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Russian Economy - The Month in Review

Yearbook 2000

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.

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Russian Economy - The Month in Review
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Russian Economy - The Month in Review 2000

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Economic Developments

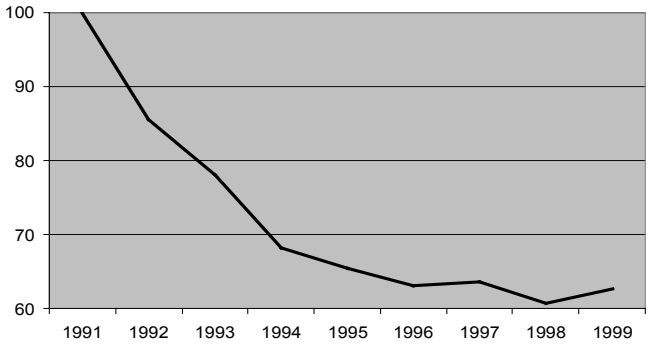
Russian GDP grows 3 % in 1999

According to Goskomstat's preliminary information, Russian GDP rose 3.2 % in 1999 – significantly more than the earlier anticipated 2 %. The relatively modest growth in the first three quarters implies that production increased about 8 % in the last quarter of 1999. The acceleration of growth in the second half of 1999 partly reflects the low production levels in the latter part of 1998. However, effects from the deep recession in 1998 are still being felt as the level of GDP is still below the end-1997 level (see chart). The preliminary GDP estimate of 1999 is RUB 4,476 billion or about USD 180 billion.

Last year's growth comes mainly from industry, where output grew 8.1 %. Agricultural output was up 2.4 %. The situation concerning output of services is more diverse. The indicator of transport services shows 5.2 % growth, but retail trade turnover declined over 7 %. Presumably, the steep drop (-15 %) in the population's real income hit retail services. Meanwhile, services to growing industries fared relatively well.

Despite 1999's healthy growth performance, economists still await a pick-up in fixed investments, which were only 1 % higher than in 1998. Investors may wait until the presidential elections on 26 March to see what kind of economic policy the new political elite will promote and assess how smooth cooperation between the president, government and the Duma will be. Forecasters remain cautious due to the slow recovery in investments and problems with economic policy, particularly in the field of structural reforms. (See table at right).

Russian GDP in 1992-99, index 1991= 100



Russian GDP forecasts for 2000

	2000
EIU (Jan. 00)	1.0
PlanEcon (Jan. 00)	2.3
IMF (Oct. 99)	2.0
Russian Govt. (Jan. 00)	2.0
Consensus mean (Jan. 00)*	1.8

** A mean of 16 forecasters (Consensus Economics Inc.)*

Russia posts USD 33 billion trade surplus

According to preliminary information, Russian exports in 1999 were valued at USD 73.4 billion and imports at USD 40.8 billion, giving a trade surplus of USD 32.6 billion. The figures include USD 1.7 billion in unregistered exports and USD 9.5 billion in unregistered imports. For the year, exports were down 1 %, while imports were down 31 %.

Russian exports to CIS countries were down nearly a fifth and imports a fourth. The value of Russian exports to non-CIS countries rose 4 %, but imports fell 33 %. The fall in imports was a result of the rouble's devaluation. Last year, the CIS countries accounted only for 17 % of Russia's total exports and 25 % of imports.

Nearly two-thirds of export revenues came from the export of fuels, metals and metal products. The picture concerning Russia's imports is less clear due to poor statistics. In spite of a steep decline in imports of consumer goods, their share is relatively big. Finnish customs statistics (Jan-Aug 1999) indicate, however, that the share of machinery and equipment (36 %) in Russia's imports is probably higher than generally thought.

Russian foreign trade 1999, USD billion

	Exports	Imports	Trade Balance
CIS	12.4	10.2	2.2
Non-CIS	61.0	30.6	30.4
Total	73.4	40.8	32.6

Source: Goskomstat, Russian Customs Committee

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	3.2	1999
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	1999
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	1999
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	1999
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	73.4	1999
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	40.8	1999
Current account, USD billion			10.7	10.0	12.0	4.0	1.6	14.6	1-9/99

Sources: Goskomstat, CBR

A "moderately liberal" economic policy?

The new Duma held a stormy opening session in mid-January. After over 100 deputies from Fatherland-All Russia, Yabloko and the Union of Right Wing Forces walked out of the hall in protest of an unholy alliance of the Communists, Unity bloc, and Zhirinovski's liberal democrats, the new coalition members voted 285-2 to make moderate Communist Gennadi Seleznyov their new speaker. The fractious opening dampened earlier hopes for smoother cooperation among the president, the government and the Duma.

A second important issue naturally is future economic policy. Here, the picture is still unclear. At the end of December, prime minister Putin gave a policy statement in which he candidly appraised Russia's current poor situation. Unlike usual Russian commentary, Mr. Putin did not blame the West for Russia's problems, but took the refreshing view that today's problems arise from Russia's Soviet past and bad policies in the 1990s.

Mr. Putin's vague comments on future economic policy were somewhat at odds. While supporting democracy and market economy, he also stressed the incompatibility of models of other countries with Russian circumstances, which call for a strong state. Moreover, while Mr. Putin dissociated himself from any kind of state ideology, he strongly emphasised that the state's role in current Russian economy should be much more than "devising rules of the game and controlling their observance." Most observers are willing to grant that the current Russian state is very weak in many respects. However, unclear is, how the present incompetent state bureaucracy with poor resources could survive with wider functions if it cannot manage the most basic duties.

Otherwise Mr. Putin followed the policy lines of international organisations in many respects. He emphasised the importance of quickly improving the investment climate in Russia, changing the tax system, passing new land legislation, holding down inflation and keeping the value of the rouble stable, restructuring the banking system and integrating Russian economy into the world market.

Later in his speech to the Duma, Mr. Putin said his government's economic policy would be "moderately liberal", which did little to clarify the picture. Given the uncertainties of Russian politics, the IMF is not expected to make any decisions on new funding until after the presidential elections and the situation clears.

EU decides on mild sanctions against Russia

On 24 January, EU foreign ministers announced that the EU would implement stricter controls with Russia to assure compliance with its economic cooperation programs. Moreover, the foreign ministers recommended that funding under Tacis programs be redirected to humanitarian aid to Chechnya and that in the future more aid generally be given to strengthening democracy and social structures. The sanctions protest Russia's military operations in Chechnya and implement resolutions made at the EU summit in Helsinki last December. While the sanctions are considered modest in EU circles, some Russians have criticised the EU for imposing sanctions where the issues actually have to do with protecting territorial integrity and national security.

Hike in pensions and state sector wages

As of 1 February, Russian 39 million pensioners got a 20 % inflation adjustment. After the increase, the average monthly pension will be RUB 650 (USD 23), which is close to the subsistence minimum calculated for pensioners. Earlier in November, pensions were increased by 15 %.

State sector wages will be increased 20 % at the beginning of April. In 1999, consumer prices in Russia increased 37 %.

The Russian Statistical Committee said that Russian wage arrears were halved in 1999 so that at the start of this year they totalled RUB 44 billion (USD 1.6 billion). Of this, the public sector share is RUB 10 billion (USD 0.4 billion).

Budget revenues and expenditures up

In November, federal budget revenues and expenditures grew rapidly both in rouble terms and as a share of GDP. After a big jump in November, the monthly level of revenues (14.8 % of GDP) now corresponds to what is budgeted (15 %) for the year 2000. On the expenditure side, there is some confusion. Reported monthly defence expenditures declined to less than RUB 10 billion (USD 360 million) in November from about RUB 13 billion (USD 500 million) in September and October. In November, reported defence expenditures accounted for 15 % of total federal expenditures while in September and October the figure was 27 % and 25 %, respectively.

Russian Federation Jan-Nov 1999 budget execution*

	RUB billion	USD billion	% of GDP
Revenues	509	21	12.7
Expenditure	568	23	14.2
Deficit	59	2	1.5

*According to IMF definitions
Source: EEG/MinFin

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000
Federal government							Jan.-Nov.	budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	12.7	15
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	14.2	16
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-1.5	-1

* 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 lowers refinancing rate

Effective 24 January, the Central Bank of Russia decreased the refinance rate from 55 % to 45 % (see chart). The decision came after acting president Vladimir Putin asked the CBR to lower interest rates. In Russia's poorly functioning financial markets, however, the refinancing rate currently only plays a limited role as the basis for certain fees and penalties. The recent cut follows the decline of market interest rates and, hence, has no immediate direct effect on the lending activities of commercial banks. At the beginning of February, Moscow interbank interest rates (Mibor) ranged from 17 % p.a. for 1-day credit to 35 % for 3-month credit.

Only a few weeks ago the central bank raised its reserve requirements for commercial banks. Banks must now deposit 10 % of their corporate and forex deposits (up from 8.5 %) with the CBR and 7 % of their rouble deposits from households (up from 5.5 %). Unlike the interest rate cut, this move was intended to reduce the liquidity of banks, to keep interest rates high and to diminish speculative pressure on the rouble. In spite of concerns over the rouble, it now seems the government and the CBR have abandoned their plans to tighten currency regulations by forcing exporters to repatriate all of their currency earnings, instead of the current 75 %.

In January, the rouble depreciated against the dollar by 5.2 %. On 2 February, the rouble traded at 28.64 to the dollar.

Number of banks declines slowly

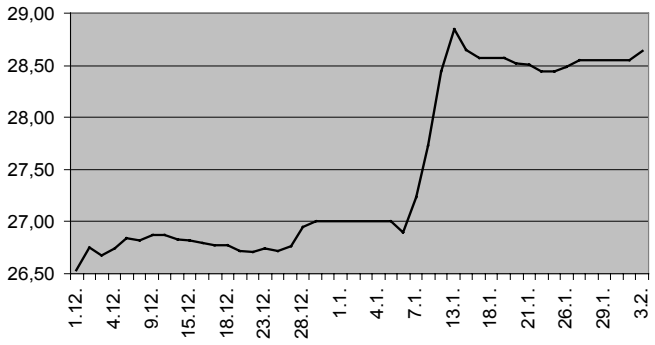
The CBR reports that last year the number of operating banks declined by 127 to 1,349. The share of problem banks in the banking sector diminished from 33 % in early January 1999 to 18 % in December.

In dollar terms, the contraction of Russia's banking sector has been more dramatic. At end-October, the value of total assets of the Russian banking sector was about USD 56 billion. In July 1998, just before the August crisis, the respective figure was USD 98 billion. Joining in the considerable criticism against the slow restructuring of the banking sector (see Opinion), first deputy prime minister Mikhail Kasyanov recently criticised the central bank of slow progress in the banking field.

New head for the FSC

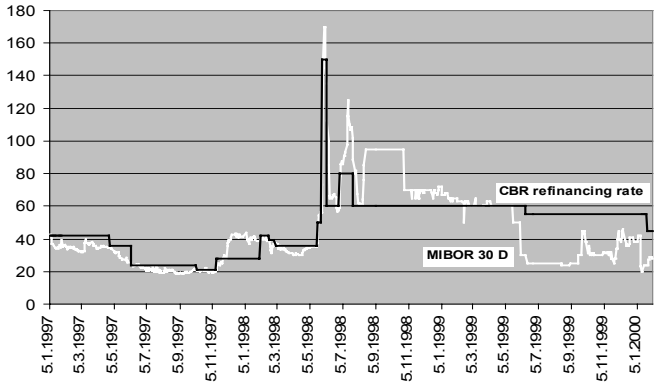
At the beginning of February, Igor Kostikov was nominated as head of Russia's Federal Securities Commission (FSC). Mr. Kostikov comes from St. Petersburg, where he was deputy head of the finance committee in charge of foreign and domestic debt issues for the city. The FSC is responsible for regulation of Russia's developing capital markets, albeit with rather limited enforcement powers. Mr. Kostikov succeeds Dmitry Vasiliev, who led the commission from its founding in 1994 until last October. Mr. Vasiliev resigned after complaining that the government showed too little interest in enforcing the law to protect shareholder rights.

Rouble/USD exchange rate, Dec 1999 – Feb 2000



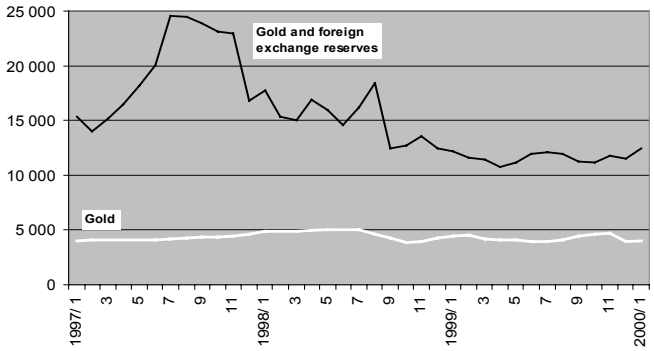
Source: CBR

Russian interest rates, % p.a.



Source: CBR

CBR's foreign exchange reserves, USD million



Source: CBR

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5		1999
M2, 12-month growth, %	113	30	29.5	36.3	62.9		11/1999
Average wage, new RUB, end of period	736	1017	1210	1463	2272		1999
Interest rates, period average							
- deposit rate, %	102	55	16.4	25.7	9.4		11/1999
- lending rate, %	320	147	46.2	41.7	38.8		11/1999
Forex reserves, USD billion (excl. gold)	14.3	11.3	12.9	7.8	8.5		1999
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.55	1/2000

Sources: Goskomstat, CBR

Russian banks: No light at the end of the tunnel

By Knut Eggenberger *

In August 1998, the rouble's devaluation and government default on its domestic debt led to a systemic banking crisis, illiquidity and insolvency for large parts of the banking system and hiccups in the payment system. Hundreds of thousands of depositors lost at least some of their savings. Even so, we should remember that government default and devaluation merely triggered the banking crisis. There is evidence suggesting that numerous banks were already insolvent before the crisis. Given the scope of this crisis, what is perhaps most surprising today is the continuing lack of a clear strategy on dealing with the banking sector. With little transparency or explanation, the CBR has propped up individual banks with cash injections and 'repo' loans. Bank owners and managers have also been given plenty of time to strip assets by transferring them into 'bridge banks' with, one must assume, the full knowledge and at least tacit approval of the authorities. In 1999, ARCO, the bank restructuring agency, took on its first restructuring projects, but it has little political clout and even less money. On a positive note, the legal framework for bank restructuring has been improved with laws on bankruptcy of credit organisations and restructuring of credit organisations.

Fundamental problems remain unresolved

It seems fair to say there was little overall progress in bank restructuring in 1999. This is not to say that nothing happened or that all the news is bad. Some banks weathered the crisis on their own, and the CBR did go ahead with the sometimes highly political task of withdrawing licenses. But a few pieces of good news do not change the big picture.

There has been no progress with two key problems troubling the Russian banking sector: lack of funding and lack of investment opportunities due to the financial fragility of potential borrowers.

The first problem comes down to the fact that there is very little trust left in private banks, so banks have a hard time attracting deposits. There has been a flight of deposits to Sberbank, which now accounts for close to 90% of rouble-denominated household deposits. Foreign banks would have much less difficulty attracting deposits, but they are – according to all we hear – not exactly rushing to lend to Russian companies. This does not have much to do with restrictions on foreign banks' operations, but rather points to the second fundamental problem hindering development of the Russian banking industry: the financial fragility of potential borrowers.

Even after the massive real devaluation of the rouble, many companies are still losing money. There is persistent macroeconomic and political instability plus a long list of structural microeconomic problems that make cash flows in the real sector highly uncertain and reduce rates of return on investment. These problems include:

- constantly changing regulations and selective enforcement of rules;
- burdensome licensing requirements;
- a complex tax system and high tax rates;
- arbitrary decisions by authorities at various levels;
- the abuse of power by officials for private gain;
- organised crime;
- selective market-distorting subsidies to well-connected competitors; and
- a court system that still makes enforcement of contracts problematic.

The impact of these problems is hard to quantify. It is, however, illustrative that there has been very little growth in the number of small companies (at least in the formal sector), which have been of such crucial importance in other transition economies. Admittedly, many economies suffer from the above-listed problems to varying degrees and still manage to grow at reasonably high rates. Therefore, I would suggest that the factors setting the Russian economy apart are its soft budget constraints and the fact that bankruptcy is not a credible threat for many companies. The large amount of capital flight supports the view that the investment environment is pretty awful. The upshot of this discussion is that it is hard indeed for a banker to find companies worth lending to.

Summing up 1999

There was little progress in reviving the banking system last year, but then this was not the main problem. More important than the recovery of the banking industry is recovery of the real sector. There was some improvement in this respect (increase in industrial production, decrease in arrears, etc.), but much of this could be due to devaluation. It might be that the outlook improves after the elections when a great deal of political uncertainty hopefully disappears. At any rate, the banking sector will hold only limited importance for years to come.

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RUSSIAN ECONOMY
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2•2000

Economic Developments

GDP growth led by recovery in industry

According to Goskomstat figures, Russian GDP rose 3.2 % in 1999. The GDP estimate of 1999 is RUB 4,476 billion or about USD 180 billion. Goskomstat also revised its 1998 GDP estimates downward so that 1998 GDP was 4.9 % less than in 1997. Due to the large drop in 1998, Russian 1999 GDP in real terms was two per cent less than in 1997.

Last year's growth comes mainly from industry, where output grew 8.1 %. As industrial production constitutes approximately 30 % of GDP, the growth in industry alone would have indicated a GDP growth rate of 2.5 % in 1999. Strong growth in industrial production is also mirrored in the GDP composition. Compared to 1998, the share of goods production in total GDP increased by 3.5 percentage points and constituted 46 % of Russian GDP. The effects of devaluation are also clearly reflected in the structure of GDP at final use. The share of total domestic consumption decreased from 77 % in 1998 to 69 % in 1999, while the share of net exports increased from 8 % in 1998 to 16 % in 1999.

Russian GDP at source, % of total

	1998	1999
GDP	100	100
Production of goods	42.2	45.7
of which:		
Industry	29.0	32.9
Agriculture	5.3	6.7
Construction	7.1	5.5
Production of services	57.8	54.3
of which:		
Transport	9.1	7.2
Trade	19.1	23.1

Source: Goskomstat

The strong growth in industrial production reflects higher exports, substitution of imports with domestically produced goods and the low 1998 figures used in comparison. Fastest growth was reported by chemical and petrochemical industry (22 %), machine building (16 %) light manufacturing (20 %), paper and pulp (17 %), ferrous metals production (14 %). Growth in foodstuffs industry (7.5 %) and construction materials production (7.7 %) was more modest.

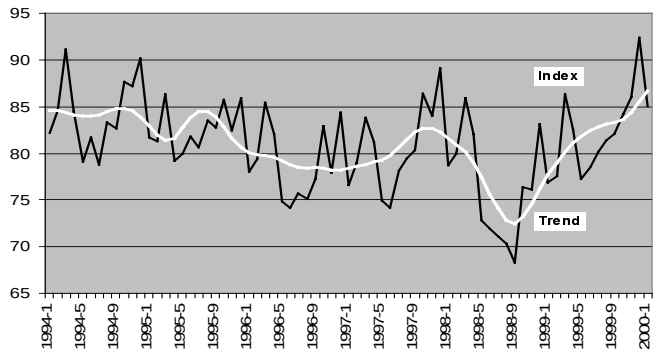
Somewhat surprisingly, fuel production rose only 2.4 % and electricity production remained unchanged. Despite current high oil prices, Russian oil production and exports have not increased significantly. As many analysts note, rapid increases in crude oil production are technically infeasible. Thus, the significant production increases in energy-intensive sectors such as pulp and paper seem to have taken place without any corresponding increase in energy production, which has raised concerns about the reliability of the data.

Continued growth in 2000?

Goskomstat reported a 10.7 % y-o-y increase in industrial production for January this year against a 4.9 % drop in January 1999. This has led some analysts conclude that strong growth will continue also in 2000. First Deputy Prime Minister Mikhail Kasyanov estimated 2.5-3 % GDP growth for this year, almost double the budget forecast of 1.5%.

If the growth is to continue for all 2000, it will have to be based on stronger domestic demand. Last year retail trade decreased by 7.7 % compared to already low 1998 levels. Investments in fixed assets rose only one per cent. Although households' real disposable income decreased last year by 15 % compared to the 1998 level, the monthly data show a modest increase since mid-1999. The planned hikes in pensions and public sector wages should slightly increase household demand in 2000. The latest Russian consumer confidence indexes indicate that an increasing share of Russians believe in continued economic growth.

Russian industrial production, Dec. 1993=100



Source: Goskomstat, BOFIT

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	10.7	1/2000
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	4.5	1/2000
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	12.3	1/2000
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3		
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1		
Current account, USD billion			10.7	10.0	12.0	4.0	1.6	14.6		1-9/99

Sources: Goskomstat, CBR

1999 budget deficit lowest since 1980s

Preliminary estimates released by the Russian finance ministry show that federal budget revenues in 1999 amounted to RUB 600 billion or 13.4 % of GDP. Expenditures were RUB 74 billion higher, leaving the budget deficit at 1.7 % of GDP. The primary budget surplus, which excludes debt-servicing costs, was 2 % of GDP. Both actual revenues and expenditures exceeded budget, but budget balance was better than forecast. The 1999 budget act foresaw an overall budget deficit including debt servicing of 2.5 % of GDP and a primary budget surplus of 1.7 % of GDP. The 1998 federal budget deficit was 4.9 % of GDP. The 1999 budget deficit is the lowest since mid-1980s.

The improved budget performance reflected economic growth, higher profitability for enterprises and the fact that more tax revenues than previously remained in federal coffers instead of being distributed to regions. Regional budget revenues fell from 15 % of GDP in 1998 to 14 % of GDP in 1999.

After the rouble's devaluation, the share of foreign trade in Russian economy has increased considerably. Exports as a share of GDP were 40 % last year compared to 26 % in 1998. Consequently customs duties accounted for 14 % of federal revenues, but total proceed from foreign trade activities are likely to be much larger. According to EEG of Minfin, State Customs Committee collected 28 % of total federal revenues. On the expenditure side of the budget, debt service is the single largest item accounting for a quarter of all federal expenditure. That share is high, especially if one bears in mind that in 1999 Russia did not service its Soviet era debt. The largest non-interest expenditure, defence, has risen since last autumn. For the year as whole defence expenditure equalled 2.6 % of GDP.

Despite higher tax revenues, improvements in tax collection were not forthcoming. According to ministry of finance, the tax collection rate for the federal budget was 76 % (75 % in 1998) and for regional budgets 95 % (94 % in 1998). The underlying reason for better tax collection at the regional level is that regional governments more easily accept mutual debt cancellations as tax payment. If tax legislation and tax collection were improved so that tax collection rates were 100%, Russian federal budget revenues would have been over 16 % of GDP, instead of 13.4 % last year.

No political business cycles this time

Contrary to the last presidential elections in 1996, political campaigning seems, apart from hikes in pensions and state sector wages, almost nonexistent. Mr. Putin's popularity appears to be so strong that the Kremlin has no need to resort to additional budgetary spending or to business tycoons' coffers. This should be good news to Russia's fragile budget balance.

Despite the London club deal (see page 3) Russia will need new foreign financing to cope with increasing debt service expenditures this year. This applies first and foremost to IMF lending. After negotiations in Moscow in early February, the IMF announced that Russia had yet to meet all terms of the agreement it made last July for further release of tranches in a USD 4.5 billion stand-by credit.

While the IMF and the Russian government agree that macroeconomic program targets have been met, the IMF still demands that several structural benchmarks be fulfilled. These include passage of legislation on bankruptcy and reporting by financial institutions, as well as arranging independent audits of the central bank and federal extra-budgetary funds. Other conditions include having the national railway, Gazprom, Transneft and the national power grid Unified Energy Systems (UES) report their financial statements according to international accounting standards (IAS). It is highly unlikely that these tasks will be addressed before the presidential elections on 26 March. Additionally, it may take several months after the first benchmarks have been fulfilled before the IMF accepts that conditions have been established to resume lending.

1999 federal budget (realised)

	RUB billion	% of total	% of GDP
Revenues	**597**	**100**	**13.4**
Tax revenues	505	84.6	11.3
of which			
VAT	219	36.7	4.9
Profit tax	79	13.2	1.8
Customs duties	86	14.4	1.9
Excises	84	14.1	1.9
Other tax revenues	37	6.1	0.8
Non-tax revenues	37	6.2	0.8
Budgetary funds	55	9.2	1.2
Expenditure	**672**	**100**	**15.0**
Domestic debt service	74	11.0	1.7
Foreign debt service	89	13.2	2.0
Defence	116	17.3	2.6
Social sphere	85	12.6	1.9
Aid to regional budgets	62	9.2	1.4
Other expenditures	246	36.7	5.4

Source: EEG / MinFin

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000
Federal government								budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	13.4	15
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.0	16
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-1.7	-1

* 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 and London Club sign a deal

On February 11, Russia and the London Club reached an agreement with London Club member banks on restructuring Russia's USD 32 billion Soviet-era debt. The commercial creditors granted Russia a 36.5 % write-off, equivalent of USD 11.6 billion. Russia on the other hand will upgrade the remaining debt to two eurobond series from their current status as Vnesheconombank debt. The first 30-year eurobond covering principal carries a seven year grace period, when Russia will pay only interest payments during the first seven years. In addition, the initial interest rate is a very modest 2.5 % a year, rising incrementally to 7.5 % a year over seven years. The USD 2.8 billion of interest due on the defaulted debt will be exchanged for a second eurobond with a maturity of 10 years and yield of 8.25 %.

The willingness of commercial banks to agree on a considerable write-off is, at least partly, explained by the extremely low market value of the debt in question. Before the agreement, the market value of Russia's London Club debt was only about USD 6 billion. Moreover, the banks have long since wiped the losses related to this debt from their balance sheets.

With the agreement, the credit rating agency Standard & Poors upgraded several Russian instruments and Fitch IBCA placed Russian eurobonds, currently rated CCC on Rating Alert positive. While the financial markets were cautiously positive to the agreement, the yield on Russian eurobonds is still internationally very high, varying between 16.3 % and 17.7 %.

The London Club agreement gives Russia some more breathing time in foreign debt service. The agreement will reduce Russia's annual debt service payments by USD 1-2 billion up to 2012. The original (pre-August 1998) debt service schedule implied annual foreign debt payments around USD 15 billion for 1999-2004 (see chart). Thus, this agreement alone will not significantly reduce debt servicing burden. As realised foreign debt servicing in 1999 was about USD 8.5 billion, it is easy to see that the situation is likely to remain difficult. Russia will have to ensure new foreign financing and implement serious structural reforms if it is to avoid events like August 1998 in the near future.

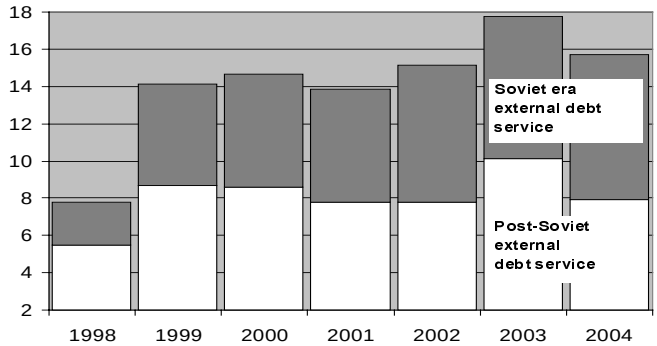
According to Russian Finance Minister Mikhail Kasyanov, Russia will start negotiations on restructuring USD 40 billion Soviet-era debt owed to Paris Club of creditor nations this summer. The original payments schedule implied around USD 3 billion annual debt servicing payments to the Paris Club.

Minfin issues two new GKOs

On February 23, the ministry of finance placed two new GKO series worth RUB 2.5 billion each. The shorter three-month treasury bill, which was subscribed nearly in full, pays an annualised yield of 20 %. This GKO issue represents the first short-term paper offered by the state to Russian investors since August 1998. While the total value of the new T-bill series is modest, the issues give the government a chance to test the market's willingness to buy T-bills. Finance Minister Kasyanov said that the ministry does not plan to issue any new GKO bonds in the near future. He also mentioned that the main purpose of the issue was to absorb excess liquidity in the banking system, which grew considerably when the finance ministry paid investors nearly RUB 10 billion in principal and interest for maturing OFZs.

The longer six-month GKO T-bill was targeted mainly at foreign investors with roubles received as settlement from the restructuring of GKO debt frozen in 1998. As investing in the new GKOs is about the only way of repatriating proceeds from earlier restructuring arrangements, some investors were willing to accept extremely low yields. Hence, the average annualised yield of this paper is negative 0.5 %. Only about half of this issue was sold.

Original (Pre-Aug 1998) debt service schedule on Russia's Soviet and post-Soviet foreign debt, USD billion



Source: Fitch IBCA

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	28.9	1/2000
M2, 12-month growth, %	113	30	29.5	36.3	57.2		
Average wage, new RUB, end of period	736	1017	1210	1463	2272	1826	1/2000
Interest rates, period average							
- deposit rate, %	102	55	16.4	25.7	8.5		
- lending rate, %	320	147	46.2	41.7	32.1		
Forex reserves, USD billion (excl. gold)	14.3	11.3	12.9	7.8	8.5	8.9	1/2000
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.66	2/2000

Sources: Goskomstat, CBR

What are the policy choices for enterprise reform in Russia?

By Juha Honkkila*

Debate on the means and policy priorities of privatisation and enterprise reform in former socialist economies has raged for a decade. In most transitional economies, the process has been relatively successful. Ownership and control rights structures have evolved very much in line with privatisation theories. One popular argument says that there is a policy trade-off between finding efficient owners and maintaining social justice. On one hand, comprehensive restructuring of enterprises requires vast amounts of physical and human capital. An easy way to do this is to sell firms to their core owners. On the other hand, overemphasis of direct sales will create an inequitable distribution of wealth, which, together with a large increase in unemployment, makes most of the population losers in the reform process. Gross inequity hurts the aggregate welfare of the economy, delays further reforms and possibly leads to a decline in future growth prospects.

Thus, most privatisation plans to date have included a mix of voucher schemes and insider privatisation as ways to compensate probable losers while bolstering the popularity for enterprise reform policies. In principle, vouchers provide each individual with equal possibilities to get a part of the economy's assets and gain from transition. In fact, evidence from the former socialist economies shows that the objectives of voucher privatisation have often not been achieved. In this sense, Russia is probably the quintessential example of failed privatisation policies.

Russia's early privatisation – tandem drawbacks

Russia's mass privatisation program was completed during the years 1992-1994. The program included more than 20,000 firms registered as joint-stock companies and made 147 million Russian citizens eligible to purchase vouchers worth 10,000 roubles. The idea was to find a quick way to end inefficient state ownership of enterprises and concurrently to give every citizen the possibility to participate in the privatisation of state-owned property. Insiders were given significant priorities in the privatisation of big and medium-sized enterprises. The program was a success if one considers the speed of privatisation and the participation of firms and citizens in the program. In retrospect, the attempt to try and combine the benefits of various privatisation methods failed to such an extent that it actually amplified drawbacks those very same privatisation methods. Russian enterprises did not find efficient owners aiming for restructuring, and the relatively low inequality figures were short-lived.

Income inequality in Russia is approximately at the level of Latin American countries and higher than in any other transition economy. Put mildly, wealth is unfairly distributed. Voucher privatisation probably was introduced too quickly and before citizens had a chance of understanding the significance of private property. Moreover, most owners lacked adequate capital to carry out a restructuring. Consequently, mass privatisation in Russia has only in few cases led to meaningful changes in the control rights structure and behaviour of firms.

Large-scale institutional reforms needed

With the presidential elections only weeks ahead, there is increasing optimism in Russia about reforms in the enterprise sector. Clearly, however, the policy options this time will be quite different from those available in 1992. While few would dispute the need for further restructuring, who is willing to cover the costs of such reforms? Official unemployment figures were around 11% in 1999, but it is quite clear that some excess employment still prevails in many privatised enterprises. Even if Russia could find new efficient enterprise managers, the consequence could be an even worse social disaster than in the early privatisation process because restructuring inevitably leads to an increase in unemployment.

Therefore enterprise reform policy needs to be far more broadly based than earlier. First, the Russian economy needs large-scale institutional changes to make the enterprise sector work more efficiently. Changing ownership from public to private did not lead to the required improvements in enterprise management, and hopefully the Russian government has learned this lesson: simply changing legal ownership rights does not necessarily improve anything. Second, putting an end to the demonetisation of the economy needs to be a top priority. You can't have a functioning market economy as long as enterprises prefer barter trade to money. Without creating the proper legislation, straightforward settlement of inter-firm contracts remains problematic. The government faces an equally critical problem with tax payments. There are only limited possibilities for the Russian public sector to support any further increase in unemployment, even in the short term. With the current rates of non-payments of taxes there are no possibilities for the local or central governments to improve their balance. Moreover, the public will not agree on any further reforms if the expected losers can not be compensated by social security.

The Russian government needs to be considerably stronger and wealthier before it can attempt any shock therapy-type changes in the ownership structure of firms. There also needs to be an appropriate legal and institutional background that encourages enterprises to start behaving in a more market-oriented fashion.

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RUSSIAN ECONOMY
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Economic Developments

Will strong GDP growth continue in 2000?

Strong growth in industrial output during the last quarter of 1999 (11 % y-o-y) and in January-February this year (13 %) indicates that growth should remain high at least for the first half of 2000. In just two months, the consensus mean forecast for Russian GDP growth has increased by 1.3 percentage points. Six months ago, many observers considered overly optimistic the 1.5 % GDP growth assumption on which Russia's budget act was based. Now several forecasters are saying 5 % growth this year is realistic. Last year, Russian GDP grew 3.2 %.

Russian GDP growth forecasts for 2000

	%
Consensus mean* (Jan. '00)	1.8
Consensus mean* (March '00)	3.1
Goldman Sachs (March '00)	5.0
Creditanstalt (March '00)	1.0
IMF WEO (March '00)	1.5
PlanEcon (Jan. '00)	2.3
Russian budget (Dec. '00)	1.5

** A mean of 16 forecasters (Consensus Economics Inc.)*

Despite the healthy economic performance, certain factors may precipitate uncomfortable surprises as early as this year. First, up to April, comparisons on year-on-year change are made against very low 1999 levels. Second, lower oil prices could hit the value of Russian exports. Third, the immediate benefits of the devaluation of the rouble are gradually fading, while longer-term consequences like wage pressure are growing. A particularly interesting question is how the government will manage state expenditures in the current situation. Finally, the picture concerning domestic demand is still somewhat unclear although the latest information on growing investments is promising.

Thus, the current relatively positive situation is basically the result of external factors rather than good policies. As much as ever, Russia faces a demand for structural and fiscal reforms to insure that growth continues on a sustainable basis.

Record current account surplus in 1999

According to the latest CBR data, Russian exports in 1999 were USD 75 billion while imports contracted by approximately 30 % to about USD 40 billion. Thus, the trade balance surplus was USD 35 billion. Although the services balance showed a deficit and Russia's net interest expenditures were highly negative (USD 7.7 billion), the current account rose to a record USD 25 billion surplus.

Despite the huge current account surplus, the CBR's foreign currency reserves increased only slightly. This was due to debt repayments and difficulties to get new financing. For example, the Ministry of Finance last year borrowed at least USD 4 billion in foreign currency from the central bank to service its debts. Also, balance of payments statistics confirm that foreign investors did not return to Russia last year. Foreign direct investment in 1999 amounted only to USD 2.9 billion, roughly the same amount as in 1998, but a considerable drop from USD 6.6 billion in 1997. Portfolio investments turned negative last year.

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

	1997	1998	1999
Current account	**3.9**	**2.1**	**25.0**
Trade balance	17.4	17.4	35.3
Exports, f.o.b.	89.0	74.8	74.7
Imports, c.i.f.	-71.7	-57.5	-39.4
Services	-4.6	-3.3	-3.3
Exports	14.2	12.8	9.1
Imports	-18.9	-16.1	-12.4
Investment income	-8.1	-11.4	-7.7
Received	4.1	4.0	3.4
Paid	-12.3	-15.4	-11.2
Other items, net	-0.7	-0.6	0.7
Capital and financial account	**6.9**	**2.1**	**-16.1**
Capital Account	-0.8	-0.4	-0.3
Received	2.1	1.7	0.9
Paid	-2.9	-2.1	-1.2
Financial account	7.7	2.5	-15.7
Direct investment to Russia	6.6	2.8	2.9
Portfolio investment to Russia	45.6	8.4	-0.8
Other items, net	-44.5	-8.7	-17.8
Net errors and omissions	**-8.9**	**-9.5**	**-7.1**
Change in reserves	**-1.9**	**5.3**	**-1.8**
('-' growth, '+' decline)			

Source: Central Bank of Russia, 31 March 2000.

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	13.0	1-2/ 00
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	6.0	1-2/ 00
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	12.3	2/ 00
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	6.4	1/ 00
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	2.4	1/ 00
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0		

Sources: Goskomstat, CBR

Debt servicing situation still tough

For all 1999, interest expenditures on foreign debt amounted to RUB 89 billion (USD 3.6 billion) or 13 % of all federal expenditures. Additionally, Russia last year repaid principal of USD 5.5 billion on its foreign debt (including IMF). Despite the selective default of Soviet-era debt, Russia succeeded in attracting USD 2.8 billion in fresh foreign credits mainly from bilateral creditors. This reduced net foreign repayments to USD 2.8 billion last year.

Domestic debt servicing equalled RUB 74 billion (USD 3 billion) or 11 % of total expenditure. Additionally, the total stock of domestic debt was reduced by RUB 183 billion to RUB 884 billion. Russian domestic debt consists primarily of government T-bills (GKO/OFZ). The nominal value of the bonds is RUB 520 billion, of which only about RUB 250 billion is openly traded in MICEX. The rest of the domestic debt stock is held primarily by the CBR and Sberbank. According to MinFin, a mere 10 % of new T-bills issued in 1999 was sold to bond markets. The remainder was directed to the CBR, Sberbank, and Vnesekonbank. These three are also the sources for foreign-currency-denominated domestic debt.

This year, Russia should pay about USD 10 billion in interest and principal repayments on its post-Soviet foreign debt. However, the budget law for 2000 approved last December allocates only about USD 7 billion for all federal debt servicing expenditures. Russia's total federal debt roughly equals the 1999 GDP, while the foreign debt is about 80 % of GDP (see table below).

Structure of federal government debt, end 1999

	RUB bln.	USD bln.
Foreign debt		**146**
IMF		15.1
IBRD		6.5
Paris Club		43.0
Other official bilateral creditors		30
London club		32
Other commercial creditors		5
Eurobonds		15
Domestic debt	**884**	**33**
MinFin bonds	300	11.1
GKO	10	
OFZ	510	
Other	64	
Total		**179**

Sources: MinFin, Troika, IMF, IBRD, FITCH IBCA, BOFIT

Realised 1999 federal and regional budgets (* excluding RUB 62.1 billion in federal transfers)

	*Federation***			*Regions*		
	RUB bln.	% of total	% of GDP	RUB bln.	% of total	% of GDP
Revenues	611.7	100.0	13.7	585.8	100.0	13.1
Taxes	509.5	83.3	11.4	493.1	84.2	11.0
VAT	221.0	34.5	4.9	65.9	11.2	1.5
Personal income taxes	19.9	3.3	0.4	97.0	16.6	2.2
Profit taxes	81.0	13.2	1.8	138.8	23.7	3.1
Excises	84.2	13.8	1.9	24.2	4.1	0.5
Customs duties	86.3	14.1	1.9	-		
Other taxes	17.1	2.8		167.2	28.5	3.7
Foreign operations	34.7	5.7	0.8	-		
Sale and rent of state property	6.8	1.1	0.1	15.9	2.7	0.4
Other revenues	60.7	9.9		76.8*	13.1	1.7
Expenditures	664.7	100.0	14.9	648.9	100.0	14.5
Administration	14.8	2.3	0.3	31.7	4.9	0.7
Law enforcement and security	55.4	8.3	1.3	19.0	2.9	0.4
Industry, energy and construction	16.9	2.5	0.4	14.1	2.2	0.3
Agriculture	9.1	1.4	0.2	26.7	4.1	0.6
Social and cultural expenditures	85.1	12.8	1.9	280.4	43.2	6.3
Defence	116.1	17.5	1.2	-		
Transfers to regional budgets	62.1	9.3	1.4	-		
Debt service	162.6	24.5	3.6	-		
Other expenditures	142.6	21.5		277.0	42.7	6.2
Balance	53.0		-1.2	63.1*		-1.4*

*Source: Goskomstat; ** Federation's figures differ slightly from those of MinFin (see below).*

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000
Federal government								budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	13.4	15
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.0	16
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-1.7	-1

* 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.

Russian markets calm

The markets well anticipated Mr. Putin's victory on 26 March, and consequently showed little reaction to the presidential election results. Share and bond prices rose before the elections, then retreated slightly after the results were clear. Even the drop in technology stocks in the US and Europe had little impact on the Russian market. Foreign investors are now focusing on the yet-to-be-announced central elements of the new president's economic policy.

Russia's higher export earnings and moderate growth in portfolio investments have increased foreign reserves and helped stabilise the rouble. The Central Bank of Russia's gold and currency reserves rose from USD 12.5 billion at the start of the year to USD 15.5 billion as of 1 April. Following a sudden drop of the rouble at the beginning of April, the CBR's official exchange rate stood at 28.78 to the dollar on April 4.

The CBR lowered its refinancing rate from 38 % to 33 % on March 21. Twice previously this year, the CBR dropped the refinancing rate by a total of 17 percentage points. The CBR's latest lowering and its statements that the refinancing rate is likely to fall signal that the central bank intends to use the refinancing rate more actively in guiding market rates. Falling inflation in Russia has helped to bring both interest rates and T-bill yields down. Twelve-month inflation in March was 22 %.

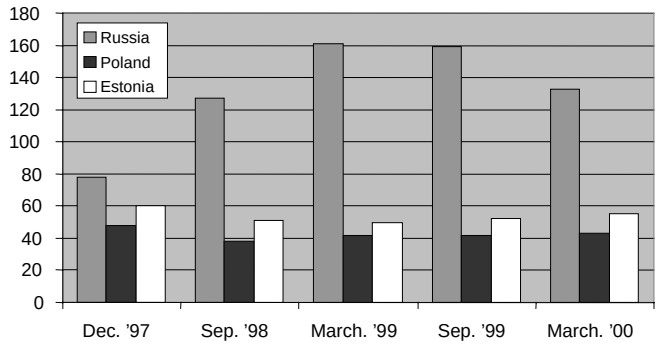
Decreasing yields in GKO markets

During the first quarter of 2000, Russia's Ministry of Finance paid almost RUB 20 billion (USD 700 million) in interest and principal repayments on domestic market-based debt. Through placements of small amounts of previously unsold GKOs and two new GKO issues in February, the Ministry raised some RUB 7 billion (USD 250 million) in fresh financing from the markets during the first three months of this year. The nominal value of GKO and OFZ bonds traded in MICEX issues was RUB 255 billion at the end of March. The market value of these T-bills was slightly below RUB 200 billion and the average maturity was about a year and a half. Trading has been very slow in the four new GKO-series targeted at foreign investors. The yields on these bonds have remained negative as investing in these GKOs is about the only way of repatriating proceeds from earlier restructuring arrangements. The yields of longer OFZ bonds decreased by more than 20 percentage points during the first quarter. At end-March, the average annualised yield on all types of government T-bills was less than 40%.

Slight improvement in creditworthiness

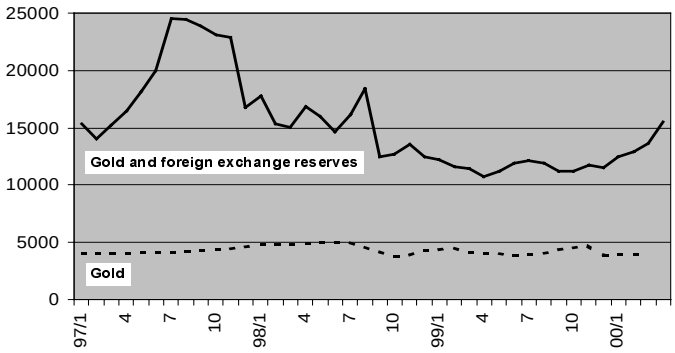
Russia's slightly improved country risk rankings reflect strong economic growth, recovering oil prices, progress in London Club debt talks and near-term expectations of more business-friendly (or, at least, more stable) economic policies. In *Euromoney's* latest survey of sovereign creditworthiness, Russia rose 20 places to a ranking of 133 out of the 180 countries rated. Russia placed between Turkmenistan and Ukraine. According to this rating, Russia's creditworthiness is close to the CIS average, but well below the Baltics or CEE countries.

Country risk rankings for Russia, Poland and Estonia



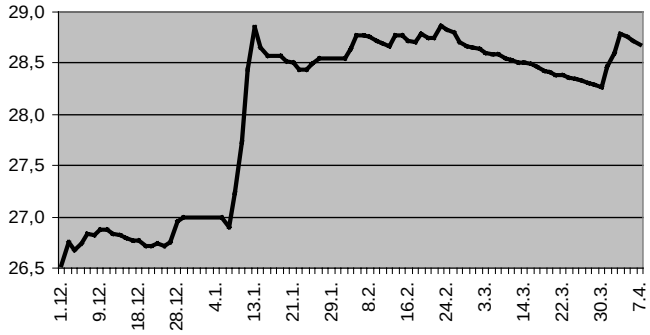
Source: Euromoney

CBR's foreign exchange reserves, USD million



Source: CBR

Rouble/USD exchange rate, Dec. 1999 – April 2000



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- deposit rate, %	102	55	16.4	21.8	13.7	13.4	1/ 00
- lending rate, %	320	147	46.2	41.5	40.1	33.8	1/ 00
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	15.5	3/ 00
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.46	3/ 00

Sources: Goskomstat, CBR

Russia in the EU or Russia in Wonderland?

By Pekka Sutela

Why have the economic transitions of post-socialist countries of Central Europe, the Baltic states included, been success stories, while the countries of the former Soviet Union continue to lag? A growing body of econometric research suggests that it is not only necessary to reach macroeconomic stability and appropriate prices, but also implementation of structural reforms and institutional development. Moreover, the relative importance of the latter two areas seems to grow over time.

Need for a clear policy goal

Lewis Carroll (*Alice's Adventures in Wonderland*) never pretended to be an expert on Russia, although his one trip into Russia took him as far as Nizhnyi Novgorod. But in his own way, he certainly seems to have understood history. In Chapter 6 of *Alice*, the heroine has just lost charge of a baby pig, when the Cheshire Cat appears. "Cheshire Puss," she asks, "Would you tell me, please, which way I ought to go from here?" "That depends a good deal on where you want to get to," says the Cat. "I don't much care where," says Alice. "Then it doesn't matter which way you go," says the Cat. "-- so long as I get somewhere," Alice adds. "Oh, you're sure to do that," says the Cat, "if you only walk long enough." Has there ever been a more succinct description of goal-oriented management?

By contrast, Central European nations never doubted their goal. They wanted to "return to Europe" to become again "normal European countries." Reintegration with Europe meant plunging into the Euro-Atlantic alphabet soup of organisations – EU, NATO, OECD, WTO, etc. – as soon as possible. Joining a group of clubs, all with the same underlying mentality, imposed a huge degree of policy conditionality on these countries. It obliged consistency and far-sightedness in decision making.

Russians have never thought of their country as a normal European country. Indeed, many think it never should be one. The notion that Russia can be a normal country with Russian characteristics hardly translates into a binding policy conditionality. It does mean Russia lacks a clear goal and has little wish to make a clean cut with the past. However, this does not mean that Russia is willing to choosing any road. Few will seriously argue for a return to the ancient regime. After a decade-long learning process, Russians generally support a market economy, openness and democracy of some sort. Nevertheless, the lack of a binding conditionality has tended to make policies captive to vested interests, rent seeking and no-holds-barred struggles for power.

Several conclusions follow. First, Russian policies and their support by the international community have been overly influenced by an exaggerated fear of a Communist comeback. Second, the partial, weak conditionality that international financial institutions offer is, at best, a poor substitute for the conditionality of a return to Europe. Third, is it impossible to define a return-to-Europe path for Russia.

Unfortunately, the EU's approach has been less than accommodating. Members routinely point out that Russia will never become a member of the Union. For reasons unclear, the size of the country is often invoked. This is a strikingly peculiar argument. Perhaps more realistically, it may claimed that the possibility of Russian membership is so distant that even mentioning it raises unjustifiable hopes – and perhaps claims for pre-membership privileges and resource flows. Such claims should not be accepted. The aim is to provide a clear and demanding goal, not to provide additional soft finance. There has been too much of that already.

EU as a policy anchor for Russia

A precedent has been created with the re-affirmation of the membership prospects for Turkey, another country whose membership might be distant but for which the prospects of accession may offer a goal and thus a policy anchor.

Vladimir Mau, one of Russia's cleverest policy experts, recently proposed that all national economic policies should be measured to facilitate a future membership in the EU. Whether Russia actually becomes a member is a political issue, he stresses, adding that the country is not ready to discuss the matter in any case. In the longer perspective, Russia's position might be similar to Norway: a country meeting membership requirements, but not a member.

A parallel approach was recently taken by Leif Pagrotsky, Sweden's Minister for Foreign Trade and a central figure in Sweden's upcoming EU Presidency. Sweden has declared relations with Russia will be a priority of their Presidency. Pagrotsky says the EU needs a concrete long-term program for Russia's inclusion into European cooperation structures. He is pushing for Russia's gradual entrance into internal markets, with a possible fast-tracking for Kaliningrad.

It may also be high time for the rest of us to start rethinking Russia's possible role in Europe. As Mau emphasises, it is for Russians to make the decisions and implement them. Perhaps the old adage of not closing doors for Russia should be understood for what it says: not closing *any* doors.

*The author is BOFIT's head.

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RUSSIAN ECONOMY
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Economic Developments

Light industry leads recovery

Preliminary information from Goskomstat indicates that, after 7.3 % growth in the fourth quarter of 1999, brisk GDP growth continued in January-March, clearly exceeding 6 % on year.

The major contribution to economic growth comes from industry, where output rose 11.9 % in the first quarter compared to the same period a year ago. Performance of light industry has been particularly impressive, rising 45 % on year in the first quarter of 2000. Other high-growth industrial sectors include printing (31 %), pharmaceuticals (28 %), ferrous metallurgy (25 %) and the chemical and petrochemical industries (25 %). The food industry showed 17 % growth in January-March. The fuel industry recorded a 5 % output growth, while production of electricity was up less than 2 %. Economists have yet to find a salient explanation for why electricity production figures so poorly reflect developments in other industries. Earlier in the 1990s, output of electric power generation declined much less than industrial output on average.

As an indication of developments in services, the output of transportation services increased some 7 % year-on-year in January-March. Also the turnover of retail trade sector indicated a similar growth.

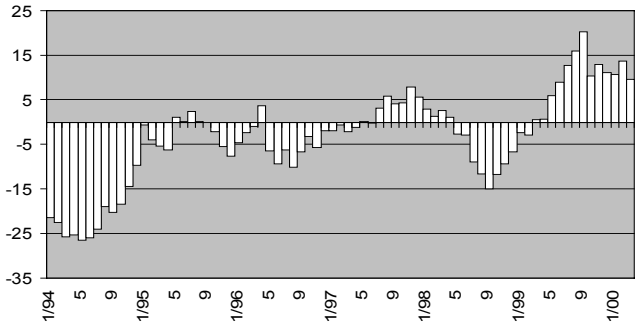
Regarding demand indicators, fixed investments rose 6 % in the first quarter. There is also potential for household consumption to recover; in the first three months real disposable incomes were up about 8 %. Average real wages are recorded to be 25 % higher than a year ago.

January-February exports up almost 50 %

In January-February, the dollar value of Russian exports (USD 14.1 billion) was 47 % higher than in the same period last year. Crude oil accounted for 25 % of the value of exports, so oil prices are obviously a major factor behind increased export revenues. However, export volumes of many goods have increased. About a fifth of exports go to CIS countries. In January-February, the dollar value of imports (USD 6.0 billion) remained in the last year's level. Consequently, during the first two months of this year the trade account surplus widened to USD 8.1 billion from USD 3.6 billion last year, and a 12-month trade account is close to USD 40 billion (see graph).

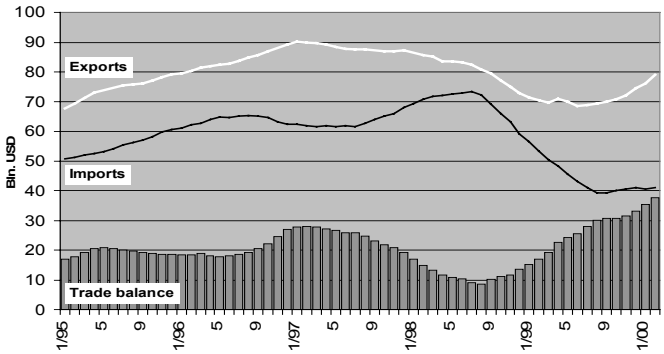
According to Trade Ministry data, volumes of crude exports has increased 4 % and natural gas 8 % in January-February, while oil product exports fell sharply by 21 %. During last winter, exports of oil products were restricted in order to secure domestic needs. CIS countries took 11 % of Russian crude exports, down from 18 % in January-February 1999. CIS markets account for some 44 % of total Russian gas exports.

Russian industrial production
- %-change from previous year



Source: Goskomstat

Russian foreign trade, USD billion,
- 12-month moving sum



Source: Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	11.9	1-3/ 00
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	4.5	5.9	1-3/ 00
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	12.3	3/ 00
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	14.1	1-2/ 00
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	6.0	1-2/ 00
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0		

Sources: Goskomstat, CBR

A new economic programme under preparation

For the first time since the beginning of reforms, a new government will have an opportunity to implement policies in non-crisis conditions: the economy is growing, investments are recovering, the financial situation of the government is improving and the trade balance shows a huge surplus. Moreover, the political situation seems relatively calm despite the problems in Chechnya. There has been little progress in structural reforms since the August 1998 crisis, so the need to continue economic reforms is as pressing as ever if the current favourable developments are to be sustained. Indeed, the three groups currently drafting versions for Russia's coming economic program are all focused on the issues of structural reform and sustainability.

The drafts of economic programs are being prepared by the Russian strategy centre led by German Gref, a group at the economy ministry and a group led by presidential economy advisor Andrei Illarionov. The Gref program is expected to follow liberal lines and will probably form the basis of the next government's economic policy. The draft program has been presented to acting president Vladimir Putin and IMF representatives. The economy ministry's program has also been discussed within the cabinet and the Illarionov proposal has been submitted to Mr. Putin. The current topics under discussion focus on prioritisation of reforms, implementation deadlines and the size of the public sector.

There is a remarkable consensus on macroeconomic policies, i.e. the need for budget discipline and the importance of a stable exchange rate. The Gref program emphasises even-handed treatment of companies and improvement of the investment climate. The program also covers tax reform, tax relief and elimination of subsidies, as well as implementation of new legislation on land ownership and bankruptcy. Other key points are harmonisation of federal and regional statutes and reform of the court system. The "ultraliberal" Illarionov program calls for cutting public sector spending by half to 20 % of GDP and reducing administration (e.g. reducing the number of ministries to five).

This time around Russian authorities seem much more committed to reforms. Some even claim that, due to the improved economic situation, there is no longer any need for an IMF agreement. Still, one could argue that from the standpoint of the new government's credibility it would be desirable to agree with the IMF on a new economic program. It would make it easier to conduct negotiations with the Paris club of sovereign creditors on restructuring of USD 45 billion Soviet era debt. Moreover, president Putin and his new government have yet to establish a track record on economic policy, which certainly keeps foreign investors cautious. Thus, this time the issue is more credibility than the need for money from the IMF and it is promising that the Russian government invited IMF and World Bank representatives to Moscow in the latter part of April to discuss its current economic blueprints.

According to the acting prime minister Mikhail Kasyanov, a new economic program should be ready by the end of May.

Budget revenues increasing

According to preliminary information, the Russian federation recorded a budget surplus of 1.4 % of GDP in January-April. The primary surplus excluding debt servicing was 4.6 % of GDP. In the first quarter, the respective figures were 0.5 % and 3.8 %. The remarkable improvement in April is largely due to good revenue performance. In April, tax revenues exceeded the budget target by almost a fifth.

Regarding the structure of revenues, the Ministry of Finance estimates that only about 12-17 % of total monthly revenues comes from oil companies. Thus, the budget situation is perhaps not as sensitive to changes in oil prices as is often thought. The budget for 2000 assumes an oil price of 18 dollars per barrel. At the beginning of May, Brent crude traded at about 25 dollars per barrel.

... but so are expenditures

Although there is no information yet available on budget expenditures in April, they are likely to rise. At the beginning of April, state sector wages were increased 20 %. Moreover, the government recently decided to increase average pensions from 640 roubles to 713 roubles (11 %) effective from the beginning of May instead that they would be increased in the late 2000 as was agreed earlier. In February, pensions were increased by 20 %.

The latest pension increase is intended to compensate pensioners for a 35 % hike in the average tariff for electricity and a 15 % hike in the price of natural gas for households. Thus, as the year wears on, we may see inflation becoming a larger policy challenge for the government.

Russian authorities have estimated the cost of the war in Chechnya at RUB 7.5 billion (USD 270 million) in the first three months of this year. The Russian government has also said it would need about RUB 7 billion (USD 250 million) in this year to rebuild in Chechnya.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2000
Federal government								Jan.-Feb.	budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	13.4	17.5	15
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.0	13.0	16
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-1.7	4.5	-1

* 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 await economic program

During April, Russia's financial markets remained relatively calm. 12-month inflation slowed to below 20 %. Thanks to the huge trade surplus, the Central Bank of Russia's currency reserves increased to USD 17.1 billion as of 28 April compared to USD 15.5 a month earlier. Higher reserves have helped the rouble appreciate slightly. Russian share prices also recovered from lows in mid-April. At the beginning of May, Russian share prices were about 25 % higher than on 1 January (see graphs).

Nevertheless, big fluctuations in interest rates indicate that the situation cannot yet be considered normal. Apparently, the markets are awaiting news of how the government's economic programs address the fundamental problems related to the banking sector, corporate governance and financial market regulation.

The role of foreign banks under consideration

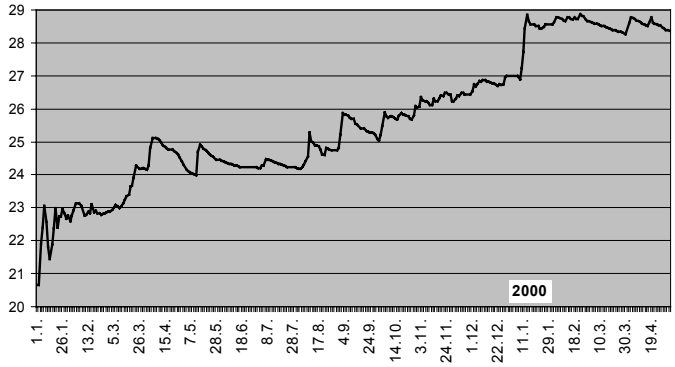
With regard to economic policy, an interesting question is what will be the role of foreign banks in Russian banking business. According to CBR chairman Viktor Geraschenko, foreign banks should be allowed to come to Russia, but not to the extent seen elsewhere in Eastern Europe. The share of foreign capital in Russia's banking capital is limited to 12 %. According to the CBR, after the August 1998 crisis this share increased to 25 % as the foreign banks carried out recapitalisation faster than the Russian banks, but has since declined so that today the share of foreign capital merely matches the requirements.

Government confident on debt servicing

The higher world price for oil has boosted export tax revenues and improved the Russian government's liquidity situation to the point it finds it easier to service its foreign debts. The finance ministry is expected to disburse about USD 3.1 billion for foreign debt interest and principal in the second quarter of this year. The Russian government calculates it can purchase sufficient amounts of foreign currency without relying on central bank lending (which it has used since the onset of the 1998 financial crisis). If Russia realises its hope of raising USD 1-1.5 billion in credits from the World Bank and possibly the IMF in the second half of this year, Russian officials feel confident the country will meet its foreign debt servicing obligations for the year.

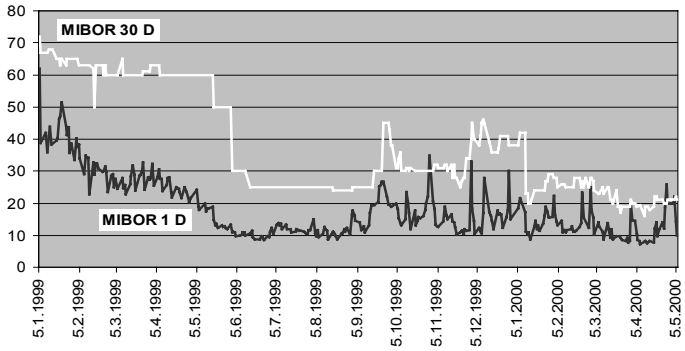
Regarding the rescheduling negotiations of Russia's USD 45 billion debts to the Paris club of sovereign creditors, acting prime minister Mikhail Kasyanov says that Russia will not hurry to start these talks in the coming months.

Rouble/USD exchange rate in 1999-2000



Source: CBR

Russian interest rates in 1999-2000



Source: CBR

Russian share prices in 1999-2000, RTS-index

Source: RTS

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	22.5	3/ 00
M2, 12-month growth, %	113	30	29.5	36.3	57.2	58.6	3/ 00
Average wage, new RUB, end of period	736	1017	1210	1463	2272	2023	3/ 00
Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	7.9	2/ 00
- lending rate, %	320	147	46.2	41.5	40.1	31.2	2/ 00
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	17.1	4/ 00
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.40	4/ 00

Sources: Goskomstat, CBR

Business opportunities in Russia!

By Christian Ramm-Schmidt*

During the past 18 months we've heard mostly bad news from Russia. Indeed, the media have fallen all over each other seeing who could publish the most shocking tale of Russian misery. When you are in the "front lines" everyday, you soon realise that these pessimistic views based on official statistics don't tell the whole story. Thus, my own experience suggests that media views of Russia can often be seriously skewed and sometimes just plain false. Despite Russia's failure to move ahead with needed structural changes, the country nevertheless offers good possibilities to conduct profitable business in certain sectors. This includes the brewing and beverages industry in which my company, Baltic Beverages Holding AB (BBH), is involved.

Choosing a business and approach right for the times

The massive devaluation of the rouble not only made importing to Russia unprofitable in most cases, it also highlighted the importance of establishing businesses within Russia. Any successful approach to establish a business in Russia hinges on two questions: "What should we do?" and "How should we do it?"

Given the economic conditions in Russia, we have found that what we call the "Fast Moving Consumer Goods" sector offers good business opportunities. Let's look at our businesses, beer.

To develop a business you must understand Russian culture and local conditions. We've watched numerous Western firms fail while attempting to apply an unmodified parent company organisation and management models to their Russian subsidiary, ignoring meanwhile the motivating forces that drive relevant interests in Russia. At BBH, we took out time learning the market and eventually found a business approach that worked – and that differs considerably from what we see other companies trying to do. What I would stress here is that we built up our business and operations using local management talent and local staff. We gave them the means to develop a going concern, and they became local heroes. They have deep familiarity with local officials, politicians and interest groups. We made our local managers partners in the business, and they have rewarded us with unswerving loyalty, doing their utmost to protect the business against external threats. Also, I would say financial incentives work at least as well as they do in the West. Rather than a global branding strategy, we have built up local and national brands. We've found that exchanges with our local staff needs to be much more up-front and personal than in the West. Finally, we've continued to adhere to approaches geared for the medium and long term, which has helped make us less susceptible to fluctuations of the moment.

Profitability and fast growth

BBH was established in 1991. Today it owns twelve breweries and eight malting facilities. Four of our breweries are in the Baltics, six are in Russia and two are in Ukraine. BBH is the dominant market leader in the Baltics and Russia, and competes for second place in Ukraine. By 1999, BBH breweries were producing roughly three times the volume of all beer consumed Finland. Our volumes have grown on average at a rate of 81 % a year. Profitability has been excellent, delivering higher margins than in the West. In 1999, we showed an operating profit of more than USD 100 million in spite of the sharp devaluations of the rouble and hryvnia. We continue to invest at a rate of about USD 120 million annually. Most of this is financed out of cash.

In Russia, BBH holds a 25 % market share. Our highest volume growth also comes from Russia, and we fully expect brisk growth this year. Presently, things are running smoothly in Russia; the Russian crisis has passed and we rarely refer to it any more. Our banking partners serve us rather well, payments get transferred and we have little trouble getting loans in roubles or dollars. Like in the West, you are expected to demonstrate your creditworthiness. Current interest rates are even tolerable. Finally, I would note we have never had difficulties repatriating dividends to our shareholders.

Need for a more balanced view

For the sake of fairness, it should be mentioned some of the real dangers to operating a business in Russia. The infrastructure is weak, crime is widespread and the laws are full of loopholes and inconsistencies. For these reasons, most members of the business community are now hoping that Mr. Putin's government will finally push for legislative reforms.

And I would mention our efforts to encourage Western investors to get involved in projects related to local production of products we need: glass bottles, crown bottle caps, labels, etc. Even when we have offered "symbiosis benefits," i.e. long-term delivery contracts that essentially secure our partners a growing business for years, we've generally received curt negative replies from the firms we approach. Most of the time we get a short lecture on the instability of the Russian situation and an explanation as to why their firm's top management sees it prudent to postpone any decisions on the matter at this point in time.

In fact, the motivation of my writing is to balance these overly pessimistic views. There are business opportunities in Russia!

**The author is CEO of Baltic Beverages Holding AB, a joint venture owned by the Finnish Hartwall and the Swedish-Norwegian Pripps Ringnes*

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BANK OF FINLAND
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RUSSIAN ECONOMY
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Economic Developments

Private demand joined the growing sectors

According to Goskomstat, the production of goods and services in the five core sectors (a proxy for GDP) of the Russian economy rose over 8 % in January-April compared to the same period last year. Perhaps due to seasonal factors, on-year output growth decelerated in April, while monthly output declined by 5 % from March.

Presumably, the growth is led by export demand, but also investments rose significantly (13 %) in January-April. Moreover, private consumption seems to be picking up; it grew almost 8 %, while real incomes were up 25 %.

Although industrial output growth in April was less than 6 %, in the first four months it rose 10 %. However, the April slowing was enough to flatten the trend indicator in the attached figure.

First quarter trade surplus doubled

In the first quarter of 2000, Russia's trade surplus was almost USD 14 billion, while in the same period last year the surplus was only USD 6 billion. Improvement in the trade balance is due to a sharp increase in exports to USD 23 billion from USD 16 billion in January-March 1999. The increase of exports is mainly a result of higher prices for oil and other raw materials, but also export volumes of the most important commodities have increased. So, for example, the volume of crude exports increased by 3 %, gas by 11 %, and many metals by over 10 %.

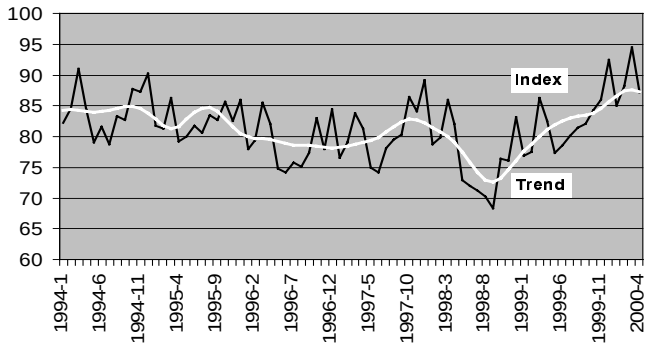
As a result of the weak rouble, Russia's imports still remain depressed. Russian import figures show almost no signs of recovery of investment goods as imports of machinery was down 16 % from the already low level of January-March 1999.

In March 2000, CIS countries accounted for 16 % (also 16 % in 1999) of Russian exports and 30 % (23 % in 1999) of imports.

Share of barter in sales decreasing

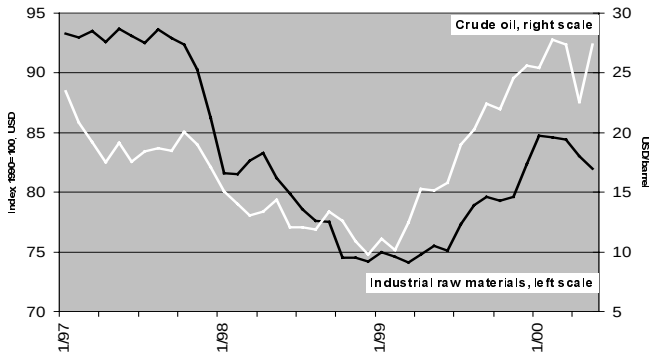
As a result of favourable economic developments and the improved liquidity of enterprises, the share of barter in industrial sales has decreased from 46 % in January 1999 to 33 % in January 2000 (see graph). According to a survey by *Russian Economic Barometer*, enterprises report that in the same period their capacity-utilisation rate increased from 56 % to 64 %.

Russian industrial production, Dec. 1993 = 100



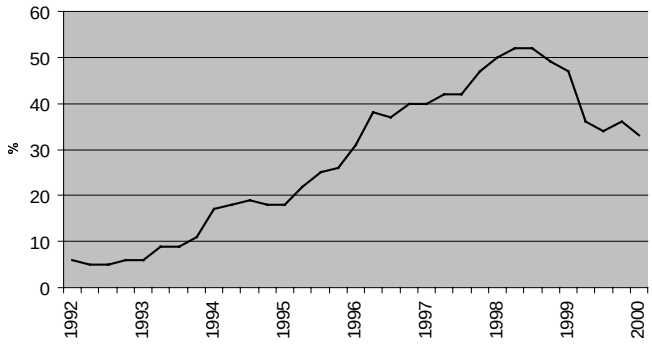
Source: Goskomstat, BOFIT

Prices of oil and industrial raw materials in 1997-2000



Source: HWWA, Bank of Finland

Share of barter in industrial sales in 1992-2000



Source: The Russian Economic Barometer

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	10.3	1-4/ 00
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	4.5	13.1	1-4/ 00
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	11.7	4/ 00
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	22.8	Q1
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	9.7	Q1
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0		

Sources: Goskomstat, CBR

New decision makers and economic program

The nomination in early May of Vladimir **Putin** (47) as the second president of Russia was later followed by the partial formation of a new government generally perceived to be committed to reforms. Former first deputy prime minister and finance minister Mikhail **Kasyanov** (42) was appointed to prime minister by an overwhelming majority of the Duma. Former deputy finance minister Aleksei **Kudrin** (39) was promoted to the posts of deputy prime minister and finance minister. Only three new ministers were appointed to the government. German **Gref** (36), head of the Russian strategy centre took over as economy and trade minister, Alexander **Gavrin** (46), became energy minister and Gennadi **Bukayev** (52), a former department head at the tax ministry, was appointed as the new tax minister.

The official publication of the new economic plan was postponed to at least mid-June. However, the summaries of the Russian Strategy Centre's draft economic plan published in several Russian newspapers give some idea about the new priorities in reforms. According to preliminary information, the main goals of the plan include free competition, protection of property rights, and the free movement of goods, capital and labour within the country. Within this framework, the program targets to GDP growth of 5-6 % annually for the next ten years, to an annual inflation rate below 10 %, to a balanced budget and to a foreign debt ratio below 60 % of GDP.

Tax reform a top priority

To speed up the tax reform and get the tax changes included in next year´s budget, the Duma is expected to discuss the suggestions of the government (see table) before early July, when the summer break is scheduled to start.

The purpose of the tax reform is to simplify the tax system and to reduce the overall tax burden from over 40 % to about 35 % of GDP. The reduction of the overall tax burden is to be compensated for by increased tax intake and substantial hikes in excise duties.

Russia still has some 30 different federal taxes, only 15 of which are planned to remain. The variety of regional taxes should be replaced by five unified regional taxes. The plan calls for elimination of tax breaks and fewer exemptions. The present progressive income scale with rates ranging from 12 to 30 % would be changed to a flat 13 % income tax.

As regards enterprises, the profit tax is planned to be raised to 35 % from the present 30 %. However, more enterprise expenses will be deductible. The turnover tax would be abolished and the current basic VAT rate would be preserved.

Table. Planned tax reforms

1. Reducing tax burden
* Reduce the number of taxes
* Abolish turnover taxes
* Introduce a flat 13 % income tax
* Consolidate certain social payments under a single "social" tax
* Cut tax breaks
* Expand tax-deductible expenses for companies
* Replace fixed oil excise duties with a flexible tax
* Introduce special taxes for oil producers with low-output wells
* Introduce a special tax regime for production sharing agreements
2. Increasing tax burden
* Raise profit tax to 35 % from the present 30 %
* Keep the current 20 % basic VAT rate, but limit exemptions
* Increase taxes for use of natural resources and owning property
* Increase excise duties on gasoline about 500 %
* Increase excise duties on tobacco at least 100 %
* Replace the current flat tax on automobiles to a value-based tax
* Introduce a tax to support the environment

Source: Reuters

Budget revenues continue to rise

According to MinFin information, the federal budget showed a surplus of 2.4 % of GDP in the first quarter of this year. The primary surplus excluding debt servicing was 5.6 % of GDP. The budget revenues (17.6 % of GDP) consisted mainly of taxes (15.6 % of GDP). Particularly, VAT revenues and customs duties have risen considerably. In the first quarter, VAT revenues accounted for 6.7 % and customs duties 3.8 % of GDP, whereas the comparable figures in the same period of 1999 were 4.1 % and 1.7 % of GDP.

The federal budget draft for 2001 calls for a balanced budget. Given that the second part of the tax code will be approved mainly as suggested by the government, revenues and expenditures are planned to amount to 17 % of GDP.

Reform of Russian administration initiated

As a part of president Putin's attempt to strengthen the role of the state and increase respect for the law, he initiated an administrative reform by reallocating Russia's 89 regions into seven federal administrative districts led by presidential representatives. The posts of the 89 earlier presidential representatives were abolished. As a part of the reform four ministries, five state committees and five other central administrative bodies were also abolished.

Despite the mixed response to the administrative reform, Russia needs reform of federal-regional relations. The present situation with various bilateral agreements between the centre and the regions is inefficient, unfair and costly. It also promotes massive bureaucracy and corruption.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2000
Federal government								Jan.-Mar.	budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	13.4	17.6	15
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.0	15.2	16
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-1.7	2.4	-1

* 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.

Foreign reserves grow steadily

The Central Bank of Russia's (CBR) gross foreign reserves equalled USD 19.9 billion as of 2 June, which means that CBR reserves increased almost USD 3 billion during the last month. The steady growth of reserves since the beginning of the year is mainly due to the surge in export revenues. The nominal value of the rouble has remained fairly stable.

In general, the money and capital markets seem to be biding their time, so interest rates show no longer a clear declining trend. At the moment, the market has at least three concerns: (i) inflation pressures are likely to increase due to recovering domestic demand, raising of domestic energy prices, and wage increases; (ii) despite the ambitious tax reform initiative of the government, the entire economic reform package has yet to be released, and the Duma has yet to confirm its readiness to support reforms; and (iii) international uncertainties (oil prices, stock markets), which have a strong influence on Russian markets. Thus, the 1-month interbank rate (MIBOR) has remained close to 20 %, while the yield on long-term government securities (OFZ) maturing after 2001 stands at about 40 %.

The RTS index of the Russian stock market slipped by some 30 % in the first three weeks of May, in line with international events. Since then, the RTS index has recovered to around 200 points in the first week of June, up from 156 in 23 May.

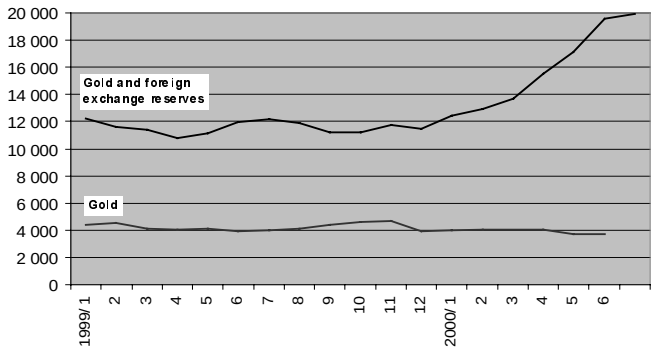
Financial market reform still an open question

Information concerning financial market and the banking sector reforms is still rather scanty and general. Under the government's partly revealed plan, the banking system would be brought back to health with measures that include revoking the licenses of insolvent banks, audits of the country's 100 largest banks, limiting the number of banks with permits to deal in foreign currency, and modernisation of the payments system. In the sphere of monetary policy, Russia would seek to strengthen the real exchange rate of the rouble, restrain inflation and lower real interest rates. By the start of 2004, the program would lower the annual inflation rate to below 10 %.

Share of foreign banks declining

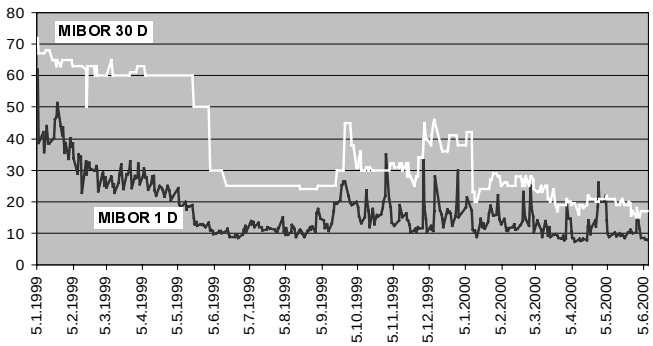
According to the CBR, there were 127 banks with foreign capital at the end of March. Foreigners were majority owners in 32 banks, and of these, 21 banks were fully owned by foreigners. In January-March, the total number of operating banks decreased by 18 to 1,297. In the same period, the share of foreign credit institutions in the total statutory capital of the Russian banking system fell one percentage point to 9.7 %. Under Russian law, the share of foreign capital in Russia's banking capital is limited to 12 %.

CBR's foreign exchange reserves in 1999-2000, USD million



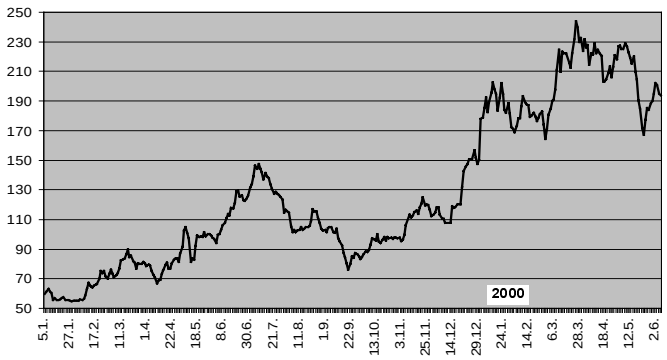
Source: CBR

Russian interest rates in 1999-2000



Source: CBR

Russian share prices in 1999-2000, RTS-index



Source: RTS

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	19.4	5/ 00
M2, 12-month growth, %	113	30	29.5	36.3	57.2	54.6	4/ 00
Average wage, new RUB, end of period	736	1017	1210	1463	2272	2038	4/ 00
Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	5.4	4/ 00
- lending rate, %	320	147	46.2	41.5	40.1	29.1	4/ 00
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	19.9	2 June/ 00
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.25	5/ 00

Sources: Goskomstat, CBR

Debt relief – a legitimate debt management instrument?

By Juhani Laurila*

In February, the Russian Federation agreed with the London Club of commercial creditors on a further restructuring of Soviet-era debt. The London Club forgave 36.5 % of Russia's USD 32 billion debt, which at the time had a real market value of only about USD 6 billion. Thus, the debt reduction implied holders of these claims actually agreed to write off slightly over USD 2 billion of their market value. The residual debt, on the other hand, will be swapped for 10 and 30-year Russian eurobonds and upgraded, as the Russian government agreed to take over the debtor's obligations from Vnesheconombank. The purpose is to compensate the losses from the debt reduction to the creditors through mark-up of these claims. Assuming that the upgrading raises the market value of the remaining debt 50-60 %, holders of these Russian eurobonds would get more or less full compensation for the debt reduction. Moreover, the London Club creditor banks have long ago cleaned the losses related to this debt from their balance sheets.

At its meeting next autumn, the Paris Club will hardly be able to follow the London Club debt forgiveness formula, even if Russia has requested it do so. Unlike the London Club, the Paris Club members have no secondary markets to lean on. In other words, the Paris Club creditors will be asked to accept debt reductions that remain final and uncovered. Moreover, the claims of the Paris Club are held by their original holders – member governments – who are still waiting to get back their USD 45 billion. One would expect that the member governments' negotiators feel, or at least, should feel, accountable to their taxpayers, the ultimate holders of these claims.

Uncomfortable marriage…

Russia had its debt restructured or rescheduled either by the Paris Club or London Club every year from 1992 to 1996, and then again in the "second wave" of 1999 and 2000. This frequent recourse to debt renegotiations confirms the fact that Russia remains both illiquid and insolvent. The repeated rescheduling negotiations create an impression that this action has become a permanent aspect of the Russian approach to managing external debt. Indeed, Russia can count on the fact that most creditors prefer to remain flexible so as to maintain good business and political relations. And Russia has little need to worry about worsening creditworthiness or lower credit ratings – they hardly can get worse. Perhaps these are the thoughts finance minister Mikhail Kasyanov had in mind when he celebrated the results of London Club negotiations as "a good deal for Russia." Still, do the Russian authorities really consider rescheduling negotiations a sort of game to win time and relief, instead of an opportunity to regain international creditworthiness and manifest willingness to eventually honour their international financial obligations?

There are, of course, extenuating circumstances. Firstly, Russia is not alone as there are numerous frequent customers seeking to avail themselves of debt relief services. Secondly, as a creditor, Russia has the bad luck of holding some USD 150 billion in mostly bad claims towards former Soviet republics and allies. Moreover, the Russian government has consistently confined its requests for debt relief only to Soviet-era foreign debt, declaring that the servicing of USD 51 billion in post-Soviet foreign debt takes priority.

… Forever?

No matter, how generous the Paris Club debt relief, it remains to be seen whether it will be the last such relief requested. Assuming moderate growth in Russian real GDP during the coming years (say 2-3 % per annum), and a parallel growth in fiscal revenues with some real appreciation of rouble, the share of foreign debt service payments of fiscal revenues necessary to get the foreign debt fully serviced should be raised from a quarter (as in 1995-1999) to more than a third of fiscal revenues. Unless Russia is unable to meet these rough minimum conditions, the creditors are likely to find themselves faced with a "third wave" of requests for debt relief in ten years or so.

The possibility to resort to debt forgiveness is usually considered when trying to solve the problems of Highly Indebted Poor Countries, or HIPCs. Russia is not a HIPC. Its foreign debt amounts only to 80 % of GDP, which is moderate by international standards. Russia is also a relatively rich country with an abundance of natural resources and human capital. Unfortunately, only possessing these resources is a meagre comfort, unless they can be mobilised to foster economic growth. The inept financial, fiscal and corporate management has deprived the Russian economy of the capital necessary to accomplish this adequately. Perhaps it is more appropriate to characterise Russia as a RIPMC, a Reasonably Indebted Poorly Managed Country.

While at this point international creditors seem to have little choices besides accommodating themselves to a defaulted country's bad housekeeping, we should also remember that the Russian economy is paying a high price. It has been set adrift to ride out the ups and downs of world market prices of oil and raw materials, without adequate domestic or foreign savings to finance the development of its economy.

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RUSSIAN ECONOMY
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Economic Developments

Investments up 14 per cent

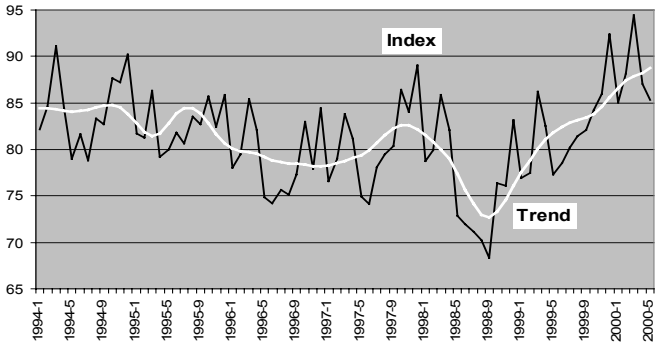
According to preliminary Goskomstat information, Russia's GDP in the first quarter rose 8.4 % compared to the same period of 1999.

Industrial output in January-May grew 10.4 % compared to the same period in 1999. The highest growth rates were recorded in light industry (37.3 %), ferrous metallurgy (24.3 %) and pharmaceuticals (21.3 %). May industrial output was 10.6 % higher than in May 1999. Also investments and private consumption grew strongly – in January-May fixed investments were up 14 % and retail trade turnover was up almost 8 % compared to January-May 1999.

As regards the industrial output on month this year, April's slowing was followed by a another decline in May, when industrial output was down by almost 2 % compared to April. However, on month decline in April and May was due to seasonal factors, and the trend indicator in the attached figure suggests no deceleration of growth in the recent months.

Declining unemployment (unemployment rate in May was 2.7 percentage points lower compared to May 1999) and increasing real wages (+22.3 %) have apparently dampened the willingness of people to strike. For the first time in recent years, there were *no* strikes recorded in May. By comparison, there were almost 500 strikes in January this year and 70 in May 1999. Strikes are predicted in the autumn, however.

Russian industrial output, Dec. 1993 = 100



Current account surplus continues to strenghten

According to CBR data for Q1 of this year, Russian goods exports were valued at USD 23.3 billion, while imports amounted to USD 9.7 billion. The resulting trade surplus was USD 13.6 billion. Compared to Q1 1999, the trade surplus has doubled due to surge in the value of exports. Thus, despite the clearly increased deficit in the services balance and the negative net interest expenditures on roughly the same level as in Q1 1999, the current account surplus continues to strengthen. In Q1 it amounted to USD 11.2 billion, while in Q1 1999 it was USD 5.1 billion.

Along with the huge current account surplus, the foreign currency reserves of the CBR have been on the rise. In June, foreign reserves amounted to USD 21 billion, up from USD 12.5 billion at the end of 1999.

The strong showing of the Russian economy did not influence the behaviour of foreign investors in Q1. Foreign direct investments stayed at roughly the same level as in Q1 last year, while portfolio investments turned slightly positive. Capital flight has reportedly declined.

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

	1998	1999	2000 Q1
Current account	**2.1**	**25.0**	**11.2**
Trade balance	17.4	35.3	13.6
Exports, f.o.b.	74.8	74.7	23.3
Imports, c.i.f.	-57.5	-39.4	-9.7
Services	-3.3	-3.3	-1.5
Exports	12.8	9.1	1.8
Imports	-16.1	-12.4	-3.4
Investment income	-11.4	-7.7	-1.0
Received	4.0	3.4	2.4
Paid	-15.4	-11.2	-3.4
Other items, net	-0.6	0.7	0.1
Capital and financial account	**2.1**	**-16.1**	**-5.8**
Capital Account	-0.4	-0.3	0.0
Received	1.7	0.9	0.2
Paid	-2.1	-1.2	-0.2
Financial account	2.5	-15.7	-5.8
Direct investment to Russia	2.8	2.9	0.6
Portfolio investment to Russia	8.4	-0.8	0.1
Other items, net	-8.7	-17.8	-6.5
Net errors and omissions	**-9.5**	**-7.1**	**-2.3**
Change in reserves	**5.3**	**-1.8**	**-3.1**
('-' growth, '+' decline)			

Source: Central Bank of Russia, 30 June 2000.

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2	8.4	Q1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	10.4	1-5/ 00
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	14.0	1-5/ 00
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	11.5	5/ 00
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	31.6	1-4/ 00
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	13.2	1-4/ 00
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0	11.2	Q1

Sources: Goskomstat, CBR

Government approves its economic program

At the end of June, the Russian government finally approved the long-awaited economic program. The program consists of three separate, but connected, documents. One is a strategic plan for the next ten years, while the others cover the rest of 2000 and 2001. Although the contents of these documents have been discussed in the media, the full text has yet to be published. Moreover, the government still needs to finalise the long-term plan.

The ten-year plan resurrects the concept of a social contract between the state and society, and calls for strict fulfilment of commitments from the authorities and individuals. Under the plan, modernisation of the Russian economy means continued liberalisation and creation of conditions for sustainable growth. This, in turn, leads to better living standards. The concrete goals for the next ten years include a minimum target of 5 % annual GDP growth and a maximum of 10 % annual inflation after 2004, a twofold increase in real incomes, at least 80 % higher real private consumption and a one-third rise in domestic investments.

One of the documents covering the next 18 months sets the priority tasks for that period, while the other concentrates on concrete measures. The contents of these plans cover a wide variety of topics ranging from culture, education and northern-region policy to those related to the economy. Social policy, which is an important element of the above-mentioned social contract, gives priority to social security for Russia's poorest citizens, and seeks to reduce the income disparity of rich and poor. Pension reform should further improve the situation by assuring real increases in pensions.

In Russia, there has never been lack of economic programs and plans, but authorities' track record for implementing them is strikingly poor. So, in the near future, it will be interesting to see how the new decision makers will overcome the old problems related to, for example, a poor administrative capacity and strong vested interests related to any radical reforms. Moreover, although the government itself has announced its dedication to the new economic program, there has been some discussion about differences in opinion between the chief designer of the program, economy and trade minister German Gref and prime minister Mikhail Kasyanov.

While the economic program for the next 18 months seems to be much more specific in its goals and the time schedule than the previous programs published by Russians authorities, an agreement with the IMF on a new economic program (a stand-by arrangement) would certainly add to the credibility of the current plans. However, an agreement with the IMF is not likely before late autumn.

Tax reforms proceed

During June, the Duma approved second readings of three important tax bills. The bills establish a flat 13 % income tax, consolidate social contributions under a single social tax and leave the value-added tax almost unchanged. The most notable changes in VAT practices include a slight extension of a list of products qualifying for a reduced 10 % VAT rate and a lifting of VAT on exports of goods besides oil and gas to CIS countries. Third readings of the above-mentioned bills are expected to be formalities. Prime minister Kasyanov has asked Duma deputies to postpone their holidays to complete their discussion of the tax bills.

In January-April, tax revenues (15.7 % of GDP) were clearly up compared to the same period in 1999 (10.3 %). According to finance minister Kudrin, during the last six months the share of non-cash tax payments has decreased from 40 % to 10-15 %. He believes all taxes in Russia will be paid in cash by the end of this year.

In January-April, the budget showed a surplus of 3.7 % of GDP while the primary surplus amounted to a record 6.7 % of GDP.

Senators against Putin

At the end of June, the upper house of the Russian parliament, the Federation Council, took a stand on president Putin's bill limiting the Council's powers. Under the bill, regional governors would no longer be assured of seats on the Federation Council. Moreover, approving the bill would have eliminated the senators' immunity from criminal prosecution. After the veto of the Federation Council, the Duma could have immediately overruled it by gathering a 2/3 majority (300 deputies). However, it was willing to compromise and decided to vote for the establishment of a conciliatory commission.

President Putin has shown determination in his attempt to proceed with administrative reform aimed to improve adherence to the constitution and federal statutes in the regions and improve the efficiency of central administration. He has already abolished numerous regional-level regulations that were in conflict with federal law. The Federation Council's rebuff was his first clear set-back. After the Council vote, Mr Putin reversed his insistence on having the bill on formation of the Federation Council approved without any changes. He announced his willingness to accept the establishment of a conciliatory council and the "soft variant" according to which the present senators could remain their seats until the end of their terms instead of having to leave by the beginning of February as the bill requires.

Fiscal indicators (per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2000
Federal government								Jan.-April	budget law
- revenues	14.5	14.1	13.7	12.5	9.8	9.0	13.4	17.8	15
- expenditures*	15.9	18.1	16.6	15.8	16.6	13.9	15.0	14.1	16
- balance	-6.5	-11.4	-5.4	-7.9	-6.7	-4.9	-1.7	3.7	-1

* 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.

Concerns over accelerating inflation

With the recovery of domestic demand, wage increases, hikes in energy prices, and increased money supply related to climbing foreign reserves, inflation pressures are becoming a serious challenge for economic policy. In June, consumer prices increased 2.6 % from May, which is clearly more than in the previous months (see graph). Consequently, although 12-month CPI inflation currently runs at about 20 %, it will be extremely difficult to reach the 18-20 % inflation target for 2000. Regarding inflation pressures, one should note that 12-month producer price inflation (PPI) is still running at about 55 %.

The huge trade surplus and resulting increase in foreign reserves have kept the rouble relatively stable in nominal terms. Given that Russia's CPI inflation is much higher than inflation in its main trading partners, the rouble has strengthened in real terms by about 10 % from its low at the beginning of 1999 (about 40 %, if one uses PPI as a basis for calculations, see graph). However, the rouble is still clearly undervalued. This is indicated, for example, by the low average monthly wage of about USD 70. Thus, prime minister Kasyanov's recent worries about the rouble becoming too strong seem a bit premature. Perhaps more appropriately, one should ask how strong inflation pressures would be now if the rouble had weakened along with domestic inflation.

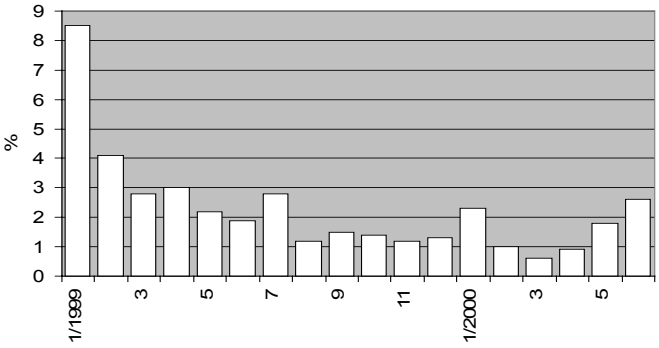
Partly due to the increased inflation pressures, interest rates have stopped falling. Moreover, despite the good macroeconomic situation and the government's approval of the new economic program, equity markets have been relative depressed both in terms of prices and turnover (see graph).

Russia blacklisted for money laundering

In June, the OECD's special working group on money laundering, the FATF, released a list of countries prone to money laundering and insufficiently interested in preventing it. Russia joined 14 other countries on the list that included Israel, Lebanon, Liechtenstein, Panama, the Philippines and small island states involved in financial services.

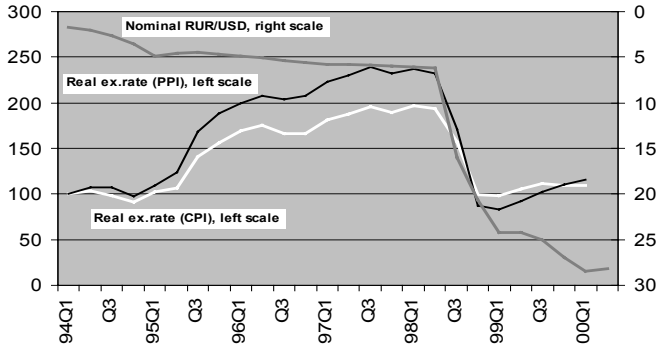
The FATF noted that Russia's most critical barriers to discouraging money laundering are its lack of a comprehensive money laundering law and regulations that meet international standards. Specific weaknesses cited in the FATF's report included poor rules on customer identification, the lack of a reporting system for suspect transfers, inadequate supervision resources and incapacity in providing assistance in international money laundering investigations.

Monthly inflation in 1999-2000



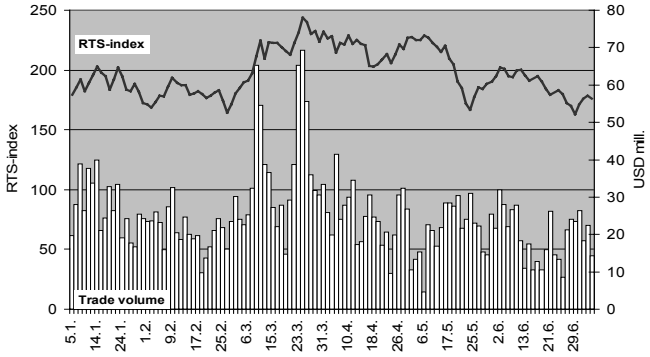
Source: Goskomstat

Rouble's nominal and real exchange rate in 1994-2000
- rising curve = rouble strengthens



Source: CBR, BIS, BOFIT

Russian share prices (RTS) and trade volumes in 2000



Source: RTS

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	6/ 00
M2, 12-month growth, %	113	30	29.5	36.3	57.2	53.3	5/ 00
Average wage, new RUB, end of period	736	1017	1210	1463	2272	2080	5/ 00
Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	7.3	5/ 00
- lending rate, %	320	147	46.2	41.5	40.1	25.3	5/ 00
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	21.0	6/ 00
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.07	6/ 00

Sources: Goskomstat, CBR

The lure of the authoritarian temptation

By Pekka Sutela*

President Putin, we now know, is not only a lawyer, but also an educated economist, with a 1996 post-graduate degree from the St. Petersburg Mining University. Russia has, in addition to the Presidential Economist, also a Governmentally Ratified Economic Future, a GREF, that is. This long-awaited economic programme has been much applauded: it was written by Russians, not given from outside; it was authored by the best liberal and other experts; it has been planned for the long period of ten years; it has such emphases that were earlier absent; it is pragmatic, sober and specific; and given the strong support enjoyed by Mr Putin, it has a real chance of being implemented. Even if the programme is imperfect, the inefficiencies of the economy are so huge that modest change in the right direction has major potential for outcome improvement.

Others remind that programmes were never in short supply in Russia; governments should be judged by deeds not by words; the devil is always in the detail; programmes without implementation are today's opium not only for the chattering classes but also for foreign financiers and investors; and ten years in an exceedingly long period to plan, particularly in Russia. The existence of inefficiencies is no guarantee for growth: otherwise transitional recession would not have existed.

The GREF is not generally available. As a policy document it will change over time, adapting to political, administrative and economic circumstances as they develop. In stead of trying a technical analysis, a wider view is here appropriate.

A new social contract?

Clearly, the GREF is a major statement. It ranges from cultural policies to monetary matters. The authors of the programme even go lyric and propose that the GREF be understood as a new social contract, the basic understanding between "state and society, state and business" defining their mutual responsibilities for the purpose of realising human potential.

This may be just the usual hubris induced by launching the GREF on Jean-Jacques Rousseau's birthday. Still, this is not the first social contract proposed in Russia. The latest one was in 1991, when Yeltsin sowed an anti-Gorbachev revolution and reaped deformed capitalism. Putin and the GREF promise social stability, consensual policies, normal conditions for business and a law-based administration. Fight against poverty is the main task, Minister German Gref has announced. The Russian "subsidiary state" state will help the poor, while the oligarchs will be guided towards economic development, job creation and stability. That will slash income differentials. Privatisation will not be reconsidered, if it was done according to legislation existing at the time, Prime Minister Kasyanov adds. Cost recovery in housing and utilities will be reached gradually, as purchasing power rebounds. Nobody will suffer, as a continuously booming economy will facilitate improvements. This is the message to the population. At long last, the Russian state is thinking strategically, and the future is – well, glorious, at least relative to what Russia is today. The growth projections of the GREF have been given much prominence in Russia.

Surely, this should give pause for thought. Is this not too good to be true? Have we not seen promises of bright future before? After all, the near consensus of observers yesterday was that a deformed capitalism is inevitable in Russia given the heavy price of the past, the weakness of the state, and the underdevelopment of institutions and civil society; that Russia is a peculiar economic system, unable of sustained high growth in the absence of further radical reform; that there are such long-run trends of deterioration in the infrastructure, provision of basic public goods and economic structure that threaten the cohesion of the state and society; that Russia risks becoming a failed state; and that for that to be avoided, such radical reform is needed that is incompatible with social stability and political consensus.

Now the new Russian complacency challenges such views.

The sources of complacency

Such complacency has many roots: the unprecedented state of the macro-economy, the youthful President, the existing consensus on macro-economic policies, the new prominence of the liberal economists, the mere tiredness with failure and decline. This is all understandable. But it also has another, and potentially at least a more dangerous root: the lure of the authoritarian temptation. Whether because of the Marxist background, because of historical analogies and wishful thinking, or because of examples like Pinochet and de Gaulle, all too many intelligent Russians tend to think that the weakness of the Russian state is an anomaly that has gone a long way in causing the twenty years' crisis of 1980-2000. Now a strengthening of the state will provide the stability guaranteeing normal capitalism. The bright future is at Russia's fingertips – once again.

This view has a number of problems. Putin's track record so far tells as much about authoritarianism and arbitrariness as about consensus. He personally is neither Pinochet nor de Gaulle. The weakness of the state does not easily disappear. All attempts at a gradual sustained reform, like the GREF proposes, have earlier failed in Russia. The prospect of eternal improvements without the need for anybody to suffer has always been a technocratic dream. Reforms are more about privilege, power and conflict than about social stability. And the main lesson that history has to offer is that authoritarian politics and liberal economics go rarely together. Usually the latter has to give way, often when policies fail and the Leader feels threatened.

One would wish to be wrong, as the stakes are high. Perhaps even high indeed.

**The author is BOFIT's head.*

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RUSSIAN ECONOMY
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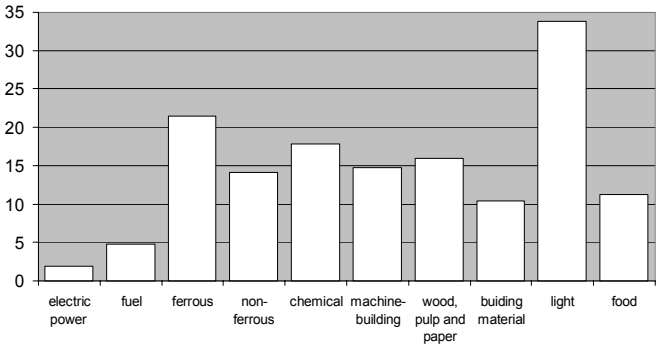
Economic Developments

Record GDP growth in the first half

According to preliminary Goskomstat information, GDP in January-June rose a record 7.5 % from the first half of 1999, despite slowing growth in the second quarter.

Industrial production in January-July grew 10 % compared to the same period in 1999. Regarding different industrial sectors, light industry remained the leading industrial branch with 34 % growth compared to January-July 1999 (see figure). Also investments have been picking up strongly recently. Fixed investments were up by 17 % in January-July.

January-July growth in industry (y-o-y %-change)



Several indicators concerning the living standard of Russians have also shown improvement. According to preliminary information, real disposable income including income transfers grew almost 9 % in January-July. In the same period, the real average wage was up 23 %. A pensions hike at the beginning of August lifted the average pension payment in Russia to 882 roubles (32 dollars) a month. It was the first time in ten years that the average pension exceeded the pensioners' subsistence minimum. The increase affects about 23 million pensioners. The strengthening of domestic consumption demand is indicated by 8 % growth in the volume of retail trade.

There are big differences, however, in regional economic performance. Goskomstat has classified Russia's 89 regional units into groups according to the new seven federal administrative districts. Economic growth has been strongest in the North-Western district, with industrial output and housing construction increasing by over 20 % in the first half of 2000. Also the unemployment rate there is the lowest of all districts – 6.2 %. The rapid growth in North-Western district is explained by a strong growth in extractive, timber, paper and metallurgical sectors and the related shipping activities of north-western ports. The weakest growth figures were reported in the Trans-Volga district. Overall, the larger regions performed poorly in relation to national average.

Growth forecasts revised upwards

Compared to GDP forecasts at the beginning of the year, forecasters are now more optimistic regarding the sustainability of Russia's economic recovery. The Consensus Economics mean forecast for Russian GDP growth in 2000 in January was less than 2 %. In July, it was nearly 5 % (see table).

Russian GDP growth forecasts for 2000- 2001 (%)

	2000	2001
Consensus mean (Jan.'00)	1.8	2.8
Consensus mean* (July '00)	4.9	3.7
ABN AMRO Bank (July '00)	4.0	4.0
Creditanstalt (July '00)	5.2	3.9
Economic Intelligence Unit (Aug. '00)	5.0	
Goldman Sachs (July '00)	6.0	4.0
Russian government (2001 budget draft)	5.0	4.0

** A mean of 19 forecasters (Consensus Economics Inc.)*

Russia limits energy exports

Effective 1 September, Russian producers are permitted to export only 10 % of their fuel oil output. The corresponding limit on diesel oil is 25 %. The quotas are intended to secure adequate domestic fuel supplies next winter and will be reviewed monthly.

The return to quotas stems from very low domestic energy prices and may also indicate still prevailing payment problems within the country. However, earlier experience shows that the quota system is rather inefficient as energy firms quickly learn to get around the rules. Thus, a permanent solution would be to allow domestic energy prices to more closely reflect market prices. This would also mitigate the overall problems related to heavily subsidised domestic energy prices.

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2	7.5	H1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	10.0	1-7
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	16.5	1-7
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.0	7
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	75.1	49.1	H1
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	40.2	20.7	H1
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0	11.2	Q1

Sources: Goskomstat, CBR

Putin urges speedier economic reforms

In his first state-of-the-nation address, president Putin implied that the present bright economic prospects are not enough for Russia. He warned of over-optimism and pointed out that the current economic growth mainly stemmed from the rouble's devaluation and high world prices for Russian exports. He even stated that Third World economic conditions awaited Russia if economic and political reforms were not implemented soon.

Certainly, there are good reasons to be cautious as so many things await reform. In this respect the adoption of the second chapter of the new tax code in the end of July was an important step (see table). The new code will come into force at the beginning of 2001 and is envisaged to change Russia's entire tax system. Even so, there are many open questions related to details and implementation of the new tax system.

Russian tax reform – taxes approved and under discussion

1. Value-added tax	20% VAT rate, 10% for basic food and children's clothing, 0% for exported goods (exception – oil and gas exports to CIS); into force 1 Jan. 2001
2. Excises	E.g. 5% jewellery;15% natural gas sold within Russia and CIS, 30% if sold outside; per tonne/litre fees for gas, fuel, engines, cars, alcohol; into force 1 Jan. 2001
3. Unified social tax (for employers)	The basic tax rates: 35.6% for annual incomes below100,000 roubles; 20% for income between 100,001-300,000 roubles; 10% for income between 300 001-600 000 roubles; 2% for income higher than 600,000 roubles Tax revenues will be divided between the Pension fund, Social security fund and Medical insurance fund (both at federal and regional levels); into force 1 Jan. 2001
4. Social tax (for employees)	7.6% passed the Duma on second reading
5. Income tax	A flat rate of 13%; 30% on dividends; 35% on casino winning, insurance payments, interest on bank deposit; into force 1 Jan. 2001
6. Turnover tax	1%; into force 1 Jan. 2001, but to be abolished from the beginning of 2003
7. Profit tax	The government has suggested raising the tax from 30% to 35%.

Sources: RET, July 2000; Nalogovyi kodeks RF; BOFIT

Government presents the 2001 budget draft

In August, the Russian government approved its 2001 budget draft, which for the first time was planned to be in balance. Thus, revenues and expenditures are RUB 1,194 billion (15.4 % of GDP, or USD 40 billion at the expected average exchange rate of 30 roubles to the dollar). The budget draft assumes real GDP growth of 4 % next year with nominal GDP climbing to RUB 7750 billion (USD 258 billion). Inflation target is 12 % and the average world crude oil price is expected to be 18-19 dollars a barrel.

Assuming a rescheduling deal with the Paris Club, Russia plans to pay USD 11.5 billion to its foreign creditors. Without any rescheduling, the sum would be USD 14.5 billion. The budget also assumes Russia will borrow USD 2.7 billion from the IMF and the World Bank.

The Duma is to consider the 2001 budget draft in the end of September. According to preliminary comments Duma deputies are dissatisfied with excessively low estimates for inflation and oil prices and with the removal of the so-called development budget to finance high-quality investment projects. Criticism has also been voiced against the removal of seasonal credits for agriculture and industry. Moreover, the recent submarine accident has incited communist deputies in particular to demand more resources for the army. This idea seems to be supported by president Putin. At the end of August, he raised salaries of the army, police and workers of the nuclear weapon industries and ordered to set up four new marine rescue centres.

The governors of Russian regions have complained about the unequal division of revenues between federal and regional budgets. They object to government plans to transfer the 15 % of the regional share of value-added tax revenues to the federal budget and deliver regions the means to cope with allowances of children, invalids and veterans. Leaders of donor regions would prefer not to rely on federal budget transfers, but rather keep as much tax revenues as possible in their own regions.

Administrative reform proceeds

President Putin continues to succeed in one of his priority areas – development of centre-region relations. At the beginning of August, he signed a law on formation of the Federation Council that further erodes the powers of Russia's regional leaders. Under the new law, each of Russia's 89 administrative regions is granted two permanent seats on the Federation Council. One representative is to be selected by the regional parliament, while the other is to be nominated by the region's highest public officer.

The reallocation in May of Russia's 89 administrative regions into seven federal administrative districts led by presidential representatives has until now not led to any concrete results. In mid-August, prime minister Kasyanov signed a decree to set out the powers and rights of these representatives. The decree gives them quite substantial rights in appointing regional officials. They are obliged to inform the president about discrepancies between regional and federal laws.

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999	2000 Jan.-Jun.	2000 budget law	2001 budget draft
Federal government								
- revenues	13.7	12.5	9.8	9.0	13.4	17.1	15	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	13.1	16	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	4.0	-1	0

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

Sources: Goskomstat, IMF, MinFin.

CBR cuts refinancing rate

Thanks to good growth performance, a fiscal surplus, a huge first-half trade surplus of USD 29 billion, and positive reactions to the new economic program, Russian financial markets were rather calm during the summer months. Yields on government bonds (OFZ) were down over 10 percentage points since June to an average 23 % at the beginning of September. At the same time, Russian share prices have strengthened. The RTS index has increased some 20 % from the beginning of June, and ended August at about 240 points.

With the decline in market rates, the central bank decided to cut its refinancing rate from 33 % to 28 % on 10 July. In June-July, the rouble strengthened about 0.5 roubles per dollar, but since then it has been quite stable around 27.70 roubles per dollar.

One reason for a relatively good situation in the financial markets is the fact that inflation has been slower than one could have expected. So, after an inflation peak of 2.6 % in June, monthly inflation in July decelerated to 1.8 % and in August was even less. Still, given improving demand conditions, hikes in fuel and electricity prices, and a substantial increase in the money supply, it will be difficult to squeeze the annual inflation rate under the current 20 %.

Deal with London Club enters the final stretch

Another reason behind the current good mood in the financial markets is the fact that Russian authorities are about to finalise the debt arrangements with the London Club of private creditors. In August, Russia's finance ministry published details of the exchange of Vnesheconombank debentures owned by the London Club creditors for new Russian sovereign eurobonds.

The latest deal is based on an agreement reached in February 2000, when the London Club forgave 36.5 % of its USD 32 billion Soviet-era debts. Now the remaining USD 18.2 billion has been converted into PRIN-eurobonds with a redemtion period of 2007-2030. In addition, USD 2.8 billion in unpaid interest has been reissued as IAN-eurobonds maturing 2006-2010.

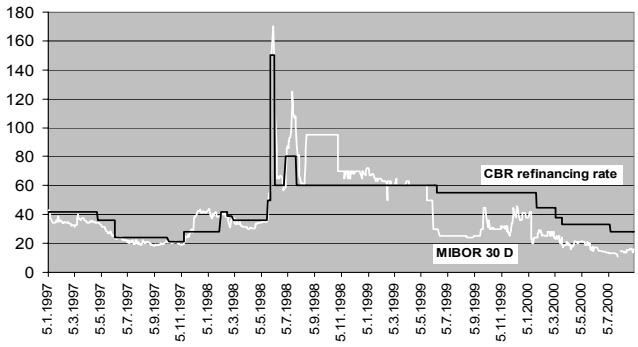
After the deal, the international credit rating agency Fitch IBCA raised its short- and long-term rating on Russian sovereign eurobonds from B- to B. This means that the Russian government has a relatively good ability to answer for its debt commitments in the near future. In the longer term Russia's capacity to fulfil its commitments will depend on whether Russia will create a healthier business environment and achieve sustained economic growth.

No progress with the Paris Club

In contrast to the deal with the London Club, there has been no progress with the Paris Club of sovereign creditors. On 20 July, prime minister Mikhail Kasyanov wrote in Financial Times and strongly advocated a similar debt relief arrangement with the Paris Club as Russia has concluded with the London Club. Mr. Kasyanov argued that Russia needs the debt write-off to push ahead with structural reforms. He also compared Russia's situation to that of western Europe in 1947 (Marshall Plan) and eastern Germany after unification. Moreover, Kasyanov argued that a principle of equal treatment of creditors implies that the Paris Club should agree to a similar degree of debt relief as that granted by the London Club.

However, equal treatment of debtors could make it difficult for the G7 countries to forgive Russia's debts as country's external balance situation is currently extremely strong and Russia's long-term potential to repay its debts is also much better than the capacity of the most of highly indebted countries. Moreover, the partial debt write-off by the London Club was not due to kind-heartedness of private creditors. Rather, the debt write-off was related to a deal where "bad" debt (PRINs and IANs) was traded for "good" debt (eurobonds) and following increase of the price of new debt papers balanced the losses related to partial debt forgiveness. As there is no market for the Paris Club debt, a similar option is unavailable for sovereign creditors. These countries must raise the money for debt relief from their taxpayers.

Russian interest rates in 1997-2000, % p.a.*



** Since 1 August 2000, MIBOR 30D = MIBOR 30-90 D*
Source: CBR

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	18.7	8
M2, 12-month growth, %	113	30	29.5	36.3	57.2	59.7	7
Average wage, new RUB, end of period	736	1017	1210	1463	2272	2289	7
Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	7.1	6
- lending rate, %	320	147	46.2	41.5	40.1	22.8	6
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	24.1	25 Aug.
RUB/USD, end of period	4640	5560	5960	20.65	27.00	27.75	8

Sources: Goskomstat, CBR

The changing role of Russian regions

By Laura Solanko and Merja Tekoniemi

The regional division of present-day Russia is a product of Soviet-era nationality policies. Regional boundaries today may seem senseless from an economic standpoint and typically do little to preserve the cultural identities of smaller groups such as Carelians, Mari or Inguts. Moreover, most, if not all, regions remain economically dependent on a few industrial enterprises. Many of these enterprises are still producing the wrong goods in the wrong place to be viable in a market economy. And yet no serious attempt has been made to change regional boundaries.

In every other respect, the position of regions has changed dramatically since the break-up of the Soviet Union in 1991. After being subdued under the strictly centralised Soviet regime during their previous existence, regions today exist as undefined states with no clear framework for cooperation between them and the centre.

The confused 1990s

The 1992 federal treaty and the new constitution of 1993 brought a formal legal basis for centre-regional relations, but at the same time were unclear on many issues. This strengthened the growing inequality between regional units. At the beginning of 1993, president Yeltsin stated, "*The Russian government does not conduct any kind of a regional policy. This does not mean that the process of defining the contents of Russian regional policy is under way, but really that such a policy does not exist.*"

Thus, the regions were left alone to cope with the economic hardships of 1990s as they saw fit. Some, notably the few resource-rich ethnic republics, decided to pursue maximisation of their political and economic independence. Many regions resorted to anti-market measures such as export restrictions, import tariffs and local money surrogates in their pursuit for self-sustainability, especially in the food sector. Every region tried to keep good relations with the government to attract the most subsidies, transfers and cheap loans for their regional development.

The centre tried to clarify the situation by negotiating "power-sharing" arrangements with certain regions. These bilateral secret agreements, however, did little to improve the situation. The federal authorities were both unwilling and incapable of controlling a rapidly growing jungle of contradictory and unconstitutional regional laws. In 1996, as part of president Yeltsin's re-election strategy, governors were for the first time elected and not appointed by the president. While this helped clarify centre-region relations, it did not advance the creation of a sound and fair legal structure. The often-cited words of president Yeltsin to regions "*to take as much autonomy as they can swallow*" resulted in a costly, inefficient and unfair system of various bilateral agreements between the centre and regions.

The Putin era

The Putin era so far seems to be based on a completely different set of ideas than those of his predecessor. In his inaugural address in early May, Mr. Putin stated that he would seek to strengthen the role of the state, which implied greater efforts to establish respect for the law, crack down on crime and implement economic reforms without endangering the emergence of democracy.

One of his first acts as president was to initiate an administrative reform that reallocated Russia's 89 regions into seven federal administrative districts led by representatives picked by Mr. Putin. Also numerous regional-level regulations in conflict with federal law were abolished. After tough negotiations, he even succeeded in passing a law on formation of Federation Council. The act diminishes the powers of regional leaders by eliminating their automatic right to a seat on the Federation Council. He also now has the right to dismiss regional leaders and disband regional parliaments.

A recentralised state?

While it is too early to judge the merits of these legal reforms, Russia clearly needs simple, enforceable legislation to elaborate the division of powers among federal, regional and local governments. A clear and predictable framework is a prerequisite for economic reforms at the regional level. As long as the rules of the game are obscure and subject to change overnight, a rational regional leader most probably directs his efforts towards rent-seeking or obtaining federal subsidies. Counting on increased tax revenues through better regional economic performance can hardly be an optimal strategy if it is unclear who gets the tax revenues next year.

But, as always, there is also the reverse side. We see imposing more control on regional activities as a good move – but only to a limit. Overwhelming recentralisation and excessively tight restrictions on regional economic policies are bound to be detrimental. The Soviet-type impossibility of doing anything without permission from above is incompatible with innovation, imitation and economic reform at the regional level. The big danger is that regional initiatives will be killed before they are ever born.

Due to the massiveness and variety of natural, economic and social conditions, Russia needs to allow for regional variation in policies within clear legal framework. Regional experimentation and competition has often cited as a crucial factor in China's economic success. There is also evidence from Russia that a well-performing region tends to draw other regions onto the reform path. In northwestern Russia, for example, Novgorod's success in attracting FDI seems to have inspired the neighbouring Pskov region to get to work on improving its investment climate. Russia cannot afford to overlook this incentive for economic reform at the regional level. Weak regions mean a weak Russia.

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Economic Developments

Grain harvest up, industry continues to grow fast

According to official sources, agricultural production in the first eight months was up 5 % compared to January-August 1999. In August, production was 15 % higher than in August 1999. As of end-September, almost 90 % of the total sown acreage had been harvested, yielding about 63 million tonnes of grain. In 1999, Russia the total harvest was 55 million tonnes. This year the average yield for all grains appears higher than last year.

In January-August, industrial production rose 10 % compared to the same period last year. The unemployment rate determined on the basis of ILO methods has dropped from 12 % at the start of 2000 to less than 10 % in August. There are 7.1 million unemployed people in Russia.

Russian energy prices far below market prices

Along with international developments, Russian domestic prices for gasoline and fuels have been increasing. In June the price of gasoline was over 70 % higher than a year earlier. Price hikes affect various regions differently. In some Russian regions, fuel shortages have led to various regional attempts to force oil producers to secure oil deliveries to regional markets.

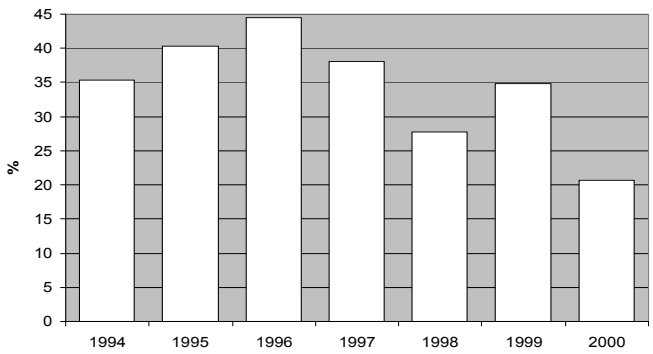
However, in spite of significant price increases in rouble terms, the gap between domestic and world market prices shows no signs of narrowing, so that Russian domestic prices of energy remain far below world market prices. As demonstrated by the chart to the right, the domestic wholesale price for crude oil is only about one-fifth of the world market price.

For oil producers, high world market prices have made exporting far more profitable than selling oil in the domestic market. So, in addition to fiscal reasons, the authorities have been active in trying to tax the high profits in order to secure the domestic energy supply. According to the current rules, the tariff regime requires the export tariff to be revised every other month to reflect the world market price of Urals crude. Even with a 35 % hike in the export tariff in August, the government already is seeking to raise the tariff another 26 % to 34 euros per tonne effective early November. Nevertheless, taxation of energy in Russia is still considered to be rather modest and current estimates show that the recent hikes in the export tariffs of oil will not significantly affect the volume of oil exports.

In addition to tariff policy, the government has used export quotas for fuel and diesel oil (e.g. in September, firms were allowed to export only 10 % of their fuel oil output and 25 % of diesel output) to secure adequate domestic fuel supplies for the coming winter. However, these quotas are not expected to change the present situation substantially as enterprises evade regulations through various means. Moreover, the poor situation is not only caused by low domestic prices, but also by the fact that selling in the domestic market often means submitting to barter transactions or even non-payment.

Obviously, the problems related to domestic energy supply, and more generally to huge energy subsidies in Russia, could be solved by freeing (or at least significantly increasing) domestic energy prices. Unfortunately, very few in Russia support radical changes in energy policy, and both Russian enterprises and many powerful official bodies see the current situation as continuing. For example, Russia's long-term energy strategy through 2020 vaguely states the improvement of price and tax policies as important tasks in the field of energy. According to the document, however, energy prices will continue to be regulated in order to secure domestic energy requirements and competitiveness of domestic firms. Moreover, regarding energy prices the recent economic program of the government is no more specific and gives no clear indication of radical reforms in this field.

Russian domestic price of oil as % of world market prices



Source: Goskomstat, IEA, BOFIT

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2	7.5	H1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	10.0	1-8
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	17.6	1-8
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	9.8	8
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	75.1	57.7	1-7
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	40.2	24.4	1-7
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0	11.2	Q1

Sources: Goskomstat, CBR

Disagreement on 2001 budget assumptions

Despite fierce criticism from the Duma concerning the macroeconomic indicators in the 2001 budget draft, the Russian government is sticking to its initial assumptions about economic development next year. Budget discussions were already postponed once to give Duma deputies more time to familiarise themselves with the draft budget.

The Russian government wants to leave its 2001 budget assumptions untouched to have room to manoeuvre if the economic situation in Russia worsens or the assumed lending from the IMF and World Bank (USD 2.7 billion) fails to materialise. Concerning the latter threat, high oil prices and a huge trade surplus have caused representatives of international financial organisations to state publicly that Russia does not need financial aid at this point. Even Russians themselves have made similar statements. In the September IMF/World Bank annual meeting, finance minister Kudrin stated that Russia expects to agree on an economic program with the IMF, but the program would not include a request for additional loans.

Poor rankings for Russian institutions and policy

In spite of the current good macroeconomic performance, the World Economic Forum's *Global Competitiveness Report 2000*, published by the beginning of September (www.worldeconomicforum.org), sees Russia's future growth prospects as rather poor given the current fundamentals. The report assesses the competitiveness of 59 countries using indices that aim to measure factors contributing to high productivity and economic growth in individual countries. Although Russia's ranking has slightly improved from last year, its current ranking of 55 between Venezuela and Zimbabwe indicates fundamental problems in its institutional set-up and economic policies. The report ranked the United States first as having the best growth potential.

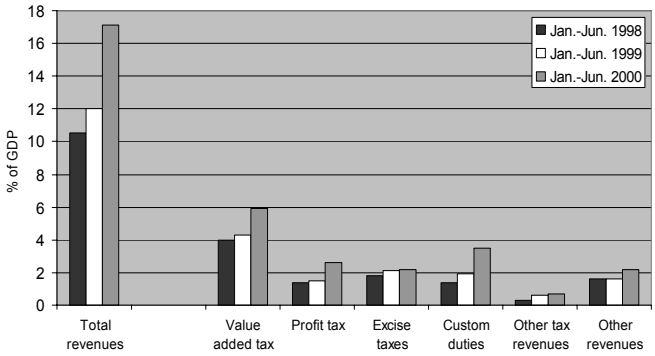
Another interesting assessment of institutions and economic policymaking may be found in the *Year 2000 Corruption Perception Index*, published by Transparency International (www.transparency.de) in mid-September. This index ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The results are based on several surveys among business people, the general public and country analysts. The 2000 Corruption index places Russia together with Kenya at a rank of 82 out of 90 countries, which indicates severe problems in its public administration. Finland was ranked first as the least-corrupt country, while Nigeria, at 90, was perceived a country with the most severe problems in this field.

Strong fiscal performance in the first half of 2000

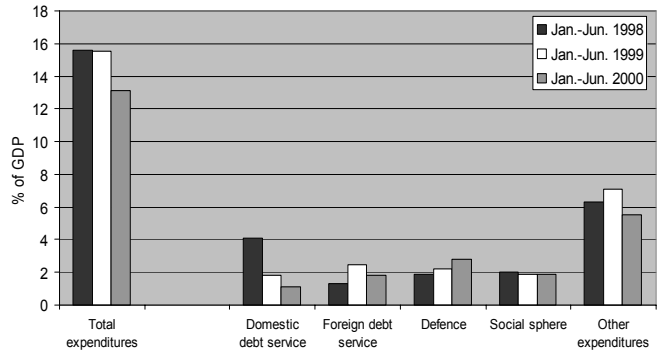
The 2000 budget execution proceeds with above-target results. If compared to previous years, revenues in the first six months surged from 10.5 % of GDP in 1998 to 17.1 % of GDP this year (see figure). The increase in the share of VAT, profit tax and customs duties has been impressive, while the share of excise taxes and other tax revenues has remained almost steady.

Besides good revenue performance, the government is showing tighter control over expenditures. Expenditures have gone down from 15.6 % of GDP in the first half of 1998 to 13.1 % of GDP in 2000. Debt servicing costs have decreased from 5.4 % of GDP in January-June 1998 to 2.9 % of GDP in 2000. Domestic debt servicing costs have contracted proportionally more than foreign ones. Social sphere expenditures have stayed the same – a fact that has been broadly criticised. Defence expenditures, on the other hand, have risen from 1.9 % of GDP in the first half of 1998 to 2.8 % of GDP in the same period in 2000.

Federal budget revenues, % of GDP



Federal budget expenditures, % of GDP



Source: Minfin

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999	2000 Jan.-Jul.	2000 budget law	2001 budget draft
Federal government								
- revenues	13.7	12.5	9.8	9.0	13.4	17.0	15	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	13.2	16	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	3.8	-1	0.0

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

Sources: Goskomstat, IMF, MinFin.

Equity markets face big fall in September

Despite the relative calm on Russian financial markets in September, share prices measured by the RTS index fell from a high this year of 246 on 29 August to 188 on 22 September. The drop was partly driven by ownership disputes involving two Russian telecom companies and uncertainties over the restructuring and ownership arrangements of mining giant Norilsk Nickel. Moreover, share price movements indicate that the Russian markets are still highly sensitive to uncertainties in other emerging markets.

Important privatisation deal

Privatisation is regarded as a key priority in the Russian government's economic program, which calls for privatisation of most state-owned enterprises within the next 18 months. In mid-September, the government received USD 1.1 billion for selling an 85 % stake in Russia's 14th largest oil producer Onaco to EuroTEK, a company controlled by the Tyumen Oil Company. The deal was the second largest privatisation sale ever in money terms, exceeded only by the privatisation sale of Svyazinvest, a telecom group. The auction was considered to be fair – a good sign for foreign investors still reluctant to make major investments in Russia.

No pick-up in foreign direct investments

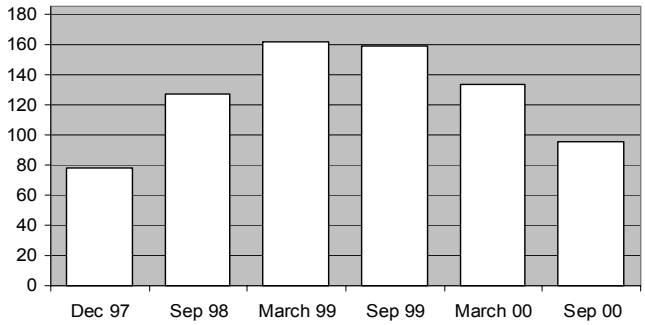
According to Goskomstat, USD 1.8 billion in foreign direct investment (FDI) flowed into Russia in the first six months of this year – a 26 % drop from the same period a year earlier. At the same time, domestic fixed investments increased about 15 %. Industry received 45 % of FDI, transport 25 %, retail and food services 14 %, and data communications 6 %. Within the industry segment, 41 % went to food processing, 24 % to fuel production, 16 % to machine building, and 10 % to forest products and wood processing.

Goskomstat reports that at end-June some 47 % of Russia's nearly USD 15 billion cumulative stock of foreign direct investment came from the US (see table). The role of Cyprus in investments to Russia strongly suggests that what is actually happening is that Russian money is circulated through foreign subsidiaries back to Russia to avoid taxes and other interventions by domestic authorities.

Russia's country risk ranking improves

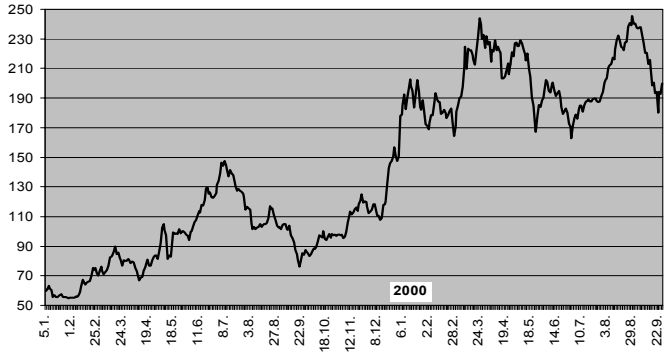
Due to a more stable and reform-friendly political environment and healthier economic performance, Russia's country risk declined significantly during the last six months. According to September country-risk ranking by *Euromoney* magazine, Russia's current ranking among 185 countries has risen from 133 in March to 95. Although the higher ranking indicates improved creditworthiness, Russia's credit ratings are still very low and Russian firms' access to foreign finance is limited. As usual, Luxembourg and Switzerland are considered the least risky countries.

Russia's country risk ranking among 185 countries



Source: Euromoney

Russian share prices in 1999-2000, RTS-index



Source: RTS

Leading investors (FDI) to Russia
- cumulative stock at end-June 2000

	USD billion	% of total
Total stock of FDI	14.5	100
United States	6.9	48
Cyprus	1.1	8
Germany	1.1	8
United Kingdom	1.0	7
Netherlands	0.9	6
Others	3.5	23

Source: Goskomstat

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	18.7	8
M2, 12-month growth, %	113	30	29.5	36.3	57.2	59.7	7
Average wage, new RUB, end of period	736	1017	1210	1463	2272	2325	8
Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	5.1	8
- lending rate, %	320	147	46.2	41.5	40.1	21.2	8
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	24.7	22 Sep.
RUB/USD, end of period	4640	5560	5960	20.65	27.00	27.75	9

Sources: Goskomstat, CBR

A time for change in Russian trade policy

By Matti Anttonen

Thanks to a cheap rouble and high world prices for energy and raw materials, Russia's ratio of exports to GDP rose to over 45 % and the trade surplus was more than USD 30 billion during the seven first months of this year. Yet, despite this increased dependence on foreign trade, the openness of Russian trade is still disputable. Even with the improved price competitiveness of Russian producers, the structure of foreign trade remains unchanged. Russia imports manufactured goods and exports energy, raw materials and semi-finished products.

On the other hand, the undervalued rouble supports exporters and protects local producers better than any duty or technical hindrance to trade ever could. Thus, the current situation would be ideal for opening markets and creating new production through competition and foreign investment. Taking advantage of this opportunity could substantially contribute to the overall stability of the Russian economy.

Another step towards WTO accession?

WTO membership and implementation of the Partnership and Cooperation Agreement (PCA) as the basis of EU-Russia relations are crucial to ensure the healthy development and competitiveness of the Russian economy over the long term. The WTO has met with Russia in Geneva regularly during the past five years. The Russian side has explained legislative development, answered thousands of questions from member states, and engaged in preliminary discussions on tariffs with certain member states.

At times it seemed unclear if WTO membership was really a priority for Russian government, but now the situation seems to have changed. Russian authorities dealing with the WTO, fully grasping the magnitude and scope of the task ahead for Russia, today expects Russia to join the WTO in 2003.

Already we see the Duma discussing a new customs code and a government decision to restructure customs tariffs. Duties will likely be lowered and tariff lines regrouped to make the system transparent and resistant to customs fraud. It remains to be seen whether new duties, particularly on machinery and components, will be lowered enough to make the Russian economy more competitive, or whether short-term fiscal goals will prevail. In any case, improved federal finances should allow lower duties without endangering the budget balance.

It has been estimated that Russia must cut duties, which presently average 15-16 %, by half. At a practical level, this will have less effect than one might imagine. A recent EBRD *Transition Report* observed that Russia only collected 7.3 % tariff revenue on its imports in 1998 – a far cry from the above-mentioned weighted average.

Moreover, it is technically easier to lower custom duties than to broaden market access to a service sector that was effectively closed for foreign operators just ten years ago. While many foreign enterprises have established a commercial presence in Russia, numerous horizontal and sector-specific restrictions persist. Abolition of these restrictions would help turn the capital flows towards Russia and bring in much-needed management skills along with investment. Notably, the restrictions on foreign banking and insurance services are incomprehensible when the country clearly needs to improve the efficiency of these sectors.

Discussions on agriculture, for example, have yet to start, as there is no agreement even on statistical data used. WTO-members have had years to adapt their policies and systems of agricultural support. Russia must do this while tackling the transformation of its long-neglected agricultural base.

Extensive discussions also lie ahead in other sectors. Russia must adopt WTO rules on technical barriers to trade, sanitary and phytosanitary measures, and intellectual property.

Overall, Russia clearly needs to make considerable legislative changes and substantive concessions before accession negotiations can be concluded.

Closer cooperation with the EU

EU-Russia relations took a new start after the entry into force of the PCA in late 1997. The EU remains Russia's main trading and economic partner. The EU adopted a common strategy on Russia in June 1999, and Russia answered with its own EU strategy in October.

The institutions created by the PCA provide the framework for discussing practical trade problems, as well as wider issues. The PCA, when fulfilled, would substantially improve the scope of trade and investments between the EU and Russia. A top commitment is making Russian economic legislation compatible with the Union's.

EU enlargement will also strengthen the relationship. Many of the acceding countries are Russia's major trading partners, and four share a border with Russia. Consequently, the average import duties these countries charge for Russian goods will be lowered to the EU-levels and custom procedures and rules will be unified.

Russia has a clear long-term perspective in its relations with the EU. The PCA envisages free trade between Russia and the EU. Fulfilling the main provisions of the PCA and WTO accession are the keys to getting there.

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Economic Developments

Grain harvest better than in 1999

The grain harvest is expected to be fairly good both in quantity and quality. It is estimated to reach 65–66 million tonnes in clean weight, which by far exceeds the 1999 harvest of some 55 million tonnes. However, compared to the 1991–1995 average grain harvest of 88 million tonnes, this year's harvest is still modest.

There are plenty of fundamental problems related to agriculture, which contribute to lower grain harvests even when weather conditions are favourable. Among them are slow agricultural reform, diminished area under cultivation and ageing equipment. Moreover, official grain harvest figures only tell part of the story, because farmers tend to hide grain from state to sell it unofficially later and avoid taxes. According to studies of the Institute of the Economy of Agriculture, small farmers may hide up to 50 % of their crops, while larger farms conceal about 20 % of their crops.

As harvest prospects are substantially better than last year, agricultural production is estimated to increase a couple percentage points this year. Nevertheless, food imports are expected to grow. The poor overall situation in agriculture is said to be a major impediment to the development of strong domestic food industry.

First half current account surplus 22 % of GDP

According to the CBR's latest balance of payments data, the current account was USD 23 billion in surplus in the first half of 2000 (an amazing 22 % of the first half GDP). This compares to USD 25 billion in the whole 1999 and USD 2.1 billion in 1998. The growth in surplus has been spurred by high oil prices leading to a surge in dollar export revenues (50 %), while imports increased only modestly (6 %) in the first half of this year compared to the same period in 1999. Investment income has stayed roughly the same as in 1999.

As far as the capital and financial account is concerned, the balance of payment data shows that Russia still has big problems in attracting new foreign capital into the country. Foreigners have yet to return to Russian securities markets as buyers, and direct investments were down from the last year's already depressed level to USD 1.1 billion. Moreover, the "net errors and omissions" item gives no indication that the capital flight is declining.

Due to a record current account surplus, the CBR's foreign currency reserves increased by USD 9 billion in the first half of 2000.

The strong showing of Russian exports continues into the second half of this year. For the period January-August, Russia's foreign trade surplus was USD 39 billion compared to USD 18 billion in the same period last year. According to Goskomstat, exports were up 48 % and imports 8 % compared to first eight months of 1999. Thus, imports appear to be slowly recovering. A huge current account surplus is reflected in the record level of CBR's foreign currency reserves, which stood at USD 26 billion as of end-October.

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

	1998	1999	2000 H1
Current account	**2.1**	**25.0**	**23.0**
Trade balance	17.4	35.3	28.7
Exports, f.o.b.	74.8	74.7	49.0
Imports, c.i.f.	-57.5	-39.4	-20.3
Services	-3.3	-3.3	-3.4
Exports	12.8	9.1	4.1
Imports	-16.1	-12.4	-7.5
Investment income	-11.4	-7.7	-2.7
Received	4.0	3.4	3.0
Paid	-15.4	-11.2	-5.7
Other items, net	-0.6	0.7	0.4
Capital and financial account	**2.1**	**-16.1**	**-9.2**
Capital Account	-0.4	-0.3	0.0
Received	1.7	0.9	0.4
Paid	-2.1	-1.2	-0.4
Financial account	2.5	-15.7	-9.2
Direct investment to Russia	2.8	2.9	1.1
Portfolio investment to Russia	8.4	-0.8	-1.1
Other items, net	-8.7	-17.8	-9.2
Net errors and omissions	**-9.5**	**-7.1**	**-4.5**
Change in reserves	**5.3**	**-1.8**	**-9.3**
('-' growth, '+' decline)			

Source: Central Bank of Russia, 2 October 2000

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2	7.5	H1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	9.7	1-9
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	17.5	1-9
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	9.9	9
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	75.1	66.8	1-8
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	40.2	27.6	1-8
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0	23.0	H1

Sources: Goskomstat, CBR

The 2001 budget proceeds in the Duma

So far, the reading of 2001 budget draft seems to be proceeding in the Duma without major problems. The passage of the 2001 budget in the first and second readings went swiftly – only the Communists categorically opposed the new budget. For Duma deputies, the use of the possible extra revenues raised if oil prices remain higher than projected in the budget has been the most important issue. The budget anticipates the price of oil to average 21 dollars per barrel, well below the current price of about 30 dollars. Presumably, the government's cautious attitude is due to risks related to a major tax reform starting at the beginning of next year and foreign debt repayments.

The government agreed to certain, albeit not very essential, concessions. The most important concession was the shift of income tax revenues almost completely to the regional budgets. On the other hand, federal financial aid to regions was reduced. Cuts were also made in domestic debt servicing, state administration and international activities. However, these cuts were balanced by transferring altogether RUB 30 billion to other sectors of the economy. Defence, agriculture and education received two-thirds of the sum.

The government originally proposed using the possible extra oil revenues solely to service foreign debt. However, ahead of the 2001 budget's second reading, there was apparently an agreement to use only half for servicing foreign debt with the other half going to funding domestic needs. The decision on disposition of the extra revenues will probably be finalised before the third reading.

Budget policy priorities in 2000 – 2001

The government economic program lists nine priorities in reforming the Russian budget policy in 2000 – 2001 (see Table). Of these, tax reform has made the most headway with many parts of the second chapter of the tax code already passed. The government is soon expected to submit to the Duma several new bills on taxation of enterprises, securities operations and deductions of business expenses from taxable profit. Nevertheless, there are many open questions related to details and implementation of the new tax system. The goal of a fully functioning new tax code at the beginning of next year thus seems quite ambitious.

Many of the priorities in the field of budget policy are related to making the budget process more transparent and effective. Unfortunately, reforms in this field are lagging. Discussion of the draft law on improving monitoring of the federal budget has been delayed and the reform of federal-regional budget relations lies ahead. The Ministry of Defence serves as a good example of non-transparent and ineffective use of budget revenues. It has yet to be incorporated into the federal treasury system, so the military's use of money could be properly monitored.

The budget policy priorities also include trimming budget expenditures and concentrating the resources on key goals. For this year, the key goals are the elimination of budget arrears, increasing state pensions and salaries, as well as guaranteeing domestic security. So far, the government's major achievements concern real incomes. State pensions have been raised several times this year. After the hike in August, the average pension for the first time in ten years exceeded the pensioners' subsistence minimum. In addition, pensions were again increased by 10 % from the beginning of November. Presumably, salaries are also rising as the general wage level in real terms in September was reported to be 24 % higher than a year ago. Moreover, budget wage arrears have decreased by some 37 % since the beginning of this year.

In 2001, the government plans to keep expenditure increases in control by eliminating ineffective investment projects and subsidies. Moreover, many of the prevailing social benefits will be eliminated and transformed to be based on means testing. On the other hand, budget expenditures will be increased in the areas of education, health, culture, science and the justice system.

List of budget policy priorities in 2000 – 2001

1. Approval of new tax laws, forming the second part of the Tax code;
2. Assessment of the effectiveness of budget expenditures;
3. Reduction or cancellation of state obligations that cannot be financed;
4. Concentration of budget resources on key priorities and the consequent reduction of ineffective expenditures;
5. Creation of clear system in dividing powers of different budget levels;
6. Clearing of federal budget debt and completion of restructuring the state debt;
7. Completion of formation of federal system of public funds and speeding up this process in other budget levels;
8. Increasing the transparency of budgets and the process of budget formation; and
9. Transfer to new principles in controlling state property.

Sources: "Osnovnye napravleniya sotsialno-ekonomitseskoy politiki Pravitelstva Rossiyskoi Federatsii na dolgosrotsnuyu perspektivu" http://www.akm.ru/rus/gosinfo/progr_gov/soderganie.stm and Bjudzhetnoye poslaniye prezidenta, Rossiiskaya gazeta 3 June 2000.

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999	2000	2000	2001
Federal government						Jan.-Aug.	budget law	budget draft
- revenues	13.7	12.5	9.8	9.0	13.4	16.8	15	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	13.3	16	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	3.5	-1	0.0

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

Sources: Goskomstat, IMF, MinFin.

Relative calm on financial markets

Strong growth performance, twin surpluses in the fiscal and external sectors and a stable political climate (indicated by a smooth 2001 budget reading process) have kept the situation in financial markets fairly calm. In nominal terms, the rouble has been rather stable against the dollar in recent months. On the other hand, the rouble has strengthened against the euro some 20 % during the last 10 months. Given the nominal appreciation against the euro and Russia's still relatively high inflation rate, the trade-weighted real exchange rate of the rouble has strengthened some 15 % this year alone (see charts). Nevertheless, the real effective exchange rate of the rouble is still about 25 % below the pre-1998 crisis level and actors in the markets seem rather satisfied with the current situation. Except for the frequent end-month peaks of short-term interest rates, there seems to be no particular concerns in the markets. As regards bond markets, the average yield of government bonds (OFZ) has varied between 21 and 23 % during the last two months after falling over 10 percentage points during the summer.

Preliminary information on inflation indicates that consumer prices increased 1.5-2.0 % in October, a modest rise from 1.3 % in September. Thus, annual inflation remains stubbornly at around 20 %. A further decline in interest rates presumes lower inflation expectations, but at the moment it is difficult to see any immediate reason to scale down expectations as producer price inflation is running twice as fast as consumer price inflation, energy prices are increasing, and domestic demand is recovering. However, very tight fiscal policy, productivity growth and nominal appreciation of the rouble could potentially dampen inflation pressures.

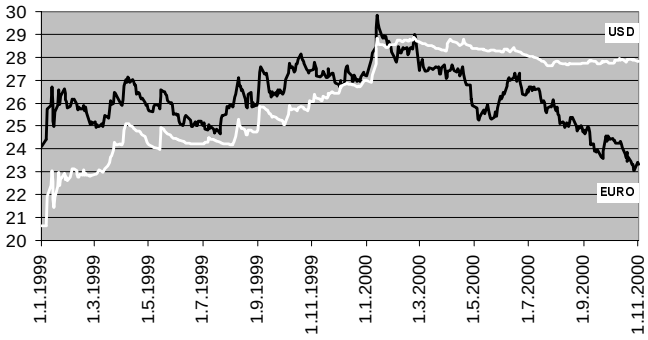
Recently, Russian equity markets are said to be following developments in international and, in particular, the US stock markets. Thus, the good macroeconomic situation has not been reflected in booming equity prices. Naturally, the prevailing problems in corporate governance have kept investors cautious.

No progress in the banking sector

Contrary to developments in financial markets, the situation in the banking sector is as lousy as ever. There is almost no indication of a change for the better as the new economic program is quite scanty about reforms in the banking sector and the 2001 budget draft does not allocate any meaningful resources for bank restructuring.

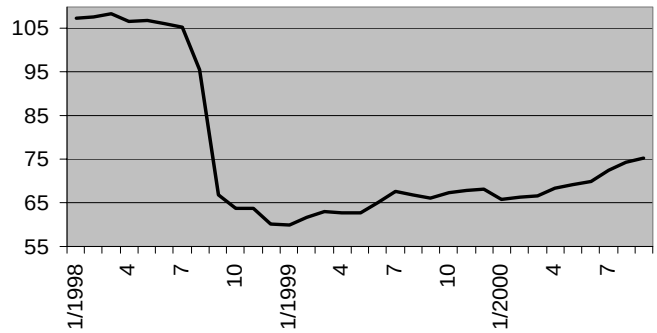
The one piece of good news is that the Russian government now wants the CBR to get rid of its holdings in commercial banks. According to a preliminary timetable released by prime minister Mikhail Kasyanov, the central bank will seek to divest its five commercial banks outside Russia by 2002. The CBR's holdings in Vneshtorgbank should also be sold by 2003, as well as the CBR's stake in Sberbank, the national savings bank, by 2005.

RUB/USD and RUB/EUR exchange rate 1999-2000



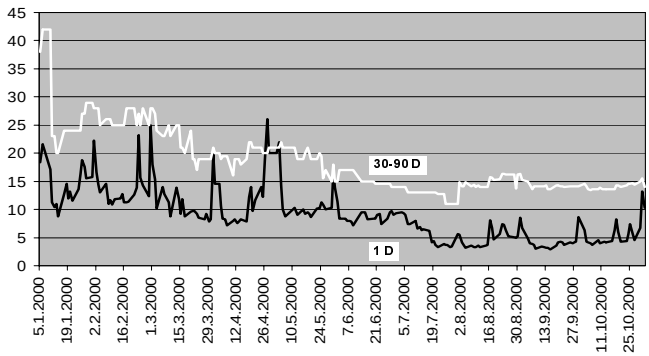
Source: CBR

Rouble's real exchange rate (index)



Source: Russian Economic Trends

Russian short-term interest rates (MIBOR) in 2000, % p.a.*



* 1 January 2000 – 31 July 2000 Mibor 30 D
Source: CBR

Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	18.5	9
M2, 12-month growth, %	113	30	29.5	36.3	57.2	66.1	9
Average wage, new RUB, end of period	736	1017	1210	1463	2272	2403	9
Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	9
- lending rate, %	320	147	46.2	41.5	40.1	20.2	9
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	25.7	27 Oct.
RUB/USD, end of period	4640	5560	5960	20.65	27.00	27.83	10

Sources: Goskomstat, CBR

The technology level of Russia's construction industry

By Pertti Naulapää*

In 1998–1999, a Finnish-Russian research group studied the adjustment of industrial enterprises in Russia's construction sector to the market economy. They looked at construction companies, construction materials makers and construction machinery manufacturers. The study comprised 42 companies in the regions of St. Petersburg, Moscow, Tver, Nizhni Novgorod and Novosibirsk. The companies studied were reputed to be the best companies in each region.

The objective was to find out how industrial enterprises in Russia's construction sector adjust to the market economy and attempt to identify ways to evaluate the adjustment and performance of the enterprises. Core issues included determination of the technology level of the enterprises and the effects and potential for technology transfer.

Scandinavian firms as benchmarks

In the study, three groups of variables were analysed: (1) the adjustment of the business environment in different regions, (2) the adjustment of enterprises to changes in the business environment, and (3) the performance of the enterprises.

Regarding enterprise performance, specific benchmarking models were developed to evaluate production technology and production management of the firms in question. The models defined the basic technologies and management processes used by a Scandinavian enterprise. Models were devised for evaluation of both constructors and manufacturers. These models were then applied to a construction company and a manufacturing company in Finland. The results served as benchmarks for the evaluation of Russian companies.

The technology level of an industrial enterprise can be defined in terms of production technology, production management and product quality. Production technology is defined here as a combination of resources, procedures and methods to produce the enterprise's products. Production management encompasses planning, organising, staffing, executing and controlling the production operations of the enterprise. Product quality indicates the quality level of the final product.

Significant regional differences

The analysis of the results revealed significant regional differences. Measured by several indicators, the adjustment process in St. Petersburg was significantly ahead of the other regions; Novosibirsk lagged significantly. One indicator used was the competitive share of the construction market (i.e. the share of market where competition plays a role) indicated by the top management. The competitive share in St. Petersburg was estimated to be 60 % of the total construction market, while in Moscow it was only about 30 %. This seems to indicate that the city of Moscow tightly controls the market. In Novosibirsk, the competitive share was even lower, representing only about 20 % of the total construction market.

Moreover, the benchmark Nordic companies had technology levels (i.e. production technology, production management and final product quality) that scored above 80 on a scale of 100. Thus, the research group considered ratings above 80 as representative of a good Nordic level. Among Russian companies, the average level of production technology was based on rating of 48 for production technology, 44 for production management and 55 for final product quality. In production management, the best Russian-owned and operated company had a rating of 62.

Regional differences in technology levels among enterprises were also large. The companies in St. Petersburg performed better than companies in other regions. Moreover, the gap between Nordic benchmark companies and the Russian companies studied appears to be widening. The main reasons seem to be very low investment in developing production technology and improving management processes, as well as a lack of real competition.

In the companies examined, the financial performance of the companies correlated very weakly with the technology level of the companies. The competitive position of the companies, indicated by the top management of the companies, was not based on efficiency, price or quality. It was primarily based on old networks and contacts. The technology level correlated significantly with the age, customer structure, market position, degree of international cooperation and international business, the share of barter sales of total sales, top management profile, financial resources and the marketing resources of the companies.

Poor technology level in Russian firms

The study of industrial enterprises in the construction sector in Russia indicates that the technology level in Russian enterprises is low. The situation appears to be much worse than widely believed and the gap with Western companies seems to be growing. As an illustration of the magnitude of problems, the research group estimated that Russian-owned and operated companies rely on production technology that is equivalent to what was used in Finland about 30 years ago. The main barriers to technology transfer are lack of financing, management systems, as well as ownership structures, organisational culture and poor incentive structures.

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Economic Developments

Significant changes in the structure of GDP

Goskomstat reports total output in Russia increased over 8 % in January-October compared to the same period a year ago. Industrial output increased nearly 10 %, while agricultural production was up less than 4 %. Regarding the service sector, transportation is reported to have grown by 5 % and retail turnover by over 8 %.

The fastest growing industrial sector was light industry, where output increased 29 % in January-September. Of the major industries, growth was also higher than average in ferrous metallurgy (19 %), chemical and petrochemical industries (16 %), machinery (16 %) and forest industry (14 %). The fuel sector (5 %), on the other hand, has been unable to take full advantage of strong demand and high prices, which clearly indicates capacity constraints. The electrical power industry (2 %) continues to puzzle. In previous years electric power generation fell much less than GDP, but now it lags overall GDP growth.

On the demand indicators, fixed investments were estimated to have increased an astonishing 20 % in the first ten months compared to the same period in 1999. Also household consumption has increased significantly as real disposable income increased over 9 % in January-October. Public consumption increased only very modestly (less than 2 % in the first half). Given the strong export demand and depressed imports, the contribution of net exports to GDP growth has been quite important.

Structure of Russian GDP, %

	1998	1999	1-6/2000
GDP	100	100	100
Final consumption	78	71	66
Fixed investments	18	16	16
Net exports	8	17	24
Other items, net	-4	-4	-5

Source: Goskomstat

If we look at the structure of Russia's GDP and how it is used, the situation is interesting (see table). Despite strong investment growth since 1999, the investment ratio (investments/GDP) is still only some 16 %, while net exports are some 24 % of GDP. So, taking into account the development of other GDP items, the share of final domestic consumption has fallen well below 70 % of GDP.

After brisk 2000, slower growth foreseen in 2001

Following rapid growth of the Russian economy this year, policymakers and observers in and outside Russia have substantially raised their growth projections for this year from the previous estimates in late spring and early summer. Now the year is expected to finish with GDP growth of 6 % to 7 %. As world energy prices have risen from spring, estimates of the current account surplus have been scaled up and vary mainly from 13 % to 18 % of GDP. Projections of inflation for this year remain essentially unchanged although money growth, fed by the large external surplus, has somewhat accelerated.

While the message of fast growth has spread, growth in 2001 is cautiously expected to slow to about 4 %. The current account surplus would decrease next year (although it would still reach around 8 % to 9 % of GDP), and inflation would decline. Underlying the forecasts of slower growth and a smaller external surplus, major predictors point to uncertain external conditions (notably oil prices), higher imports due to increasing consumption and investment, real appreciation of the rouble and a risk of higher inflation.

For sustainable growth, all projections reiterate the need – and present political and economic opportunities – to pursue structural reforms. While the expected pace of growth next year is not slow, it hardly suits a catch-up scenario.

Projections for 2000 and 2001

	GDP % change		Inflation %		Current account USD billion	
	2000	2001	2000	2001	2000	2001
IMF	7	4	16	11	32	23
OECD	6.5	4	22	15	40	25
EBRD	6.5	4	21*	15*	36	
Consensus Forecasts **	6.5	4.3	20	16	41	31
Government Program	5	4.1	13*	10*	29	20

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

*** Source: Consensus Economics Inc.*

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2	7.5	H1
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	9.8	1-10
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	19.6	1-10
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.0	10
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	75.1	75.6	1-9
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	40.2	31.3	1-9
Current account, USD billion			10.7	10.0	12.0	3.9	2.1	25.0	23.0	H1

Sources: Goskomstat, CBR

2001 budget passes its third reading

On 1 December, the 2001 budget draft won clear majority approval in its third reading. The big issue in earlier readings, namely the use of possible extra revenues if the oil price remains higher than the budget assumption, was resolved. According to the agreement, half of any additional revenues up to RUB 70 billion (7 % of budget revenue) will be applied to servicing state debt. The other half would go to financing extra budget expenditures. Additional revenues exceeding RUB 70 billion would be spent in the ratio of 70 % on debt and 30 % on other budget items. The next and last budget reading is planned for 15 December, after which the budget proceeds to the Federation Council and then on to president Putin for signing.

New import tariffs introduced

At the end of November, the Russian government approved a decree on changes in the import tariff regime aiming at simplification, increased transparency and efficiency. The reform package includes diminishing the number of main import tariff categories from seven to four (5 %, 10 %, 15 % and 20 %). The maximum import tariff will thus fall from the present 30 % to 20 % with some exceptions (e.g. imported cars will still have a 25 % tariff). Certain items will also remain duty-exempt. The basic principle is that the import tariff increases with the degree of value added. The average import tariff is planned to go down from over 13 % to 11–12 %.

Many of the hundreds of subcategories will be unified in order to prevent circumvention of higher tariffs. About a third of goods (over 3,500 items) in the foreign trade register will carry new import tariffs.

The new regulations enter into force on 1 January 2001 and will be valid for nine months. This is due to uncertainty about the effects of the reform on the quantity and structure of imports, extent of illegal imports and budget revenues. According to the most optimistic views (the Economy and Trade Ministry and the State Tariff Committee), budget revenues could increase 10–15 % due to increased legal imports. In contrast, the Finance Ministry estimates that budget revenues from foreign trade activities will fall.

There are also varied opinions on the overall rationale and effectiveness of the suggested changes. It is commonly acknowledged that the present customs system does not optimally serve any of its purposes – regulatory, protective or fiscal. Bribery is far too common in customs activities to guarantee a lower tariff rate or lower price for an item. Because of this, some specialists consider that reforms of administrative and technical procedures in the customs system deserve the highest priority. Reform here would help both in identifying and discouraging violations. This matter needs to be considered prior to approval of the new customs code, which in turn is a vital aspect of Russia's acceptance into the WTO.

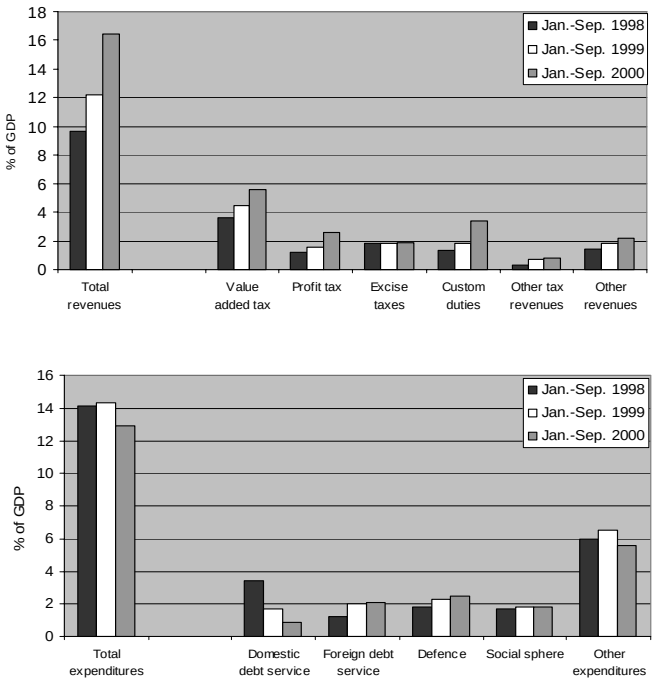
Budget revenues remain high

The 2000 budget execution continues to proceed above target. In the period January-September, federal government budget revenues rose to 16.4 % of GDP (see figure). Despite huge revenues, expenditures as a share of GDP have declined to 12.9 %. Thus, the budget surplus was 3.6 % of GDP with a primary surplus (which excludes debt-servicing costs) of 6.6 % of GDP.

The good revenue performance is a result of increased revenues from taxes and customs duties. Over a third of all budget revenues in January-September came from value-added taxes. The share of customs duties was over 20 %, almost double compared to the first three quarters of 1999. Profit taxes brought in 16 % and excise taxes 12 % of all budget revenues.

Debt servicing remains the largest single expenditure item of the federal budget, representing about a quarter of all expenditures. While debt servicing costs as a share of GDP have declined from 4.6 % in January-September 1998 to 3 % this year, the share of external debt-servicing costs has risen to two-thirds of total debt-servicing costs. Defence accounts for some 19 % of expenditures and the social sector about 14 %.

Federal budget revenues and expenditures, % of GDP



Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999	2000 Jan.-Sep.	2000 budget law	2001 budget draft
Federal government								
- revenues	13.7	12.5	9.8	9.0	13.4	16.4	15	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	12.9	16	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	3.6	-1	0.0

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

Sources: Goskomstat, IMF, MinFin.

CBR has few monetary policy tools

With market interest rates falling, Russia's central bank moved on 4 November to lower the refinancing rate from 28 % to 25 %. The role of the refinancing rate as a monetary policy instrument, however, is quite limited. In terms of implementing monetary policy, the CBR's decision to increase the interest rate it pays on commercial bank deposits by some 1–1.5 percentage points in the last week of November probably has greater impact. This move was seen as a reaction to greater rouble liquidity and expectations of accelerating inflation. The interest rates on deposits are staggered by maturity, so that e.g. the rate on overnight deposits is now 1.5 %, one-week deposits 5 % and one-month deposits 8 %. Commercial banks have approximately RUB 70 billion (USD 2.5 billion) on this deposit facility with the CBR, which represents about 7 % of total bank assets. The CBR has noted that the interest rate it pays on such deposits is its only effective monetary tool. In parallel, the question remains of how to communicate monetary policy to the public.

Equity markets slump

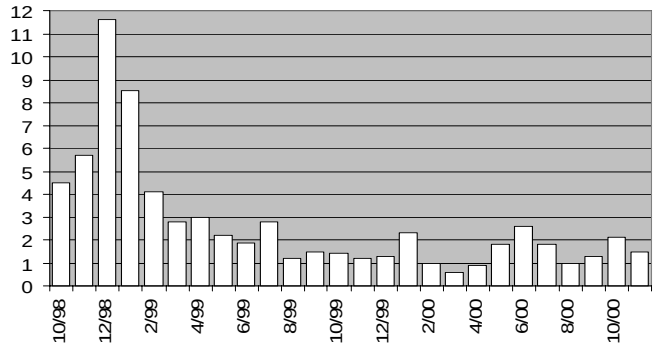
After a large drop in September, Russian share prices suffered a major fall in the last week of November. The RTS index fell about 15 % during the week, after the trend decline of previous weeks (see graph). The index closed at 143 on 30 November, when trading was stopped for an hour. Russian shares lost an average of one-quarter of their value in November. In recent months, Russian equity markets have been said following western markets, especially the NASDAQ exchange, but this time it seems that also concerns regarding oil companies had a particular impact. Naturally, domestic corporate governance issues, such as uncertainty around the restructuring plans in non-ferrous metals producer Norilsk Nickel and energy monopoly UES keep investors cautious. Moreover, Gazprom's board meeting on 5 December should discuss and clarify disputes that the company managers have been transferring assets and profits from Gazprom to other companies.

Russia sounds out Paris Club on upcoming debt

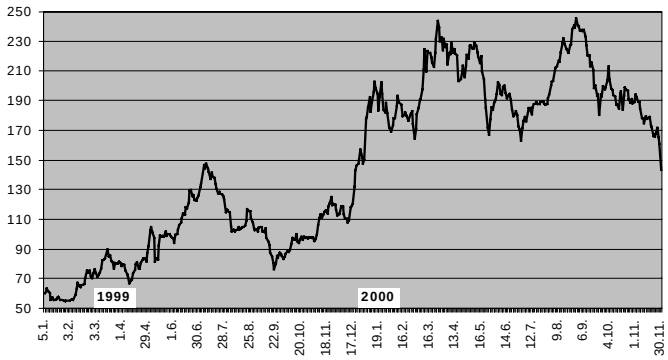
Russia freshly concluded the last bilateral agreement on rescheduling its Soviet-era debt due in 1999-2000 to the Paris Club of official creditors, and reiterates it pursues consultations on debt falling due in 2001 and 2002. Servicing that debt would cost Russia about USD 3.8 billion in 2001, equal to 9 % of next year's federal budget expenditure. However, no funds have been earmarked for this purpose in the 2001 draft budget. The first repayment to the Paris Club in 2001 is scheduled for February.

Further rescheduling of Russia's Soviet-era debt to the Paris Club has become more elusive after the negotiations between Russia and the IMF late last month on a new economic program and precautionary stand-by credit did not yet reach a conclusion. CBR statistics put the Paris Club debt figure at over USD 38 billion as of end-June this year.

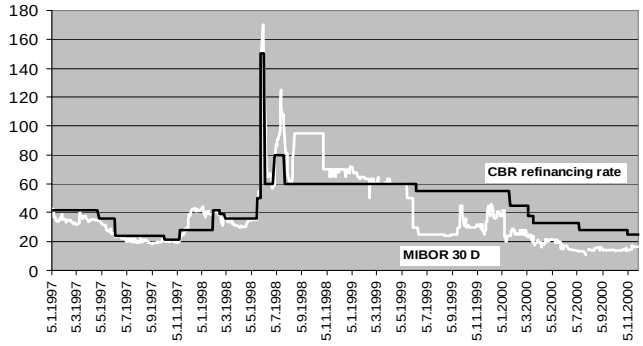
Monthly inflation in 1999-2000



Russian share prices in 1999-2000, RTS-index



Russian interest rates in 1997-2000, % p.a.



Monetary indicators

	1995	1996	1997	1998	1999	2000	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	19.7	11
M2, 12-month growth, %	113	30	29.5	36.3	57.2	60.2	10
Average wage, new RUB, end of period	736	1017	1210	1463	2272	2391	10
Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	4.5	10
- lending rate, %	320	147	46.2	41.5	40.1	19.9	10
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.1	24 Nov.
RUB/USD, end of period	4640	5560	5960	20.65	27.00	27.85	11

Sources: Goskomstat, CBR

The dilemmas of Russian monetary policy

By Tuomas Komulainen and Iikka Korhonen*

The Russian rouble has been stable against the dollar for the past year and even appreciated against the euro. Inflation has remained stable around 20 %, and many Russian policy-makers now proclaim the success of monetary policy.

Due to the depreciation of the rouble since August 1998 and high oil prices, Russia now faces an extremely large current account surplus (USD 23 billion in the first half of 2000, or 22 % of GDP). Gold and foreign currency reserves have risen from USD 12 billion at the end of 1998 to USD 27 billion in November 2000. Correspondingly, the monetary base has also risen, which in turn has boosted the larger monetary aggregates. The year-on-year changes in M2 (which includes cash in circulation and deposits) have been at least 50 % since June 1999. In contrast with the past, rapid money growth has not been reflected in consumer prices. However, increases in producer prices are clearly higher, around 50 %.

Why hasn't inflation shot up?

The main reason for discrepancy between the money growth and inflation is the rapid decrease in velocity of the money. This effect can be most easily understood by looking at the familiar equation of exchange, MV=PY, where M is money, V the velocity of money, P price level, and Y real economic activity. The right-hand side of this identity is usually taken to be nominal GDP. In Russia, the increase in M has not resulted in a proportionate rise in P because Y has increased and V has decreased.

Why has velocity of money slowed in Russia? In transition countries, the velocity of money generally starts to decrease gradually after stabilisation. The slowing reflects the fact that the economies are becoming more monetised. In advanced transition countries, the ratio of broad money to nominal GDP typically exceeds 40 %, and is even higher in e.g. the Czech Republic. This ratio reflects demand for money, which in turn reflects macroeconomic stability and the development of financial sector. In Russia between 1993 and 1999, this ratio fluctuated around 15 % (figure), but it is now rising.

Further slowing in the velocity of money?

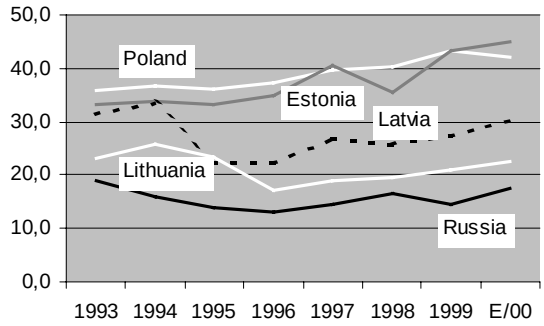
So far lower velocity has prevented Russian inflation from rising to over 20 %. But if the oil prices remain at the present high levels, it is probable that Russia will continue to post large current account surpluses. This will mean higher currency reserves and money growth. So what will happen to Russian inflation? Obviously, the answer depends on real GDP growth and – more importantly – on changes in the velocity of money. A very simple thought experiment allows us to gauge the possible effects on Russian inflation from high money growth and continued monetisation. Let's assume that the CBR's currency reserves continue to grow so that M2 growth is 30 % per year. This rate is consistent with a smaller current account surplus than at present. Moreover, let's assume that over the next five years the velocity of money decreases 10 % every year, while GDP continues to grow at an average of 4 % per year. This assumption on the change in the velocity of money is fairly optimistic given the past experiences of Russia and other transition countries.

With the aforementioned assumptions, inflation remains at its present level at around 20 % for the next five years. If the CBR sticks to its policy of stable rouble exchange rate against the dollar, such inflation would mean a real appreciation of the rouble of 150 % against the dollar (assuming 3 % US inflation). At the moment, many Russian producers still rely on the weak rouble to shield them from foreign competition, so if the rouble appreciates significantly in real terms, their competitiveness may be threatened. Thus, increasing productivity will be especially important in non-oil sectors. The situation is even worse for Russian producers if the velocity of money decreases less than assumed, or if money growth is higher.

Further monetisation possible?

What can Russian authorities do to keep the inflation at reasonable levels? If large current account surplus persists, the increased liquidity in the economy must be sterilised or the monetary aggregates will grow. Sterilisation of large capital flows is costly and it can not be a long-term strategy of a central bank. Moreover, the CBR currently lacks the proper tools (see page 3) to control money growth. Developing the proper market-based tools to conduct monetary policy is not just necessary for the CBR, it is also important for the development of the banking sector. Evidence from the other transition countries suggests that monetisation of the economy requires continuing macroeconomic stability. Russia currently has a good chance to maintain economic and political stability. To attain further monetisation of the economy, a properly functioning financial sector is therefore imperative – and reforms of the Russian banking sector have barely begun.

Ratio of M2 to GDP in some transition economies, %



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RUSSIAN ECONOMY
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Economic Developments

The oil price takes a plunge

The world market prices for crude oil have fallen quickly. Through the autumn until late November, the price for Brent crude held at 32 to 34 dollars a barrel, the highest levels seen in ten years. By Christmas, however, the price had fallen below 24 dollars. Early January has seen slight price recovery to the range of 24 to 25 dollars.

The effects of changes in crude oil prices on Russia are quite large since Russia currently earns more than a fifth of its current account income (exports of goods and services) from crude oil, while another 10 % comes from oil products.

If the crude price holds at current levels, or about 3 dollars below the average of 2000, and the prices of oil products decline similarly, then Russia's export income should decrease more than USD 4 billion this year. This would still leave a sizeable current account surplus for Russia (ignoring other possible changes, e.g. import growth) but would slice about 1.5 % from the value of Russia's GDP. These changes come as no surprise to policymakers in and outside Russia. The freshly enacted federal budget 2001 assumes an average crude price of 21 dollars a barrel, while the IMF's global forecast of last autumn foresees an average price of 23 dollars a barrel for 2001.

Brisk output growth supported by agriculture

According to Goskomstat figures, Russian GDP grew 7.9 % in the third quarter of last year compared to a year earlier (6.7 % during the second quarter). The GDP growth rate for the January-September was 7.7 %. The GDP breakdown indicates that the good third quarter was due to continuing fast growth in construction (11 %), industry (9 %) and trade (8 %), as well as higher growth in agriculture (5 %) and the services sector (around 8 %), especially telecommunications. The transport sector recorded 5 % growth.

In January-November, industrial production grew by 9.6 %. During the eleven months, agricultural production was up 4.1 % from a year earlier, and confirmed Goskomstat figures put the 2000 grain harvest at 65 million tonnes clean weight. This clearly exceeds the 55 million tonnes of 1999, although it is still considerably below the average of grain harvests of the 1990s – almost 82 million tonnes.

Current account surplus remains large

The CBR's balance of payments figures for the first three quarters of 2000 show a current account surplus of almost USD 34 billion, which equals 19 % of January-September GDP (22 % in January-June). High oil prices have boosted Russia's income from goods and services exports by over 40 % and exports of goods by nearly a half in January-September. Imports of goods and services increased 15 % and imports of goods picked up over 8 %.

The capital and financial account includes some major one-time items relating to the write-off of Russia's debt to the London Club of commercial creditors. Direct foreign investments to Russia have run lower (at USD 1.8 billion) than a year earlier. "Errors and omissions" are as large as in 1999, which suggests that capital flight continues as before. Despite large net capital outflows, the surging current account surplus has made the CBR's foreign exchange reserves grow by USD 13 billion in January-September.

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

	1998	1999	2000 1-9
Current account	**0.7**	**25.3**	**33.6**
Trade balance	16.9	36.2	44.5
Exports, f.o.b.	74.9	75.8	75.6
Imports, c.i.f.	-58.0	-39.6	31.1
Services	-4.0	-3.9	-5.6
Exports	12.4	9.0	7.1
Imports	-16.3	-12.9	-12.7
Investment income	-11.8	-7.6	-5.5
Received	4.3	3.9	3.6
Paid	-16.1	-11.4	-9.1
Other items, net	-0.5	0.6	0.2
Capital and financial account	**3.0**	**-16.0**	**-12.9**
Capital Account	-0.4	-0.3	11.0
Received	1.7	0.9	11.6
Paid	-2.1	-1.2	-0.6
Financial account	3.4	-15.7	-23.9
Direct investment to Russia	2.8	3.3	1.8
Portfolio investment to Russia	8.9	-1.3	-9.7
Other items, net	-8.3	-17.7	-16.0
Net errors and omissions	**-9.0**	**-7.5**	**-7.4**
Change in reserves	**5.3**	**-1.8**	**-13.3**
('-' growth, '+' decline)			

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.6	3.2	7.7	1-9
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	8.1	9.6	1-11
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-6.7	1.0	17.7	1-11
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	11
Exports, USD billion	53.6	59.7	68.1	81.3	88.4	86.7	73.9	74.3	84.4	1-10
Imports, USD billion	43.0	44.3	50.5	60.9	61.5	66.9	59.5	41.1	35.3	1-10
Current account, USD billion			8.4	7.4	11.8	2.0	0.7	25.3	33.6	1-9

Sources: Goskomstat, CBR

The 2001 budget passes

Discussion during the fourth and last reading of the 2001 budget mostly concerned technical details. The budget was approved without problems with over 300 deputies supporting it. As in previous readings, the Communists and Agrarian deputies voted against the budget bill. The new budget is balanced with revenues and expenditures totalling RUB 1,194 billion (15.4 % of GDP). It is based on assumptions of 4 % GDP growth, 12 % annual inflation and an average oil price of 21 dollars per barrel.

The apportionment of 2001 budget revenues and expenditures differs somewhat from previous years. The share of tax revenues is expected to increase to well above 90 % from over 80 % in 1999 and 83 % in January-October 2000. The strongest increase comes in VAT revenues, the share of which is planned to go up to over 40 % of all revenues from about 34 – 35 % in 1999 and Q1-Q3 2000. The share of excise taxes is also set to grow to about 16 % from over 11 % in Q1-Q3 2000. The share of profit taxes, which has been hovering around 10 –13 % in recent years is projected to increase only slightly (to over 14 %). Revenues from export taxes and import tariffs are estimated to grow mildly in rouble terms and decrease as a share of all revenues from 21 % in Q1-Q3 to 16 % in 2001.

The largest expenditures in the 2001 budget are defence (18 % of expenditures), transfers to regional budgets (16 %) and foreign debt servicing (15 %). The defence sector has traditionally been the largest single expenditure item. Compared to years 1998-99 and Q1-Q3 2000, the share of transfers to regional budgets has increased substantially (from 9 –12 % to 16 %) in the 2001 budget. In debt servicing, the emphasis has turned from domestic to foreign debt servicing.

Divvying up extra revenues from 2000

In December, the Duma passed a complementary 2000 budget act to allow for the use of revenues exceeding the 2000 budget targets. According to the bill, these revenues amounted to RUB 306 billion (USD 11 billion), of which RUB 146 billion will go to foreign debt payment. The remaining RUB 160 billion will be divided among the military (RUB 69 billion), the justice system (RUB 32 billion) and regional budgets (RUB 28 billion). Industry, the energy sector and construction projects will each get an extra RUB 18 billion, while another RUB 6 billion will go to education. Agriculture, health care and the social sector will each receive less than RUB 4 billion. In reality, some of the above-mentioned expenditure increases were already implemented in October and November. In January – November the budget expenditures amounted to 99 % of those originally budgeted.

Assuming that the revenue estimate holds, 2000 budget revenues amounted to RUB 1,103 billion (USD 39 billion, a 38 % increase from the original 2000 budget), while expenditures climbed to RUB 1,014 billion (USD 36 billion, +19 %). The resulting RUB 89 billion (USD 3 billion) surplus roughly corresponds to 1 % of estimated GDP. In fact, this brings the revenue figure near the amount budgeted for 2001 (RUB 1,194 billion).

Parts of new tax code enter into force

Parts of the new tax code came into force at the beginning of this year. The changes cover VAT, excise taxes, social tax, income tax and turnover tax. Those taxes most directly affecting ordinary citizens experienced the most radical changes. Income tax is now a flat 13 % for everybody and the social tax for employees is 7.6 % in lieu of earlier fund contributions. Tax exemptions have been increased and widened (e.g. expenses from medical services may now be deducted from taxable income). The unified social tax paid by employers may lure them to pay higher wages as the tax decreases regressively as wages increase. As regards other taxes of enterprises, the profit tax law is still being prepared in the government and Duma. In summer 2000, the government suggested the profit tax be raised to 35 % from the present 30 %, while allowing for greater deductions on expenses.

Import tariffs down, key export tariffs up

The import tariff regime has changed this year with the number of tariff categories diminished and average import tariff foreseen to decrease some percentage points (see Month in Review 11/2000). In contrast to this, tariffs on exports climbed last year, mainly due to high oil prices.

The government has applied tariffs and export restrictions on oil and gas to ensure sufficient domestic supplies and to garnish a share of the increased profits enjoyed by the oil and gas companies. In March 2000, the government decided to peg crude oil export tariffs to world prices from the beginning of June. Under the scheme, no export tariff will be charged if the world market price for crude oil falls below USD 12.50 a barrel. If the price exceeds USD 32.50 a barrel, the export tariff reaches the maximum EUR 48 per tonne (USD 45).

Since summer 2000 the export tariffs on oil and oil products have increased frequently. At the end of 2000, the tariffs on these products varied from 27 to 34 euros per tonne compared to the level of 10–20 euros per tonne in the beginning of 2000. In addition, in the middle of December 2000 the government decided, despite the significant fall in oil prices and the strengthening of the euro, to increase the export tariffs substantially. From mid-January they range from 31 to 48 euros per tonne.

Fiscal indicators (per cent of GDP)

	1995	1996	1997	1998	1999	2000	2000	2001
Federal government						Jan.-Oct.	budget law	budget draft
- revenues	13.7	12.5	9.8	9.0	13.4	16.2	15	15.4
- expenditures*	16.6	15.8	16.6	13.9	15.0	13.1	16	15.4
- balance	-5.4	-7.9	-6.7	-4.9	-1.7	3.1	-1	0.0

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

Sources: Goskomstat, IMF, MinFin.

Despite high money growth, 2000 inflation was 20%

Inflation (in terms of consumer prices) in Russia remained at about one-and-half per cent on a month-on-month basis both in November and December. On a 12-month basis, inflation stood close to 20 % during the autumn and was 20.2 % at the end of the year. Inflation for all of 2000 came in relatively well in line with the levels projected last spring in some domestic and many foreign forecasts, as well as with the target in last year's budget (18 %).

Inflation decelerated substantially from 1999 – especially considering that Russia's money supply (rouble M2) grew 60 % last year. While money supply has in many earlier years been a rather straightforward factor in affecting the pace of inflation, this relationship was different during the past year as the demand for rouble money increased quite significantly.

The structure of the money supply during 2000 did not reflect any quicker growth of bank savings over cash which could have curbed inflation. Instead, inflation was rather contained by such factors as good growth of the economy, rapid growth of the use of money for payment in those parts of the economy which earlier relied much more on barter and other money surrogates, and a relatively stable rouble exchange rate. Switches from foreign currency cash, a large unrecorded item in Russia's monetary economy, to rouble cash or deposits could also in principle lift rouble M2 without increasing total money supply and inflation but at least the low interest rates on deposits do not suggest this.

Rouble inches down, euro climbs

After staying above 28 roubles to the dollar since early July, the rouble fell below this level before the year's end. The dip was mostly connected with banks' and their clients' moves to switch part of their ample rouble liquidity into foreign exchange for the turn-of-the-year break. The rapid fall of the oil price in December may also have provided some impetus.

In early January the rouble remained below the 28 mark which is the level it retained through the entire first half of 2000. The CBR and Russian government circles in charge of the economy have given reminders that the state budget for 2001 assumes an average exchange rate of 30 RUB/USD, and further that the CBR will, as necessary, continue to intervene with its foreign exchange reserves, which currently equal three quarters of the economy's rouble money supply.

The latter part of December also saw the euro surge globally, up 13 % in relation to the rouble since early December. This gave a step-reversal to the rise of the rouble's real exchange rate against the euro and brought the real rate back down to about 30 % below the pre-1998 crisis level. This extends the pricing benefits Russian industries have enjoyed competing against imports from the euro area since the rouble's fall in autumn 1998.

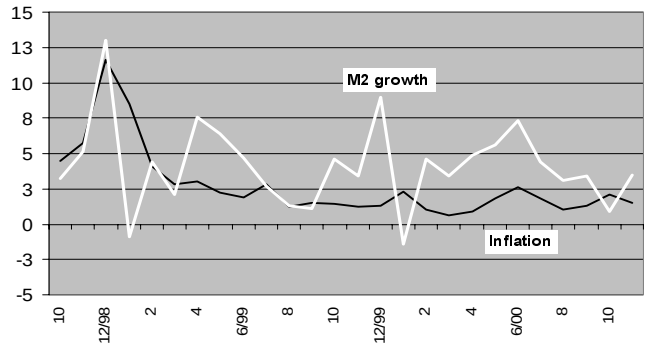
Russia's Paris Club debt draws attention

Recent months have seen continued public exchanges of views about Russia's Soviet-era debt to the Paris Club of sovereign creditors. There is no indication from any creditor for a debt write-off and talk about any new overall rescheduling seems to require an agreement between Russia and the IMF on an economic program. The next round of Russia-IMF talks is planned for late January or February.

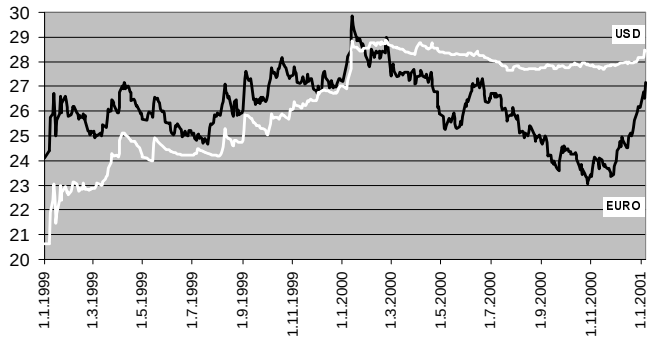
Attention thus focuses on Russia's repayments in the near future. After its autumn soundings with the Club, Russia has pursued the idea of debt-for-equity swaps (with the notable exclusion of stock in the most valuable companies having state ownership). High-level arguments have also been raised in Russia as to the benefits of paying debt, e.g. avoiding high interest rates, gaining access to international financial markets and eliminating excess liquidity from the economy. The Paris Club and some Club members have recalled the agreements and stressed that Russia should stay current on its debt servicing from 1 January 2001. Russia very recently noted that such payment may be barred as the state budget for 2001 does not include funds for repaying Soviet-era debt to the Paris Club.

In the midst of these exchanges, the first non-rescheduled repayments of about USD 1.5 billion are approaching their due dates which are in this and next month.

Monthly inflation and money supply in 1999-2000



RUB/USD and RUB/EUR exchange rate 1999-2000



Monetary indicators

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Interest rates, period average							
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	11
- lending rate, %	320	147	46.2	41.5	40.1	18.2	11
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	12
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	12

Sources: Goskomstat, CBR

Swings over Russian economic transition

By Vesa Korhonen*

The exchange rate and oil prices play

Transition changes structures, and during the past decade some sectors in the Russian economy have declined while others have certainly risen. However, an overall transition turn to growth where the rises clearly exceed the declines is hard to discern in Russia. In the earlier part of the 1990s, the large economic transition fall naturally overshadowed the fair amount of dependence of the smallish Russian economy on world energy prices, which have continuously had the potential to swing the economy.

In 1997, after some years of upbeat expectations and projections, the Russian economy was finally inching up. The fall of the oil world market price in early 1998 had a tangible downside effect on the Russian GDP, but in summer the economy made a true dive after years of continuous fiscal deficits which were unsustainable and inconsistent with the exchange rate policy (geared to a stable rouble as an anchor) as well as with the slack progress of economic and political transition in Russia.

Leading to the upswing of 1999-2000, the 1998 policy collapse knocked down the rouble exchange rate by 60 %, which has ever since helped Russian import-substituting industries grow remarkably.

The rouble's crash also shrunk the economy drastically in dollar terms, and as world oil prices have climbed, the share of export earnings of the value of the GDP has increased from 20-25 % in 1994-97 to one half last year (see chart). The share of the fuel core, i.e. oil and gas exports, has risen from 9-10 % in 1994-98 to almost one quarter of the GDP value (although the entire fuel industry employs only about 1 % of the work force).

Given the 1999-2000 exchange rate, the Russian GDP value changes about 0.5 % for every dollar-per-barrel change in the oil world market price. Thus, in 2000 the steep climb of oil as well as gas prices to ten-year highs has indeed boosted the Russian GDP income; in the first half of last year the increase in Russia's oil and gas export income alone accounted for 50 % of the rise in the GDP value (the effect has come some 90 % from the price increases while the export volumes have grown under 10 %).

Now the good wave is fading as the oil price will not rise any more but has instead fallen quickly towards its long-term average (18 USD/bbl) and inflation continues to eat away the exchange rate benefit.

Economic policies challenged

The basic notion that economic swings shake balances which are for economic policies to guard has concerned Russia as well during the 1999-2000 upswing. The state budget has gained considerable revenue from taxes thanks to improvements in the economy, from price-linked export tariffs on oil and via better tax collection. But the small size of Russia's monetary economy also links external swings strongly with inflation since a dollar-per-barrel change in the oil price causes a 4 % change in the economy's rouble money supply (M2), or about a 1.5 % change in the broader money supply (M2XX, i.e. rouble money + foreign currency deposits + estimated foreign cash in Russia). Exports have lifted the foreign currency reserves to 75 % of M2 at the end of 2000, and monetary policy has therefore faced an increased challenge to contain liquidity in the economy while it is short of actual tools for the task e.g. due to banking sector problems and lack of marketability of government debt held by the CBR. Exchange rate policy, in contrast to efforts of earlier years to mostly prop up the rouble, has in 2000 comprised interventions to prevent the rouble from rising too much.

In turn, the current shift of lower oil prices and growing imports may help monetary policy in checking liquidity and can also assist exchange rate policy to keep the rouble stable (unless, of course, the swing goes too low). But fiscal policy faces tightening revenue prospects, which has been foreseen in the cautious oil price assumption in the 2001 federal budget. In contrast, the recent decision to spend over half of the extra budget revenue of 2000 domestically reduces the room of fiscal manoeuvre and adds liquidity to the economy to the tune of 15 % of M2, which looks odd with the lower inflation target for 2001.

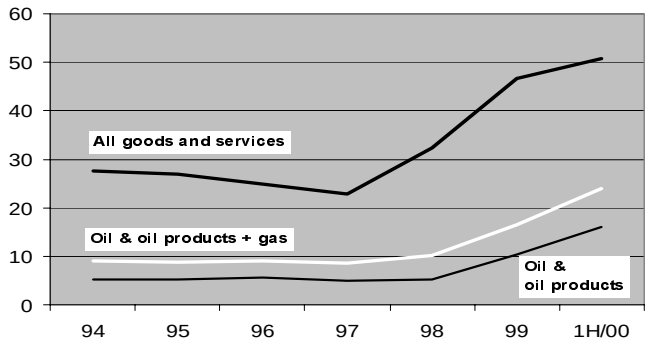
Transition a root issue

Exposure of the Russian economy and economic policies to external swings is one reflection of shortfalls in Russian economic transition which is meant to bring the economy forward on a wider front. Russian transition has progressed remarkably since the early 1990s but it suffered a reactive backlash after the 1998 crisis.

The EBRD's composite transition indicators tell that of the eight main reform areas monitored, scores for five areas in Russia (price liberalisation, governance & enterprise restructuring, trade & foreign exchange system, banking reform, and securities markets & non-bank financial institutions) fell in 1998-99. In 2000, the three last-mentioned were still below the score of 1997. Among the 26 transition countries monitored by the EBRD, only three to four countries have lower scores for trade and banking system reform, and the overall scores for the eight areas put eight former Soviet countries ahead of Russia.

The time still lies ahead when transition in Russia drives the economy more than energy price and exchange rate swings, and now a supportive economic upswing is not in the cards.

Share of exports in Russia's GDP, %



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