a class of newly rich, but it also imposes losses on most of population.

Second, it was not understood that creating the legal framework for markets – through privatisation, in particular – did not guarantee the spontaneous formation of efficient market institutions. A given legal system can give rise both to good and bad institutions. Among the latter, barter, arrears, corruption and tax avoidance developed on a huge scale in Russia. Once in place, such institutions become well entrenched, culturally sanctioned and self-reinforcing. Price liberalisation and standard stabilisation measures taken under unstable transitional institution structure may provoke the formation of these bad behavioural norms. Not understanding this was the third neoliberal mistake.

Fourth, its seems often to be reasonable to transplant institutions; there is no need to reinvent the wheel. When such transplantation occurs across cultural boundaries, however, "institutional conflicts" easily arise, either leading to the death of some institutions or to the formation of strange mutations: stable, but inefficient, institutional traps. The typical post-privatisation Russian industrial firm, the joint-stock company dominated by the employees, is a prime example of this kind of development.

Fifth, the role of the state was undervalued. The World Bank, in particular, has recently raised this issue. This is not the issue of the "strength" of the state, as most Russian debates put it. A strong state may serve just narrow elite interests. What is needed is an effective state that can coordinate different social preferences and work towards social goals, also by delegating power to those that can best use them. By reallocating rights through liberalisation, privatisation and deregulation the state automatically takes over an enhanced role. Therefore, the government effectiveness has greater importance at times of change than under stable conditions. The experience of effective governments in France, Japan, Korea after the Second World War showed that industrial policies and indicative planning could also find their places in the governmental toolbox.

Russia is tired of reforms but needs them perhaps more than ever. The task now is to reform the state, including the political institutions. Russia also needs a programme for getting out of the four basic institutional traps: barter, arrears, tax avoidance and corruption. A reasonable balance among the interests of different groups within and around enterprises has to be found. The financial system has to be reformed. All of this needs much work, including serious theoretical consideration, before new guidelines for reformers are available. Perhaps the Washington Consensus will be followed by a Moscow Consensus – at least it is exactly the Russian case that offers the most food for thought here.

**The author is a visiting researcher at BOFIT.*

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Economic Developments

Industrial growth accelerates

Industrial output in June was already up 9% compared to June 1998. The respective figure for July was almost 13%. Consequently, output growth in January-July accelerated to 4.5% from 3.1% in June. All major industrial branches recorded growth in July and growth rates above 20% were reported for such industries as ferrous metallurgy, chemicals and petrochemicals, industrial machinery, wood processing and light industries. Of course, the level of output a year ago was exceptionally low, and this partly explains the high growth figures of this summer.

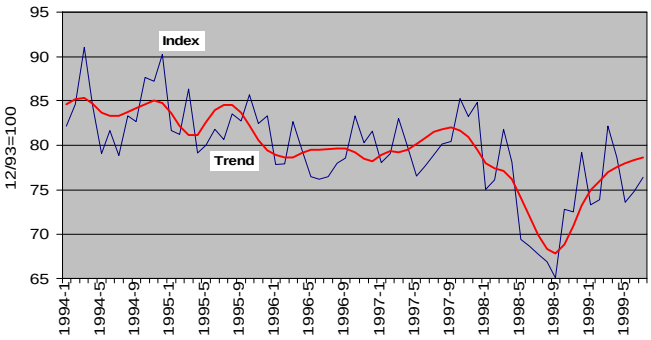
Import substitution largely explains current growth in industrial production as many demand indicators are still in deep recession. Thus, while in January-July fixed investment were only 1% less than in the same period in 1998, real disposable income was still 26% down from last year. In the current fiscal situation, the growth contribution of the public sector appears modest, though the federal government's expenditures as a percentage of GDP has increased (see next page).

Export volume up, dollar value down

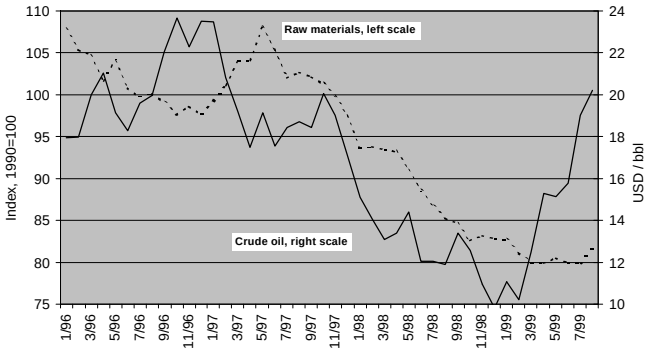
Goskomstat's information on Russia's trade reveals interesting insights to the dynamics of Russian economy. First, there has been a lot of room for import substitution as imports in dollars have declined 45% in the first half of 1999 compared to the same period a year ago. Second, the situation regarding demand side factors is unclear. In dollar terms exports have declined in the first six months by 12% as Russia's export prices have been lower than a year ago. However, a volume of exports has increased in 14 out of 22 reported export product groups. Thus, presumably, the total volume of exports has increased, which has also contributed to industrial growth in Russia. On the other hand, there is no evidence of new export products. This indicates that the positive growth effects of devaluation might be short-lived.

Due to huge drop in imports, Russia's 12-month trade surplus in June grew to about USD 25 billion from about USD 11 billion a year ago. In January-June, non-CIS countries accounted for 83% of total exports and 78% of total imports.

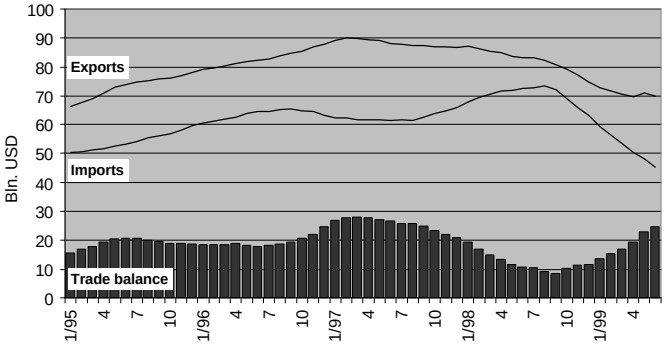
Russia's industrial production, Dec. 1993=100



Prices of oil and raw materials, 1996-99



Russia's foreign trade (12-month moving sum)



Sources: Goskomstat, Bank of Finland

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP,%	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-2.9	1-6/99
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	4.5	1-7/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	-0.8	1-7/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	12.4	7/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	32.6	1-6/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	19.7	1-6/99
Current account, USD billion			10.7	10.0	12.0	4.0	2.4	5.1	Q1

Sources: Goskomstat, CBR

Stepashin out, Putin in

On 9 August, President Boris Yeltsin sacked prime minister Sergei Stepashin and named Vladimir Putin as acting prime minister. Most recently, Mr Putin served as head of the Federal security service and as secretary to the security council. The Duma later confirmed Mr. Putin. His decision to retain all ministers responsible for economy shows willingness on his part to continue with economic policies agreed with the IMF.

First half federal budget shows improvement

Although the Russian federal budget balance lagged far behind the IMF program targets earlier this year, figures from the first half of this year show modest improvement on the fiscal side. The January-June federal budget revenues amounted to RUB 226 billion (13.2% of GDP) and expenditures RUB 290 billion (17.0%), leaving the budget deficit at RUB 64.8 billion (3.8%).

While the first half figures leave the total budget in the red, the IMF program concentrates on primary surplus, i.e. the budget balance before the debt servicing costs. In 1999, the IMF program target for the federal budget primary balance is 2% of GDP. In January-May, the primary budget did not show any surplus. However, the situation improved significantly in June as the surplus in this particular month increased to 4.4 percent of the GDP. Thus, January-June budget figures now show a primary surplus of 0.9% of GDP.

The improving budget situation is largely due to progress in tax collection. In June, the federal budget tax revenues were 26% higher than in May. According to the Russian Ministry of Taxes and Levies, this trend continued in July, when tax collection was one-third above the target. Increased energy prices and devaluation benefits enjoyed by Russian exporters have also begun to show in tax revenues. In the second quarter, taxes from foreign trade in rouble terms increased 52% compared to the first quarter. Improved tax collection and higher export tariffs have also compensated for the reduction of import taxes.

In the coming months, a new regulation stipulating that from August onwards, petroleum companies must pay their taxes wholly in cash instead of resorting to barter arrangements, should help the state to meet its cash constraint. Moreover, the government is considering raising the crude oil export duty later this autumn.

Despite improved situation concerning budget revenues the overall fiscal situation is still fragile. As indicated by the attached graphs, along with revenues also budget expenditures as per cent of GDP have increased. Thus, after high inflation period, one should be worried about how well the authorities can control budget expenditures during a pre-election period.

At the end of August, the IMF mission visited Moscow to discuss current developments and the possible release of a USD 240 million tranche related to the 4.5 billion dollar IMF loan agreed on in late July. The loan has been parcelled into seven tranches, of which three are scheduled to release this year. The agenda also included the 2000 budget draft.

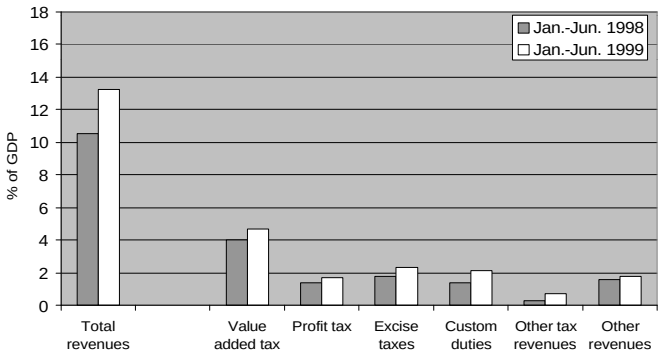
Government outlines federal budget for year 2000

The draft for next year's budget foresees revenues of RUB 745 billion (14.6% of estimated GDP) and expenditures of RUB 803 billion (15.8%), leaving a deficit of RUB 58 billion (1.1%). The target for primary surplus is 3.2%. The government bases its budget estimates on an exchange rate of 32 roubles per dollar and annual inflation rate of 18%. GDP is estimated to be RUB 5,100 billion (USD 159 billion).

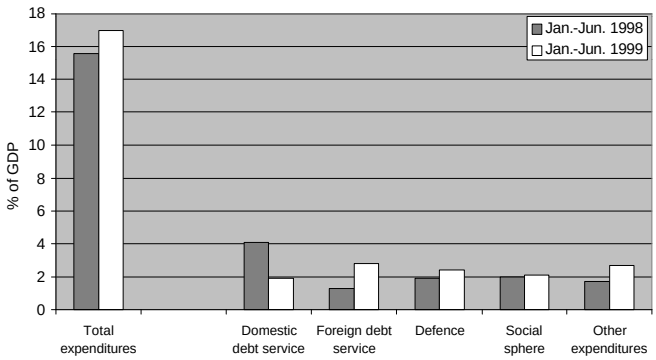
The draft budget foresees debt service payments of RUB 220 billion (USD 7 billion), or 27% of total budget expenditures.

The newly appointed government sent the budget draft to the Duma on 25 August.

Federal budget revenues, % of GDP



Federal budget expenditures, % of GDP



Source: Minfin

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Jan.-June	1999 budget law
Federal government								
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	13.2	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	17.0	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-3.8	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

Economic situation balances political tensions

The replacement of Sergei Stephasin with Vladimir Putin as prime minister, the outbreak of fighting in Dagestan, wild rumours and new allegations concerning large-scale money laundering and corruption, and the coming elections have all flared political tensions. In earlier circumstances, such unnerving events could have panicked the financial markets. In today's Russia the situation has been relatively peaceful. This might reflect the fact that markets are still paralysed by debt problems, poor situation in the banking sector, and, consequently, by overall lack of interest in Russian markets. Also, the new IMF arrangement, high oil prices and growth of industrial production help to stabilise markets. Thus, although share prices have decreased by some 30% since the mid-June and there has been variation in share prices and exchange rate also in August, recent movements have been relatively moderate considering recent events.

One factor behind the current stability is low inflation. In June, consumer prices increased 1.9% compared to the previous month and in July a respective figure was 2.8%. In August, monthly inflation is expected to be about 2%.

Paris club signs agreement on debt restructuring

Immediately after Russia reached an agreement with the IMF at the end of July, Russia and the Paris club of sovereign creditors signed an agreement postponing for a period of 15 to 20 years some USD 8 billion in payments on Soviet-era debt falling due before the end of the year 2000. Discussions on a final solution to Soviet-era debts would be held in autumn 2000. It was stressed that a final solution does not mean debt forgiveness. Countries represented by the Paris club are owed approximately USD 38 billion.

Russia has also held discussions with the representatives of the London club of private creditors. The parties agreed to continue discussions on further restructuring of the USD 32 billion in mainly Soviet-era debt in September. The London club consists of commercial banks and is led by Deutsche Bank. Russian finance minister Mikhail Kasyanov said that his country's goal was to get an agreement on full restructuring of the debt. Russia's creditors, in turn, are only willing to accept an interim solution lasting until after Russia's presidential election next year.

Over two-thirds of Russia's total foreign debt of about USD 150 billion is inherited from the Soviet Union.

In addition to debt rescheduling talks, the IMF-arrangement has helped to resume lending programmes by the World Bank and the Japanese government.

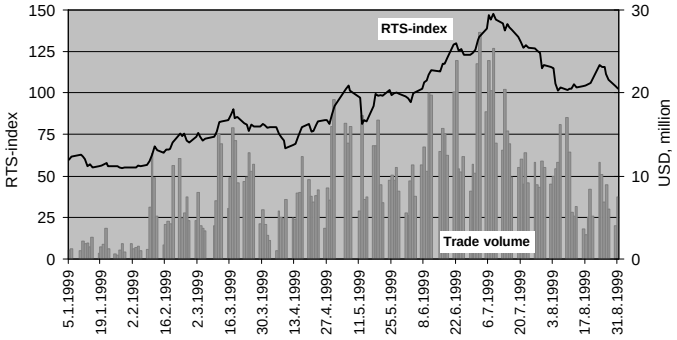
Stamps are back

In July, the Russian authorities changed their rules concerning currency exports by foreign travellers. According to the old practice, travellers could take out of the country currencies worth of USD 500 without a declaration. Often, customs officers did not even bother to stamp people's custom declarations at the borders.

Since July, foreigners are allowed to take out only as much foreign currency as what they declared when they arrived in Russia. Before entering Russia, one must now fill in a customs declaration and demand custom officers to stamp it at the customs checkpoint to prove it is true. To get more currencies out, additional documents are needed. Residents are allowed to take out of the country USD 1500 without declaration.

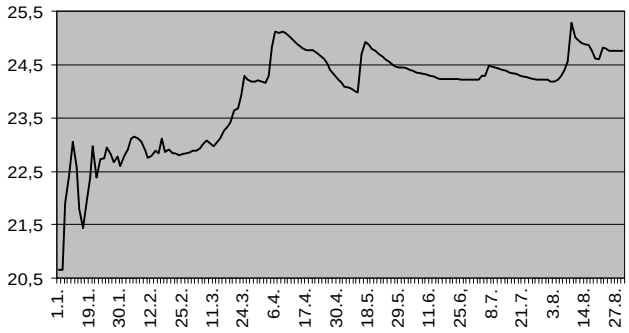
A new practice has raised confusion and angry among western travellers, though the new rules are easy to circumvent legally. So, in practice they are just an additional inconvenience and a reminder of the tendency in Russia to resort to cumbersome bureaucratic methods.

Russia's stock market in 1999, daily data



Source: RTS

Rouble/USD exchange rate in 1999



Source: CBR

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M2, year-to-year growth, %		217	113	30	29.5	36.3	46.6	5/99
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1610	7/99
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- deposit rate, %			102	55	16.4	25.7	11.0	6/99
- lending rate, %			320	147	46.2	41.7	32.1	6/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	7.8	7/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	24.75	8/99

Sources: Goskomstat, CBR

Upturn next year, again?

By Pekka Sutela*

One of the few constants in Russia watching ever since late 1992 is the unfading expectation that an economic upturn will come next year. Now, the current growth of industrial production has again fuelled discussion on Russia's prospects.

Differing short-run views

Disagreement is rife over what will happen in the short run. Analysts at Goldman Sachs argued in late July that a revival of the Russian economy is underway. The new, more competitive exchange rate has abolished the earlier mismatch. That is, Russian institutions were simply too weak to bear the earlier, strong exchange rate. Therefore, Goldman Sachs concludes the prospects for growth are good. Analysts at the sovereign rating agency Fitch IBCA responded in August that this view of a new dawn in Russia ignores the scarcity of evidence that investment and growth will emerge to sustain the current recovery once the scope for import substitution has been exhausted.

The current economic growth is fuelled by import substitution. The market shares of imported consumer goods have plunged since the crisis – in some cases by half. This is basically a one-time shift that will feed into longer-term growth only if the increase in domestic production also feeds into higher wages and other incomes. Otherwise, domestic producers will only have a larger share of a smaller market. Most probably, real incomes will rebound. Thus, the big question is whether the window of competitiveness is open long enough so that Russian productivity and quality could be increased sufficiently to withstand competition.

Russia's economic upturn becomes fact only after brisk investment growth is established. Today, there is no definite sign of an upturn in investment. Moreover, the upcoming elections together with paralysed financial system do not offer a good environment for investments in the near future.

Russia's export performance offers another perplexing picture. In dollar terms, exports in January-June remained some ten per cent lower than a year ago, but volumes of most major export items have grown. Notably, the growing volumes are in traditional Soviet/Russian branches. There is no evidence of new competitive Russian export products in spite of existing excess capacity. We may conclude that in many cases, this capacity is worthless.

An important long-term consensus

Please note the huge shift in sentiment since late 1996. Earlier, noted experts (Layard and Parker, 1996) were able to publish a book arguing that, even under the worst circumstances, the Russian economy will grow robustly by the end of the millennium. Now the consensus explicitly shared by Goldman Sachs, Fitch IBCA and others is that Russia will at best achieve modest growth in the long run without deep structural changes. Another voice in the same tune is the recent World Economic Forum competitiveness study (Sachs and Warner, 1999). Using e.g. surveys of executive opinion, the study assesses competitiveness from the standpoint of openness, government, finance, infrastructure, technology, management, labour and institutions. These assessments of competitiveness are also transformed into growth projections. Worldwide, Singapore scores highest with a growth projection of 5.0% annual GDP growth per capita in 2000-2008. Russia is the last among the 59 countries studied, with a growth projection of 0.9%. Russia, these executives argue, is one of a handful of countries with a lawless state, plagued by corruption, violence, crime and lack of judicial independence.

One might respond that such opinion is self-serving and overly influenced by the events of last year. But, as the playwright put it, if that's the way it seems, that's probably the way it is. Executives, after all, are the ones that allocate investment. If they continue to decide that Russia cannot be trusted with productive investment, there will be no sustainable growth in Russia. Despite mild disagreement on the possibilities of increased capacity utilisation in Russia, there is wide consensus that over a longer period sustainable growth must be based on investment.

No new dawn in sight in Russia

What is the probability of a new dawn in Russian economic reform? Before the elections (especially in light of last month's events), it appears close to nil. After the elections, given the current front-runners and what we know about ongoing change inside the electorate, the likelihood of a new dawn is not much higher. We may also witness a long-term change in the willingness of the international community to continue financing Russia. Foreseeable debt service obligations alone threaten the surplus that might otherwise be used for investment. And debt service and investments are not the only items competing for possible net additions to Russian resources. Nearly all social functions, ranging from infrastructure and the military to education and social services, can with great justification claim that they have been neglected during the last ten years. If there are any new resources to divide, the struggle over them will be fierce. Much needs to change in Russia for investment to emerge the winner.

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Economic Developments

Strong industrial growth, investment still down

Recovery of industrial production, which started almost immediately after the August 1998 devaluation, continued strong in August with industrial output 16% higher than a year ago. However, as the graph below shows, the level of industrial production in August 1998 was extremely low and, hence, the latest figure gives an overly rosy picture of the current situation (still, the figures for the next few months will also be high). For the period January-August, industrial output was up 6% compared to the same period in 1998. Other output indicators showed more modest growth. In January-August, transportation grew 4%, while agricultural production contracted 1.5% compared to the same period a year ago.

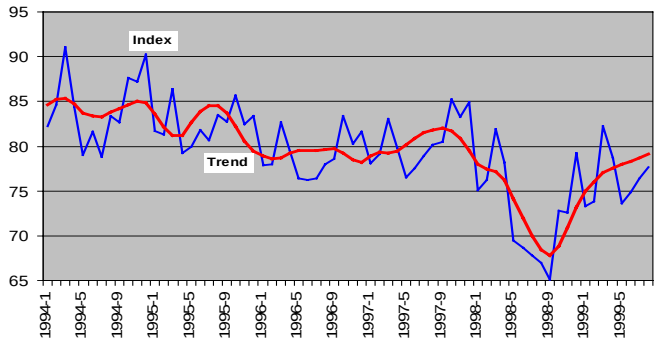
According to Goskomstat, Russia's GDP declined 1% in the first half of this year compared to the previous year.

When considering the sustainability of this industrial recovery, it is noteworthy that fixed investments are still contracting. In August, investments were down 0.6% compared to August 1998. The figure for the first eight months of this year was down about the same amount. Other domestic demand indicators also reveal the narrow basis of current economic growth. In nominal terms average wages were up 50% in August on a year-on-year basis, but in inflation-adjusted real terms they were about a third lower. The average wage in Russia today is only about USD 60 per month. Real disposable income, which is a wider income definition including income transfers, was about 20% lower than in August 1998.

Hence, the growth of industrial production is predominantly based on two things: import substitution in a shrunken domestic market and growth of exports. Although there is no information concerning the total volume of foreign trade, industry-level data indicate that the volume of total exports has increased. In dollar terms, however, both exports (-11%) and imports (-44%) were still down in January-July compared to the same period in 1998.

Although Goskomstat reported revised 1998 monthly figures for industrial output in August, there still seem to be severe problems related to the accuracy and coverage of data concerning national accounts. For example, a recent study (F. Schneider, 1999) estimates Russia's shadow economy to be about 40% of GDP.

Russian industrial output, Dec. 1993=100



Source: Goskomstat, Bank of Finland

GDP forecasts revised upward

Forecasts of GDP growth have been revised upwards thanks to strong growth in industrial output after the devaluation of the rouble, recovery in agricultural output due to a better harvest than a year ago (although still poor, even by Russian standards), and a favourable outlook for exports. Last spring the consensus forecast was that GDP would contract nearly 3% in 1999. Today, positive growth in 1999 is seen as a realistic possibility. Nevertheless, the forecasts for GDP growth in 2000 remain modest, reflecting uncertainties related to the upcoming elections.

Russian GDP forecasts, 1999-2000

	1999	2000
EIU (20 Sept.)	-1.0	1.0
Fitch IBCA (23 Sept.)	0.8	1.1
IMF (WEO, Oct. 1999)	0.0	2.0
MinFin (19 Aug.)	0.0	1.5
PlanEcon (24 Sept.)	2.0	-

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-1.0	1-6/99
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	5.9	1-8/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	-0.7	1-8/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	12.4	8/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	38.8	1-7/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	22.8	1-7/99
Current account, USD billion			10.7	10.0	12.0	4.0	2.4	9.0	H1/99

Sources: Goskomstat, CBR

Budget situation improves significantly in July

According to the Ministry of Finance, during the first seven months Russian Federation budget revenues increased to RUB 281 billion (USD 12 billion) or 12.8% of GDP. Federal expenditures in January-July were RUB 345 billion (USD 15 billion), which account for 15.7% of GDP. Thus, the budget deficit decreased from 5.4% to 2.9% of GDP in January-July 1998. The deficit has been financed by the central bank.

In July, the budget performance was particularly strong due to favourable developments on the revenue side. In July, the federal budget was almost in balance. Thanks to July's good result, the January-July primary budget, which excludes debt service payments, showed a surplus of 1.6% of GDP. The end-year target for the primary surplus, agreed on with the IMF, is 2.0% of GDP.

Duma rejects 2000 budget draft

On 29 September, the Duma overwhelmingly (212 to 105) voted down the first reading of the government's draft budget for 2000. The Communist-dominated lower house forwarded the draft budget to a trilateral commission made up of representatives of the government, the Duma and the Federation Council, the upper house of parliament.

The main disagreements on the draft budget involved foreign debt servicing costs and issues related to fiscal federalism. Deputies criticised the budget for concentrating on foreign debt servicing while giving too little attention to social services and defence. Regarding centre vs. regions issues, prime minister Putin emphasised the need to favour the centre if Russia wants "to build a strong centre and united government." Nevertheless, regional leaders continue with their traditional reluctance to compromise their share of power and resources.

Already a week before the first reading, the Duma undermined government's budget efforts by rejecting an initiative concerning several taxes. A tax initiative was a part of an agreement between the government and the IMF.

The draft for next year's budget foresees revenues of RUB 745 billion (USD 23 billion or 14.6% of estimated GDP) and expenditures of RUB 803 billion (USD 25 billion or 15.8%), leaving a deficit of RUB 58 billion (USD 2 billion or 1.1%). The primary surplus target is 3.2% of GDP. The government bases its budget estimates on an exchange rate of 32 roubles per dollar and an annual inflation rate of 18%. GDP is estimated to be RUB 5.1 trillion (USD 160 billion). The draft budget foresees debt service payments of RUB 220 billion (USD 7 billion), or 27% of total budget expenditures.

The next reading of the budget in the Duma is likely to take place in mid-October.

Russia raises oil export tariffs

The Russian government has raised the oil export tariff from 5 euros per tonne to 7.5 euros per tonne. The tariff applies to oil exports to countries outside the CIS customs union (Belarus, Kazakhstan, Kyrgyzstan and Tajikistan). The government hopes the move will increase revenues and hold down oil exports so that Russia will have adequate domestic fuel oil supplies this winter. Russia will also keep the 5% export tariff introduced last February on certain metals, including lead and tin.

Difficulties at home and abroad

The overall situation of politics and economic policy-making in Russia is perhaps even more difficult than what was foreseeable only a few months ago. In addition to the upcoming parliamentary and presidential elections, several other factors today complicate Russia's situation.

The battles in Dagestan, bombing attacks against civil apartment blocks in Moscow, and the air bombing of Chechnya by Russian troops have increased political tensions and put pressure on fiscal policy and financial markets. In September, the army reportedly received some RUB 2.5 billion (USD 100 million) in extra funding from the budget to handle the situation in Dagestan. While the sum might sound small in some circles, it represented about 5% of total monthly federal expenditures. Naturally the burden will increase if the situation in North Caucasus worsens.

Western countries have become more critical of Russia following allegations of Russian involvement in large-scale money laundering and corruption in the Kremlin. G-7 leaders have urged Russia to crack down on corruption to ensure international funds do not go astray. Moreover, the leading industrial countries demanded stronger safeguards including stricter audit of the central bank as a precondition for further lending to Russia by international financial organisations. The earlier findings that Russian authorities lied to the IMF about Russia's foreign exchange reserves in 1996 likely influenced the G-7 announcement. The upcoming presidential elections in the US have also contributed to discussion of Western policies towards Russia.

The IMF emphasises that there is no evidence its money has been misused and the Fund will continue to support Russia's reform efforts. Nevertheless, the aforementioned events have tinged IMF-Russia relations and may cause delays in disbursement of the next credit tranche related to the USD 4.5 billion stand-by agreement of July 1999.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	1999
Federal government							Jan.-July	budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	12.8	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.7	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-2.9	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

Share prices hit by political uncertainties

During mid-September, Moscow's RTS index fell about 25% to a level previously seen in April (see graph). Although there was some recovery, share prices at month's end closed about a fifth lower than a month ago. Meanwhile, the rouble strengthened slightly after a sudden one rouble per dollar weakening in two days at the beginning of September (see graph). At end-September, the rouble traded at 25.18 to the dollar.

One factor behind the rouble's relative stability is low inflation. August monthly inflation was only 1.2%. While 12-month inflation at the end of August was still 121%, it will be much lower at the end of September as the inflation peak of September 1998 passes.

First big bank declared bankrupt

At the end of September, the Moscow Arbitration Court declared MENATEP bank insolvent and ordered that the sale of its assets be started. While the bank's debts were reported to be at least RUB 30 billion (USD 1.2 billion), observers are sceptical about creditors' chances of getting anything back. MENATEP, once Russia's fifth largest financial institution, becomes the first big bank to be declared bankrupt.

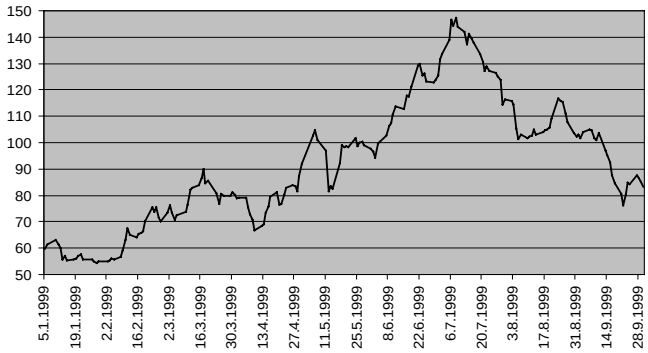
Earlier in September, the Central Bank of Russia revoked the licences of seven small commercial banks. Four of the banks were registered in Moscow, while the other three were based in various regions of Siberia. In August, the CBR pulled the licence of Toribank, a mid-size Moscow bank, and installed temporary administrators in SBS-Agro bank with instructions to carry out a special audit of the bank. Temporary administrators were also installed in several other banks in August, including Voronezh bank and Metrakombank.

Much remains to be done, however, in restructuring Russia's banking sector. As of end-August 1999, the total number of licensed banks in Russia was 1,390, some one hundred less than a year ago. However, during the same period, the number of bank branch offices fell from about 4,800 to around 3,900. Russian banks are tiny by international standards. Information from early August showed that only 245 Russian banks had capitalisations of more than RUB 40 million (USD 1.7 million). Total assets of Russian banks are USD 45 billion. In comparison, the Finnish-Swedish MeritaNorbanken, has total assets of about USD 110 billion.

Y2K?

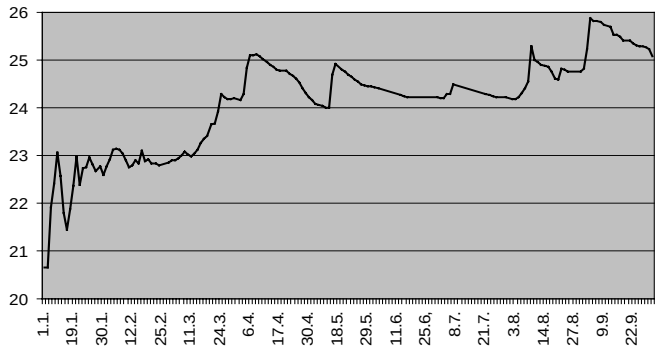
According to the CBR, some 20% of Moscow banks may be vulnerable to the Y2K problem. Although the financial sector in Russia has paid attention to millennium questions, the scale and complexity of problems – and the lack of time – may cause problems. There may be problems in other sectors as well. For example, gas giant Gasprom has announced that about 9,000 of its 28,000 computers were exposed to the millennium bug and, hence, will be replaced or modified during the next three months. US officials are reported to be particularly concerned about problems in Russia's power and telecommunications systems.

Russia's stock market in 1999, daily data



Source: RTS

Rouble/USD exchange rate in 1999



Source: CBR

Monetary indicators

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	121.0	8/99
M2, year-to-year growth, %		217	113	30	29.5	36.3	54.0	6/99
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1586	8/99
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.	16.0	6/99
- deposit rate, %			102	55	16.4	25.7	12.6	7/99
- lending rate, %			320	147	46.2	41.7	39.0	7/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	6.8	8/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	25.08	9/99

Sources: Goskomstat, CBR

New price determination theory and Russia

By Tuomas Komulainen*

After the high inflation of 1992-1994, the Central Bank of Russia (CBR) embarked on policy of stabilisation. The aim was low inflation and a stable currency. Indeed, the rouble was stabilised and annual inflation brought down to single digits. The CBR succeeded, but only for about a year. Following the events of 17 August 1998, the rouble depreciated around 70% against the dollar in just two months. By August 1999, consumer prices were 121% higher. What went wrong with Russia's stabilisation policy, and what kind of monetary and exchange rate policy should Russian authorities aim for in the future?

Playing chicken

Most early macroeconomic literature emphasises the monetary nature of inflation determination. A fixed exchange rate is used as a nominal anchor, and the central bank with its money supply determines inflation. The money supply has to be in harmony with the exchange rate goal. This stabilisation strategy has been used in transition countries and elsewhere with good and bad results.

Recent literature (e.g. Woodford and Canzoneri) challenges earlier assumptions by emphasising the role of fiscal policy in price determination. The specific insight is that the public sector's present-value budget constraint (PVBC) should be seen as an equilibrium condition. Thus, the real value of the nominal liabilities (debt and monetary base) issued by the public sector equals the expected present value of current and future primary surpluses and central bank transfers. If fiscal policy does not ensure this budget constraint, the price level has to jump and diminish liabilities in real terms. Thus, a game of chicken occurs: either the central bank or fiscal authority has to abandon its goal.

If the authorities target exchange rate stability, the situation becomes more difficult. In a fixed exchange rate regime, both domestic inflation and interest rates should be converging between countries. However, if fiscal policy is still an exogenous political process not satisfying the PVBC, the exchange peg has to break. The domestic currency will devalue and prices will jump in order for the PVBC to hold.

In other words, a country cannot have low inflation and a stable currency if fiscal policy is not sufficiently disciplined. Canzoneri et al. (NBER, WP 6471,1998) shows that a wide class of fiscal policy rules are enough to satisfy the PVBC. For example, a small adjustment in the budget is enough to satisfy an increase in the liabilities side. The private sector must believe that the fiscal policy adjustment will occur also in the future.

Experience in Russia

Annual inflation in Russia fell from 224% in 1994 to 11% in 1997. Using a crawling peg regime, the CBR diminished the yearly nominal depreciation rate of the rouble from 30% in 1995 to 7% in 1997. Direct transfers from the CBR to the government ceased. Moreover, the CBR and Sberbank held extensive amounts of government debt, which gave some relief to the budget.

Unfortunately, the federal budget deficits were between 5-8% of GDP during 1995-1998. In 1995, the government short-term debt (GKO) market was created. By August 1998, the amount of rouble denominated GKO-debt had grown to RUB 300 billion (USD 49.2 billion) or 15% of GDP. Federal debt to GDP increased from 30% in 1995 to over 55% before the August 1998 crisis. Under a crawling peg regime, the central bank was still able to use higher interest rates to keep the exchange rate target and control inflation, but only at the cost of increased debt payments by the government. By August 1998, debt service expenditures corresponded to 50% of federal budget revenues.

Calculations made in the winter 1998 warned that Russia would have needed over 4% GDP growth rates or crucial primary surpluses to keep the debt-to-GDP ratio under 100% in the future (BOFIT 2/98). Russia's fiscal policy was not sufficiently in balance with the budget constraint (PVBC) to hold. The low inflation policy required a far tighter fiscal policy to succeed. Thus, the price level and the exchange rate jumped for the PVBC to hold. Government liabilities and expenditures were also greatly reduced in real terms. The restructuring of GKO- and Soviet era -debt has also given further relief. Anyhow, the new theory of price determination gives one possible explanation why Russia's stabilisation policy did not succeed.

Where now?

The new theory of price determination and the Russian experience indicate that the CBR and Ministry of Finance should together decide what fiscal policy and inflation the authorities will target. A poor public sector places certain restrictions on tax collection and budget discipline. On the other hand, if Russia wants to have a money-based economy where investments and growth are present, it needs a predictable monetary policy and stable currency. The experience in the first half of 1999 gives a glimmer of hope that Russia is moving towards more balanced fiscal policy.

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Economic Developments

Year-on-year investments up in September

Russian industry has almost returned the output level of the latter part of 1997 when the Asian crisis hit the Russian economy and industrial production started to decline. Industrial output in September was 20% higher than in September 1998 and during the first nine months of this year Russia's industrial output was up 7% compared to the same period in 1998.

Moreover, the current growth extends beyond industrial sectors. A proxy indicator for GDP, which includes industry, agriculture, construction, transport and retail trade, shows that in September total output was almost 10% higher than in September 1998. This translates to about 2% output growth in the first three quarters compared to the same period last year. For the first time in a long while, monthly investments were higher (almost 5%) than twelve months previous. Consequently, investments in January-September remained in the same level as a year ago.

Note that the August-September comparative figures for 1998 describe the situation after the August 1998 crisis, so it is natural to expect improvement in many indicators. For example, in July real personal incomes were recorded to be over 25% less than in July 1998, while in September they were only 4% lower than a year ago. Also, 12-month inflation decelerated from 120% in August to about 60% in September.

Russian crisis vs. CIS integration

Effects from the Russian crisis have had severe implications for other countries in the CIS region, including spill-over effects on regional trade flows. According to the CIS Interstate Statistics Committee, Russian exports to CIS countries in the first half of 1999 fell 38% compared to a year ago. Exports were down 56% to Kazakhstan, 32% to Ukraine and 32% to Belarus. Russian imports from CIS countries also shrank 46% compared to the first half of 1998. The recent trade developments between the CIS countries have given rise to new problems and challenges concerning cooperation and integration within the region.

USD 9 billion current account surplus in first half

In the first half of this year, Russian goods exports amounted to USD 33 billion and imports USD 20 billion, giving a trade surplus of USD 13 billion. The current account surplus for the same period was USD 9 billion. In the first half of 1998, the current account was USD 5.2 billion in deficit. The improvement in Russia's external balance is due mainly to a strong contraction in imports. While exports fell 13% compared to the first half of 1998, imports were down 44%. Moreover, due to Russia's partial insolvency interest payments on Russian external debt were USD 2 billion smaller than in the same period a year ago.

Russia's balance of payments statistics reveal that foreign investments have dried up since 1997. In the first half of this year foreign direct investments amounted to only USD 1.4 billion and portfolio investments were negative.

Russia's balance of payments in 1997-1999, USD billion

	1997	1998	1999H1
Current account	**4.0**	**1.6**	**9.0**
Trade balance (goods)	17.4	16.9	12.0
Exports	89.0	74.8	37.2
Imports	-71.6	-57.9	-25.2
Services	-4.7	-3.2	-1.0
Exports	14.2	12.9	4.6
Imports	-18.8	-16.1	-5.6
Investment income	-8.1	-11.4	-3.1
Received	4.1	4.0	2.8
Paid	-12.2	-15.4	-5.9
Other items, net	-0.6	-0.7	0.1
Capital and financial account	**5.7**	**2.8**	**-5.0**
Capital Account	-0.8	-0.4	-0.1
Received	2.1	1.7	0.4
Paid	-2.9	-2.1	-0.5
Financial account	6.5	3.2	-4.9
Direct investment in Russia	6.2	2.8	1.4
Portfolio investment in Russia	45.6	8.4	-0.1
Other items, net	-45.3	-8.0	-6.2
Net errors and omissions	**-7.8**	**-9.7**	**-3.4**
Change in reserves	**-1.9**	**5.3**	**-0.6**
('-' growth, '+' decline)			

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-0.7	1-6/99
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	7.0	1-9/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	0.1	1-9/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	12.4	9/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	44.5	1-8/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	26.1	1-8/99
Current account, USD billion			10.7	10.0	12.0	4.0	1.6	9.0	1-6/99

Sources: Goskomstat, CBR

Fiscal situation improves

Thanks to improved revenue performance, the January-August fiscal deficit shrank to 2.5% of GDP. The primary budget surplus (excluding debt servicing costs) in the first eight months was 1.7% of GDP. For January-August 1998, the budget deficit was 4.9% of GDP. Under the current economic program agreed with the IMF, Russia's 1999 budget aims at a primary surplus of 2% of GDP.

Federal revenues and expenditures in proportion to GDP are both up compared to the same period a year earlier. Budget revenues in January-August corresponded to 13% of GDP – three percentage points higher than in the same period in 1998. Budget expenditures in relation to GDP also rose slightly.

Russian Federation Jan-Aug 1999 budget execution*

	RUB bln.	USD bln.	% of GDP
Revenues	333	14	12.8
Expenditure	398	17	15.3
Deficit	65	3	2.5

*According to the IMF definition
Source: EEG/Minfin

2000 budget passes second reading

On 5 November, Russia's lower-house Duma approved the second reading of an amended 2000 budget draft by an overwhelming majority (265 to 57). Compared to the government's earlier budget draft, which was opposed by the deputies, the current draft is based on a higher GDP growth estimate of 2% for 2000. The budget draft further assumes industrial output will grow 4%, investment will rise 2-3%, the average exchange rate will be 32 roubles to the dollar and inflation will run at 18-20%. The average world price of oil is expected to remain at its current level. The nominal GDP in 2000 is estimated to be about RUB 5340 billion or USD 170 billion.

A more optimistic view of output growth in 2000 made it possible to raise budget revenues and expenditures by about 50 billion roubles (USD 2 billion), and thus satisfy the demands of deputies without compromising the deficit target of 1% of GDP. The projected primary budget surplus (budget balance before debt servicing costs) is 3% of GDP.

The major disputes over the budget have involved debt servicing, defence expenditures and the issues related to relations between the centre and regions. The current budget draft proposes that the share of budget expenditure used for debt servicing is 26% (RUB 220 billion or USD 7 billion), which is one percentage point less than in the previous draft. Meanwhile, the share of defence spending was increased by one percentage point to 17% (USD 4.5 billion). Regarding fiscal federalism, no major change is foreseen in the balance between the centre and regions in the current budget draft.

The third reading of the budget in the Duma is scheduled for 29 November. The fourth, more formal reading should take place at the beginning of December.

Russian Federation 2000 budget draft

	RUB bln.	USD bln.	% of GDP
Revenues	797	25	15
Expenditure	855	27	16
Deficit	58	2	1

IMF demands greater transparency

At the end of July, Russia and the IMF agreed on a new USD 4.5 billion stabilisation (stand-by) program. However, the overall attitude toward Russia has become more critical since the signing of the agreement. The sudden change of government in August, money laundering charges (Bank of New York case), a report noting irregularities in the CBR's management of its currency reserves (FIMACO case) and the intensified fighting in and around Chechnya have all contributed to a more critical stance towards Russia.

For the next USD 640 million tranche to be released, Russia has been asked to do the following:

- The CBR's internal control systems must be improved, especially from the standpoint of currency reserves. Demands include that the CBR perform a quarterly internal audit.
- To improve the transparency of CBR operations, the CBR's currency reserves should be transferred out of its subsidiaries abroad. There are also demands for a deadline when CBR would give up its ownership in its foreign subsidiaries.
- The Russian government should adopt a good practice code for fiscal policy so that, for example, international lending institutions could be provided with reliable records of how funds are actually used.
- Russia should set a timetable for when the CBR and commercial banks will shift over to internationally accepted accounting standards.
- A new stricter law on money laundering.
- An audit of Sberbank.

The IMF mission arrived in Moscow in the second week of November to discuss the structural reforms and the 2000 budget.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Jan.-Aug.	1999 budget law
Federal government								
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	12.8	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.3	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-2.5	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

High interest rates indicate deep problems

According to the Russian Statistical Agency, consumer prices in October rose 1.4% from September. Despite the relatively good situation concerning inflation and the real economy, however, the situation is worrisome in the field of monetary policy and financial markets. Naturally, this casts a shadow over the prospects of Russian economy in general.

First, the CBR's currency reserves are still quite low in spite of the significant improvements in the trade and current account balances. At the end of October foreign currency reserves stood at USD 11.8 billion, of which gold comprised some 40%. The low reserves are partly due to debt service payments, but it also indicate a lack of confidence in the rouble and, hence, Russian economic policy in general.

Second, although the CBR has announced that the rouble will be allowed to weaken against the dollar in line with domestic inflation to support a competitiveness of Russian enterprises, it seems that the authorities have difficulties keeping the process smooth. In September, the rouble fell in line with inflation by 1.3%. In October, it depreciated by 3.7% against the dollar. Related to monetary policy and the current IMF deal, the CBR refused at the end of September to abolish, as previously agreed, its requirement of a 100% collateral deposit on prepaid imports. The decision is linked to the postponement of USD 640 million IMF credit tranche and continuation of currency controls is believed to help to defend the external value of the rouble in the current situation.

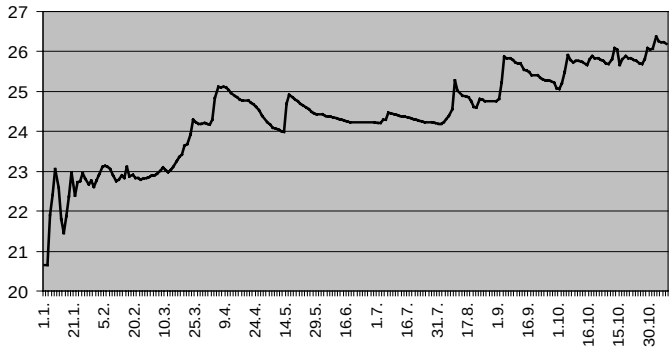
Third, extremely high interest rates demonstrate a deep lack of confidence among the players in the money market. For example, the current interest rate for a 3-month rouble credit in the interbank market (MIBOR) is 39%, 12-month time-deposit rates for households are about 40%, and the yield of government bonds (OFZ) varies between 60-100%. At the same time, current monthly inflation of 1.4% translates to about 20% annual inflation.

First default on Russian eurobond

In spite of the economic recovery in Russia, the debt situation seems to remain as difficult as ever. On 3 October, the Nizhny Novgorod region missed an interest payment on its five-year USD 100 million eurobond. A one month later, on 5 November, it was reported that the Leningrad region also failed to pay full interest on a USD 50 million syndicated loan. Both regions had been considered to be relatively good performers.

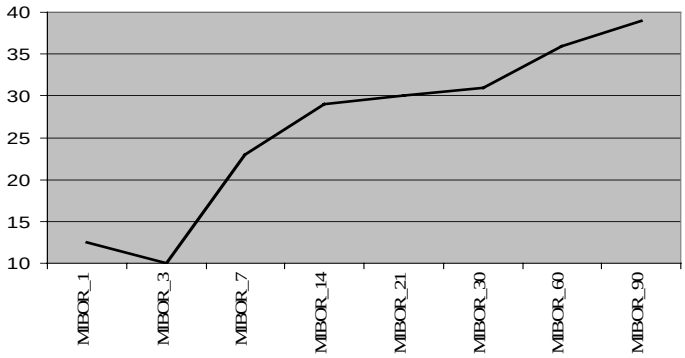
Russia's debt problems obviously have had a direct effect on the country's creditworthiness ratings. In September, Institutional Investor published its semi-annual survey of sovereign creditworthiness. Russia's rank among the 136 countries surveyed was 105. According to Institutional Investor, since September 1998 no country's creditworthiness has deteriorated more than Russia's.

Rouble/USD exchange rate in 1999



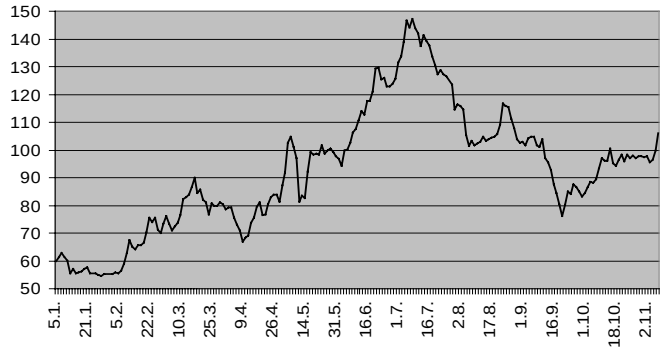
Source: CBR

Interest rates on Moscow interbank market (yield curve) - 8 November 1999



Source: Finmarket

Russia's stock market in 1999, daily data



Source: RTS

Monetary indicators

	1993	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	842	224	131	22	11.0	84.4	62.0	9/99
M2, year-to-year growth, %		217	113	30	29.5	36.3	71.9	8/99
Average wage, RUB, end of period	141218	354206	735500	1017000	1210000	1463	1704	9/99
Interest rates, period average								
- T-bill (GKO) yield, %			168	86	26.0	n.a.	16.0	6/99
- deposit rate, %			102	55	16.4	25.7	9.7	9/99
- lending rate, %			320	147	46.2	41.7	37.9	9/99
Forex reserves, USD billion (excl. gold)	5.8	4.0	14.3	11.3	12.9	7.8	7.1	10/99
RUB/USD, end of period	1247	3550	4640	5560	5960	20.65	26.05	10/99

Sources: Goskomstat, CBR

Russian Reform: Too little too late or too much too soon?

By Juhani Laurila*

Less than ten years ago, many of us thought we heard a sigh of relief as the Soviet system dissolved. We heard hopes aired that the intrinsic dynamics of market forces would now rectify structural failures. Against this background, the "Washington consensus", with its fairly detailed list of recommendations, was considered progressive at that time. But the experience accumulated since then, and particularly developments in Russia, prompt the question, has too little been done and perhaps the wrong things? Or were we, perhaps, expecting too much too soon?

Is Russia a special case?

The lively discussion assessing the results of the 10-year reform work singles out Russia as a special case. Several authoritative economists share the view "too little too late." Indeed, no new "Marshall Plan" was launched to push Russia on the road to prosperity. Instead, there was poverty created through the hyperinflation of 1992-1994. But would Russia had been ready for big money? The massive outflow of capital bears evidence that the institutional environment was inadequate to warrant the quality of public spending or to attract private sector capital. The Russian public sector was, and still is, occupied by an army of command-minded administrators, who seek to maximise their power, often against the interests of the ordinary citizen or entrepreneur. They do not see much good in efforts to get the institutions or having their role turned from administrator or regulator to civil servant. Due to the inferior quality of the public services and the obstacles to improving them, Russia continues to be a special case.

The antagonistic legacies from the Soviet era with misconceived populist ideas of capitalism and liberalism, reinforced by corruption and hit-and-run capitalism, have corroded the popularity of market reforms in Russia. This hardly helps the Russian government in its efforts to turn a venal and heavy administration into a transparent, business-friendly promoter of law and order. The necessary structural and institutional reorientation with training, new disciplines and attitudes calls for much time and effort.

Compliance with the basic human rights, development of civil society and genuine democracy, unfortunately, will have to wait.

Instead of integrating with the rest of the world, Russia has started to disintegrate and isolate itself politically. Russia's modest GDP reflects its relatively undeveloped commercial sub-structures and unrefined division of labour. This is expressed as a large shadow economy, a high degree of de-monetisation and the absence of hard budget constraint. The share of the private sector in an already small GDP leaves little to celebrate.

Finally, most welfare indicators point downward. According to the forecasts of the Russian Statistical Agency, the Russian population will be reduced by 15-17 million in less than 20 years. Apparently, ordinary people are paying the heaviest price of the inadequacy of structural reforms.

What is to be done?

Perhaps it is best for every actor to take a critical look in the mirror – placing further blame at this point is hardly fruitful. A lot has been achieved. The IMF and other multilateral organisations deserve credit for their efforts to introduce sound macroeconomic policies through monetary and fiscal austerity and liberalisation. The macro reforms with liberalisation and stabilisation have succeeded in bringing down inflation and delivering modest promises of GDP recovery. In terms of structural and institutional reforms, we now have a functioning central bank, treasury, stock- and foreign exchange markets, as well as a nascent private sector in Russia.

Western donors can hardly do more than the Russian government and people are willing to do themselves. Everyone now knows, the Russian economy does not suffer from the lack of money, but the lack of good corporate and public sector governance. The reformers in the Russian government and administration know they face time-consuming and difficult challenges – self-reform, self-restructuring, self-reorientation and self-discipline. This calls for increased efforts for technical assistance from donors: legal advice, institution building, training etc. directed to all levels of public sector administration.

For the sake of practicality, donors might do well to focus their current efforts on officials and administrators working in the customs, taxation and police forces. Over-ambitiously holistic approaches may give the result that nothing is done well. To avoid this, donors should divide their labour and efforts among specialised agencies and harmonise their work in the field.

Above all, the reinforced commitment from the Russian government must be there. Until such commitment is forthcoming, no one should expect too much too soon. We know now that technical assistance will always be too little. We must hope that it is not too late.

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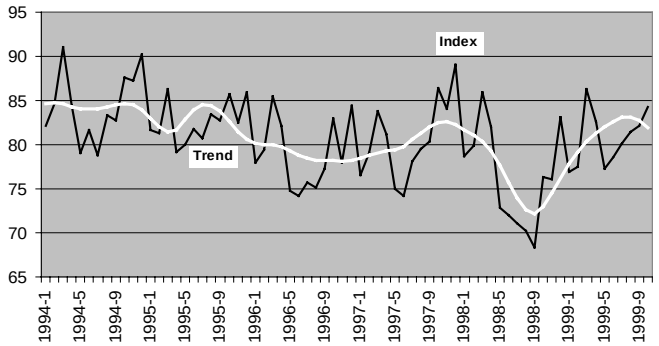
Economic Developments

Industrial growth rate decelerating?

In January-October, Russian industrial production increased by almost 8% compared to the same period last year. Growth figures of recent months have been particularly remarkable: in September industrial production was 20% higher than in September 1998, October's respective figure was 10%.

Despite high growth figures in recent months, however, the trend component of the industrial production series in the chart below casts doubt on whether strong growth will continue. Indeed, has the Russian economy already exploited the growth potential related to rouble's devaluation and import substitution? As the trend is based solely on raw series for industrial production, its tail naturally may swing along with the latest observations so that next month the situation might look like quite different. Nevertheless, it is interesting that October's 10% year-on-year growth was insufficient to keep the trend component in a positive growth path. Hence, questioning the strength of recent growth in Russia is certainly justified.

Russian industrial output, Dec. 1993=100



Poor grain harvest again

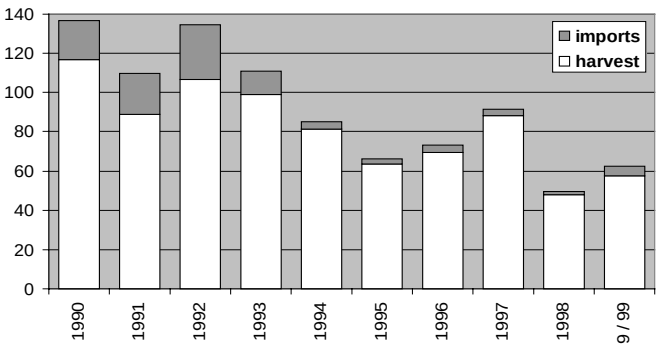
According to the latest information from the Russian Ministry for the Food and Agriculture the expected grain output is nearly 55 million tonnes in 1999. Although the harvest was better than last year, it was still poor. Draught made the 1998 harvest of 48 million tonnes the worst in 40 years. Grain reserves have fallen to no more than 4-5 million tonnes. Given that Russia's estimated annual demand for grain exceeds 70 million tonnes (including 35 million tonnes for fodder), the output together with available stocks will leave Russia with a deficit of more than 10 million tonnes of grain from July 1999 to June 2000. The gap will be filled through imports.

In many areas, heavy rains disturbed the yield and the harvesting of grain. Local authorities in regions with a good harvest have decided to restrict the grain exports from their territories to major cities. Stepping up administrative barriers on interregional trade as well as price and mark-up controls on food products have distorted the markets. There is also evidence that grain stocks are being hoarded in the hope of gaining windfall profits created by price hikes.

Due to the lack of investment, Russian grain production is a low-productivity sector. This and poor weather conditions are the main reasons the grain harvest in 1999 was less than half of 1990's record harvest.

Notably, there have been several major changes in grain market structure. Along with a drop in grain consumption, there has also been a marked shift from fodder to bread grain consumption during the 1990s. In 1990-1994 the annual grain consumption amounted to 110-140 million tonnes, of which the share of imported grain comprised 15%. In 1995-1998, grain consumption was 50-90 million tonnes a year of which only 4-5% was imported. This fall relates to a contraction in livestock production from 2/3 to 1/3 of the total agricultural production from the first to the second half of this decade.

Russian grain production and imports, million tonnes



Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	-0.7	1-6/99
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	7.5	1-10/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	2.0	1-10/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	50.8	1-9/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	29.5	1-9/99
Current account, USD billion			10.7	10.0	12.0	4.0	1.6	9.0	1-6/99

Sources: Goskomstat, CBR

January-September federal deficit 2.1% of GDP

Federal budget revenues for January-September 1999 amounted to RUB 384 billion (USD 15 billion). Revenues from value-added tax comprised 37% of total revenues, while the share from excise taxes and customs duties was 15%. Profit taxes accounted for 13% of total revenues. The total January-September revenue figure of 12.7% of GDP is 3.4 percentage points higher than a year ago.

Expenditures amounted to RUB 447 billion (USD 18 billion), which translates to 14.8% of GDP (13.7% in January-September 1998). Debt servicing accounted for 26% (domestic debt 12% and foreign 14%) of total budget expenditures. In the same period last year, the respective figure was 34%. Reported defence expenditures in January-September were some 16% of total expenditures. However, after the war in Chechnya started, reported defence expenditures in September jumped to 27% of monthly federal expenditures, or 2.3% of GDP.

As a result of favourable revenue performance, the budget deficit has shrunk from 4.4% of GDP in January-September 1998 to 2.1% in 1999.

Russian Federation 1999 budget execution,* Jan.-Sept.

	RUB bln.	USD bln.	% of GDP
Revenues	384	15	12.7
Expenditure	447	18	14.8
Deficit	63	3	2.1

*According to the IMF definition
Source: EEG/Minfin

Duma approves the budget for 2000

On 3 December, the Duma approved in its fourth and final reading the year 2000 budget by a vote of 308 to 52. The budget is based on a GDP forecast of RUB 5,350 billion (USD 167 billion), or 1,5% GDP growth. The inflation forecast is 18% and the average exchange rate is one dollar to 32 roubles.

The total budget expenditures are RUB 855 billion (USD 27 billion) and revenues of RUB 797 billion (USD 25 billion). The overall budget deficit of 1% of GDP and the 3% of GDP primary budget surplus (which excludes debt servicing costs) fall within limits agreed with the IMF.

In the previous readings, the share of debt servicing was decreased to 26% (USD 7 billion) while defence spending was raised to 17% of total budget expenditures. In the last round, the major issue was the tax status of closed administrative territories, or ZATOs. The government wanted to end tax breaks for ZATOs, claiming that they would cost the government some RUB 40 billion (USD 1.3 billion) in lost budget revenues next year. Although the government had to compromise in this issue, it is likely that the tax privileges of ZATOs will be cut back next year.

The new budget has already been criticised for failing to anticipate the continued conflict in Chechnya, political costs of the election year, new tax loopholes and possible delays or a cessation in IMF lending. The budget foresees nearly USD 6 billion in new foreign financing.

The budget now moves to the Federation Council for consideration on December 22. If accepted, it will then be submitted to president Yeltsin for signing into law.

Russian Federation 2000 budget

	RUB bln.	USD bln.	% of GDP
Revenues	797	25	15
Expenditure	855	27	16
Deficit	58	2	1

IMF may further postpone payments to Russia.

At the end of November, the IMF's managing director, Michel Camdessus, suggested that international pressure against Russia's military intervention in Chechnya might delay the release of the next USD 640 million loan tranche. Moreover, in spite of better-than-expected macroeconomic performance (budget performance), the IMF indicated that the progress in structural reforms still lags.

Meanwhile, Japan released a USD 375 million tranche to Russia. The money, part of a USD 1.5 billion lending package agreed in February 1998, had been withheld since the August 1998 financial crisis.

PM Putin's comments on economic policy

In his appraisal of the economy before the Duma, prime minister Vladimir Putin stressed that he saw no reason to intervene in the privatisations to date and that efficient owners have the full support of his government. He also noted that, while Russia had returned to positive GDP growth, no substantial structural reforms contributed to the recovery. Rather, the economic growth was mainly the result of the rouble's devaluation and higher world prices for natural gas and oil.

While the Putin government lacks an official economic program, the PM said his government would increasingly focus on economic policies that support domestic markets and de-emphasise export of raw materials. He observed that Russia's high-tech sector and domestic industries need greater support, and that Russia should adopt an aggressive foreign trade policy with a modest protectionist stance.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Jan.-Sep.	1999 budget law
Federal government								
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	12.7	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	14.8	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-2.1	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

Russia fails to agree with London Club creditors

After several years of negotiation on restructuring its Soviet-era debt, Russia reached agreements with the Paris Club of sovereign creditors in 1996 and with the London Club of commercial creditors in 1997.

After the August 1998 crisis, payment arrears related to Soviet-era debt once again started to accumulate as the Russian government focused its efforts on servicing debt acquired after 1992. Immediately after Russia reached an agreement with the IMF in July 1999, the Paris Club signed an agreement postponing for a period of 15 to 20 years some USD 8 billion in payments on Soviet-era debt falling due before the end of the year 2000. Discussions on final settlement of Paris Club claims are planned for autumn 2000. Russia's debt to the Paris Club is about USD 38 billion.

Despite several meetings in the latter part of October and the beginning of December, the London Club and the Russian government failed to agree on restructuring of Russia's USD 32 billion in Soviet-era debt. Russia has proposed a 40% write-off of Russia's debts in exchange for conversion of the remaining debt to paper with the same status as eurobonds. As the negotiations broke off without agreement, Russia skipped a scheduled payment of USD 550 million to the London Club on 2 December. The estimated arrears to the London Club currently stand at about USD 1.4 billion.

Russia's return to international capital markets depends on the outcome of talks with the London Club. The date for the ninth round of negotiations is still open, but there is some hope that the parties will meet still in December.

At the end of June, total foreign debt of the Russian government was USD 160 billion and domestic debt RUB 539 billion (USD 22 billion).

Banks renew efforts to avoid bankruptcy

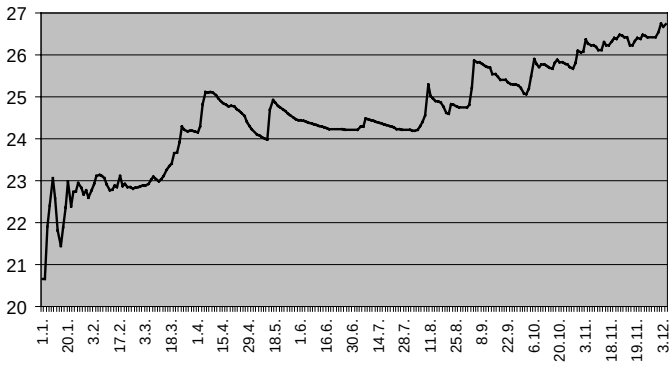
Russia's banking sector restructuring has progressed very slowly and unevenly. Of the former giants of the Russian banking system, Uneximbank, which lost its banking licence in June, had its licence reinstated in November and a court stopped bankruptcy proceedings against it. Earlier, Mezhkombank also managed to win back its licence. Now both banks are trying to find ways to restructure their obligations, particularly those to foreign creditors. The deals under discussion differ considerably. In the Uneximbank case, the bank will probably be merged with Rosbank. Creditors will receive a mixture of cash and new loan notes. Mezhkombank, for its part, has agreed to swap debt for equity and is likely to be taken over by a US bank. In general, there seems to be a bias in favour of Russian shareholders against creditors in restructuring deals.

For the time being, only one major Russian bank has declared bankruptcy since MENATEP was ordered at the end of September to start selling off its assets.

Russian banks will move to IAS by the end of 2001

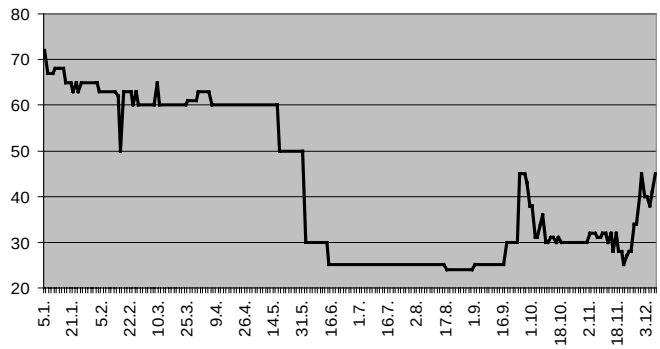
Assessing the state of the Russian banking system is made all the harder by the fact that Russian accounting practices do not correspond to international accounting standards (IAS). For example, under Russian accounting standards, Uneximbank is reported to have net assets of USD 92 million. After provisions under international standards, it has net liabilities of about USD 1 billion. After almost a decade of pleas from the international community for Russia to move to international accounting standards, the CBR finally announced that it and banks under its supervision would make the move to IAS by December 2001.

Rouble/USD exchange rate in 1999



Source: CBR

Interest rates (1-month MIBOR) in 1999



Source: CBR

Monetary indicators

	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	224	131	22	11.0	84.4	50.3	11/99
M2, 12-month growth, %	217	113	30	29.5	36.3	63.3	9/99
Average wage, new RUB, end of period	354	736	1017	1210	1463	1717	10/99
Interest rates, period average							
- T-bill (GKO) yield, %		168	86	26.0	n.a.	16.0	6/99
- deposit rate, %		102	55	16.4	25.7	9.0	10/99
- lending rate, %		320	147	46.2	41.7	37.0	10/99
Forex reserves, USD billion (excl. gold)	4.0	14.3	11.3	12.9	7.8	7.6	11/99
RUB/USD, end of period	3550	4640	5560	5960	20.65	26.42	11/99

Sources: Goskomstat, CBR

Size versus quality in the Russian public sector

By Jukka Pirttilä*

Just about any debate on Russian economic policy these days includes criticism of the size and quality of the public sector. Attempts to quantify these two suggest that while the overall size of the government may be problematic as well, the problems associated with low quality seem far more pressing in Russia's case.

Large public sector goes with the territory

In 1998, the overall size of the Russian public sector (including federal and local government outlays and extra-budgetary funds) was 37 %. Given Russia's per capita GDP of USD 2,300, the size of its public sector appears vastly out of proportion to other lower middle income countries, where the government's share typically revolves around 25-30 % of GDP. However, as the figure below suggests, when compared to other transition economies, the Russian public sector's size is actually slightly *below* the expected value. By definition, transition economies inherited large public sectors from socialism. Further, a host of other factors such as high old-age dependency ratios and large investments in health and education help explain the high level of government activities. Despite such commitments, many transition economies (notably, Hungary and Poland) have managed to enter respectable growth paths.

A chilling assessment of quality

A recent study by La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998) examines government quality indicators for over 200 countries. The attached table compares the Russian government's scores to mean values for the sample countries.

In the first category (Interference with the private sector), Russia performs perhaps better than expected. However, the high value of the regulation index indicates a cumbersome bureaucracy. Note that the marginal tax rate as such conveys a biased picture due to the otherwise highly distorted tax system. In the second area (Efficiency), Russia's situation is alarming. Russia's public sector is among the most corrupt in the countries covered by the study of Transparency International. As expected, tax evasion is rampant. In the third area (Scope of government activities), the figures indicate that the share of subsidies from total outlays is high and that the role of often inefficient state-owned enterprises (SOEs) is still prominent. This division of resources apparently contributes little to private sector well-being and growth. Finally, data on government wages and employment reveal that the efficiency of the public sector as a major employer is undermined by low pay.

Policy conclusions, if any

While there is no doubt that the low quality of public sector constitutes a serious impediment to growth, it is uncertain how to remedy the situation. The limiting of distortions by simply downsizing a badly functioning government is a rather cynical solution for a country that needs effective government to, for example, alleviate poverty, repay debt and replace infrastructure. It seems far more promising to strive for better quality and targeting of public sector services. Clearly, considerable study on how this might be accomplished is needed.

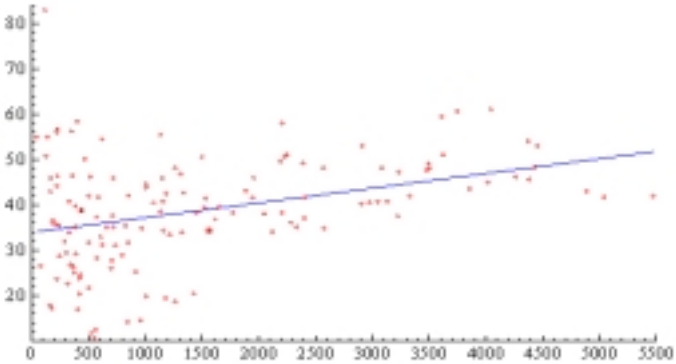


Figure: Consolidated government expenditure (% of GDP) plotted against per capita GDP in USD in all transition economies (excluding Slovenia) in 1992-1997 based on EBRD data.

Variable	Russia	Mean	Scale
Interference with the private sector			
Property rights index	3	3.3	**1**...5
Regulation index	4	2.7	**1**…5
Highest marginal tax rate	35	41.4	0…100
Efficiency			
Corruption index	2.4	4.5	1…**10**
Tax compliance	2.1	3.2	1…**6**
Avg. gov. wages as multiple of GDP per capita	0.9	3	0…100
Scope of government activities			
Transfers and subsidies, % of GDP	20	9	0…100
SOEs in the economy	0	4.4	0…**10**
Public sector employment, % of population	10	5	0…100

Table: Government quality indices. The structure of the table is from La Porta et al (1998) 'The Quality of Government', SITE Working Paper. Scores for Russia are compiled by the author from the sources mentioned in La Porta et al, except for Transparency International's Corruption Index and government wage and employment data from Goskomstat. Bolded figures in 'scale' indicate the best value in the range.

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RUSSIAN ECONOMY
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Economic Developments

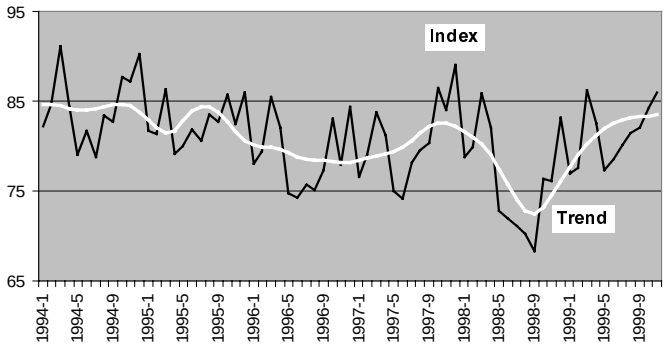
Economy grows, but investors remain cautious

According to preliminary Goskomstat figures, Russia's GDP increased 1.5% in January-September as compared to the same period in 1998. The value of Russian GDP in the first nine months was RUB 3,119 billion (USD 130 billion), of which production of services comprised 48%, goods 42% and net taxes 10%. Given the relatively positive information concerning the situation in the last quarter, the overall growth performance of Russian economy in 1999 is clearly the best since the beginning of reforms.

In November industrial output grew 13% compared to November 1998, which translates to almost 8% growth in January-November. November's performance was good enough to sustain a rising trend in the industrial production series in the chart below. Moreover, the chart indicates that industrial output has recovered and surpassed the pre-Asian-crisis levels of late 1997.

Despite more than a year of positive growth, there are still no signs of a recovery in investments. In January-November fixed investments were up just 2%. In fact, November 1999 investments were a half per cent less than in November 1998. It will be interesting indeed to see whether recent events (the changes in the Duma, the resignation of President Yeltsin, the nomination of Mr. Putin as acting president, and earlier presidential elections) will have any major effect on investor behaviour. Or will investors stay on the sidelines until they see real changes in policy-making and the business environment?

Russia's industrial output, Dec. 1993=100



January-October trade surplus hits USD 25 billion

In January-October, Russia's exports were USD 58 billion and imports USD 33 billion leaving a trade surplus of USD 25 billion. This significant trade surplus is a result of the rouble's depreciation since August 1998 and the consequent decline of the value of imports by 37% in the first 10 months of 1999. Notably, in spite of huge devaluation of the rouble and higher energy prices, the dollar value of Russia's exports declined by 6%. Much of this decline is due to a 26% decline in exports to the CIS area. As the value of exports to other countries remained at about the same level as in 1998, the share of the CIS in Russia's total exports declined to 16%.

In the first three quarters of 1999, Russia's current account surplus increased to USD 14.6 billion.

Russia's balance of payments in 1997-1999, USD billion

	1997	1998	1999/ 1-9
Current account	**4.0**	**1.6**	**14.6**
Trade balance (goods)	17.4	16.9	21.3
Exports	89.0	74.8	50.6
Imports	-71.6	-57.9	-29.3
Services	-4.7	-3.2	-1.7
Exports	14.2	12.9	7.2
Imports	-18.8	-16.1	-8.9
Investment income	-8.1	-11.4	-5.4
Received	4.1	4.0	3.1
Paid	-12.2	-15.4	-8.5
Other items, net	-0.6	-0.7	0.4
Capital and financial account	**5.7**	**2.8**	**-7.7**
Capital Account	-0.8	-0.4	-0.2
Received	2.1	1.7	0.6
Paid	-2.9	-2.1	-0.8
Financial account	6.5	3.2	-7.5
Direct investment in Russia	6.2	2.8	2.0
Portfolio investment in Russia	45.6	8.4	-0.5
Other items, net	-45.3	-8.0	-9.0
Net errors and omissions	**-7.8**	**-9.7**	**-6.4**
Change in reserves	**-1.9**	**5.3**	**-0.4**
('-' growth, '+' decline)			

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	1.5	1-9/99
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	7.8	1-11/99
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.7	1-11/99
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	11/99
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	57.6	1-10/99
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	33.1	1-10/99
Current account, USD billion			10.7	10.0	12.0	4.0	1.6	14.6	1-9/99

Sources: Goskomstat, CBR

New millennium, new players

December brought many new faces into Russia's policy-making arena. Only a fourth of previous deputies managed to keep their seats in Duma elections on 19 December, where the voter turnout was 62%. Then on 31 December president Yeltsin surprised everyone by announcing his immediate resignation. At the same time he named prime minister Vladimir Putin as acting president until the presidential election on 26 March 2000. Originally, presidential elections were to be held in July.

Now, as Kremlin supporters did relatively well in the Duma elections, it may be possible for the first time since the beginning of reforms that a majority in the Duma will back the government. Preliminary results indicate that the Unity party won 72 seats, or 16% of the Duma's 450 seats. The Union of Right Forces, led by young reformers, also managed a good showing with 29 seats (6%). Nevertheless, the Communists retained their position as the largest bloc in the Duma, managing to hold 113 seats (25%). The Communists held 157 seats in the previous Duma, elected in 1995. The Fatherland-All Russia bloc was left with 66 seats (15%) and the Liberal Democrats took 17 seats (4%), while in 1995 they got 51 seats. Yabloko, which enjoys strong support in St. Petersburg, won 21 seats (5%). In the previous Duma, Yabloko had 45 seats.

A total of 132 (29%) small party and independent candidates won Duma seats. Thus, there will be more information about the relative strength of different groups only when the Duma convenes on 18 January. The nomination of Mr. Putin as acting president and early presidential elections make it even more difficult to assess the current political situation in the Duma as deputies reconsider their positions. In any case, Mr. Putin enjoys a great public popularity and is clearly the strongest president candidate at the moment. Mr. Putin's economic dilemmas are reviewed in the Opinion article in the last page of this issue.

Military spending up

Federal budget revenues for January-October reached 12.5% of GDP. For the same period in 1998, they were only 9.0% of GDP. Tax revenues, which account for 85% of total budget revenues, were 10.6% of GDP (7.7% in Jan-Oct 1998). The government has also managed to increase the share of cash used in tax settlement.

Expenditures for January-October were 14.2% of GDP (13.0% in Jan-Oct 1998). Nearly a fourth of expenditures went to the servicing of domestic and foreign debt. Another 13% went to social services. Defence absorbed 17% of budget expenditures in January-October, although in September and October the one-month share was about 25%. For the first ten months, the share of defence expenditures to GDP rose to 2.4% from 1.8% in the same period in 1998. Meanwhile, the share of federal social expenditures fell from 1.9% to 1.8%. While all military expenditures are included in the federal budget, the federal budget covers less than a quarter of total consolidated budget social expenditures. Regional and local governments carry the major burden for social spending.

For January-October, expenditures exceeded revenues by RUB 61 billion, leaving a budget deficit equivalent to 1.7% of GDP. Most of the shortfall was covered by state borrowing from the central bank to meet foreign debt servicing.

Russian Federation Jan-Oct 1999 budget execution*

	RUB bln.	USD bln.	% of GDP
Revenues	442	18	12.5
Expenditure	503	20	14.2
Deficit	61	2	1.7

*According to the IMF definition
Source: EEG/Minfin

Russian government raised export tariffs

In December, the Russian government doubled the oil export duty to EUR 15 per tonne. The tariffs on copper, nickel and zinc were doubled to 10%, while the tariffs for other metals were raised to 6.5%. A new export tariff on natural gas also went into effect in December. The charge is 5% of the value of the exported gas with a minimum of EUR 2.5 per tonne. Russia's large oil companies have been highly critical of the latest measures, claiming that high duties will prevent new investment in the energy sector.

Yeltsin approves the budget for 2000

On 31 December, president Yeltsin signed the year 2000 budget law. It was the first time since 1995 that a federal budget was approved before the start of the fiscal year. The 2000 budget is based on a GDP forecast of RUB 5,350 billion (USD 167 billion), or 1.5% GDP growth. The inflation forecast is 18% and the average exchange rate is 32 roubles to the dollar.

The level of budget revenues (15% of GDP) seems to be rather optimistic as in January-October 1999 revenues were only 12.5% of GDP (12.8% in October).

Russian Federation 2000 budget

	RUB bln.	USD bln.	% of GDP
Revenues	797	25	15
Expenditures	855	27	16
Deficit	58	2	1

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Jan.-Oct.	1999 budget law
Federal government								
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	12.5	11.9
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	14.2	14.4
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-1.7	-2.5

* Figures for 1993 – 1996 exclude interest payments on short-term government debt

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

Stocks reacted positively to December events

The recent parliamentary election outcome, the resignation of president Yeltsin and the nomination of Vladimir Putin as acting president have generally been seen as factors enhancing stability and confidence in the Russian economy. For many people, the events in December demonstrate that Russia has made a definite break with its past and reforms are inevitable. The uncertainties over Mr. Yeltsin and his transition are over and, most important, the transition happened in a constitutional way. The appointment of Mr. Putin as acting president was also generally seen as good for Russia's economy. Moreover, acceleration of presidential elections will decrease uncertainties related to, for example, fiscal policy during the pre-election period.

The RTS index of stocks on the Moscow stock exchange, which already rose in response to the outcome of the parliamentary elections, shot up 18.5% on 31 December after the Yeltsin resignation. During the first business days in January, the RTS index strengthened further. On 6 January the RTS index closed at 185.52. In 1999, Russian stock prices increased 195% making Russia one of best performing markets in the world. The prices of government bonds have also risen significantly.

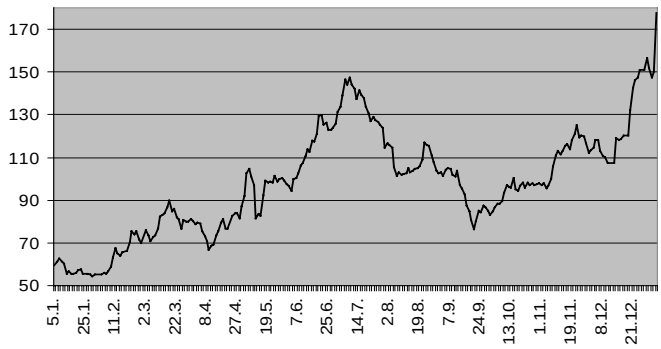
... but the rouble didn't join the party

The stock market exuberance, parliamentary elections and Yeltsin resignation had little impact on the rouble's exchange rate. The rouble was down in SELT from 26.70 just before the 19 December elections to 27.40 roubles to the dollar on 6 January. Interest rates remain high, in spite of Mr Putin's mention of a possible lowering of the refinancing rate of the central bank. The current refinancing rate is 55%.

Mr. Putin has intervened in other monetary policy issues as well. For example, he approved a central bank plan forcing exporters to sell 100% of their export earnings, instead of the current 75%, on authorised exchanges. The move was intended to support Russia's foreign reserves and the value of the weakening rouble. Russia must pay some USD 3 billion in foreign debt payments in the first quarter, although its currency and gold reserves at year's end stood at just USD 12.5 billion.

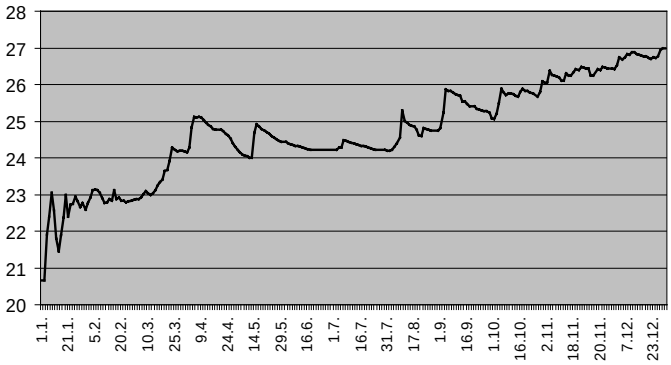
From the point of view of central bank independence, Mr. Putin's activity in the field of monetary policy is worrisome. Moreover, lowering interest rates on the one hand and tightening currency controls on the other sounds contradictory if the purpose is to support the value of the rouble. It should not be a big surprise that the plan to increase regulations in financial markets to tackle the problems related to the value of the rouble have been criticised by the IMF and others.

Russian share prices in 1999, RTS index



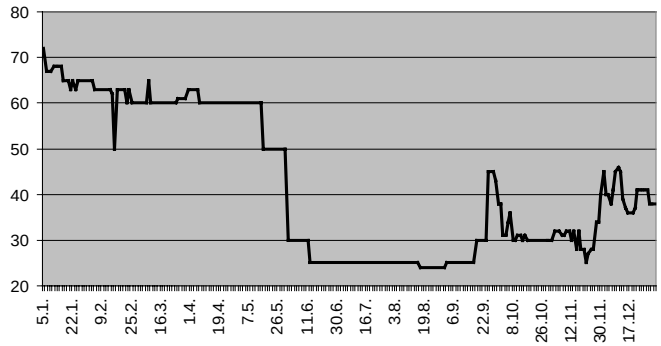
Source: RTS

Rouble/USD exchange rate in 1999



Source: CBR

Interest rates (1-month MIBOR) in 1999



Source: CBR

Monetary indicators

	1994	1995	1996	1997	1998	1999	as of
Inflation (CPI), 12-month, %	224	131	22	11.0	84.4	36.5	12/99
M2, 12-month growth, %	217	113	30	29.5	36.3	63.3	9/99
Average wage, new RUB, end of period	354	736	1017	1210	1463	1785	11/99
Interest rates, period average							
- T-bill (GKO) yield, %		168	86	26.0	n.a.	16.0	6/99
- deposit rate, %		102	55	16.4	25.7	9.0	10/99
- lending rate, %		320	147	46.2	41.7	37.0	10/99
Forex reserves, USD billion (excl. gold)	4.0	14.3	11.3	12.9	7.8	7.6	11/99
RUB/USD, end of period	3550	4640	5560	5960	20.65	27.00	12/99

Sources: Goskomstat, CBR

Putin - harbinger of a second phase of economic reform?

By Pekka Sutela*

In a 28 December position statement, Vladimir Putin outlined his economic ideas in the widest strokes. He argued for continued structural reforms, including such long-sought measures as fiscal and tax reform, bank restructuring and Russia's accession to the World Trade Organization. But he also argued that Western liberalism cannot work in Russia. A Russian model of market economy and democracy is needed; one that reflects such Russian values as patriotism, the country's superpower status, state-centrism and social solidarity.

Putin the reformist?

Are reformist tendencies embodied in this position statement? First, Mr. Putin claims that Russia's recent troubles are mostly inevitable, given the initial conditions and political dilemmas the country inherited. Russia today is in dire straits, not because of Yeltsin, Gaidar, Chubais and others, but due to factors beyond their control. Moreover, reformers will assuredly soon join the government, because Putin needs their ideas. His political success so far is partly their work. The attraction also goes both ways. Many pro-Putin economic reformers seem tempted by the authoritarian approach, believing in the need for discipline and order for positive economic change. They see Putin as a sort of Russian Pinochet. A politically authoritarian solution to economic reform was impossible under Yeltsin as political liberalisation had already started under Perestroika. Now, some argue, the time for economically enlightened authoritarianism has come.

There are also two schools of thought in Russia on how to get the country growing again. Former Prime Minister Primakov and his advisors argued that Russia inherited a huge stock of valuable physical and human capital from the USSR, which now lies under-utilised. Therefore, Russia's growth can, in the first instance, be based on increased capacity utilisation, activated by proto-Keynesian demand management policies. Here, structural reform is less needed than an undervalued exchange rate.

Putin, on the other hand, is clearly inclined to accept the opposite view: the inherited capital stock is almost worthless in the new conditions, so growth must be investment-driven. To improve the investment climate and create an efficient mechanism for financial intermediation, vast structural reforms are needed. Putin argues "everything" should be done in favour of foreign investment.

Thus there are political and economic grounds for seeing Putin as a potential economic reformer. But this is not all we know about him.

A hidden agenda?

Perhaps out of political consideration for neutralising a potential competitor, Mr. Putin also implicitly praises the essentially inactive period of Primakov's government, saying that the search for a proper Russian path only started when Primakov came to power in the wake of the August 1998 financial crisis.

Moreover, Mr. Putin's views on state-centrism are strong indeed. He underscores the need for state regulation of the economy through "coordination" of economic and social forces and determination of the optimal goals and parameters of development. Despite assurances that he wants no return to directive planning, he clearly entertains the idea of a system much stronger than classical French indicative planning. Notably, a separate governmental Centre for Strategic Studies has been established to determine the proper strategy for the next 15-20 years and more. There has never been a lack of strategy papers in Russia.

Thus, it is scarcely surprising that Mr. Putin strongly believes in industrial policies pursued through tax concessions, subsidies and foreign trade policies – and possibly protectionism. Naturally, he wants to support almost everybody: high-tech industries both for domestic markets and exports, non-commodity producers for home markets, and commodity exporters. On one hand, this is consistent with continued rouble undervaluation. However, he also says he wants higher real wages.

Naturally, not too much should be read into short position statements made by a politician approaching a crucial election. Mr. Putin may be a politically autocratic economic reformer, but history shows that in most cases would-be Pinochets end up being repressive both in politics and their management of the economy.

Worst-case future

If Mr. Putin chooses to exercise the ample powers conferred on him by the Russian constitution, the country could face increased political instability. The Russian state remains weak. No new president can make it stronger fast, if at all. Also the current Chechnya expedition may backfire or ghosts from Mr. Putin's past could return to haunt him. Further, any attempts to impose discipline and order through a weak state could well end up creating discipline and order for some, law for none and liberties for a selected few – certainly the worst-case future for Mr. Putin's Russia.

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