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Russian Economy - The Month in Review

Yearbook 2002

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 2002

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Economic Developments

Consumption and investments grow …

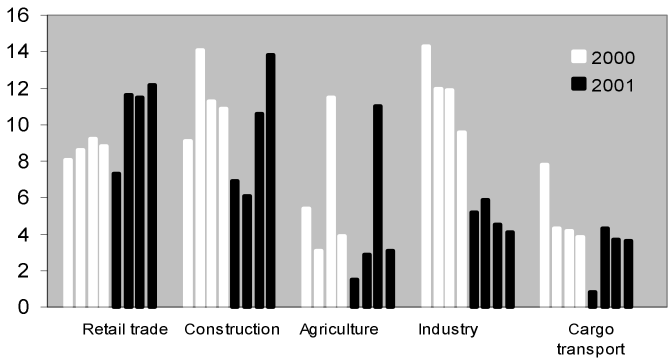
Preliminary data issued by Goskomstat on Russian GDP indicate that the economy grew 5 % in 2001, after expanding 9 % (an upward revision) in 2000 (all quarterly data is due for revision in March). Russia's performance was thus somewhat better than foreseen a year ago by most projections that grouped around 4 %. The last months of 2001 slightly dampened last autumn's more positive expectations that the year would finish out overall in the range of 5-6 %.

A preliminary breakdown of the GDP suggests that private consumption continued to grow last year at the year 2000 rate of about 9 %. This provided a remarkable boost to retail trade, which expanded 11 % and accelerated in spring and on to the end of the year (see chart). In staggering contrast, statistics suggest consumer services grew only 1 %.

In the GDP accounts, fixed capital formation increased almost 12 % in 2001, close to the pace of the previous year (13 %, a downward revision). More usual Goskomstat data put investment growth in 2001 at under 9 %. In any case, these developments pushed construction in Russia to 10 % growth in 2001. The pace of growth in investment and construction quickened over the year on a year-on-year basis, peaking in the fourth quarter.

Alongside the two boom sectors, agriculture also did well recording a nearly 7 % increase last year. Industrial production growth, however, eased considerably from its year 2000 rise, decelerating further in the second half of 2001. Cargo transport continued to increase at a relatively established rate of around 3 %.

Growth in key sectors of the economy 2000-01,
% change from the same quarter of the previous year



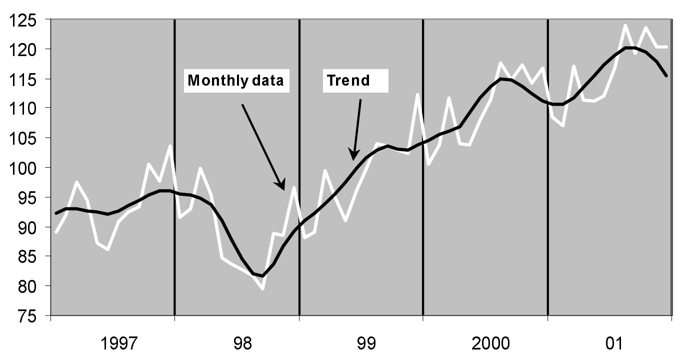
Source: Goskomstat

… while industrial output stagnates

For 2001 overall, industrial production grew 5 %. Among the seven large industry branches, which accounted for over 85 % of total industrial production last year, the food industry retained brisk growth of over 8 %. Machinery and equipment production increased around 7 %, followed by the chemical & petrochemical industry at 6.5 %. The only large industrial branch that added momentum to production growth was the fuel industry – up over 6 % over 2000. This was because Russia's crude oil production expanded almost 8 % and despite the fact that natural gas output declined again slightly (down 1 %). The electricity sector was up 2 %. Non-ferrous metallurgy recorded 5 % growth, while ferrous metallurgy showed zero growth.

Four of the seven major branches of industry experienced slower growth in the second half of 2001. The most notable exception was the food industry, which continued its surge on the domestic market. Industrial production growth was exceptionally slow in December. Seasonally adjusted computations, including those of Goskomstat and the economy ministry, indicate that industrial production stagnated or even declined slightly in 4Q 2001. The economy ministry's branch-specific calculations further suggest that the slowing concerned nearly all branches. The situation is similar to late 2000 and 1999, and in each year appears partly due to slow or non-existent investment growth (seasonally adjusted). Last year, the rapid increase in imports quite apparently started to bite, even if import growth eased in the last quarter. More rapid rises in wages and domestic energy and cargo prices relative to other industrial producer prices during the year increased cost pressures.

Industrial production 1997-2001, Dec 1995 = 100



Source: Goskomstat, BOFIT

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	9.0	5.0	
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	10.8	11.9	4.9	
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	
Exports, € billion*	41.2	51.0	57.0	63.3	71.3	78.8	66.9	70.7	114.8	114.5	
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	36.9	48.8	59.3	
Current account, € billion*			7.1	5.6	9.3	1.9	0.6	23.1	50.3	31.8	1-9/01

*Sources: Goskomstat, CBR. *) Before 1999 values in ECU.*

Export and import tariffs lowered

Since the beginning of this year, the government has issued several decrees on lowering key customs tariffs. Among the most important are *export tariffs* on crude oil and certain unrefined oil products, which, in accordance with a new law, have been cut from €23.40 ($20.60) to $8 per tonne (just over $1 per barrel), effective from the start of February. The new law stipulates a new scale for determining the export tariffs in accordance with the world price of Urals-grade crude. Thus, if the oil price falls below $15 a barrel, no tariff is levied. Between $15 and $25, the tariff rises incrementally to $3.50 a barrel. A similar progression continues above $25 a barrel. Presumably, the tariffs will be reviewed every other month as previously.

The government also cut export tariffs on motor gasoline and gasoil from €39 to €25 per tonne, effective early February. The latest cut applies to heavy fuel oil, halving the export tariff from €20 to €10 per tonne, effective early March. The government also decided not to apply export tariffs on certain wood materials and paper products, as well as gold and precious stones, effective February.

The decision to cut export tariffs on oil products will help compensate Russian producers for some of their losses from the recent drop in oil prices and the impact of export cuts pledged to OPEC late last year. Producers also hope the move will help exports and reduce the present glut on Russia's domestic oil market. Domestic oil prices have been driven down substantially (as low as $5-6 per barrel for producers). Russian authorities have already hinted that Russia may not join further production cuts.

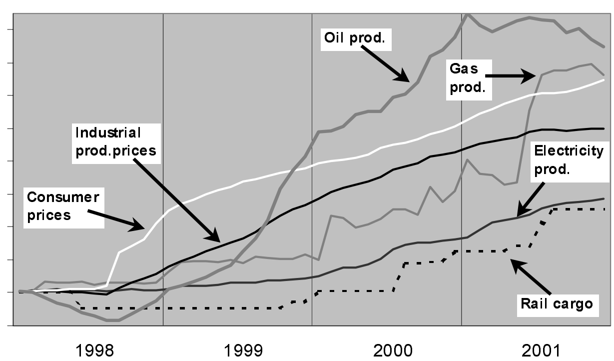
Some *import tariffs* have also been lowered. From the start of 2002, import tariffs of some 140 commodities were changed, about 90 % of which were reduced with an average decrease of 5 %. The decision was a prolongation of a broad reform of import tariffs launched at the start of 2001 that harmonised tariffs for some 3,500 commodities. In October 2001, import tariffs were lowered on about 400 commodities. Import tariffs should continue to fall and another round of import tariff revisions is expected this summer. The cuts should reduce customs circumvention. Statistics put imports unrecorded by customs at about 25 % of all imports.

Natural monopoly tariffs increase

The government decided on long-waited increases in natural monopoly tariffs. At the end of last year, the government imposed an average ceiling of 35 % on the hikes. January's increases were far less, and distinctly less than the utilities had asked for. For example, the wholesale price for electricity from Unified Energy Systems (UES) will rise 20 % in March. Consumer prices for electricity will go up an average of 18 %, although the increases may vary from region to region. Natural gas prices will also go up 20 % in March. Rail freight tariffs will go up 16 % in February. Prime minister Mikhail Kasyanov said further increases could be considered in the second half, but only in special cases. The exception is the price of natural gas, which could change as soon as Gazprom finalises its budget plan. The government and president Putin noted the tendency should be for natural monopolies to seek ways to cut their costs instead of passing them on to consumers.

Russia's caution over hikes in regulated prices is deeply rooted in their social and political sensitivity. They could also become a non-market tool for winding down inflation. Last year, the three major regulated prices (electricity, gas, railway cargo) were allowed to rise in real terms until late summer, when they were more or less frozen for the rest of the year. They mostly lag general inflation, however, since other prices shot up dramatically following the 1998 financial crisis (chart).

Consumer prices and selected producer prices, December 1997 = 100



Source: Goskomstat

Exchange rate policy foresees stable real rate

The rouble weakened relatively quickly in January (around 1.5 %), due to market pressures and despite CBR currency market interventions (see chart on page 3). The decline also quickened at the beginning of previous years. However, given the weaker external circumstances, notably the lower world oil price, the authorities now foresee less stringent exchange rate policy. Last autumn, the CBR monetary policy draft anticipated a substantial rise of the real exchange rate in 2002. The final plan, adopted by the CBR at the end of November, toned down this outlook. The federal budget and the government's fresh scenarios circle around real stability against the dollar, depending on the oil price. The scenarios confirm the earlier view that a stable real rate should result from a 10 % nominal weakening over the year and 12-14 % inflation.

Fiscal indicators (per cent of GDP, unless otherwise indicated ; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2001	2002
Federal government							Jan-Nov	budget	budget
- revenues	12.9	12.5	12.3	11.0	12.6	16.0	17.1	15.4	19.4[3]
- expenditures[1]	18.6	20.9	19.4	16.9	13.9	13.5	13.8	15.4	17.8[3]
- balance	-5.7	-8.4	-7.1	-5.9	-1.3	2.5	3.3	0.0	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	57.6	47.8[1]		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	139.0[2]		

[1]of the Oct 00-Sep 01 GDP of RUB 8501 bln, [2]1 October 2001, [3] including social tax channelled via the federal budget (2.6 % of GDP)
Sources: budget figures: IMF (1995-1998); EEG (Economic Expert Group)(1999-2001), debt: IMF (1995-1999), Minfin (2000-2001)

January saw price jumps

Consumer prices rose over 3 % in January from the previous month. In 2001, the start-of-the-year acceleration was below 3 %. Components of last month's rise included food prices, which rose 2.8 % (3.1 % in January 2001) mainly due to the large spike in prices of fruit and vegetables. Prices of services, which leapt 7.5 % (under 5 % a year earlier) overall, were driven by large hikes in rail passenger traffic and telecom services (both 18 %) and housing-related services (nearly 9 %). Some of these hikes may reflect local or regional responses to suppressed price pressures that mounted during last autumn's efforts to contain the rise of regulated prices. A unique event, contributing 0.2 % of the total according to Goskomstat, was a pilot factor-rise of housing service prices in Moscow.

Russian equities rise

Russian share prices have been on a strong upward path lately. Between early October and end-January, the RTS index rose 65 %, gaining 10-15 % each month. The index peaked last month at 300, then settled back to a range of 280–290 – levels not seen since late spring 1998 (chart). Composite indices of Russian shares were up similarly, e.g. the AKM index rose almost 60 % over the same period. Daily trading volumes of RTS shares averaged $25 million in January compared to $18 million in 2001. The daily trading volume of shares at MICEX was also brisk at about $150 million. Reportedly, this was partly due to more inflow of Western funds to the Russian stock market.

A range of factors influenced the rise. Looking at the fundamentals, Russian share prices have relatively lower price-to-earnings ratios than their Western counterparts. Gradual improvements of Russian corporate governance also have supported share prices. Between October and January, the rise of many Western stock exchanges, e.g. in the US, also helped pull up Russian shares.

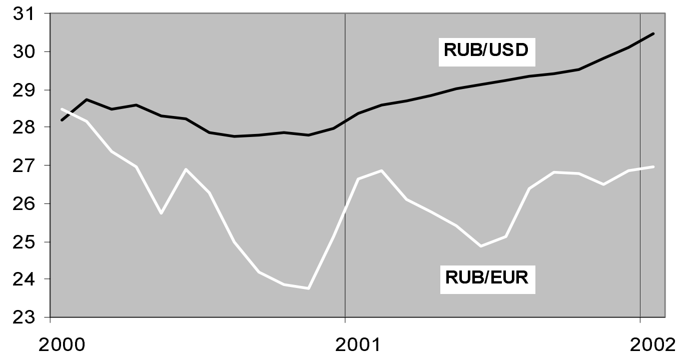
The upbeat investor sentiment since October spread to several sectors. Russian oil and gas shares (up 50 % on the average in the AKM sector index) received boost in January from the decision by OPEC, Russia and other non-OPEC producers to cut production. Shares of electricity giant UES and energy companies roughly doubled their value from early October by mid-January, when they slid on news of smaller-than-awaited electricity price hikes. Telecommunications (up 70 %) gained from ongoing mergers. Sberbank's share value tripled, partly due to plans of freeing foreign purchases of small stakes in Russian banks from prior permission. Shares of machinery and equipment producers also rose about 60 %.

While Russia's stock market is small by international standards and covers only a fraction of Russian enterprises, it has nevertheless recovered to a capitalisation of some $90 billion – the equivalent of nearly 30 % of GDP.

Soviet-era trade debt restructuring proceeds

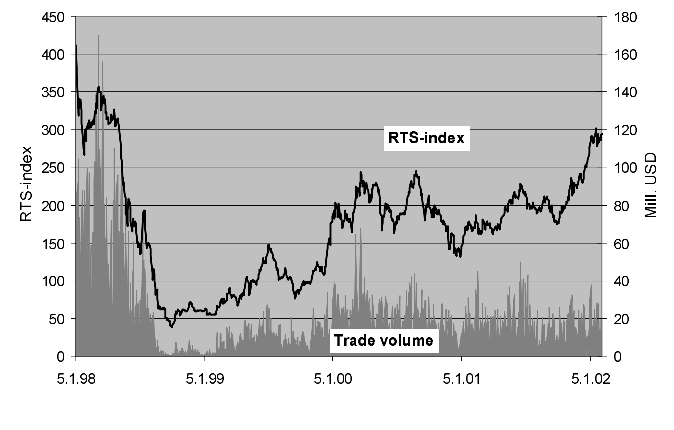
Principal agreement on writing off part and restructuring the rest of Russia's uninsured Soviet-era trade debt was reached in April 2001. It was followed by a government decree approved in late December, according to which the debt would be transformed into Russian government eurobonds to be offered to creditors. The plan is to issue up to USD 2 billion in government bonds in March-April and perhaps another USD 2.5 billion in July. The bonds would mature in 2010 (overdue interest payments) and 2030 (principal and accrued interest). The overdue interest payments will be converted to eurobonds with about 10 % discount off their nominal value. The discount on principal and accrued interest is more than a third of the nominal value. Latest estimates put the Soviet-era trade debt above USD 6 billion.

RUB/USD and RUB/EUR exchange rate in 2000-02, monthly average



Source: Central Bank of Russia

Russian share prices in the RTS index and RTS daily trading volume in 1998-2002



Source: RTS

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	19.0	1/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1		
Average wage, RUB, end of period	736	1017	1215	1482	2283	3025	4294		
Interest rates, period average									
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	4.8		11/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	17.0		11/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	36.4	1/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	30.69	1/02

Sources: Goskomstat, CBR

Looking at the Russian economy in 2001-02

By Vesa Korhonen*

Growth slowed

After growing a fifth in the past three years, the Russian GDP is higher than in any time since 1993 (see chart). The average living standard is likely better than at that time as after years of transition the current GDP contains proportionately more viable goods than the pre-1994 GDP. Russian GDP per capita is still €6-7 a day (€62 in the EU countries in 2000), although the rouble's domestic purchasing power lifts the figure to the area of €16 to €25 a day. In 2001, GDP growth slowed to 5 %, and the government's latest projection for 2002 is 3.5 %.

As for demand, private consumption (half of GDP) rose nearly 10 % in both 2000 and 2001 while public consumption (14 % of GDP) grew slightly since 1997. Capital formation (18 % of GDP), after diving until 1998, continued its rebound in 2000-01 at 12-13 % a year. Total exports (37 % of GDP) nearly stalled in 2001. On the supply side, construction, trade - especially imports - and agriculture grew briskly. Industrial growth slowed. Bank lending increased more than in 2000.

GDP growth stalled late last year as investment growth slowed, costs (wages, energy, transport) rose fast in 2000-01 and the rouble real exchange rate possibly entered a braking level. Decline in open unemployment turned to slight rise in 2H01. The external surplus, which was still a hefty 10 % of GDP for all of 2001, dropped further in the autumn (6-7 % in 4Q01) after the oil price plunged.

Economic policy faced new challenges

Fiscal policy continued to be the cornerstone of economic policy in 2001. Federal budget revenues increased further to 17 % of GDP while total public sector revenues hardly expanded. As federal expenditures remained at the 2000 level (non-interest expenditures were 11 % of GDP), the federal surplus grew to around 3 % of GDP. With the oil price down, contingency planning was invoked. Part of budget expenditure is to be put on hold in 2002 if needed, helping to balance the budget at the oil price of $16 a barrel (Urals, or about $18 for Brent). Full foreign debt servicing is budgeted this year and part of accrued surpluses was set aside for the 2003 debt service peak and reportedly used for 2003 debt buy-backs.

Monetary policy again faced rather rapid growth of domestic money supply, fed by the external surplus. To contain liquidity, interest rates on banks' deposits with the CBR were raised several times (albeit their negative level in real terms leaves the effect opaque). Issuance of CBR bills and CBR sales of T-bills were tested last year. The main efforts, however, came from other policy areas as much of the budget surplus was deposited with the CBR, and the CBR also made currency interventions to check drops in the exchange rate.

The rouble, after being broadly stable in nominal terms in 2000, slid 7 % against the dollar last year. Since late summer, as market pressures grew and production growth slowed, the policy moved to holding a stable real exchange rate. This is the stance for 2002. The real rate is at 75 % of the pre-1998 crisis level against Russia's main trading partners' currencies.

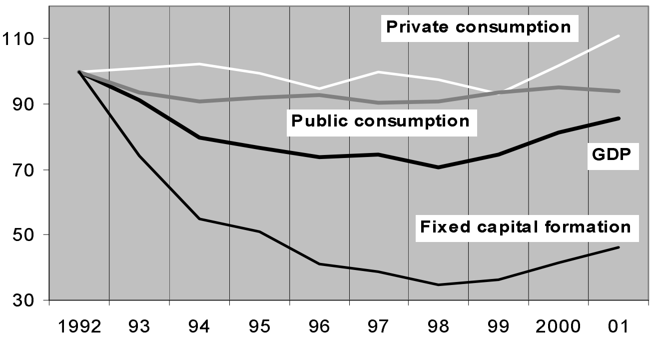
Rapid money supply growth (40 % in 2001), rising wages (45 %), increases of regulated prices, a weaker rouble and possibly sticky expectations kept consumer price inflation at 19 %. Producer price inflation in most main sectors fell below consumer price growth. This year a smaller external surplus should help towards the 12-14 % inflation goal. Caution with raising regulated prices is pronounced. The overall inflation set-up is also complicated by a low level of bank deposits (about €55 billion) compared to cash in the economy (rouble cash at about €20 billion and foreign cash at 2-3 times that).

Legislative reforms encouraging

Last year saw major legislative steps that included relaxing taxation of companies and banks, curtailing bureaucracy and the discretion both at the start and during a firm's life, and improving protection of shareholders and creditors. Laws against money laundering and on investment funds also saw daylight. Moreover, Russia received its first labour code, its first law on private land ownership (albeit excluding agricultural land), and laws to reform the court system and the pension system. All the laws are in force by now and the legislative process is set to continue this year in various areas. At the same time, it seems that reforming Russia's gas, electricity and rail monopolies as well as the banking sector may still take time, and ownership of agricultural land and forests may not easily move towards single nation-wide rules.

There is reform drive in the federal centre. The test is in implementing the improved rules widely enough at the regional and local levels. That should help Russia notably towards less capital outflows (they fell in 2001) and more domestic and foreign manufacturing investments and SMEs (still scarce), thus propping sustainability of growth.

Russian GDP and domestic demand, 1992 = 100



Source: Goskomstat

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Economic Developments

Output growth stalls

Growth of production in Russia slowed again in January, with industrial output increasing just 2.2 % y-o-y (2.6 % in December and around 5 % in October-November). The production indicator for five key sectors rose 3 % y-o-y (5 % in December and around 6 % in October-November). Seasonally adjusted figures from Goskomstat and the economy ministry propose industrial production actually declined in January for the fourth month in a row. As for demand, regular surveys of Russian enterprises suggest almost no export growth took place in the past trimester, while Goskomstat reports investment growth nearly halted on-year in January. The private consumption surge may have also eased slightly, albeit the on-year increase was still brisk in terms of retail trade growth (10 % in January against 12 % in 4Q01). The latest surveys suggest some general demand recovery in February. The government's latest projection for this year's GDP growth (assuming a price of $18.50 per barrel for Urals crude, implying about $20 for Brent crude) is 3.5 %. The latest Russian and Western consensus projections also arrive at that figure.

Investment focus on energy increases

Investments in Russia expanded fairly rapidly in 2001 (almost 9 % in volume terms), while the level of Russia's total fixed investments using the nominal exchange rate was still a relatively modest €60 billion (€45 billion in 2000). The rise in the share of industry in the total was due almost entirely to investments in oil extraction and refining (table).

Structure of fixed investments in 2000-01, %

	2000	2001
Industry	41.4	42.6
- fuel industry	20.8	22.1
- - crude oil industry	13.5	14.4
- - oil refining	1.5	2.1
- - gas industry	4.9	4.7
- electricity production	4.2	4.1
- metallurgy	5.3	5.5
- food industry	3.3	3.2
- machine building	3.0	3.0
Agriculture	2.8	2.7
Construction	2.5	3.0
Transport	23.8	23.1
Communications	2.5	3.0
Housing sector	15.1	13.3

Source: Goskomstat/Ministry of Economy

The other large investment sector, which lost share slightly, was transport (again, considerable energy-related pipeline investments). The housing sector's share fell more substantially. There were few signs of diversification of investments as a whole, although telecom and construction seemed to revive. In 4Q01, the share of the oil industry fell more than in earlier years. Thus, the uncertain outlook for the world oil market possibly started to restrain total investment growth in Russia.

Exports decrease, Western imports surge

Russia's export income fell 15 % y-o-y in 4Q01, keeping exports for all of 2001 roughly at the previous year's level (€115 billion, or over $100 billion). Imports expanded about 20 % in 2001 (to €60 billion, or $53 billion), even though in 4Q01 import growth eased to around 15 % y-o-y. There was a marked shift towards imports from non-CIS countries, which boomed around 30 % in 2001 to €45 billion and grew roughly at that rate also in 4Q01.

Export income was constrained mainly by weaker prices. Thus, late last year export prices were down for oil and oil products by 35-40 % y-o-y, about 5 % for gas, and between 10 and 30 % for key export metals. The export volume in 2001 increased a couple per cent according to the economy ministry. Notably, deliveries of oil and oil products picked up around 10 % (8 % in 2000) whereas gas exports volume fell 7-8 % (down 6 % in 2000) and most metals 5 to 10 %. In non-CIS exports, the share of oil, oil products and gas was still about a half in 2001. The share of metals and products fell to 15 %, while machinery and equipment rose to 9 % (growth by a quarter in value terms). The share of chemicals remained at 7 %.

Most estimates put Russia's import volume growth very high in 2001 (noting a decline in prices). Non-CIS imports (as recorded by customs) state that machinery and equipment imports grew almost 40 % in value (the number of imported cars roughly doubled), and imports of food and agricultural raw materials rose 35 %. The shares of machinery, food and chemicals in non-CIS imports were 37, 24 and 20 %, respectively. Nonetheless, 23-24 % of total and non-CIS imports went unrecorded by customs in 2001. This year, the government's latest expectation of import growth is only around 4 %.

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.2	-3.5	0.8	-4.9	5.4	9.0	5.0		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.0	1.9	-5.2	10.8	11.9	4.9	2.2	1/02
Fixed investments, %	-40.0	-12.0	-27.0	-13.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	0.5	1/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	8.9	1/02
Exports, € billion*	41.2	51.0	57.0	63.3	71.3	78.8	66.9	70.7	114.8	114.5		
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	36.9	48.8	59.3		
Current account, € billion*			7.1	5.6	9.3	1.9	0.6	23.1	50.3	31.8		1-9/01

Realised 2001 budget shows substantial surplus

The 2001 budget year was a success for Russia. It ended with a surplus of 3.1 % of GDP and a primary surplus (without interest payments on debt) of 5.7 % of GDP. VAT revenues represented the single most important revenue item covering 40 % of all budget revenues. Customs duties were also up due to high energy prices and import growth. Overall, about 35 % of all federal budget revenues has been estimated to come from taxes paid by the energy sector. As regards expenditures, defence was allocated most as the sector received additional funding from last year's extra revenues. Interest costs for domestic and foreign loans, as well as aid to other budgets, were about equal in size, each representing about 2.5 % of GDP. Non-interest spending was 12 % of GDP for the year. It stayed tight until December when it jumped to over 20 % of GDP.

Budget surplus likely to contract in 2002

The 2002 budget baseline assumes that last year's record surplus will be halved to 1.6 % of GDP (if Urals crude world price averages $23.50 per barrel). About half of the change is due to an increase in expenditures, and an even larger effect is expected from a decrease in revenues from customs duties and the profit tax. While revenues and expenditures appear to increase substantially, the growth mainly reflects the inclusion of part of unified social tax revenues into the budget, which raises budget revenues and expenditures by 2.6 % of GDP. Without including the unified social tax, revenues will decrease as a share of GDP from 17.6 % in 2001 to 16.8 % in 2002 and expenditures increase from 14.5 % to 15.2 %. Non-interest expenditures are budgeted to increase by 0.6 % of GDP.

VAT and customs duties should continue to form the two largest revenue streams. Revenues from profit tax are supposed to decline due to a decrease in the tax rate from the beginning of this year. On the expenditure side, defence, interest payments and regional supports are the leading items. However, social sphere expenditures will get a boost from 2.3 % of GDP in 2001 to 2.6 % of GDP, even if the unified social tax expenditures allocated to the state pension fund are excluded.

Trilateral labour agreement

Russian employee and employer organisations and the government concluded an agreement in January on social and labour policies for 2002-04. Besides addressing various issues in fiscal, monetary and trade policy as well as reforms, the agreement noted concrete targets in the area of wage, employment and social policies. For 2002-04, the three parties will strive to ensure that public sector wage scales rise faster than inflation, as well as will make efforts to create one million new jobs (equal to 1.4 % of the workforce) and to limit the unemployment rate to 9.4 % in 2004 (9 % at the end of 2001). The agreement also seeks price changes in the housing sector in line with the development of real incomes of households. These elements emphasise social stability but they may somewhat restrain restructuring in the economy. A separate protocol to the agreement recites the proposal of employee organisations that the minimum wage be increased this year to a level that matches the subsistence minimum. Labour minister Alexander Pochinok noted such a move would cost the federal budget well over 20 % of GDP and the enterprise sector over 60 % of GDP.

Realised 2000 - 2001 federal budgets and approved 2002 federal budget

	2000			2001			2002		
	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP
Revenues	**1133**	**100.0**	**15.5**	**1591**	**100.0**	**17.6**	**2126**	**100.0**	**19.4**
Tax revenues	965	85.2	13.2	1461	91.8	16.2	1726	81.2	15.8
of which									
VAT	*372*	*32.8*	*5.1*	*639*	*40.2*	*7.1*	*774*	*36.4*	*7.1*
Customs duties	*229*	*20.2*	*3.1*	*332*	*20.8*	*3.7*	*324*	*15.2*	*3.0*
Profit tax	*178*	*15.7*	*2.4*	*214*	*13.5*	*2.4*	*207*	*9.8*	*1.9*
Excises	*131*	*11.6*	*1.8*	*203*	*12.8*	*2.2*	*225*	*10.6*	*2.1*
Other tax revenues	*55*	*4.8*	*0.7*	*73*	*4.6*	*0.8*	*197*	*9.2*	*1.8*
Non-tax revenues	74	6.6	1.0	115	7.2	1.3	104	4.9	1.0
Budgetary funds	93	8.2	1.3	15	0.9	0.2	14	0.7	0.1
Unified social tax [4]							281	13.2	2.6
Expenditure	**1046**	**100.0**	**14.3**	**1310**	**100.0**	**14.5**	**1947**	**100.0**	**17.8**
Domestic debt service [1]	55	5.3	0.8	46	3.5	0.5	58	3.0	0.5
Foreign debt service [1]	203 [2]	19.4	2.8	185	14.1	2.0	227	11.7	2.1
Defence	192	18.3	2.6	247	18.8	2.7	301	15.4	2.7
Social sphere [3]	134	12.8	1.8	204	15.6	2.3	281	14.4	2.6
Unified social tax [4]							282	14.4	2.6
Aid to regional budgets	101	9.7	1.4	230	17.6	2.5	265	13.6	2.4
Other expenditures	361	34.5	4.9	398	30.4	4.5	533	27.4	4.9
Balance	**174**		**1.2**	**281**		**3.1**	**178**		**1.6**

1) includes only interest payments

2) includes the balance of restructuring London Club debt (RUB 81 billion)

3) Social sphere expenditures include education, health, social policy, mass media and culture, and the arts.

4) The part of the unified social tax to be transferred to the state pension fund

Source: EEG / MinFin

Fiscal indicators (per cent of GDP, unless otherwise indicated ; end-year figures for debt)

Federal government	1995	1996	1997	1998	1999	2000	2001	2002 budget
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	19.4[2]
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.5	17.8[2]
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.1	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	57.6	43.4	
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	130.1[1]	

1) 1 January 2002; 2) including social tax channelled via the federal budget (2.6 % of GDP)

Sources: budget figures: IMF (1995-98); EEG (Economic Expert Group)(1999-2001), debt: IMF (1995-99), Minfin (2000-01)

Arrears and barter stabilised, tax debts restructured

While reliance on barter, other money surrogates, and arrears in enterprises decreased substantially in the earlier part of last year, the decline has since halted. While slower economic growth and tighter liquidity have so far not increased the use of non-monetary payments, it also now appears that further inroads against the use of surrogates and reduction of arrears may be more difficult.

Regular surveys (which cover several hundred firms) indicate that over last autumn the share of barter levelled at around 14 % of sales of the industry (chart). Goskomstat's survey of the largest taxpaying companies and monopolies notes that the share of non-monetary payments of all payments they received has remained at 22-23 % since early last year due to the continued use of offsets (10 %) and promissory notes (7-8 %). More comprehensive Goskomstat data show that overdue payables of enterprises to suppliers increased quite modestly in relation to GDP (chart), but their stock remained sticky through the autumn (e.g. as a share of enterprises' total working capital, at 12 %).

Enterprises' arrears to public sector budgets were quite steady through 2001 in nominal terms. As a share of the working capital, they decreased to 10 % late last year, although the tax ministry's records put debts to public sector budgets much higher (at some RUB 1,650 billion, equal to 25 % of the working capital). At least a third of this was fines for the delays. Against the abyss, the government last year launched an overall effort to restructure the tax debt. The deadline for companies to apply for debt restructuring ceased in December 2001. However, some enterprises – mainly in the agriculture and defence sectors – were given until 1 April 2002 to apply for restructuring. After the deadline, the government plans to bankrupt non-applicants. According to the tax ministry, 84,000 enterprises applied by the end of 2001 and over RUB 550 billion were restructured.

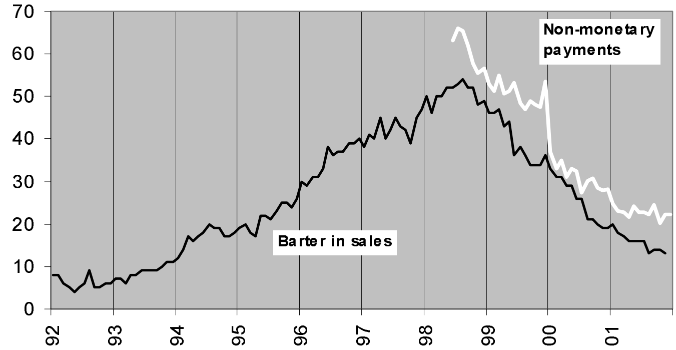
Russian borrowing and debt reviving

Last year the Russian government borrowed quite modestly. This year it plans to be somewhat more active in loan taking. The 2002 budget foresees borrowing on international markets of up to $2 billion, although the finance ministry recently noted the cost of borrowing might still be deemed too high. On the other hand, the issuance of $2 billion government bonds to transform Soviet-era trade debt is planned for this spring. On the domestic market, the government is planning to issue treasury bills (mainly GKOs and OFZs) for RUB 165 billion (over $5 billion). This year's first issues auctioned in January and February were placed at moderate yields compared to inflation (on the average, under 14 % for six-month GKOs and 15.4 % for 30-month OFZs).

Russian foreign and domestic market debt has also continued to do better due to increased confidence arising e.g. from Russia's orderly debt servicing since early 2001, upgrades in Russia's credit ratings, the country's strong fiscal policy, and last year's reform impetus. The government's debt servicing prospects are also stronger. The finance ministry confirmed that the 2003 foreign-debt-service spike should shrink from about $19 billion to $15-17 billion (this year's foreign debt service is budgeted at $14 billion). The markets persistently claim part of the spike was bought back, possibly by Russian state-owned banks.

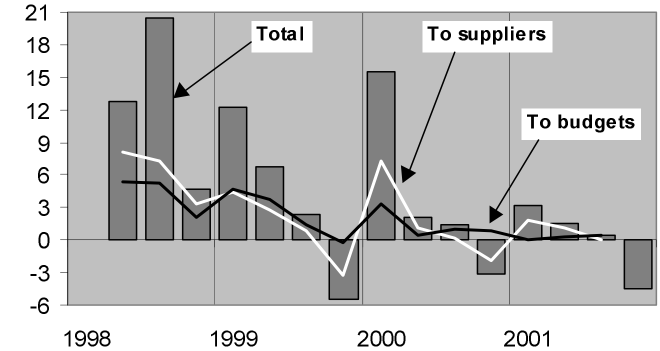
Positive sentiments on the market have brought yields on Russian debt down last year and this year. For example, the yields on Russian eurobonds maturing in 2005 and 2007 are now around 7-8 % (9-11 % 3 months ago and 15-20 % a year ago) and their spread around 3-4 % over US T-bills. Russia's domestic T-bills also carry lower yields, e.g. OFZs trade at 14-15 % (around 17 % six months ago).

Share of barter in industry sales and non-monetary payments in large enterprises' payments received, %



Source: Russian Economic Barometer, Goskomstat

Change of overdue payables of enterprises, % of quarterly GDP



Source: Goskomstat

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	17.7	2/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	39.2	1/02
Average wage, RUB, end of period	736	1017	1215	1482	2283	3025	4294	3680	1/02
Interest rates, period average									
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	4.8		11/01
- lending rate, %	320	147	46.2	41.5	40.1	18.2	17.0		11/01
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	36.9	2/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	30.93	2/02

Sources: Goskomstat, CBR

Don't belittle the role of oil prices for the Russian economy

By Jouko Rautava*

There is near universal agreement among economists today that Russia is less vulnerable to external shocks than it was before 1998 crisis. In fact, by most economic indicators, Russia is one of the best performing countries among the emerging market group. Despite the improved economic situation and major reform initiatives in recent years, however, the question regarding the role of oil prices on Russia's economy remains crucial. The debate around this issue has become all the more interesting lately as new empirical research has stoked the discussion.

Traditional view

A prevailing view still is that Russia's economy and fiscal situation are crucially tied to oil prices and the rouble's exchange rate. This view notes that exports were about one-third of GDP in 2001, and roughly half of export revenues came from energy. Moreover, the federal budget appears to be heavily dependent on both total output and energy prices. According to several sources, revenues from the energy sector account for 30-40 % of the central government's total revenues.

On the other hand, there has been surprisingly little research on how oil prices affect Russian macroeconomic dynamics. Most analyses are based on rather simple and straightforward calculations as to how much a one-dollar change in the oil price changes Russia's exports or fiscal revenues. Typically, the Russian government, international financial institutions or investment banks focus on Russia's external and fiscal vulnerability, i.e. Russia's ability to service its debts. Most country reports currently conclude that due to Russia's excellent fiscal and external situation, as well as its pro-reform government, the country today is much less vulnerable to a decline in oil prices than before the 1998 crisis.

A salient shortcoming of these analyses is that they assume GDP developments rather than estimate GDP with a model that explicitly accounts for changes in output from a terms-of-trade shock due to changes in energy prices. Likewise, the impact of the real exchange rate on GDP has received scant attention in empirical research despite good reasons to examine the combined effects of the exchange rate and oil prices.

Another view

Discussion on Russia's oil dependence has become much more interesting – and controversial – lately. Last autumn, sources close to the government argued on several occasions that decreases in oil prices have no negative impact on real GDP growth. Because these views are said to be based on a macroeconomic model developed for the Russian Ministry for Economic Development and Trade, they might affect the views of decision-makers. Clearly, these arguments challenge the popular view on the role of oil in the Russian economy and call for further examination.

New evidence on the importance of oil prices

In a recent BOFIT paper, "The role of oil prices and the real exchange rate in Russia's economy" (BOFIT DP No 3/2002), an econometric model based on VAR and cointegration methodology is constructed to examine Russia's dependence on oil prices and the rouble's real exchange rate. It also asks whether there have been changes in this respect during Putin's term.

The estimation results indicate that there is a stable long-run relationship between international oil prices and the level of GDP so that a 10 % permanent increase (decrease) in the level of oil prices would cause the level of GDP to increase (decrease) by 2.2 %. Respectively, a permanent 10 % appreciation (depreciation) of the real exchange rate of the rouble is associated with a 2.4 % fall (increase) in GDP in the longer run. The results also confirm the strong dependence of fiscal revenues on output and oil prices. These results seem robust in the sense that similar effects – although stronger as one might expect – are achieved by replacing oil prices with an index of a broad range of raw material and energy prices.

The exercise also finds no major changes in the relationship among key economic variables. In particular, no evidence is found to support views that the impact of oil prices on Russia's output and fiscal revenues would somehow have weakened in recent years.

Danger of groundless complacency?

Naturally, one must be cautious in assessing the Russian economy with econometric methods, because e.g. the data quality is questionable. Nevertheless, it seems that there are no reasons to deny or belittle the impact of oil prices on Russia's economic development (although one might debate the magnitude of such effects). As the study results indicate, the impact of the oil price changes on output could be balanced by respective changes in the real exchange rate. However, this counterbalancing effect is not necessarily mechanical and should not lead to a conclusion that changes in international oil prices are no longer an important issue for Russia. Underestimation of the role of oil prices on Russian economy might lead to unfounded complacency in economic policy. Thus, as far as the impact of oil prices is concerned, Russia should continue to focus on balancing possible problems in the short-run and decreasing its dependency on energy prices in the longer run through changes in the business environment.

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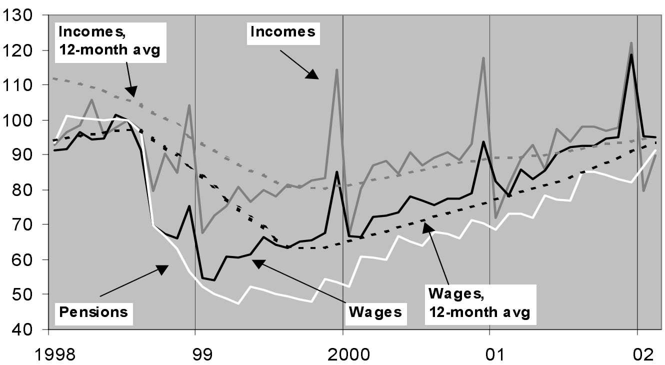
Economic Developments

Incomes recover to near 1998 pre-crisis level

The rise in incomes continued at a brisk pace last year. Russian *real disposable incomes* (income minus mandatory payments and adjusted for inflation) increased 6 % in 2001, after growing 9 % in 2000. With the rise in real incomes, the share of population earning less than the subsistence minimum decreased from 29 % (about 42 million persons) on average in 2000 to 28 % (40 million) in 2001. *Pensions* rose over 45 % in nominal terms and over 20 % in real terms. However, Russian pensions are still tiny, on average just over 1,300 roubles (€50) per month as of February 2002. W*ages* also rose over 45 % in nominal terms and over 20 % in real terms in 2001 (for both measures, the same pace as in 1999 and 2000). The average wage in Russia in February was 3,800 roubles a month (€140). Real wages were about 5 % lower and the real income and real pensions about 10 % lower as compared to the pre-1998 crisis level.

Wage developments were sharp since Russia's financial crisis in 1998. In the industrial sector, the average nominal wage rose about 50 % in both 2000 and 2001. As the rouble exchange rate was relatively stable in 2000 and 2001, the average wage in industry also increased about 50 % in euro terms in both years and was €160 per month in 2001, i.e. the 1997 level. Growth of productivity in industry somewhat moderated the cost effect, but in euro terms, the industry wage per unit produced still rose 40-45 % per year in both 2000 and 2001. The rouble's collapse in 1998 reduced the unit wage cost 60 % from 1997 to 1999, and from that low point it reached in 2001 about 80 % of the 1997 level.

Disposable incomes, wages and pensions in real terms, July 1998 = 100



Source: Goskomstat

Current account surplus and capital flows ease

The current account surplus declined in 2001 to $35 billion (€39 billion) from over $46 billion in 2000. The surplus equalled 11 % of GDP (18 % in 2000). In 4Q01, it fell to under 8 % of GDP as export income shrank 14 % y-o-y and import expenditure, although slowing, still grew over 15 %. The services deficit increased to $10 billion in 2001.

Last year Russia attracted slightly less foreign direct investment than in 2000 (more on page 3). Direct investments from Russia declined to $2.6 billion, but still matched inward direct investment flows. On the whole, the smaller financial account deficit than in 2000 contained two specific features. First, a large inflow was recorded in 3Q01 as Russia wrote off about $10 billion of its claims on the poorest debtor countries in the Paris Club (thus, also a large capital account deficit). Second, on a market-oriented note, private net capital outflows abated from over $15 billion in 2000 to about $6 billion. Partly reflecting unrecorded capital flows, the negative net errors and omissions declined slightly. Together with recorded private net outflows, they equalled 5 % of GDP (10 % in 2000).

Russia's balance of payments in 1999-2001, US$ billion

	1999	2000	2001
Current account	**24.7**	**46.4**	**35.1**
Trade balance	36.1	60.7	49.4
Exports, f.o.b.	*75.7*	*105.6*	*103.2*
Imports, c.i.f.	*-39.5*	*-44.9*	*-53.8*
Services balance	-4.3	-7.6	-10.2
Exports	*9.1*	*10.0*	*10.9*
Imports	*-13.4*	*-17.6*	*-21.1*
Investment income	-7.7	-6.7	-4.0
Received	*3.9*	*4.8*	*6.2*
Paid	*-11.6*	*-11.5*	*-10.2*
Other items, net	0.6	0.1	-0.1
Capital and financial account	**-15.9**	**-21.0**	**-17.8**
Capital Account	-0.3	11.0	-9.4
Received	*0.9*	*11.8*	*2.1*
Paid	*-1.2*	*-0.9*	*-11.5*
Financial account	-15.6	-32.0	-8.5
Direct investment to Russia	*3.3*	*2.7*	*2.5*
Portfolio investment to Russia	*-1.2*	*-9.9*	*-1.1*
Other items, net	*-17.7*	*-24.7*	*-9.9*
Net errors and omissions	**-7.0**	**-9.4**	**-9.1**
Change in reserves	**-1.8**	**-16.0**	**-8.2**

Source: Central Bank of Russia, 29 March 2002

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	2.1	2/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	0.3	2/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	9.1	2/02
Exports, € billion*	41.2	51.0	57.0	63.3	71.3	78.8	66.9	70.7	114.8	114.7	7.7	1/02
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	3.9	1/02
Current account, € billion*			7.0	5.7	9.2	1.8	0.6	23.1	50.4	39.0		

Consolidated 2001 budget surplus increased

Last year was the second consecutive year of consolidated budget surplus in Russia. The 2001 surplus of 3 % of GDP was larger than 2000's after revisions of the 2000 budget and GDP figures. The increase reflected increased revenues (an increase of one percentage point of GDP). As a share of GDP, all major tax revenue categories increased their share. VAT was the biggest revenue source, while profit tax revenues grew more slowly than other tax revenues. The changes in the income tax rate (to a universal 13 %) did not create a move in the effective tax rate as income tax revenues rose at the same pace as wages. Of the minor revenue sources, privatisation revenues grew markedly.

Realised 2001 and 2000 consolidated budgets

	2001			2000		
	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP
Revenues	**2674**	**100**	**29.6**	**2098**	**100**	**28.7**
Tax revenues	2332	87.2	25.8	1708	81.4	23.4
of which						
VAT	*641*	*24.0*	*7.1*	*457*	*21.8*	*6.3*
Profit tax	*514*	*19.2*	*5.7*	*399*	*19.0*	*5.5*
Customs duties	*332*	*12.4*	*3.7*	*229*	*10.9*	*3.1*
Income tax	*256*	*9.6*	*2.8*	*175*	*8.3*	*2.4*
Excises	*243*	*9.1*	*2.7*	*166*	*7.9*	*2.3*
Other taxes	*346*	*12.9*	*3.8*	*282*	*13.4*	*3.9*
Non-tax revenues	199	7.4	2.2	135	6.4	1.8
of which						
State/municipal property or activity	*124*	*4.6*	*1.4*	*72*	*3.4*	*1.0*
External economic activity	*45*	*1.7*	*0.5*	*37*	*1.8*	*0.5*
Other	-7			1	0.0	0.0
Budgetary funds	150	5.6	1.7	254	12.1	3.5
Expenditure	**2408**	**100**	**26.6**	**1960**	**100**	**26.8**
Debt service*	244	10.1	2.7	277	14.1	3.8
Non-interest expenditure	2164	89.9	23.9	1683	85.9	23.0
Social-cultural activities	*742*	*30.8*	*8.2*	*536*	*27.3*	*7.3*
Defence	*247*	*10.3*	*2.7*	*192*	*9.8*	*2.6*
Law enforcement	*185*	*7.7*	*2.0*	*133*	*6.8*	*1.8*
State administration	*111*	*4.6*	*1.2*	*73*	*3.7*	*1.0*
Industry, energy, construction	*159*	*6.6*	*1.8*	*59*	*3.0*	*0.8*
Agriculture & fishery	*69*	*2.9*	*0.8*	*55*	*2.8*	*0.8*
Other	*509*	*21.1*	*5.6*	*387*	*19.7*	*5.3*
Budgetary funds	*142*	*5.9*	*1.6*	*248*	*12.7*	*3.4*
Balance	**267**		**3.0**	**138**		**1.9**

*Source: Goskomstat; *includes interest payments only.*
The consolidated budget includes federal and regional budgets.
GDP in 2000 was RUB 7,302 billion and RUB 9,041 billion in 2001.

The consolidated budget expenditure structure is dominated by social and cultural spending. Last year it accounted for over 30 % of all expenditures and its share has steadily increased during the Putin presidency. Defence costs, on the other hand, remained unchanged, while interest payments on debt declined considerably. Total non-interest expenditure increased by one percentage point of GDP. Spending on industry, energy, construction, transport and communications rose markedly. Revenues and expenditures of budget funds were halved as ten federal budget funds were abolished.

Banking reform takes shape – gradually

The major parts of the revised banking reform strategy adopted by the government and the Central Bank at the turn of the year foresee several draft laws this year, wider implementation from 2004 onwards and open-ended state ownership.

Regarding bank information, the adoption of international accounting standards in banking is still planned for 2004 in parallel with the changeover by other sectors of the economy. Legislation is under preparation calling for quarterly publication of financial accounts and declaration of a bank's real ownership structures.

The deposit guarantee scheme, which currently only covers state banks, will be generalised to all banks and provide deposits protection up to a yet-to-be-defined ceiling. The scheme will first be available to volunteer banks willing to meet higher capital adequacy requirements and apply international accounting. The final system will be introduced at least one year after banks have shifted to international accounting. It will be compulsory for all banks that want the right to accept household deposits. Sberbank will enter the system, with separate rules for guarantee fund deposits during a transition period.

Consolidation of the banking sector via capital requirements will also occur in two stages. The capital adequacy requirement for banks with own capital of less than € 5 million will be raised to 10 % in 2005. That requirement will apply to all banks from 2007 and all banks will at that time have to possess own capital of at least € 5 million.

Laws will also be drafted this year for other operational improvements such as improved enforcement of credit collateral and alternative arrangements to straightforward bankrupting of banks. Residents and non-residents will no longer need prior permission from the authorities in acquiring up to 10 % of a bank's shares.

The state will divest banks in which it holds equity positions of 25 % or less. Other state-owned banks will either be listed for privatisation, or remain in state ownership if they are considered strategically important or if the ownership is deemed necessary for control. The issue of the CBR ownership of Russia's largest bank, Sberbank, will be postponed until after Sberbank has joined the general deposit guarantee system. Meanwhile, control of Sberbank's operations will be enhanced, particularly credit risk management.

Fiscal indicators (per cent of GDP, unless otherwise indicated ; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2002 Jan.	2002 budget
Federal government									
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	22.4[1]	19.4[1]
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.5	8.9[1]	17.8[1]
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.1	13.5	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	57.6	43.4		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	130.1		

[1] *including social tax channelled via the federal budget (2.6 % of GDP in the 2002 budget)*
Sources: budget figures: IMF (1995-98); EEG (Economic Expert Group)(1999-2002), debt: IMF (1995-99), Minfin (2000-02)

Foreign direct investment declined in 2001

Russia's economic growth and progress with reforms have yet to tempt higher levels of foreign direct investment. According to Goskomstat figures, FDI inflows decreased in 2001 by 6-10 % compared to 2000 and 1999. They amounted to a modest $4 billion, or 1.3 % of GDP. The trade sector garnered more than a quarter of all FDI, while the transport sector's share fell to 17 %. The food industry's share declined to 13 % and the oil industry stiffly maintained its share at no more than around 10 %. Machine building rose to 8 % of the total.

Bank savings rate stagnant, lending picks up

Bank saving by households and enterprises decreased slightly in 2001 – the increase of the stock of deposits and accounts at banks was over 4 % of GDP compared to nearly 6 % in 2000 (see chart). While enterprises deposited modestly, bank saving by households increased. Growth of cash in circulation outside banks continued to increase at around 2 % of GDP. The deposit and accounts stock rose to 17 % of GDP at end-2001 (over 15 % a year earlier), including about 7.5 % of household deposits. Cash in circulation was at 6.5 % of GDP.

The maturities of household deposits continued to lengthen, especially rouble deposits (all maturity data exclude Vnesheconombank). At the end of 2001, 10 % of all rouble deposits had a maturity between six and twelve months, while almost 30 % exceeded one year. The respective shares for forex deposits were 25 % and 17 %. Sberbank, in which the CBR holds a majority stake, saw a minor erosion in its share of household deposits (just over 70 % at end-2001 compared to 75 % a year earlier).

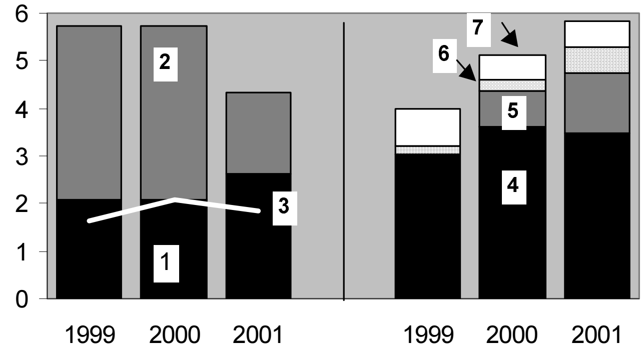
Bank credit continued to pick up, with the increase of all claims of banks on firms and households accounting for 6 % of GDP last year (5 % in 2000). Rouble lending to firms continued at the 2000 level (about 3.5 % of GDP), while forex lending rose (to about 1.5 % of GDP). Lending to households grew notably. The stock of total claims on firms and households rose to 16 % of GDP at end-2001 (13 % a year earlier), with rouble loans to firms at 9 %, forex loans to firms at 4 %, and loans to households at 1 %. Notably, the maturity structure shortened for both rouble and forex loans (excluding Vnesheconombank). In forex loans, the share of tenors over one year was 45 % at end-2001, but in rouble loans less than 20 %. Sberbank continued to account for about a third of total loans to enterprises.

Russia's country risk rankings

Russia's country risk ranking moved slightly down this spring in assessments compiled by *Euromoney*. Russia currently ranks 98th among the 185 countries surveyed (see chart). In assessments made for *Institutional Investor*, however, Russia's position improved considerably from 92nd last autumn (out of 145 countries) to 80th this spring (out of 151 countries). In relation to the larger CIS countries, Russia continuously ranks between Kazakhstan (70th in Euromoney and 74th in Institutional Investor) and Ukraine (120 and 104).

Institutional Investor's actual country credit ratings, which determine the rankings and are based on information provided by economists and sovereign risk analysts, showed a stronger six-month gain for Russia than for any other country surveyed. Euromoney's country risk score, composed of financial, economic and political information, decreased slightly from last autumn. In that survey, economic projections for Russia moved up (e.g. to 3.3 % GDP growth in 2002), while the debt information restrained Russia's overall score.

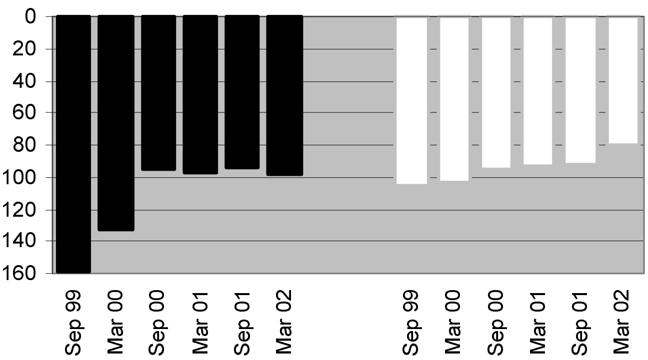
Bank deposits and accounts of firms and households, cash outside banks, and banks' claims on firms and households in 1999-2001, changes of the stocks, % of GDP



Deposits and accounts, cash	**Claims**
1 Household deposits	4 Rouble loans to firms
2 Other deposits and accounts	5 Forex loans to firms
3 Cash outside banks	6 Loans to households
	7 Other claims

Source: Central Bank of Russia

Russia's country risk rankings, Sept. 1999 to March 2002



Sources: Euromoney, Institutional Investor

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	16.7	3/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	37.2	2/02
Average wage, €, period avg, except last	79	122	145	97	58	86	126	142	2/02
Interest rates, period average									
- deposit rate, %	102	55	16.4	21.8	13.7	4.6	5.2	4.9	1/02
- lending rate, %	320	147	46.2	41.5	40.1	18.2	16.5	18.2	1/02
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	37.3	3/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	31.12	3/02

Sources: Goskomstat, CBR

Russia's northwest regions in 2001 and the challenges ahead

by Tuuli Juurikkala*

The four regions of Northwest Russia neighbouring Finland (St. Petersburg, Leningrad province, Republic of Karelia and Murmansk province, altogether 8 million inhabitants) have experienced positive economic developments in line with general trends in Russia since 1998.

Factors such as the drastic fall of the rouble and the rise in the world market price of many commodities, especially crude oil, nickel and aluminium, have contributed significantly to the growth of both Russia and its northwest regional economies. The improved price competitiveness in the domestic market has made part of the capital stock again profitable and helped meet increased domestic demand through import substitution. However, challenges vary in the northwest regions.

Slowdown in industrial growth

All four regions saw a slowdown in industrial growth in 2001. The situation was worst in St. Petersburg, where growth stalled. Only Leningrad province, with industrial growth of 11 %, beat the Russian average. There are indications of a saturation of the post-crisis rapid growth in demand for domestic goods due to the accrued real exchange rate appreciation, and Northwest Russia is no exception.

A lack of investments has threatened sustainable long-term growth in *St. Petersburg*. Weakness in other inputs – labour force and total factor productivity – has also hurt growth. Seen in this light, the 14 % increase in fixed investment in 2001 was a welcome sign. Food processing and machine building remained the most important sectors of industry. Increased export revenues have turned the budget deficit into a substantial surplus for the city.

In the surrounding *Leningrad* province, fixed investments grew considerably last year. Economic trends in the province, however, are mixed. Industry growth figures bounced from negative to 3-digit positive in 2000-01, especially in machine building. The food industry, especially tobacco production, has remained the engine of growth. Budget revenues have grown, keeping the balance positive.

The Republic of *Karelia* continues to face the challenges posed by an industrial structure dominated by logging, pulp and paper, and wood processing. The current macroeconomic situation favours export-oriented logging over wood processing. Restructuring of these sectors seems inevitable. The investment boom continued in 2001, driven by the Karelian Government's road construction program. The share of non-governmental investment declined, reflecting the somewhat unfavourable business climate in Karelia.

In *Murmansk* province, increased investment and lower unemployment indicate that the region is moving beyond the crises of the 1990s. The importance of metallurgy to the region's economy, however, leaves it constantly exposed to world market price developments.

South-north disparities prevail

Private consumption fed economic growth in the region in 2001. Unlike in 2000, growth in retail trade exceeded industrial growth in St. Petersburg and Karelia as real disposable incomes rose. Retail trade growth accelerated in the Leningrad province, while in Murmansk it was much lower than in 2000. The main factor behind this trend in the North is the decrease in real disposable incomes in the Murmansk province. Not counting investment growth, there are clear differences in the pace of economic recovery as one moves south through the region (see table).

Natural population growth, like in Russia generally, remained negative in all four regions, while Murmansk province also faced net emigration. Unlike St. Petersburg and the Leningrad province, deficits in the consolidated regional budgets of Karelia and the Murmansk province were major worries.

The same pattern is also visible in foreign investment. In 2001, $1.2 billion in foreign direct investment and loans (8 % of the national total) went to St. Petersburg. The Leningrad region received $327 million (2.3 %), compared to $42 million (0.3 %) for Karelia and $12 million (0.1 %) for Murmansk province.

Future success depends on sector development

The success of Northwest Russian regions is first and foremost sector dependent. Each region must cope with its specific economic and industrial structure. The common challenges include the development of the deteriorating infrastructure as well as negative demographic trends. Further, the same feature that has partly protected the Russian economy from a steeper downturn – its low engagement in information and communication technologies – may prove a hindrance in the long run if it does not receive adequate attention in future policies.

Key figures 2000-01, annual growth, %

	Industrial production		Retail trade turnover		Fixed investments		Real incomes (Dec to Dec)	
	2000	2001	2000	2001	2000	2001	2000	2001
Russian Federation	12	5	9	11	17	9	3	5
Northwest Federal District	23	4	9	13	4	17	3	10
St. Petersburg	27	0	7	15	-20	14	5	14
Leningrad province	27	11	2	8	10	14	-5	11
Republic of Karelia	8	3	5	9	56	47	-1	6
Murmansk province	9	2	8	2	8	24	-2	-2

Source: Goskomstat

** The author is researcher at the Helsinki School of Economics. Biannual economic monitoring reports on Northwest Russia by the School's Centre for Markets in Transition are available at www.hkkk.fi/ecomon*

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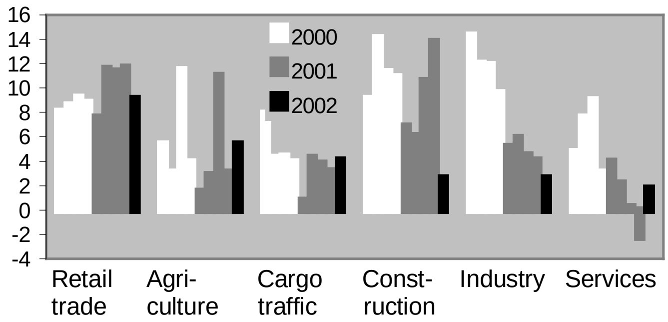
Economic Developments

Output growth slowed, signs of recovery

Production growth in Russia further decelerated in 1Q02. The indicator of five key sectors showed output increased over 3 % y-o-y, down from around 6 % in the second half of 2001. Private consumption remained strong as suggested by the still large on-year rise of retail trade (9 %, see chart). Services (not included in the five sectors) also picked up slightly in 1Q02, although their development has been sluggish since last summer. Agriculture performed well, registering over 5 % growth. Volumes of cargo transported continued their steady climb (up 4 % in the first quarter), but this was mostly due to brisk increases in the volumes shipped through gas and oil pipelines. Growth in industrial output continued at the pace set late last year (near 4 % in workday-adjusted terms). A real slowdown took place in construction, which was up only 1 % y-o-y in the first quarter. Total investments also increased by only 1 % – hardly an inspiring turnout for Russia's growth potential.

More recent developments offer some comfort, albeit not regarding investments. The five-sector indicator rose 4 % y-o-y in March. Industrial output climbed over 5 % y-o-y in workday-adjusted terms, with the seasonally adjusted trend increasing in March for the first time in many months. Although regular surveys of Russian industrial and service companies (e.g. Goskomstat, the Russian Institute of the Economy in Transition and Moscow Narodny Bank, which monitor developments in 200 to 1,000 firms) were mixed, they were mostly upbeat on output and orders in their outlook for the next few months.

Growth in key sectors of the economy 2000-02, % change from the same quarter of the previous year (non-workday-adjusted)



Source: Goskomstat

Industry growth on a narrower base

While five of the seven large industrial branches grew quickly in 2001, total industrial output growth in 1Q02 (around 3 % y-o-y) rested on three branches. Non-ferrous metallurgy rose 9 %, while the food industry defended its domestic market position (7 % growth). The fuel industry also continued to expand (6 %), with crude oil production up almost 9 % and natural gas output turning to a rise. Growth in the production of machinery and equipment, as well as chemicals and petrochemicals essentially came to a halt. Ferrous metallurgy and power production fell.

Little change in 2002 projections

The latest projections prepared in and outside Russia anticipate the GDP will grow around 4 % this year. The government forecast of February projected 3.5 % growth if the world crude oil price was about $20 per barrel, or above 4 % growth if the price was $25 per barrel. The IMF upped its regular projection last month to 4.4 %, while the OECD scaled back its forecast to 3.5 %. Assumptions of the two institutions for the world oil price in 2002 are $23-24 per barrel. Consensus forecasts compiled in the west and Russia from estimates of private banks, companies and research institutions currently foresee Russian GDP growth of 3.5 %.

According to the government's February projections, inflation will slow to 12-14 % this year, independent of whether the world oil price is $18 or $25 per barrel. The IMF retained its forecast of 14 % and the OECD revised its figure up to 15 %. The consensus forecasts retained their higher anticipations of inflation, i.e. 16 %.

As the oil price forecasts are relatively strong, the IMF and OECD expect Russia's current account to provide a surplus of 7-8 % of GDP this year. The consensus projections expect Russia's import growth to ease to 6-9 % while the government's February estimate was 4-6 %.

Inflation slows

After January's jump, consumer prices rose 1.1-1.2 % per month in February-April. The inflation rate declined to 16 % y-o-y in April, with an 11-13 % rise for food and other goods. Services prices, however, rose nearly 40 % from April 2001 as prices for housing and related services climbed constantly (up 57 % y-o-y). Certain other regulated services prices such as medical services, passenger transport and pre-school services were also up substantially (25-35 % y-o-y).

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	2.6	Q1/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	1.2	Q1/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	8.9	3/02
Exports, € billion*	41.2	51.0	57.0	63.3	71.3	78.8	66.9	70.7	114.8	114.7	25.3	1-3/02
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	14.1	1-3/02
Current account, € billion*			7.0	5.7	9.2	1.8	0.6	23.1	50.4	39.0		

*Sources: Goskomstat, CBR. *) Before 1999 values in ECU.*

Transfers count more in regional and local budgets

Regional budgets in 2000-2001 ran slight surpluses, while local budgets averaged small deficits. Consolidated regional budgets were thus fairly balanced both years. In 2001, the dependence of local, and especially regional budgets, on transfers from other budget levels increased substantially – a sign that president Putin's desire for more centralized fiscal policy is being implemented. Transfers accounted for almost a quarter of regional and a third of local budget incomes in 2001, while revenues from the profit tax and income tax were the most important sources of tax revenue. Revenues from budgetary funds (mainly regional road funds) are important for regional budgets, but insignificant for local governments. Value-added tax revenues were important still in 2000 but were transferred solely to the federal budget from the start of 2001.

Regional budgets pass on most of their transfers to other budget levels – mainly to local budgets. The budgetary funds' expenditures account for about 14 % of all expenditures, but are covered totally by their own revenues. The share of each of the other expenditure items in regional budgets remains under 10 %. Expenditure allotted to industry, energy and construction increased manifold in 2001 compared to 2000. *Local-level* expenditures focused on three items – education, housing and communal services, and health care. Together these comprise about two-thirds of local expenditures. The shares of other expenditure items were all well below 10 %.

Although the consolidated regional budget was in balance in 2001, the real situation in regions and localities is probably not so rosy. Because the possibilities of financing budget expenditures via debts are limited, regions and localities must match their expenditures with their revenues by merely neglecting certain payments in their responsibility. The growing public wage arrears, some 85 % of which are owed by regional and local governments, give an indication of how widespread the problem may be. Since the beginning of January, public wage arrears have increased by about fifth to some RUB 4.6 billion at the start of April.

Realised 2001 and 2000 consolidated regional (CRB), regional (RB) and local (LB) budgets*

	2001 % of total			2001 % of GDP			2000 % of total			2000 % of GDP		
	CRB	RB	LB	CRB	RB	LB	CRB	RB	LB	CRB	RB	LB
Revenues	**100**	**100**	**100**	**14.3**	**10.2**	**6.2**	**100**	**100**	**100**	**14.1**	**9.6**	**6.2**
Tax revenues	66.6	56.2	61.2	9.5	5.7	3.8	70.7	59.8	67.9	10.0	5.8	4.2
of which												
Profit tax	*23.0*	*22.1*	*16.8*	*3.3*	*2.2*	*1.0*	*20.9*	*21.8*	*13.6*	*2.9*	*2.1*	*0.8*
Income tax	*19.3*	*14.2*	*21.1*	*2.8*	*1.4*	*1.3*	*14.1*	*9.9*	*16.8*	*2.0*	*1.0*	*1.0*
Property tax	*6.7*	*5.4*	*6.7*	*1.0*	*0.5*	*0.4*	*6.1*	*4.9*	*6.2*	*0.9*	*0.5*	*0.4*
Resource payments	*6.1*	*5.4*	*5.2*	*0.9*	*0.6*	*0.3*	*5.7*	*4.7*	*5.7*	*0.8*	*0.5*	*0.4*
Sales tax	*3.5*	*3.1*	*2.9*	*0.5*	*0.3*	*0.2*	*3.3*	*3.0*	*3.0*	*0.5*	*0.3*	*0.2*
Excises	*3.1*	*3.3*	*1.6*	*0.4*	*0.3*	*0.1*	*3.4*	*4.0*	*1.6*	*0.5*	*0.4*	*0.1*
Local taxes and payments	*2.0*	*0.5*	*3.8*	*0.3*	*0.0*	*0.2*	*7.5*	*2.5*	*13.2*	*1.1*	*0.2*	*0.8*
Value-added tax	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*7.9*	*8,1*	*5.4*	*1.1*	*0.8*	*0.3*
Other taxes	*2.9*	*2.1*	*3.1*	*0.4*	*0.2*	*0.2*	*1.8*	*1.0*	*2.5*	*0.3*	*0.1*	*0.2*
Non-tax revenues	6.8	7.0	4.3	1.0	0.7	0.3	6.0	6.5	3.5	0.8	0.6	0.2
Transfers	16.1	22.3	34.2	2.3	2.3	2.1	10.8	15.6	28.3	1.5	1.5	1.8
Budgetary funds	10.5	14.6	0.4	1.5	1.5	0.0	12.5	18.1	0.3	1.8	1.7	0.0
Expenditure	**100**	**100**	**100**	**14.3**	**10.1**	**6.4**	**100**	**100**	**100**	**13.7**	**9.3**	**6.3**
Housing and comm. services	17.5	9.3	24.6	2.5	0.9	1.6	19.6	9.2	28.8	2.7	0.9	1.8
Education	17.5	7.1	28.0	2.5	0.7	1.8	17.4	6.5	28.0	2.4	0.6	1.8
Health care	12.7	8.6	14.9	1.8	0.9	0.9	13.4	8.9	16.0	1.8	0.8	1.0
Industry, energy, construction	8.6	8.0	6.7	1.2	0.8	0.4	2.1	2.5	0.9	0.3	0.2	0.1
Social policy	8.0	7.3	6.5	1.1	0.7	0.4	6.0	5.6	4.8	0.8	0.5	0.3
Administration	5.3	3.4	6.5	0.8	0.3	0.4	4.8	2.9	6.1	0.7	0.3	0.4
Transportation	4.5	5.0	2.2	0.6	0.5	0.1	3.6	3.4	2.8	0.5	0.3	0.2
Agriculture, fishery	3.5	4.0	1.6	0.5	0.4	0.1	4.1	4.6	2.0	0.6	0.4	0.1
Transfers to other budget levels	0.3	20.9	0.4	0.0	2.1	0.0	0.1	18.0	1.2	0.0	1.7	0.1
Other expenditures	12.1	12.6	8.5	1.7	1.3	0.5	16.7	20.4	9.1	2.3	1.9	0.6
Budgetary funds	9.9	13.9	0.2	1.4	1.4	0.0	12.2	17.8	0.3	1.7	1.7	0.0
Balance				**0.0**	**0.1**	**-0.2**				**0.5**	**0.4**	**-0.1**

*Source: Ministry of Finance; *Consolidated regional budget consists of regional and local budgets. Regional level refers to the 89 subjects of the federation and local level to thousands of localities.*

Fiscal indicators (per cent of GDP, unless otherwise indicated; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2002	2002
Federal government								Feb.	budget
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	21.2[1]	19.4[1]
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.5	15.2[1]	17.8[1]
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.1	6.0	1.6
- external debt	36.8	31.6	30.2	50.1	87.6	55.7	43.4		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	144.4	130.1		

[1)] *including social tax channelled via the federal budget (2.6 % of GDP in the 2002 budget)*

Sources: budget figures: IMF (1995-98); EEG (Economic Expert Group)(1999-2002), debt: IMF (1995-99), Minfin (2000-02)

Labour turnover increases

Goskomstat monitoring suggests that during recent years the turnover of labour in Russia has been increasing. The monitoring comprises over 41 million full-time employees of large and medium-sized enterprises and organisations. It does not include the over 20 million people working in small firms, self-employed persons, the grey economy or part-time employees of the large and medium-sized enterprises. The number of departures from firms, regardless of the official reasons, increased notably in 2000 and 2001 (see chart). Hirings have also been rising more strongly since 1999, albeit they turned to rise already in 1997. In 2001, there were 12.4 million departures and 12 million recruitments, equal to about 30 % of the employees covered by the monitoring. Officially, workers voluntarily resigned in 75 % of all cases. In reality, employers sometimes use voluntary departures as the notion in order to avoid difficulties and expenses when the worker was actually fired.

In 2001, the agriculture sector lost the most workers in net terms, i.e. 300,000 (some 7 % of the workforce employed in the sector). Industry lost about 280,000 workers (over 2 % of the workforce in the sector), while the transport sector lost about 90,000 persons (3 %). According to the monitoring, the financial sector recruited over 50,000 people more than it lost (over 8 % of its workforce).

Russian equities climb

Russian equity prices have continued their upward push. The RTS index plateaued at around 290 in February, then rose steadily throughout March and April. The overall gain since early March has been about 30 %, and the index is holding at around the 380 level. The rise was also reflected in the AKM composite index of Russian shares, which showed a 35 % gain for the period. Daily trading volumes of RTS shares in March and April rose to about $23 million, i.e. January's brisk level. Likewise, at MICEX the daily trading volume of shares increased to about $160 million.

In some contrast to last winter's stock boom, the spring rise was confined more to the fuel sector. Russian oil equities were up 35 % on average in the AKM sector index since early March as their values were propped up by a rise in the world oil prices. Gazprom shares (listed on the Moscow Stock Exchange) have also climbed 30 % since early March. Sberbank's shares continued their sharp rise (up over 80 %), supported by the bank's improved profitability and the pro-reform change of CBR leadership. Sberbank shares have risen five-fold since late October. Compared to last winter, telecommunications as well as machinery and equipment producers performed more modestly, rising around 20 % from early March.

The Russian stock market is currently up some 170 % from the beginning of 2001. As a result, the stock market capitalisation is about $120 billion – equal to around 35 % of Russian GDP. Of the total, sixteen largest Russian enterprises constitute a capitalisation of over $110 billion.

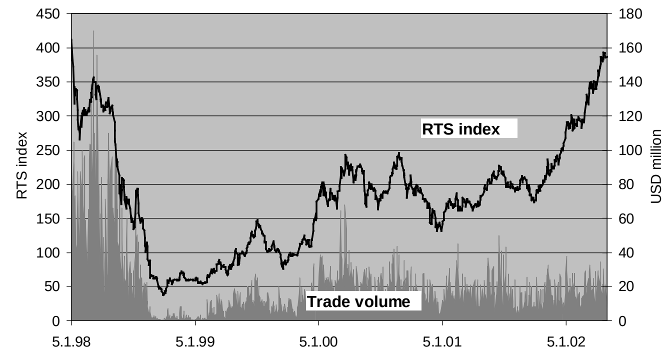
The rouble ticks steadily downward

In the interplay between the market and the CBR's market interventions, the rouble has, after weakening almost 2 % in January, steered a steadier course. It declined against the dollar around 0.7 % in February and March, but dropped only 0.3 % in April. Altogether, the rouble depreciated in January-April about 3.5 % against the dollar. As a result of the rouble's established referencing to the dollar and the strengthening of the euro (especially in April), the rouble fell almost 6 % against the euro in January-April. This implies the rouble's real exchange rate against exports from the euro area has weakened this year at that pace in industrial producer price terms.

Labour turnover in large and medium-sized enterprises and organisations in 1995-2001, % of employed

Source: Goskomstat

Russian share prices in the RTS index and RTS daily trading volume 1998-2002



Source: RTS

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Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	39.2	4/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	31.20	4/02

Sources: Goskomstat, CBR

A turning point in Russia's WTO negotiations?
by Matti Anttonen*

Negotiations on Russia's accession to the WTO have continued since July 1995 when the working party on the accession had its first meeting in Geneva. During the last two years the pace of the negotiations has considerably accelerated. The working party last met in late April. The next meeting is scheduled for June. The bilateral negotiations on custom duties and services providers' market access to Russia continue with the WTO member states. It can be clearly felt that WTO accession is among the priorities of the present Russian leadership. This has not been the case at all stages during this seven-year process.

The administrative challenge
In his recent address to both chambers of the Federal Assembly, President Putin stressed the importance of Russia participating in the making of international trade rules because Russia is now part of the world economy. Therefore Russia has little choice but to join the WTO. He warned of the ruinous consequences of protectionism and isolation.

WTO negotiations are a major challenge for the Russian state administration. Preparing Russian offers for the negotiations requires close and continuous cooperation of dozens of ministries and organisations. Many of them are quite unaccustomed to the idea of opening Russia to international competition.

Mr. Putin estimated that the Russian state apparatus has only a few dozen trade specialists. He considers this lack of experts a major obstacle in building economic relations with the outside world.

WTO accession also requires good cooperation between the executive organs and the Federal Assembly, which has to pass numerous new laws and amendments to existing laws. Moreover, the WTO accession treaty will have to be approved by the Russian parliament.

Other interest groups active
WTO membership does not merely concern the state administration but it has also become the object of a lively public discussion. Some industrialists would like to see the present duty protection continued and WTO accession postponed. Others prefer a rapid accession. Industries oriented towards domestic markets tend to belong to the former, while export-oriented industries to the latter group.

It is difficult to see why the lowering of import duties by a few percentage points from the present 11 % would constitute a major blow to Russian industry, which still enjoys a considerable degree of price competitiveness since the collapse of the rouble in autumn 1998. Lower custom duties would not have major negative consequences for state finances as lower custom duties would likely improve the collection rate. The real problems in negotiations thus lie elsewhere.

Sectoral issues carry much weight
Services industries were ignored in the planned economy. During the last decade the services sector has developed and now comprises around 50% of GDP. In many cases this was achieved with the participation of foreign capital. Further liberalisation should be envisaged in Russia's WTO negotiations. It will be impossible to conclude the negotiations with a deal that would restrict the present market access. The remaining horizontal and sectoral restrictions need to be clear and transparent.

Negotiations on agriculture have hardly begun. Here the parties must agree on the amounts of support allowed and market access. As both are important in the equation, they have to be tackled simultaneously. Additionally, the poor performance of the Russian economy during the past ten years has led to dramatically lower levels of agricultural subsidies. Nevertheless, it is difficult to foresee that WTO member states could accept an increase of support levels in Russia when others are committed to lowering them.

Legislative work continues
The last two years have seen a major overhaul of Russia's economic legislation, which has covered the tax code, labour code, land code, etc. The most critical pieces of outstanding legislation with respect to Russia's WTO accession are the customs code, a law on technical regulations and laws on intellectual property. It is not enough that the Duma merely passes these laws – they must also be effectively implemented.

In short, much work lies ahead before Russia's WTO accession becomes reality. Before that, all bilateral negotiations on customs duties and services have to be concluded and there has to be a consensus among all members of the working party about the conditions of Russia's accession.

It is premature to speculate on when - 2003 or later - the accession will actually occur.

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RUSSIAN ECONOMY
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5•2002

Economic Developments

Growth picks up, draws attention

After stalling at the start of the year, economic growth in Russia has revived. The seasonally adjusted development of both industrial production and the GDP (calculated by the economy ministry) showed some growth in April.

In parallel, the pace of economic growth in the medium to long-term has been a major topic for Russia's leadership in the past two months. Government ministers noted that the growth scenario drawn up in March, which estimated 3.5-4.5 % GDP growth for 2003-05, might be revised slightly upwards. The governmental interim scenarios currently suggest growth in the range 3.4-5.6 % for 2003-05. In all the scenarios, the world oil price assumption continuously plays an important role. Otherwise, growth is only expected to accelerate if reforms are sped up, and there would also be a lag before the upside effect would materialise.

Investment growth fell, especially non-oil

The slowdown of investment growth from nearly 9 % in 2001 to 1.6 % y-o-y in January-April (see chart) combines with some structural developments that overall do not bode well for future production potential. First, the share of machinery and equipment in investments decreased slightly in 1Q02 (to 37 %), while housing construction – always good for immediate welfare – was clearly up. Second, the share of the major investor, the oil industry, increased notably, while the share of the rest of the industrial sector was down, including the food industry. Third, companies relied on their own funds more heavily than earlier, and the increase in bank lending (see page 3) was not reflected in investment financing:. There were some shifts in non-industry investments. The share of transport investments fell sharply, while agriculture and communications were clearly up.

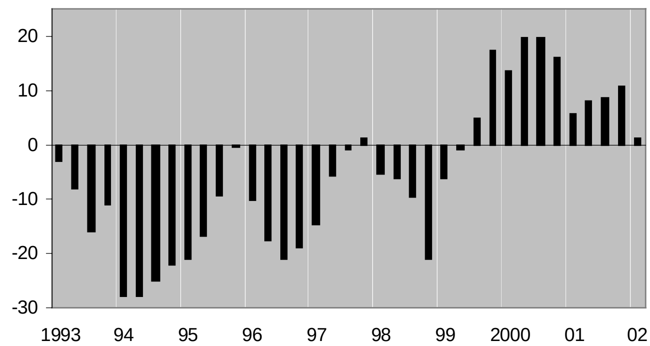
Exports lean on volume, imports still up

Russia's export income fell further in 1Q02 (-13 % measured in dollars), while imports continued to increase (10 %). A shift also continued whereby imports from non-CIS countries expanded rapidly, nearly 20 % measured in the customary dollars and 25 % measured in euros (chart).

Export income was depressed by weak prices. Although the oil price and key metal prices rose in 1Q02 from late last year, the prices of all major export products were still lower than a year earlier. Prices of crude oil, oil products and natural gas were all down around 20 % y-o-y. Russian oil exporters sought to mend the situation by boosting exports of crude oil and oil products still further (up 16 % and 11 % y-o-y in 1Q02 in volume terms). The push to increase oil exports has its limits, since it has an impact on world market prices. Natural gas deliveries fell again in 1Q02 (-2 % y-o-y).

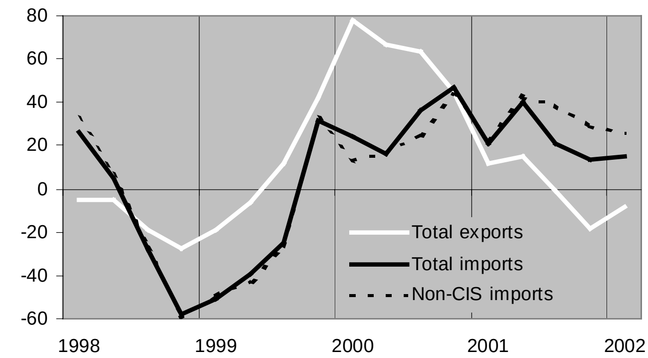
As earlier, imports were dominated in 1Q02 by machinery and equipment (one third, excluding passenger cars) and food and ingredients (one quarter). Non-CIS imports concentrated even more on the two categories. Imports of machinery and equipment (excluding passenger cars) grew 20 %, including a 30 % increase from non-CIS countries. This contrasts with domestic machinery and equipment production whose volume inched up 1 % y-o-y in January-April.

Fixed investments in 1993-2002, % change from the same quarter of the previous year



Source: Goskomstat

Russian exports and imports 1998-2002, % change of the euro value from the same quarter of the previous year



Source: Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0		
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.0	1-4/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	1.6	1-4/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	8.3	4/02
Exports, € billion*	41.2	51.0	57.0	63.3	71.3	78.8	66.9	70.7	114.8	114.7	25.3	1-3/02
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	14.1	1-3/02
Current account, € billion*			7.0	5.7	9.2	1.8	0.6	23.1	50.4	39.0		

*Sources: Goskomstat, CBR. *) Before 1999 values in ECU.*

Foreign debt continues to decrease

The finance ministry reports that the federal debt was 50 % of GDP at the beginning of 2002. *Foreign debt*, i.e. foreign currency debt, decreased rapidly in 2001, and amounted to about $133 billion (44 % of GDP) on 1 January 2002, compared to $143 billion (55 % of GDP) a year earlier. By the end of 1Q02, the debt had dropped to about $128 billion. At the beginning of 2002, nearly 18 % (almost $24 billion) of the federal debt in foreign currencies was owed to residents of Russia. It consisted mainly of eurobonds (over $9 billion), credit from the Central Bank (over $6 billion) and ex-Soviet bonds (almost $5 billion).

Russia made good progress last year in reducing its debts especially to the Paris Club, non-Paris Club countries and the IMF. Russia repaid the IMF some $4 billion, including early repayment of about $2.7 billion that the Central Bank owed the IMF. This year the Russian government will offer to convert the remaining trade debt of the former USSR, which Russia has inherited, to eurobonds worth at most $2 billion. The 2002 budget provides for a maximum $2 billion eurobond issue, but it is unclear whether the figure includes the conversion.

The federal government's *domestic debt* decreased in nominal terms about 5 % in 2001. The budget figures show net domestic borrowing this year will amount to some RUB 10 billion. In 2003, domestic borrowing will increase to an estimated RUB 50 billion ($1.5 billion) in net terms. The finance ministry wants to concentrate on issuing longer-term securities and offer yields exceeding the inflation rate.

Structure of federal government debt, 1 January 2002

	USD bln	RUB bln
Foreign debt	**133.1**	
of which		
Loans	***78.3***	
of which		
Paris Club	42.3	
To non-Paris-Club countries	14.8	
Commercial debt	6.1	
IMF	7.7	
World Bank	7.2	
EBRD	0.2	
Bonds	***45.3***	
of which		
Eurobonds	35.3	
MinFin debt to CBR	***6.4***	
Domestic debt	**17.6**	**531.1**
of which		
Bonds		***530.9***
Other		***0.2***
TOTAL	**150.7**	

Source: MinFin. The exchange rate used is 30.14 roubles/dollar.

Putin outlines 2003 budget policy

In his yearly address to parliament, president Putin summed up the major budget policy achievements of previous years and outlined the priorities for 2003. The government and parliament will use the address as a guideline for budget discussions due to start shortly. Putin also stressed the importance of reducing the level of state spending by rationalising expenditures. He claimed the level of non-interest spending in Russia is too high in relation to the current level of economic development, and thus hinders growth.

Putin suggested the government approve expenditure frames for three years to improve long-term planning. He also wants the state to refrain from delegating to the regions duties ('federal mandates') that they are unable to finance. This is related to the call for more thoroughly defined rights and responsibilities between the levels of administration. Putin also demands that the division of tax revenues be fixed for longer time periods.

Regarding budget revenues, Putin praised the ongoing tax reform, which he hopes will be completed next year. With all major tax laws passed, the most important outstanding tax legislation concerns taxation under production-sharing agreements, and taxation of small enterprises and real estate. He suggested the first quarter of each year as a deadline for passage of amendments to current tax laws and new tax laws, so as to guarantee that their effect is included in next year's budget.

Exchange rate and monetary policy face inflow

After rising only $1 billion during January-March, the CBR's foreign exchange reserves soared by $4.5 billion in April-May. Total currency and gold reserves stood at over $42 billion at end-May, equal to cover over 6 months of imports of goods and services. Rising export revenues, driven by an increase in world oil prices since early March, helped build up the supply of foreign exchange. Demand for foreign exchange was lowered e.g. by the federal government's foreign debt service payments which were less than $1.5 billion in April-May compared to $4 billion in January-March.

As a result, the CBR has mostly found itself in recent months trying to curb the rouble's appreciation. Unlike last winter, when the central bank regularly bought roubles to check the rouble's weakening, its market interventions now involved forex purchases. Moreover, to affect rouble market liquidity in the new forex influx, the CBR has since late April activated the adjustment of interest rates on its deposit facilities to banks. To press inflation, however, it is important that in parallel budget surpluses are maintained.

Fiscal indicators (per cent of GDP, unless otherwise indicated; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2002 Jan.-Mar	2002 budget
Federal government									
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	20.9[1]	19.4[1]
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.5	16.3[1]	17.8[1]
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.1	4.6[1]	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	55.3	44.4		
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	143.4	133.1		

1) including social tax channelled via the federal budget (2.6 % of GDP in the 2002 budget; 4 % of GDP in 1Q02 revenues and 2.7 % of GDP in 1Q02 expenditures)

Sources: budget figures: IMF (1995-98); EEG (Economic Expert Group)(1999-2002), debt: IMF (1995-99), Minfin (2000-02)

Foreign direct investments decline still

Foreign direct investment flows into Russia, according to Goskomstat data, shrank from $960 million in 1Q01 to about $830 million in 1Q02 (see chart). Preliminary balance of payments data from the CBR indicates a rise of FDI to about $700 million. The industrial sector received a bit more than 1Q01 (half of the total in Goskomstat data) as FDI into crude oil production and machinery and equipment industry were up. The trade sector again attracted over a third of the total, including a fifth in foreign trade. The stock of FDI in Russia rose to about $17 billion at the end of 1Q02. The US still topped the list of origin ($4 billion). Cyprus was second ($3.4 billion). In 1Q02, a notable share of the flow came from Gibraltar, also a likely point of return for Russian capital. Nevertheless, the amounts of capital returning to Russia are small compared to the estimates for capital flight.

Bank credit grows rapidly

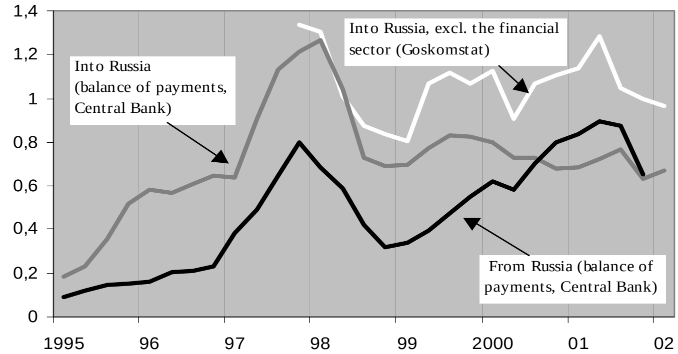
Confidence in Russian banks still looks mixed. On the one hand, as of 1 May, the total stock of rouble and foreign currency deposits attracted from households and enterprises increased 10 % y-o-y (all percentage changes in real terms, deflated by the consumer price index). At the same time, rouble cash in circulation outside banks rose over 20 % y-o-y. On the other hand, rouble time deposits grew over 40 % y-o-y, in clear contrast to forex deposits (7 % growth) and in stark contrast to rouble demand deposits (5 % decline). Brisk increases of bank capital (23 % y-o-y) propped up banks considerably. Regarding banks' assets, lending has been on a notable rise as reflected in the growth of banks' claims on private companies and households (over 30 % y-o-y increase of the stock). Among other major items, the claims of banks on the public sector, as well as their foreign assets, fell in real terms (-9 % y-o-y). Thus, financial intermediation has increased, hopefully without excessive risks on a market that is often deemed to lack enough competition.

At the end of 1Q02, money supply in Russia (rouble-M2 + forex deposits) equalled 23 % of GDP, including 17 % of deposits but still 6 % of rouble cash (chart). The claims of banks on firms and households stood at 16 % of GDP.

Russian oil exporters make their way

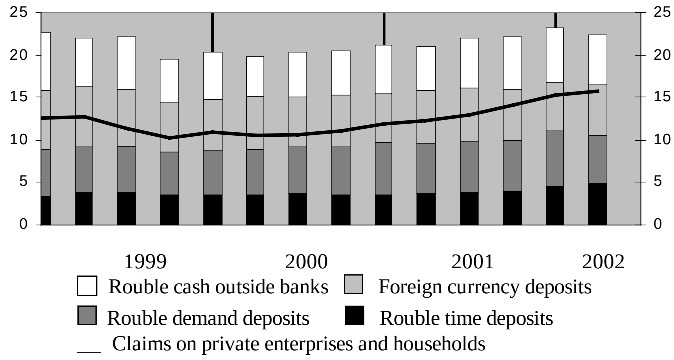
Russia announced in May it would bring its crude oil production and exports back to normal levels in the next two months. To support the world oil price, Russia indicated to OPEC in late 2001 it would limit its crude oil exports by 0.15 mbd in 1Q02. Russia later said it would extend the curb to 2Q02, while there has been some ambiguity about the base level period for the cut. Goskomstat and customs data indicate Russia's crude oil exports were up 16 % y-o-y in 1Q02 and about 0.3 mbd above the 2001 level (chart). Crude exports to the CIS expanded over 85 % y-o-y. It has obviously been hard for Russia to control exports while crude oil output continued to rise (up 8-9 % y-o-y in 1Q02). The situation caused a 20 % plunge of crude oil prices on Russia's domestic market in 1Q02.

Direct investment flows into and from Russia in 1995-2002, US$ billion, average of the last four quarters



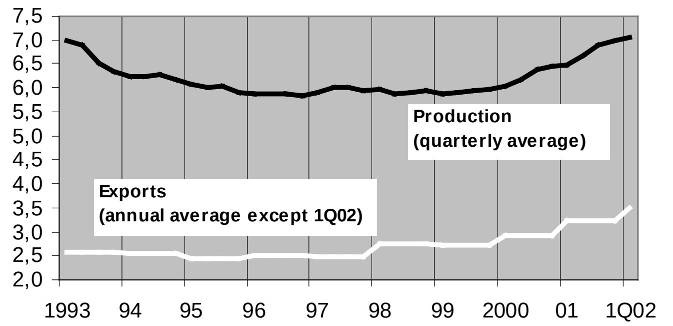
Source: Goskomstat, Central Bank

Russian banks' deposits and claims on private firms and households, and rouble cash in circulation, 1 Jan 1999 – 1 April 2002, stocks as % of GDP



Source: Central Bank, Goskomstat

Russian crude oil production and exports in 1993-2002, million barrels per day



Source: Goskomstat, Russian Customs

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.9	5/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	34.0	4/02
Average wage, €, period avg, except last	79	122	145	97	58	86	126	140	4/02
Interest rates, period average									
- deposit rate, %	102	55	16.8	17.1	13.7	6.5	4.9	5.1	3/02
- lending rate, %	320	147	32.0	41.8	39.7	24.4	17.9	15.8	3/02
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	42.2	5/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	31.31	5/02

Sources: Goskomstat, CBR

Finnish firms see more business in Russia – and reform needs

by Mirja Azeem*

After a couple of years of rapid growth, the Russian economy showed indications of slowing. Meanwhile, Russia's economic reforms have moved forward in terms of new legislation in several important areas. A considerable amount of monitoring, analysis and educated guessing currently focuses on the growth prospects for the Russian economy and whether reforms written into law will actually be implemented.

To get a better view of this situation, the Finnish-Russian Chamber of Commerce this spring commissioned the first of what will be an on-going series of semi-annual surveys of business leaders in the Chamber's member companies. The results of the March survey represent the views of over 300 business managers working in industry (over 40 %), services (almost 30 %) and trade (20 %). Some 75 % of the companies represented operate in Russia, over 40 % export directly and 8 % have production in Russia.

View of market growth

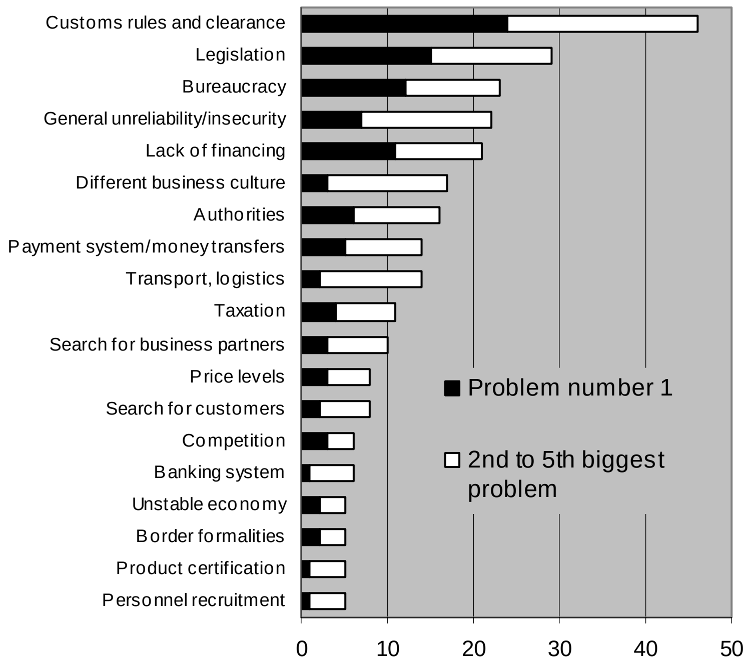
Almost 45 % of the exporting companies reported their exports to Russia increased during the past six months, while the share of firms with stagnant exports was the same. On the other hand, well over 60 % of the companies with business in Russia noted the business grew and about 30 % faced unchanged business volumes. Expectations for the next six months were rather positive with 70 % in both groups anticipating growth in exports or business on the spot. In addition, although very few anticipated rapid growth of the Russian economy, three-quarters of all the managers surveyed expected it would grow somewhat in the short term.

Naturally, these expectations cannot readily be taken as a view of how goods or services production in the Russian economy will develop, but rather how demand will rise. Demand, in turn, could well feed imports rather than domestic production. In fact, while domestic demand in Russia in 2001 increased almost 10 %, domestic production grew only 5 % and imports expanded some 20 %. Some projections of the Russian economy for longer periods incorporate the notion that rising incomes of the population will sustain growth in consumption and imports at a rate higher than production, and that this could be possible for several years due to Russia's large external surpluses.

Russian rules and authorities give concern

The spring survey, which asked respondents to name and rank up to five largest problems in their Russia operations, revealed numerous issues faced by the firms in the field. Russian legislation and regulations and the functioning of Russian authorities topped the list of business managers' worries (see chart). Customs was experienced as the foremost problem area, while legislation, bureaucracy, authorities and taxation also figured high. The outcome should encourage Russia to continue to pursue reforms. It confirms that customs reform (which has been designed, but not yet approved) is definitely necessary and will bring clear gains to the economy. The survey results further suggest that the raft of anti-bureaucracy laws, which was adopted last year for the purpose of protecting firms from the excesses of officials, should be implemented along with wider public sector reform. Notably, perceptions of Russia's taxation may have already improved, due partly to Russia's recently enacted profit tax legislation. As another area in need of reform, the banking and payments system also appeared higher in the survey than more standard issues such as business culture, prices, clients and competition. Instability of the economy and currency appeared low on the list of concerns. This should underscore the need to retain stable macroeconomic policy in Russia in conjunction, hopefully, with progress in reforms.

Biggest problems faced when operating in Russia mentioned by the 311 business managers surveyed



Source: Barometer of trade with Russia, March 2002, Finnish-Russian Chamber of Commerce and Taloustutkimus Oy

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Economic Developments

Consumption props growth, investments needed

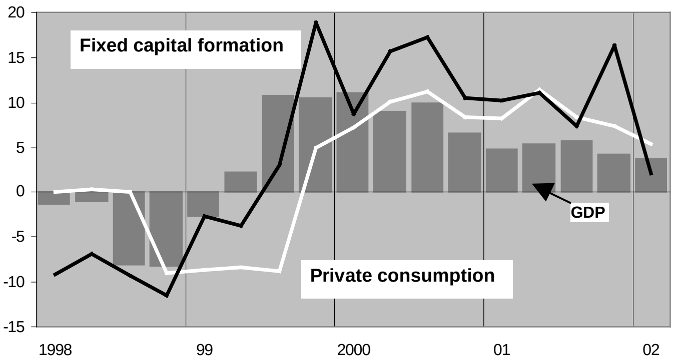
Goskomstat GDP figures for 1Q02 confirm the picture given earlier by more rapidly available sectoral indicators. First, economic growth in Russia slowed in 1Q02 (GDP grew 3.7 % y-o-y; see chart). Second, consumption was the element supporting growth, albeit private consumption increased slower (5.4 %) than any time since late 1999. Public consumption rose 2 %, after declining slightly in 2001. Third, growth of fixed capital formation (net investments) fell drastically (to about 2 %). In addition, the export volume probably grew due to the Russian oil boost.

For the medium and long-term, discussion of Russia's economic growth has recently centred on projections of 5-6 % GDP growth. The government and leading international forecasters foresee such growth as long as investments grow rapidly, reforms proceed and the oil price remains at some $23 to $24 per barrel for Brent crude.

Inflation pressure

Consumer prices rose slower in May (1.7 %) and especially June (0.5 %) compared to previous years. Nevertheless, there were also signs of inflation pressure. Wages continued to rise rapidly. In late spring, the average wage was almost 40 % higher and the average wage in industry over 30 % higher than a year earlier. Moreover, industrial producer prices climbed at well over 2.5 % per month in April and May. This was because electricity prices rose rapidly and the domestic oil price began to rise after declining continually since the middle of 2001. The domestic oil price decline was an important factor in restraining the rise of the industrial producer price index before April.

GDP, private consumption and investments 1998-2002, % change from the same quarter of the previous year



Source: Goskomstat

Current account and capital outflow shrink further

Russia's current account surplus decreased again in 1Q02 to $7 billion (well over $11 billion in 1Q01). The surplus still equalled 10 % of GDP (over 17 % in 1Q01). Export income declined 10 % y-o-y as falling income from goods exports was partly compensated for by rising services exports, a trend since 2000. Import expenditure (up 12 %) was increased by goods and a rapid rise of travel expenditure.

The financial account in 1Q02 showed a smaller deficit than a year earlier. Foreign direct investment into Russia declined, while Russian direct investments abroad also fell. Overall, recorded private capital net outflows dropped from 1Q01, especially in the banking sector. The negative net errors and omissions, pointing to unrecorded capital outflow, also improved. Together, the two items suggest private net outflows amounted to less than $3.5 billion or under 5 % of GDP (i.e. the average 2001 level). Preliminary indications by the CBR and the huge rise in its foreign currency and gold reserves in 2Q02 (by $7 billion to nearly $44 billion) suggest further easing of capital outflows.

Russia's balance of payments in 2000-2002Q1, US$ billion

	2000	2001	2002 Q1
Current account	**46.4**	**34.6**	**7.2**
Trade balance	60.7	47.8	9.5
Exports, f.o.b.	*105.6*	*101.6*	*21.9*
Imports, c.i.f.	*-44.9*	*-53.8*	*-12.3*
Services balance	-7.6	-8.5	-1.8
Exports	*10.0*	*10.9*	*2.6*
Imports	*-17.6*	*-19.4*	*-4.4*
Investment income	-7.0	-4.1	-0.5
Received	*4.3*	*6.2*	*2.2*
Paid	*-11.3*	*-10.3*	*-2.8*
Other items, net	0.3	-0.7	0.0
Capital and financial account	**-21.0**	**-17.2**	**-5.5**
Capital Account	11.0	-9.4	-0.1
Received	*11.8*	*2.1*	*0.1*
Paid	*-0.9*	*-11.5*	*-0.2*
Financial account	-32.0	-7.8	-5.4
Direct investment to Russia	*2.7*	*2.5*	*0.5*
Portfolio investment to Russia	*-10.3*	*-0.7*	*-0.2*
Other items, net	*-24.4*	*-9.6*	*-5.7*
Net errors and omissions	**-9.4**	**-9.2**	**-1.1**
Change in reserves	**-16.0**	**-8.2**	**-0.5**

Source: Central Bank of Russia, 28 June 2002

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	3.7	Q1/02
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.0	1-5/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	1.7	1-5/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	8.2	5/02
Exports, € billion*	41.2	51.0	57.0	63.2	71.3	78.8	66.9	70.7	114.7	112.9	35.1	1-4/02
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	17.3	1-4/02
Current account, € billion*			7.0	5.7	9.2	1.8	0.6	23.1	50.4	38.4	8.2	Q1/02

*Sources: Goskomstat, CBR. *) Before 1999 values in ECU.*

Government outlines 2003–05 budget framework

In line with its forecast for social and economic development, the government approved in mid-June its main budget policy principles for 2003–05. The main budget priorities for 2003 include the conclusion of tax reform and reallocation of responsibilities among administrative levels. Budget revenues are expected to decrease by one percentage point of GDP next year (table). The 2003 budget plan is projected to show a surplus of 0.8 % of GDP compared to the expected 1.6 % of GDP for this year. It assumes the world crude oil price stays at current levels, i.e. around $23 per barrel for Brent crude. The spending priorities for 2003 consist of financing reform in the armed forces, security and judicial systems, science and education. The government will receive a detailed 2003 budget plan at the beginning of August.

Preliminary federal budget parameters for 2003 and those approved for 2002

	2003 budget draft	2002 budget
Revenues (% of GDP) *	18.5	19.4
Expenditures (% of GDP) *	17.7	17.8
Interest payments	*2.2*	*2.6*
Non-interest payments*	*15.5*	*15.2*
Surplus (% of GDP) *	*0.8*	1.6
Average annual exchange rate (roubles per dollar)	34	31.5
Inflation (end-year, %)	10-12	12-14
Avg. Urals oil price ($ per barrel)	21.5	23.5
GDP (RUB bill.)	12,850	10,950

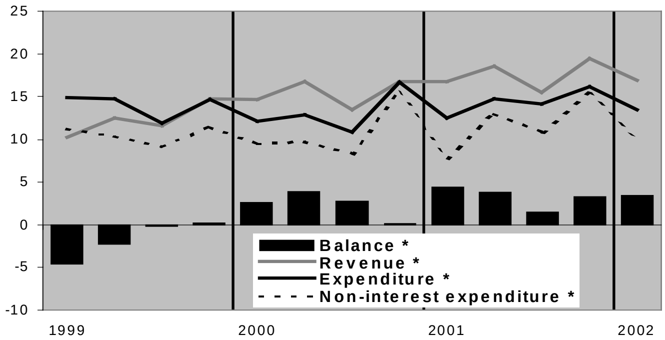
** Includes social tax revenues/expenditures.*

Federal budget surplus continues strong

Excluding social tax revenue channelled via the federal budget since the beginning of this year, 1Q02 revenues remained at about 17 % of GDP, the same level as 1Q01. Expenditures rose from 12.5 % to 13.6 % of GDP. The inclusion of the social tax flows in the federal budget increased revenues by 4 percentage points and expenditures by 2.7 percentage points of GDP in 1Q02. Excluding the social tax, the surplus was 3.3 % of GDP – lower than in 1Q01, but still substantial.

While the traditional revenue and expenditure categories generally prevailed, there were also changes compared to 1Q01. VAT and the social tax accounted for one half of all federal budget revenues in 1Q02. Revenues from export tariffs and the profit tax fell considerably in relation to GDP, while revenues from natural resource taxes rose sharply. Regarding federal expenditures, spending on the social sector, interest payments and transfers to other administration levels formed two thirds of the total. Compared to 1Q01, interest payments in relation to GDP fell, while non-interest expenditures (excluding the social tax channelling) rose substantially, mainly due to increased transfers to other administration levels.

Federal budget revenue, expenditure and surplus 1999-2002, % of the quarterly GDP



** For comparability, excluding the social tax revenue in 1Q02*

Source: Economic Expert Group

Natural monopoly tariffs to rise cautiously

The government implemented the second round of the so-called natural monopoly tariff increases on 1 July, raising wholesale prices for natural gas and rail cargo, and a little for electricity (table). The implemented hikes will presumably be the last this year. The government also tentatively decided on limits for price increases for these commodities in 2003 and outlined their schedule for 2003–05. Especially, in 2003, prices are expected to rise in real terms at a slower tempo than this year. During 2002-05, the gas price could rise some 12-18 % in real terms and almost triple in nominal terms. It would, however, remain well below world market prices. In real terms, the price for electricity would rise cautiously and rail cargo tariffs only slightly. This regulated segment of Russia's pricing system surfaced in recent negotiations for WTO membership. Russia claims its pricing systems are irrelevant to the accession talks. The system's abolition still prevails as a long-term target for Russia, as part of reforming the sectors and making users more price-conscious.

Increases of nominal gas, electricity and rail cargo prices, %

	2002 Feb-March	2002 July	2003 preliminary limit	2003-05 preliminary annual limit
Gas	20	15	20	25
Electricity	20	2.4	14-16	15-18
Rail cargo	16	6.8	12-14	9-12

Fiscal indicators (per cent of GDP, unless otherwise indicated; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2002 Jan-Apr	2002 budget
Federal government									
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	21.2[1]	19.4[1]
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.5	16.9[1]	17.8[1]
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.1	4.3	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	55.3	44.4	43.6[2]	
- external debt, bln USD	128.0	136.1	134.6	158.2	154.6	143.4	133.1	131.9[2]	

1) including social tax channelled via the federal budget (2.6 % of GDP in the 2002 budget; in Jan-Apr/02, 3.9 % of GDP in revenues and 3.1 % of GDP in expenditures) 2) 1 April 2002

Sources: budget figures: IMF (1995-98); EEG (Economic Expert Group)(1999-2002), debt: IMF (1995-99), Minfin (2000-02)

Euro's rise restrains rouble appreciation

The rouble's referencing to the dollar kept the depreciation of the rouble against the dollar at only 1 % in 2Q02 and 4 % for the entire 1H02. The large rise of the euro internationally fed straight into Russia, driving the rouble down against the euro almost 13 % during 2Q02, including nearly 6 % in June (chart). This caused the rouble to depreciate in real terms against the euro, some 10 %, and slightly decreased the rouble's real rate against the basket of Russia's main trading partners' currencies in 1H02. The strong appreciation of the euro, a major factor affecting import prices, could basically have some effect on inflation in Russia through dearer imports from the euro area. On the other hand, if the current euro/rouble rate persists, it may slow growth of imports from the euro area. This would benefit other exporters to Russia and possibly provide breathing space for those Russian domestic industries that compete with imports from the euro area.

Changes in bank deposit and loan structures

The Central Bank's sectoral and maturity data on bank deposits and loans (which exclude corporate current and settlement accounts and Vnesheconombank) are more positive than data on aggregate deposits and accounts. As of 1 May, the stock of deposits rose 20 % y-o-y in real terms (all changes are consumer price deflated). On a flow basis, bank deposits this year ran a bit lower than last year (4 % of GDP in 1Q02).

Households built up their deposits considerably (up 34 % y-o-y, including a brisk rise in 1Q02), while corporate deposits decreased. The growth of household deposits had two focuses. First, households' foreign currency deposits were up almost 50 % y-o-y (their share rose to 60 % of all household deposits). Second, household deposits at banks other than Sberbank increased nearly 60 %. Their growth at Sberbank was one quarter (Sberbank's share of household deposits slid to 70 %). Aggregate data further suggests that Sberbank's interest rates on household rouble deposits are slightly higher on average than the rest of the banking sector. However, this probably stems from pension accounts at Sberbank that carry relatively high interest rates and amount to almost one half of Sberbank's household deposits, or one third of all household deposits in Russian banks.

The maturities of household and corporate deposits lengthened since last autumn. One-year to three-year rouble and foreign currency deposits grew particularly fast (see chart).

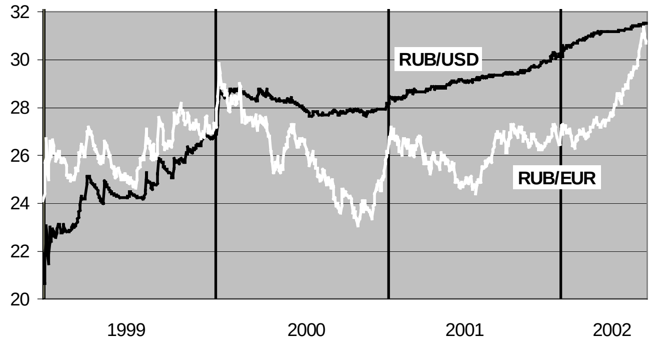
The loan data suggest last year's rapid rise of bank lending slightly eased in 1Q02. The maturity structure of loans to companies has not undergone any major changes, but the share of loans longer than one year turned to a rise this spring.

World events moderately affect Russian stocks and bonds

Prices of Russia's foreign currency bonds, i.e. eurobonds and MinFin bonds, rose gradually until mid-May, bringing the yields down. The fall last month of global equity and debt markets (which hit some emerging market countries particularly hard) was reflected in Russia albeit less strongly. Yields on Russian bonds crawled upwards in June, stepping up 0.5-1 percentage points around mid-summer. Subsequently, yields declined back, e.g. to about 7 % for eurobonds maturing in 2005 and little over 8 % for those falling due in 2007 and 2010. The bump in yields concerned virtually all the maturities from 2005 to 2030, while the eurobonds maturing in 2003 were quite weakly affected.

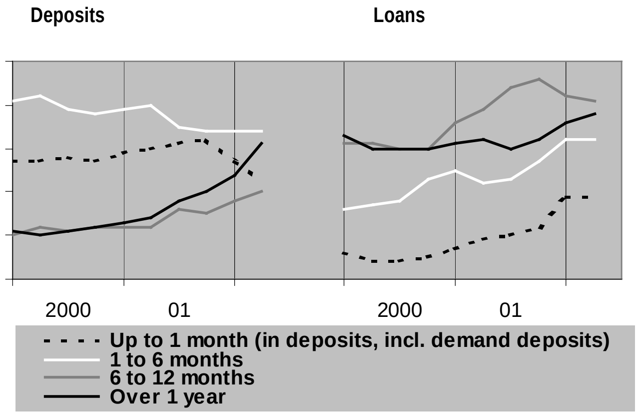
Russian share markets also fell in June. The RTS index, after peaking in late May at 425, slid 20 % by mid-summer to below 340. The RTS, however, recovered to a level of over 380 by now.

RUB/USD and RUB/EUR exchange rate in 1999-2002, daily



Source: CBR

Maturities of deposits at Russian banks and their loans to the corporate sector, 1 Jan 2000 – 1 April 2002, stocks as % of GDP



Source: CBR

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	14.7	6/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	36.7	5/02
Average wage, €, period avg, except last	79	122	145	97	58	86	126	148	5/02
Interest rates, period average									
- deposit rate, %	102	55	16.8	17.1	13.7	6.5	4.9	5.3	4/02
- lending rate, %	320	147	32.0	41.8	39.7	24.4	17.9	18.3	4/02
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	43.6	6/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	31.45	6/02

Sources: Goskomstat, CBR

The role of foreign direct investment in the Russian banking sector

by Ilkka Salonen*

The role of banks, particularly foreign banks, is still underdeveloped in the Russian economy. As a result, the banking sector is a bottleneck to economic growth. The reasons to slow development of foreign banking in Russia lie basically in the link of history and protection.

Short history with mixed traditions

While the number of banks in Russia rose to over 1,000 before a banking law was introduced, the track record for foreign direct investment in the country's banking sector remains rather modest. Joint ventures in any sector only became possible 15 years ago. The first bank joint venture (IMB) was founded in 1989, ending the state monopoly on foreign currency operations, and the first fully foreign-owned bank subsidiary was set up only in 1993. At the same time, numerous newly established private Russian banks sought government shelter for their domestic and foreign-currency operations. In the midst of various deficiencies in the markets and operating environment, Russia still managed to attract 26 fully foreign-owned bank subsidiaries (as of 1 June 2002) and another 11 banks with foreign majority ownership. However, their business is only developing after the 1998 financial crisis.

Emerging banking market

The emerging, cautious state of banking in Russia is reflected in foreign involvement that differs from the situation in most Central and East European Countries (CEECs). All major foreign-owned banks in Russia are green-field operations. Their position is substantially weaker than in most CEECs. Of the largest 30 Russian banks, only six are foreign-owned, and the share of the largest ten foreign banks amounts to no more than 7 % of the banking sector's total assets of about $100 billion.

Foreign banks in Russia have notably differing business profiles, reflecting the differences of parent bank strategies regarding Russia. Some of the largest foreign banks have been active in collecting corporate deposits, and more recently household deposits (some 5-25 % of their balance sheets). Assessing the state of the market via major items in assets is complicated by caution in risk-taking. For example, foreign banks' corporate loans and interbank loans may contain very limited exposure to Russian risk.

Ongoing issues in Russian banking

Russia's relatively small banking sector (roughly 10 % of any of the largest banks in Europe) can be traced to a range of issues.

Distrust of banks remains a leading reason for the low level of deposits, although the large shadow economy also avoids banks. Looking back at the recent history, various Russian banks have mistreated their depositors and banks thus face a long march uphill to restore confidence among the public. Moreover, the sheer size of the largest bank, Sberbank, may sometimes restrain competition.

The evolution of transparency in Russian banks has yet to reach real disclosure, and there is still no formal pressure on banks to be open. Only one bank, Sberbank, has part of its shares publicly quoted. Most large banks apply international accounting standards, but small banks do not. Moreover, the introduction of international accounting standards (slated for 2004) needs to be coupled with other improvements in internal and external bank supervision. In 1998, for example, all large banks that failed had published neat IAS figures.

Finally, hampering financing of investments, bank balance sheets are heavily weighted with short-term liabilities as the number of potential investors with a long-term interest in rouble assets is limited. On the borrowers' side, transparency is naturally important, but in the current stage of lending business such basics as collection of collateral requires serious improvement. Indeed, the preconditions of bank lending extend even to the reform of Russian courts.

Winds of change

In such an environment, even the largest foreign banks have been unable to make much headway in Russia's development. Instead, caution prevails. Foreign bank subsidiaries remain unwilling to invest substantially, the Russian public has yet to discover their way to them and parent banks are wary when injecting equity to prop up subsidiaries' lending capacity. In the future, the supply of foreign banking services in Russia may take a combination of two modes.

First, while there is currently no need for large bank FDI for financing large investments in Russia, having a local presence is necessary if a bank wants to become a serious player in Russia's still relatively volatile market. Russia also seems to have rejected the idea of allowing foreign bank branches, at least, in the near future. On the other hand, Russian companies can already borrow from abroad without CBR permission, and the likely abolition of currency controls will enhance their access to state-of-the-art cash management tools.

Second, some leading international banks may also make major acquisitions of Russian banks in the next couple of years, mainly to gain local retail banking capacity.

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Economic Developments

Economy shows signs of reviving growth

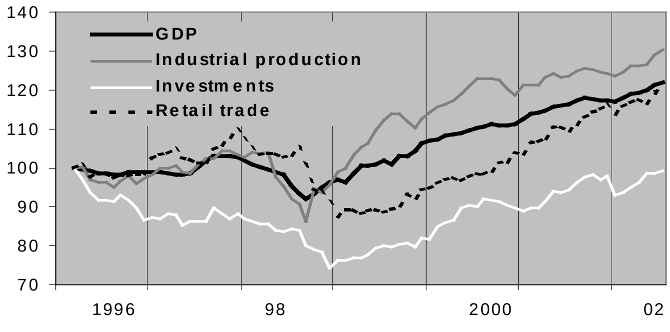
Economic growth picked up slightly in 2Q02. The five-sector indicator suggested 4 % on-year growth for the quarter and even higher growth in July. Growth of retail trade slowed but, reflecting brisk private consumption, was still 8 % in 2Q02. Industrial production revived slightly in 2Q02 (up 4 % y-o-y) and gained more pace in July. However, industrial growth in January-July relied primarily on three sectors: non-ferrous metals, food production and fuels. One of the slow sectors of the economy, construction, increased some 3 % in 2Q02, slightly faster than in 1Q02. Goskomstat data also suggests practically no growth of services in 2Q02.

Overall, seasonally adjusted calculations (e.g. economy ministry) indicate that the economy has recovered from last winter's chill (chart).

Slight changes in the investment structure

Growth of fixed investments revived from a dismal 1Q02 performance (just over 1 % y-o-y), reaching about 3.5 % in both 2Q02 and July. Changes in the structure of investments provided little hope of diversification. Compared to a year earlier, the oil industry's share fell slightly in 1H02 to below 17 %, while metallurgy rose. Investment in the transport sector (19 %) accounted for less than in 2000-01. However, housing and housing-related services grew to 15 % of the total, and the volume of completed housing space grew 15 % y-o-y in 1H02. Investments in communications and agriculture also picked up in 1H02 (4 and 3 % of the total). Companies relied even more heavily on their own funds to finance investments (52 % of the total), although bank loans also increased their share in 1H02 (to a still low 4.5 %).

GDP, industrial production, investments, retail trade (seasonally adjusted), indices, March 1996 (100) to July 2002



Source: Ministry of Economy, Goskomstat

Exports get prop, Western imports still grow

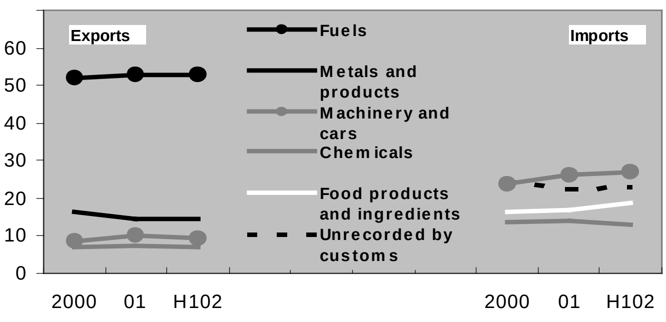
In dollar terms, Russia's exports declined 1 % y-o-y in 2Q02, bringing the drop for 1H02 to 7 % y-o-y. Total import growth halted in 1Q02, pulling down the growth in 1H02 to 7 %. The ongoing shift towards non-CIS imports kept growth in non-CIS imports at close to 20 % in 2Q02. Still, the fall of the dollar's exchange rate internationally exaggerates the import demand picture; in euro terms, Russia's non-CIS imports grew 18 % in 1H02 and 11 % in 2Q02.

Export earnings in 2Q02 were supported by increases in volumes and prices. The volume of crude oil exports grew almost 15 % y-o-y, the same pace as in 1Q02, while oil product volumes rose even faster. After about a two-year decline, gas exports picked up in 2Q02 (well over 10 %), making the overall volume growth for 1H02 4 %. The export price on crude oil rose 20 % from 1Q02, while the gas price stopped falling.

In 1H02, crude oil, oil products and gas retained their dominance in exports (over 50 %), although income from these main exports decreased. Overall other export income also fell in 1H02, but one feature was the continued growth of export volumes of basic forest industry products.

Russia's customs statistics suggest imports focused increasingly on machinery and food in 1H02. Imports of machinery and equipment (excluding passenger cars) grew over 15 % y-o-y, including a 25 % rise in non-CIS imports. Total imports of food and agricultural raw materials climbed about 10 %, while non-CIS imports grew over 25 %. The share of machinery and equipment (excluding cars) rose to 32 % of total imports and 34 % of non-CIS imports. The shares of food products and ingredients rose to 25 % of total imports and 27 % of non-CIS imports.

Major Russian exports and imports, % shares



Source: Russian customs, Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	4.1	Q2/02
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.9	1-7/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	1-7/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.6	7/02
Exports, € billion*	41.2	51.0	57.0	63.2	71.3	78.8	66.9	70.7	114.7	112.9	61.5	1-7/02
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	34.8	1-7/02
Current account, € billion*			7.0	5.7	9.2	1.8	0.6	23.1	50.4	38.4	8.2	Q1/02

*Sources: Goskomstat, CBR. *) Before 1999 values in ECU.*

Shrinking budget surpluses

Both consolidated and federal budget incomes decreased and expenditures rose in the first half of 2002, thus shrinking surpluses as compared to 1H01. Not including the unified social tax (UST), the 1H02 consolidated budget surplus fell from 4.5 to 3.0 % of GDP and the 1H02 federal budget showed a surplus of 2.6 % of GDP compared to 4.1 % in 1H01. On the revenue side, several major tax revenue sources declined markedly. As a share of GDP, consolidated revenues from the profit tax and customs duties dropped most. The decrease of these revenue streams was partly compensated for by higher income tax revenues and strong natural resource tax revenues.

Non-interest expenditure rose considerably in 1H02, mainly due to a jump in spending on social-cultural activities (excluding UST), which climbed in the consolidated budget from 8 % of GDP in 1H01 to 9.6 % of GDP this year. This category includes spending on education, health and social policy. Federal transfers to other budgets also grew. Lacking specific figures on how expenditures within these categories were distributed, it is likely that increases in public sector wages and pensions are behind most of the rise. Again this year, decreased debt servicing costs helped defray the expenditure increases.

Realised 1H02 and 1H01 federal budget

	1H02			1H01		
	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP
Revenues with UST	**991.1**	**100**	**20.5**			
Revenues excl. UST	**820.5**		**17.0**	**713.1**	**100**	**17.8**
Tax revenues with UST	929.5	93.8	19.3	661.8	92.8	16.5
VAT	*336.2*	*33.9*	*7.0*	*268.6*	*37.7*	*6.7*
Unified social tax (UST)	*170.6*	*17.2*	*3.5*	-	-	-
Profit tax	*84.2*	*8.5*	*1.7*	*102.9*	*14.4*	*2.6*
Customs duties	*139.3*	*14.1*	*2.9*	*158.0*	*22.2*	*3.9*
Excises	*111.1*	*11.2*	*2.3*	*100.4*	*14.1*	*2.5*
Other taxes	*88.1*	*8.9*	*1.8*	*31.9*	*4.5*	*0.8*
Non-tax revenues	61.6	6.2	1.3	51.3	7.2	1.3
Budgetary funds	*4.5*	*0.5*	*0.1*	*5.7*	*0.8*	*0.1*
Expenditure with UST	**828.3**	**100**	**17.2**			
Transfer of UST to Pension Fund	*132.5*	*16.0*	*2.7*	-	-	-
Expenditure excl. UST	**695.8**		**14.4**	**549.8**	**100**	**13.7**
Debt service costs*	113.6	13.7	2.4	126.2	23.0	3.1
Non-interest expenditure	582.2	70.3	12.1	423.6	77.0	10.5
Social-cultural activities	*112.2*	*13.5*	*2.3*	*84.8*	*15.4*	*2.1*
Defence	*119.8*	*14.5*	*2.5*	*106.7*	*19.4*	*2.7*
Transfers to other budgets	*153.3*	*18.5*	*3.2*	*109.7*	*20.0*	*2.7*
Other expenditure	*196.9*	*23.8*	*4.1*	*122.4*	*22.3*	*3.0*
Balance	**162.8**		**3.4**			
Balance excl. UST	**124.7**		**2.6**	**163.3**		**4.1**

Realised 1H02 and 1H01 consolidated budget

	1H02			1H01		
	RUB billion	% of total	% of GDP	RUB billion	% of total	% of GDP
Revenues with UST	**1577.1**	**100**	**32.7**			
Revenues excl. UST	**1406.5**		**29.1**	**1205.5**	**100**	**30.0**
Tax revenues	1422.8	90.2	29.5	1051.3	87.2	26.2
VAT	*336.5*	*21.3*	*7.0*	*269.0*	*22.3*	*6.7*
Profit tax	*228.5*	*14.5*	*4.7*	*241.4*	*20.0*	*6.0*
Unified social tax (UST)	*170.6*	*10.8*	*3.5*	-	-	-
Customs duties	*139.3*	*8.8*	*2.9*	*158.0*	*13.1*	*3.9*
Excises	*133.2*	*8.4*	*2.8*	*117.6*	*9.8*	*2.9*
Income tax	*150.1*	*9.5*	*3.1*	*108.4*	*9.0*	*2.7*
Other taxes	*264.6*	*16.8*	*5.5*	*156.9*	*13.0*	*3.9*
Non-tax revenues	154.3	9.8	3.2	154.2	12.8	3.8
Budgetary funds	*70.3*	*4.5*	*1.5*	*59.5*	*4.9*	*1.5*
State/municipal property or activity	*62.9*	*4.0*	*1.3*	*53.8*	*4.5*	*1.3*
Expenditures with UST	**1392.5**	**100**	**28.8**			
Unified Social Tax	*132.5*	*16.0*	*2.7*	-	-	-
Expenditures excl. UST	**1260.0**		**26.1**	**1026.5**	**100**	**25.6**
Debt service costs*	119.5	8.6	2.5	134.0	13.1	3.3
Non-interest expenditure	1140.5	81.9	23.6	892.5	86.9	22.2
Social-cultural activities	*461.2*	*33.1*	*9.6*	*322.9*	*31.5*	*8.0*
Defence	*119.8*	*8.6*	*2.5*	*106.7*	*10.4*	*2.7*
Law enforcement	*83.0*	*6.0*	*1.7*	*72.6*	*7.1*	*1.8*
State administration	*57.2*	*4.1*	*1.2*	*45.0*	*4.4*	*1.1*
Industry, energy, construction	*68.7*	*4.9*	*1.4*	*51.0*	*5.0*	*1.3*
Agriculture and fishery	*21.4*	*1.5*	*0.4*	*24.2*	*2.4*	*0.6*
Budgetary funds	*65.6*	*4.7*	*1.4*	*52.4*	*5.1*	*1.3*
Other expenditure	*263.6*	*18.9*	*5.5*	*217.7*	*21.2*	*5.4*
Balance	**184.6**		**3.8**			
Balance excl. UST	**146.5**		**3.0**	**179.0**		**4.5**

*Sources: Goskomstat/MinFin/EEG; *interest payments only. The consolidated budget includes federal and regional budgets. GDP figures used were RUB 4,016 billion for 1H01 and RUB 4,828 billion for 1H02.*

CBR releases monetary policy draft for 2003

According to the release, curtailing inflation and keeping the exchange rate stable will remain the Central Bank's top goals in 2003. The inflation expectation is expressed in terms of "base" inflation, which does not include certain regulated prices and prices of fruit and vegetables that are subject to high seasonal variations. The base inflation projection for 2003 is 7.5-8.5 %, which adds up to annual consumer price inflation of 9-12 %. Interest rates and domestic money market instruments are to receive greater emphasis as monetary policy tools. The CBR expects the rouble's real exchange rate with respect to Russia's main trading partners' currencies to strengthen no more than 4-6 % next year. The nominal exchange rate is expected to average about 34 roubles to the dollar in 2003.

Fiscal indicators (per cent of GDP, unless otherwise indicated; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2002	2002
Federal government								Jan-June	budget
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	20.5[1]	19.4[1]
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.5	17.2[1]	17.8[1]
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.1	3.3	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	55.3	44.4	43.6[2]	
- external debt, $ billion	128.0	136.1	134.6	158.2	154.6	143.4	133.1	131.9[2]	

[1)] *including social tax channelled via the federal budget (2.6 % of GDP in the 2002 budget; in Jan-June/02, 3.5 % of GDP in revenues and 2.7 % of GDP in expenditures)* [2)] *1 April 2002*

Sources: budget figures: IMF 1995-98; EEG (Economic Expert Group) 1999-2002, debt: IMF 1995-99, Minfin 2000-02

Foreign direct investments still low

The flow of foreign direct investment into Russia slowed in 1H02 compared to a year earlier. Goskomstat figures suggest they amounted to $1.9 billion in 1H02 ($2.5 billion in 1H01), while CBR preliminary balance of payments data indicate about $1 billion in 1H02 ($1.2 billion in 1H01). Goskomstat figures show the trade sector drew 40 % of the total, proportionately more than in 1H02. The share of FDI going to crude oil production still well exceeded 10 %, while machinery and equipment manufacture and the food industry each accounted for 10 % shares. Russia's FDI stock at end-June stood at less than $19 billion. The marching order often seen elsewhere seems to apply in Russia: i.e. first domestic investments would take off, capital outflows would ease, other capital inflows would pick up, and then, foreign equity risk-takers start to step in more widely.

Private capital outflows decline

While capital outflows of the Russian government have remained high this year due to foreign debt service payments and modest foreign borrowing, private capital outflows have fallen in net terms (chart). As a whole, net capital outflows of banks and firms, as well as unrecorded capital flows (as reflected by the balance of payments' net errors and omissions) decreased both last year and so far this year. In 1H02, that total net outflow amounted to less than 5 % of Russia's total trade flows against 8 % in 2001 and double that level in preceding years. The banks' net inflow has turned positive as the balance of payments especially recorded smaller outflows of assets (less deposits abroad) and also larger inflows for liabilities in 2001 (larger credits from abroad). The net capital inflow of firms remains negative despite their slightly improved ability to attract foreign loans. This is mainly because outflows via non-repatriated export income and advance payments for non-materialised imports have remained stubbornly high.

Use of money surrogates stabilised

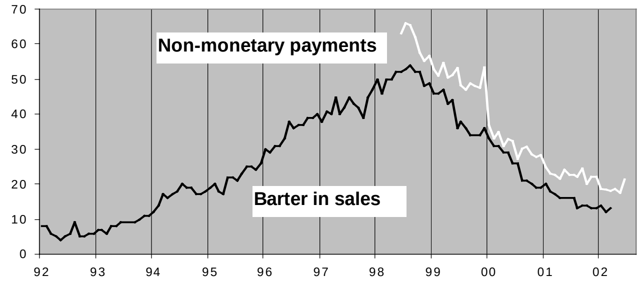
During the main part of the first half of 2002, the share of money surrogates (IOUs, offsets, barter, and others) as a means of payment was quite steady at some 18-19 % of the sales of the largest taxpayer enterprises and monopoly firms (chart). In January-June, IOUs and offsets were the most common means of money surrogates, each accounting on average for some 7 % of all sales income. Other regular surveys indicate the share of barter in sales of industrial firms covered (a few hundred firms) declined early this year. The use of monetary payments scarcely increased in summer and it now looks like the economy may be facing tougher layers of non-monetary exchanges.

Wage arrears on the rise

Apart from a small fall in the spring, wage arrears have risen this year. Since June, they increased rapidly. At the beginning of 2002, wage arrears owed by enterprises and public organisations stood at some RUB 30 billion. They had risen to almost RUB 36 billion by the start of August. Some 85 % of the arrears are owed by enterprises to industrial workers, although in the enterprises' accounts they constitute less than 2 % of the enterprises' total payables overdue (mainly to suppliers, the various public sector budgets and banks). Wage arrears of enterprises have risen much more slowly (13 % in nominal terms during January-August) than those of budgetary organisations (over 50 % during the same period). As regards budgetary wage arrears, they are mainly (about 90 %) regional arrears and owed to social sector workers.

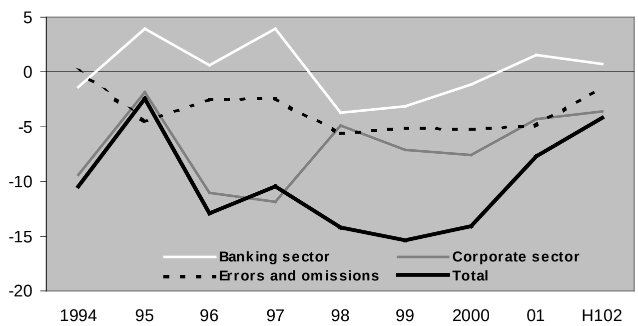
The rise of wage arrears is partly connected to increases in public sector wages and pensions, which were not fully included in federal and regional budgets this year. The federal budget has sought, rather unsuccessfully, to cover the deficit at the regional level by increasing transfers. New wage hikes are planned for the autumn and 2003.

Share of barter in industry sales and non-monetary payments in large enterprises' payments received, %



Sources: Russian Economic Barometer, Goskomstat

Private net capital inflows and errors and omissions in Russia's balance of payments in 1994-02, % of trade of goods and services



Source: CBR

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	8/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	33.5	7/02
Average wage, €, period avg, except last	79	122	145	97	58	86	126	145	7/02
Interest rates, period average									
- deposit rate, %	102	55	16.8	17.1	13.7	6.5	4.9	5.0	7/02
- lending rate, %	320	147	32.0	41.8	39.7	24.4	17.9	16.0	7/02
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	44.3	8/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	31.57	8/02

Sources: Goskomstat, CBR

The dismal state of Russia's heavy machinery industries

by Pertti Naulapää*

Production of heavy machinery, especially tractors, was once the backbone of Soviet metal engineering. A study carried out in the fall 2001 to spring 2002, found Russia's heavy machinery industries in gloomy condition. [1]

Evolving market segments

The main markets for Russian heavy machinery still are agriculture, forestry, and construction. In all these customer sectors, the technology level is very low.

Agriculture, which also suffers from minimal purchasing power, is undergoing changes. New legislation would give Russian citizens the right to buy, own and sell agricultural land, and use it as collateral. Currently, old collective farms and their successors still produce around 90 % of grain, while most milk, meat, potatoes and vegetables are produced on small household plots. Private peasant farms have little significance. During recent years, commercial farms (operator farming based on land lease) have also proliferated. According to major Russian tractor manufacturers, they will probably be the most important customer group in the future.

In construction, old Soviet structures and methods also continue to dominate. However, new types of machine entrepreneur groups have appeared to work on contractual basis on construction sites. These groups have much higher efficiency targets than general contractors.

Production at the bottom

With the disintegration of the Soviet Union, agricultural and construction machinery industries in Russia collapsed (chart). By 2000, the manufacture of tractors and grain combine harvesters fell to 7-10 % of their 1990 level, and the production of other agricultural machines and forest machines collapsed similarly. Annual production has risen slightly in the past two years (to 15,000 tractors and 6,000 harvesters). Even so, US authorities estimate that Russia still needs at least 600,000 tractors and over 400,000 combine harvesters. Russian government experts have come to roughly the same estimates. Only about 50 % of Russia's tractor fleet of 700,000 is ready for fieldwork, and the fleet continues to decrease about 10 % annually. Over 20 % of grain harvest is lost because of the condition of agricultural machinery.

The production of construction machinery also fell sharply. Compared to 1990, the production of excavators collapsed to about 10 % by 2000 and bulldozers to 20 %. After that, production picked up slightly. About 50 % of construction equipment in service has reached or exceeded its useful economic lifetime.

Imports of agricultural machinery expanded rapidly before the rouble fell in 1998. In 2000, about 14,000 agricultural and industrial tractors were imported to Russia (equal to Russian production) including about 6,000 from Belarus. Imports of combine harvesters were about 500 units in 2000. The imported share of construction machinery fleet is relatively large (in 2000, about 20 % for excavators, about 30 % for cranes, about 33 % for scrapers and 13 % for bulldozers).

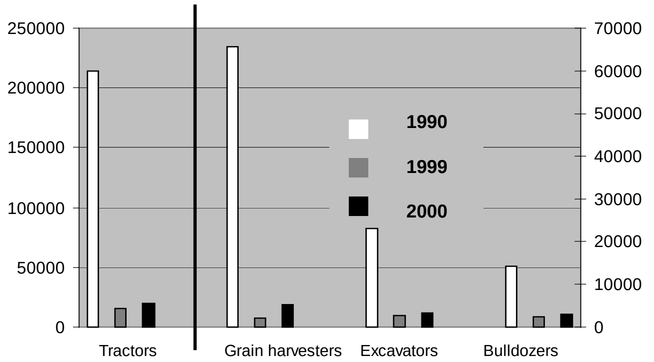
Russian-made agricultural and construction machines became competitive after the rouble devaluation. Given Russia's low labor and fuel costs and existing service infrastructure, Western manufacturers found it hard to penetrate the Russian market. Productivity requirements in Russian agriculture and construction sectors remain low and Russian machines are adequate to meet these low expectations. Obviously, as soon as competition intensifies, the need for imports of high productivity Western equipment will also increase.

Manufacturers suffer from various deficiencies

The above-mentioned study used benchmarking technology to evaluate Russian manufacturers of agricultural and construction machinery, based on nine groups of factors. For example, the average technology rating of the Russian manufacturers was about 40 on the scale of 100. Scandinavian benchmark companies had ratings of between 90 and 100. Russian production technology and production management are generally at the level Scandinavian manufacturers had in the early 1970s. Products were basically designed in the 1970s and 1980s. Thus, there is a huge need for investments in product development, production and marketing. Spare parts production and distribution systems do not function either as dealer networks are still under creation.

According to some Russian government experts, it would take about one billion dollars annually just to preserve the present tractor fleet. Yet only a fraction of this sum has been invested in tractor production during the last years. According to the same experts, about 20 billion dollars would be needed for machinery and other inputs to restore the Russian agricultural complex to its earlier levels.

Production of major Russian heavy machinery products, units



Source: Goskomstat

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[1] Naulapää, P., Structure and Potential of Russian Agricultural and Construction Machinery Markets, DBD International Development Ltd, Helsinki, 2002

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Economic Developments

Economic growth continues

In the first half of this year, Russia managed to resist the decelerating trend of economic growth prevailing in the industrialised countries. Goskomstat reported 3.9 % on-year growth for GDP in 1H02, with growth amounting to 3.7 % in 1Q02 and accelerating to 4.1 % in 2Q02. As this summer wore on, the growth picture looked mixed. The production index of five key sectors of the economy, which is used as a proxy for total production, rose over 6 % in July and 2.5 % in August.

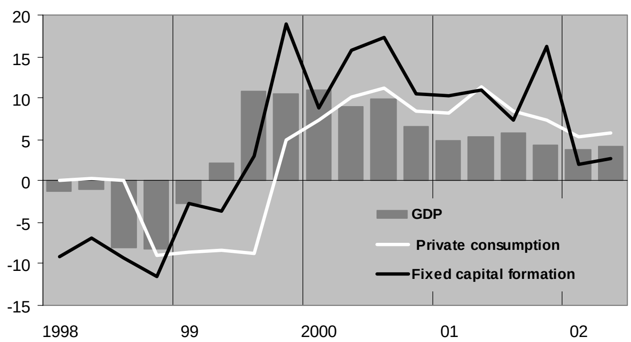
Expansion of the economy remains largely based on private consumption (up 5.8 % y-o-y in 2Q02), while fixed capital formation (net investments) grows sluggishly (up 2.7 % in 2Q02). Although growth in both categories accelerated slightly from the first quarter, it remained far below the rapid rates recorded in recent years. Public consumption picked up around 2 % in 1H02.

Consumption growth is related to the still relatively rapid increase in real money incomes of the population, which was 8.5 % y-o-y in 1Q02 and almost 9 % in 2Q02. The drastic deceleration in the rate of investment growth in early 2002 is a serious problem for further restructuring and development of the Russian economy. The share of fixed capital formation in GDP fell below 15 % in 1H02 (slightly less than in 1H01) – a far-too-modest level given the Russian economy's huge investment needs.

The volume of net exports increased in 2Q02 for the first time since 1999. The rise in oil prices on international markets, which started early this year, has further supported the value of net exports and propped up economic growth.

Encouraged by relatively rapid growth in the first half of this year, the government in September revised upwards its forecasts for GDP growth for 2002 from 3.6 % to 4 %. In September, the IMF also boosted its growth forecast for Russia to 4.4 % for this year.

GDP, private consumption and investments, % change from the same quarter of the previous year



Source: Goskomstat

Oil exports support current account

The volume of Russia's oil exports, as well as oil production generally, has risen this year. During January-August, crude oil exports expanded 11 % from a year earlier. Despite the increased volume and high world market prices on oil, Russia's export income grew only 1 % y-o-y in 2Q02 (and fell 4 % in 1H02). The current account surplus equalled almost 10 % of the GDP. The dollar value of imports increased in 1H02 about 10 % y-o-y, boosted in part by improving real incomes of the population.

In the first half of this year, the inflow of direct investment into Russia remained at roughly last year's level, indicating little enthusiasm among foreign investors, and despite several major legal reforms introduced in the past twelve months with the aim of improving the business climate. Apparently, it takes time to convince foreign investors that the new laws are being enforced properly. On the other hand, total net capital inflows of the private sector recorded in the balance of payments turned slightly positive in 2Q02 and the negative value of errors and omissions reflecting unrecorded capital flows was exceptionally small.

Due to significant export incomes, Russia's foreign currency and gold reserves continued to climb in 3Q02, amounting to $45.6 billion at the end of September.

Balance of payments, US$ billion

	2000	2001	2002H1
Current account	47.3	34.6	14.9
Trade balance	60.7	47.8	20.9
Exports, f.o.b.	105.6	101.6	48.0
Imports, c.i.f.	-44.9	-53.8	-27.1
Services balance	-6.7	-8.5	-4.2
Exports	10.0	10.9	5.9
Imports	-16.7	-19.4	-10.1
Investment income	-6.7	-4.0	-1.4
Received	4.3	6.2	3.4
Paid	-11.3	-10.3	-4.8
Other items, net	0.1	-0.8	-0.3
Capital and financial account	-21.5	-17.2	-7.0
Capital Account	11.0	-9.4	-1.2
Received	11.8	2.1	6.1
Paid	-0.9	-11.5	-7.3
Financial account	-32.5	-7.8	-5.7
Direct investment to Russia	2.7	2.5	1.3
Portfolio investment to Russia	-9.9	-0.7	-0.5
Other items, net	-25.3	-9.6	-6.5
Net errors and omissions	-9.7	-9.2	-1.3
Change in reserves	-16.0	-8.2	-6.6

Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	3.9	H1/02
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.8	1-8/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.4	1-8/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.5	8/02
Exports, € billion*	41.2	51.0	57.0	63.2	71.3	78.8	66.9	70.7	114.7	112.9	61.7	1-7/02
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	35.2	1-7/02
Current account, € billion*			7.0	5.7	9.2	1.8	0.6	23.1	51.4	38.5	16.5	H1/02

*Sources: Goskomstat, CBR. *) Before 1999 values in ECU.*

2003 budget bill passes first reading

As expected, the 2003 federal budget passed its first reading, enjoying broad support from Duma deputies. The Duma approved budget revenues corresponding to 18.5 % of GDP and expenditures amounting to 18 % of GDP. The surplus will be used to pay down part of the foreign debt and build up the financial reserve. The second reading of the budget, where the division of expenditures between different budget categories is adopted, is scheduled for the second half of October.

Natural monopolies overhaul likely to take a while

The reform of UES (United Energy Systems), Gazprom and the Russian railways remains a central issue of transition. Although a monopolies act was approved in 1995, concrete reform (albeit slow and inconsistent) truly began after president Yeltsin signed several decrees on natural monopolies in spring 1997. The overall aim of monopoly restructuring has been to focus their operations, cut costs, secure investment, and increase transparency and competition.

The government approved a program for the ***power sector*** restructuring in summer 2001. A package of several reform bills concerning UES gets its first reading before the Duma this month. The reform program aims at creating competitive energy markets in 8 to 10 years. Under the program, natural monopoly components of power industry – transmission and dispatch – will be separated from power generation and distribution, where competition will be introduced. At the beginning of the reform, conditions for competition will be created e.g. by approving necessary legislation, establishing a market infrastructure and a regulatory system. Other important measures include diminishing payment arrears and gradual elimination of cross-subsidies between industrial and household users. The plan includes setting up a state *transmission company* to handle the high-voltage grid and a *system operator* to take care of the overall functioning of the wholesale market. These companies will initially be 100 % owned by UES. The state will thereafter gradually increase its direct ownership.

The wholesale market will include generating firms separated from UES, regional energy companies and independent firms. State-controlled companies will be first allowed to sell only 5-15 % of their energy at market price. Independent firms will have no such restrictions. At the retail level, regional *energos*, controlling the regional low-voltage grid, will be restructured to separate generation and distribution. They will compete with new distribution companies as they emerge. By the late 2006 or 2007, the wholesale and retail power tariffs should be determined by the market. The final stage of the program includes attracting private investment to the sector.

In June 2002, the Duma passed first readings of a package of four bills on ***railway*** reform. The second reading is expected before the end of this year. A program of structural reform of railways was adopted in spring 2001. It consists of three stages covering a ten-year time period to 2010. The first stage (2001-2002) includes preliminary measures such as debt restructuring, taking inventory of Railways Ministry property and creating conditions to increase competition. Regulation of railways will remain with the Railway Ministry. A joint stock company, Russian Railways, will be established to take care of operations. According to present estimates, this change should materialize around March 2003. The new company will later be divided into several independent subsidiaries to take care of different railway sectors such as passenger traffic and freight traffic. Functions not closely linked to railways will be separated and privatised. The new company will compete with private companies expected to emerge. In the second and third stages of reform, cross-subsidies will gradually be phased out and investment will be brought in through the sale of shares in subsidiaries of Russian Railways.

Reform of the ***gas sector*** clearly lags behind reform of other natural monopolies. In March 2002, an investment program was finally approved for the gas sector. The government hopes to have its gas reform program approved by December 2002. According to the draft program version of December 2000, reform is to be carried out in three stages from 2001 to 2013 with the ultimate goal of creating a competitive wholesale market that includes free access of all market participants to Gazprom pipelines. Notably, the divestment of Gazprom is not straightforwardly suggested in the draft. According to the recent statements of prime minister Kasyanov, Gazprom will not be privatised before it is restructured.

During recent years, much of the debate on natural monopolies has concentrated on ***tariff issues***. At the end of September 2002, the Duma passed a law whereby power tariffs are to be specified each year before the approval of the coming year's budget. Similar amendments are planned for laws regulating railway and gas tariffs. The wholesale tariff hikes implemented in February-March and July will presumably be the only ones this year. In November, the government plans to examine the budget plans of natural monopolies and their programs for cutting expenditures, which according to the government must precede future tariff increases. Tariff increases planned so far for the next few years are relatively cautious (see Month in Review 6/02). The OECD estimates that the average industrial price for natural gas in Russia in 2000 was about 10 % of the OECD average and electricity about a quarter.

Fiscal indicators (per cent of GDP, unless otherwise indicated; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2002 Jan-July	2002 budget
Federal government									
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	20.8 (1	19.4(1
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.5	17.2(1	17.8(1
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.1	3.6	1.6
- external debt	36.8	31.6	30.2	50.1	87.7	55.3	44.4	43.6(2	
- external debt, $ billion	128.0	136.1	134.6	158.2	154.6	143.4	133.1	131.9(2	

1) *including social tax channelled via the federal budget (2.6 % of GDP in the 2002 budget; in Jan-July/02, 3.5 % of GDP in revenues and 2.7 % of GDP in expenditures)* 2) *1 April 2002*

Sources: budget figures: IMF 1995-98; EEG (Economic Expert Group) 1999-2002, debt: IMF 1995-99, Minfin 2000-02

Drop in unemployment, but pressure may mount

As of end-August, some 5.4 million Russians were unemployed according to Goskomstat calculations based on ILO methodology. The figure corresponds to 7.5 % of the workforce, which compares to 8.6 % in August 2001 and almost 10 % in August 2000 (see chart). In 1H02, the number of people on forced leave and working part-time also decreased (7 and 13 %, respectively, from 1H01). However, the ministry of labour and social development has indicated that next year the number of people of working age will be the highest in many years creating pressure in the labour market. It is forecast that in 2003 the labour supply will increase as over 700,000 young people enter the labour market. Moreover, gross emigration from CIS countries is expected to continue at the 2001-2002 level (over 200,000 estimated for 2003) and a large number of pensioners will likely continue working.

According to Goskomstat monitoring, which covers over 41 million full-time employees in large and medium-sized enterprises, the turnover of labour continued to grow this year. In 1H02, the number of hirings increased 5 % compared to 1H01, while the number of departures grew under 3 %. Some 6 % of the recruitments were to new jobs. It remains to be seen whether the new labour code (see below), expected to liberalise labour relations, will support new job creation.

New labour code to increase flexibility

After a five-year preparation period, the new labour code entered into force in February 2002 replacing the old code introduced in the early 1970s. Together with the trilateral labour agreement on labour policies for 2002-2004 (see Month in Review 2/02), it forms a new framework for relations among employers, employees and the state, and introduces market-type principles until now missing in labour relations.

Nevertheless, there are still plenty of new laws and regulations to be passed to guarantee the smooth functioning of the new code. Moreover, the new code only applies to employment contracts made after February 2002.

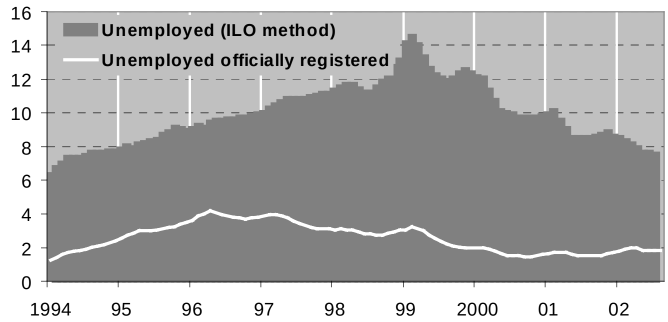
The new labour code has far more content and detail than its predecessor. It also applies to foreigners working in Russia and provides for a 40-hour working week, a 28-day minimum vacation period and a minimum wage equalling the poverty line. The dismissal of employees, nearly impossible during the Soviet era, becomes easier. The new code also calls for timely payment of wages and allows an employee to stop working if she has not received her wages within 15 days after a fixed date. This stipulation will inevitably create problems in many Russian regions and serve as a test case for the functioning of the code. Since June, the amount of wage arrears increased rapidly (see Month in Review 7-8/02), mainly due to large pay increases to budget sector employees.

Enterprise arrears persist

Goskomstat data indicate overdue payables of enterprises, after a clear decline last winter, remained relatively unchanged in 2Q02 (see chart). Overdue payables to *suppliers* (as well as overdue receivables from buyers) remained virtually stagnant. This suggests – similar to the developments in the use of barter and other money surrogates (see Month in Review 7-8/02) – that either some reliance on arrears in transactions could be emerging as economic growth has slowed this year or that stickier layers of the old arrears will persist. Overdue payables of enterprises to various public sector *budgets* underwent a partial restructuring in 1Q02, which caused them to fall. In 2Q02 the decline slowed as the effect of the restructuring waned.

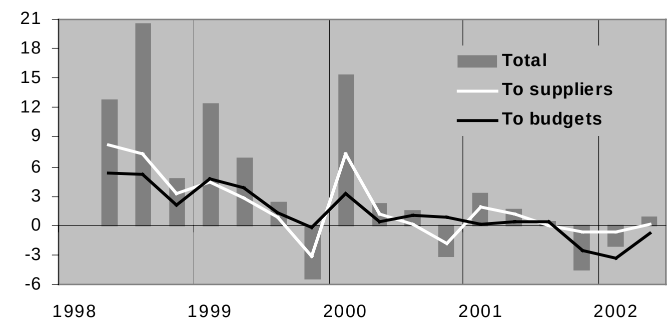
On the bright side, the role of the arrears has lost significance this year as a source of enterprise finance. For example, the share of overdue payables in the enterprises' total payables continued to decline from 30 % at the end of 1H01 to 23 % at the end of 1H02 (the latter figure includes over 10 % for arrears owed to suppliers and over 7 % for arrears owed to public sector budgets). Total payables of enterprises increased substantially this year to over 70 % of the GDP, due mainly to bank loans and other credits.

Unemployment, % of work force



Source: Goskomstat

Change of overdue payables of enterprises, % of quarterly GDP



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Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	45.6	9/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	31.64	9/02

Sources: Goskomstat, CBR

Problems of economic statistics in Russia

by Sergey Nikolaenko*

The Russian system of economic statistics is still underdeveloped in many respects. This hampers economic analysis and hence does not provide sufficiently accurate information for decision-making. In the following, some of the most important problems related to these statistics are presented in the light of concrete examples.

The basic measure of the economy – GDP

In Russia – unlike in developed market economies – calculation of GDP is based mainly on the sum of value added produced in the economy and not on aggregate spending. This is because a large share of income and transactions in Russia take place in the shadow economy, which makes it difficult to include them in statistics. Russia's production approach in calculating GDP suffers from the fact that the last comprehensive census for input-output tables, which show the structure of production in the economy, was made in the 1980s. Extrapolation has been used to construct more recent input-output tables. As a result, in most cases it is presumed that the share of intermediate production in gross production stays constant, and the dynamics of real GDP (value added) are similar to dynamics of gross production. This is not the case, of course, as e.g. increasing efficiency of production is ignored in such calculations.

Use of alternative methodologies

The reintroduction of consumer price index (CPI) in the Soviet Union in the 1980s (its predecessors had been in use in the 1920s) was an important step towards building a market economy. The CPI, even though it suffers from the fact that its weights are changed every year on the basis of household surveys, is rather good at measuring inflation. What it is not so good at is measuring the development of real indicators such as incomes and expenditures, and in particular, providing reliable monthly observations during times of crisis due to the delays in weighting changes. Nevertheless, official Goskomstat statistics use CPI in calculating real income, and hence give incorrect results. If we instead use the deflator of retail sales of goods and services (calculated by dividing the index of nominal sales by the index of real sales), it turns out that real income of the population diminished during the 1998 crisis 10 % less than official statistics show. This is due to the fact that there was a shift in consumption from imported goods, which suddenly became very expensive, to cheaper domestic goods. Also, the pre-crisis level of real consumption was already reached at the end of 2001. Official statistics show this happened in the second quarter of 2002.

Data accuracy, revision, and comparability

Goskomstat publishes its first GDP figure, based on preliminary indicators, three months after a quarter is finished. The figure is then revised as additional information emerges. The final figure usually comes out a year later, and can significantly differ from earlier figures. For example, on-year growth of GDP in 1Q 2000 was initially estimated at 8.4 %; the figure published a year later was 9.0 %. The corrected final figure of 11 % was published one year after that. Such large corrections are not uncommon internationally, but in Russia the reasons were not discussed. It is unclear whether efforts have been made to improve the system to avoid such large corrections.

There are also problems with the publication of revised statistics, stemming from the Soviet tradition that regarded amending figures as correcting mistakes. Preliminary figures receive vast publicity, while later revisions receive little comment. And there is the perhaps bigger problem of methodological changes, as official publications almost totally lack explanations of methodological adjustments and their implications for time series. No simultaneous series containing both old and new data are published. This creates situations where comparison in time of data series is difficult, diminishing their usefulness in economic decision-making.

Let us consider, for example, the statistics on enterprise profits. Official Goskomstat statistics published in March 2001 show that in January 2001 there was an on-month increase in profits of 40 %. Taken at face value, such information surely gives one reason to feel optimistic about the economic situation. However, the April issue of the relevant Goskomstat statistical publication contained a footnote explaining that Gazprom had been included in the series since the start of the year. What was (and still is) missing is information on what other enterprises are not included in the sample, what was the profit development of the old sample excluding Gazprom in early 2001, and what was the profit development of the new sample before 2001. Hence, the comparability of the series was lost.

Problems of using information

The basic reasoning behind the introduction of a flat income tax rate and unified social tax at the start of 2001 and 2002, respectively, was to improve the tax system. The losses to the budget caused by the cut in tax rates were to be compensated for by expanding the tax base through legalisation of earlier unregistered incomes. However, no one agreed with Goskomstat as to what kinds of indicators would be needed for monitoring the process. Hence, Goskomstat continues to publish incomplete wage statistics that do not allow assessment of the effects of the tax changes. To make things worse, the publication of household budget surveys was ceased in 2001 due to a change in methodology. When publication of the surveys restarted, they omitted information on taxes paid. Such omissions make evaluation of the effects of the reform difficult, and comparison of information on households impossible. Thus, two years after the introduction of major tax reforms, there is still no reliable basis on which to evaluate their impact on the economy. Worse for researchers, perhaps, was the loss of a unique chance to study the sensitivity of the Russian economy to fiscal steering methods.

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RUSSIAN ECONOMY
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10•2002

Economic Developments

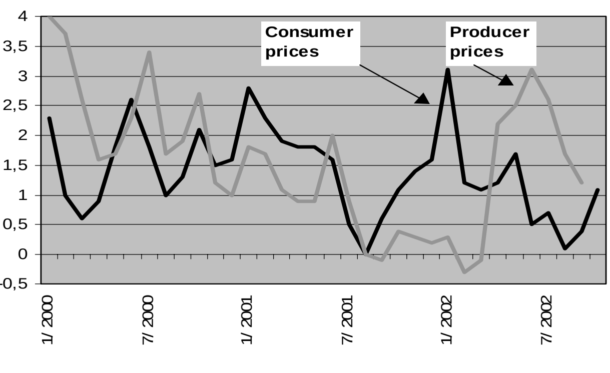
Economic growth continues, inflation rate stable

Consumer spending continues to drive economic growth in Russia. In the first nine months of 2002, retail sales, a reflection of private consumption, rose 9 % y-o-y. September retail sales were up nearly 10 % y-o-y. The strength in private consumption reflects higher real disposable incomes, up 7 % y-o-y in the first nine months of the year. Real income growth slowed in September, however, to around 3 % y-o-y. Investment, the other main component of domestic demand, has risen slowly during 2002. It was up just 2.5 % y-o-y in the first nine months of the year and less than 3 % y-o-y in September.

The composite indicator of performance of Russia's five main economic sectors, an advance indicator of GDP trends, remained below 3 % y-o-y in September for the second month in a row. Growth has slowed since the beginning of the year. For January-September, the five-sector indicator showed growth of 4 % y-o-y. Retail sales were up 9 %, freight transport 5 %, industrial output 4 % and construction nearly 3 %. Agricultural production was down 1.6 %.

All industrial sectors rose in January-September. The largest on-year growth was recorded in oil extraction and the food industry – both grew by some 8 %. In the third quarter, however, growth in food production stalled almost completely. Slow growth in light industry and the slowdown in food industry growth possibly reflect a worsening in their competitiveness vis-à-vis imports. The continuing increase in real incomes makes better quality imports affordable to consumers. Russian producers' chances for improving their products are still limited by scarce investment resources.

Consumer prices and producer prices in 2000–2002, m-o-m %-change



Source: Goskomstat

Monthly consumer price inflation accelerated in August (see graph), although on-year growth has remained stable at about 15 % since June.

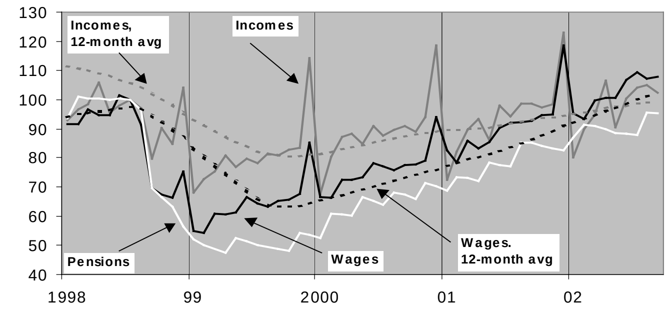
Real pensions approach pre-crisis level

All income categories have grown in real terms this year. According to preliminary information, real *disposable incomes* (adjusted for inflation with mandatory payments deducted) in September were 3 % higher than a year ago and 2 % higher than in summer 1998.

Wages, which have recovered most quickly in real terms, were almost 8 % higher in September than in summer 1998 and 17 % higher than a year ago. Despite a drop in September, however, wage arrears remain high and have risen in nominal terms by some 18 % since the start of the year. Although about 85 % of arrears are owed by non-budget organisations, arrears due to under-financing of the budget sector – especially regional budgets – have risen fastest. The traditionally large wage disparities among sectors remain with Russia's highest wages paid in the gas and oil industry (4–5 times higher than the overall average wage in August) and lowest in agriculture (44 % of the average).

Pensions are nearing their pre-crisis level. Rising 12 % since September 2001, real pensions in September 2002 were just 5 % below their level of summer 1998. Real pensions have recovered fastest in the last two years; since December 1999 they have risen almost 80 %. The average pension in September accounted for one-third of the average wage, 40 % of the average money income and 74 % of the overall minimum subsistence level in the third quarter of 2002. The average pension in September was 5 % higher than the subsistence level calculated for pensioners.

Real disposable incomes, wages and pensions, July 1998=100



Source: Goskomstat

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	3.9	H1/02
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	4.0	1-9/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.5	1-9/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.6	9/02
Exports, € billion*	41.2	51.0	57.0	63.2	71.3	78.8	66.9	70.7	114.7	112.9	68.2	1-8/02
Imports, € billion*	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	38.5	1-8/02
Current account, € billion*			7.0	5.7	9.2	1.8	0.6	23.1	51.4	38.5	16.5	H1/02

Sources: Goskomstat, CBR. *) *Before 1999 values in ECU.*

2003 budget moves ahead

The 2003 budget passed its second Duma reading in mid-October with only minor changes. The second reading fixed budget spending by category and left spending within categories to be resolved in the third reading, which is set for late November.

The largest expenditure categories in the 2003 budget are federal transfers to regional budgets (30 % of expenditures), defence (16 % including expenditure on reform of the armed forces) and interest payments on debt (12 %). Spending on the justice system and internal security accounts for a tenth of all expenditure. While federal transfers appear to have risen substantially from 2002, the increase is actually somewhat artificial as over half of federal transfers consist of unified social tax (UST) transfers to Pension Fund. This year they were classified as social policy expenditures.

As a share of GDP, transfers to regional budgets rose to 2.5 % of GDP in 2001, up from 1.4 % of GDP in 2000. In 2002 budget they were set at the 2001 level. In 2003, they will account for 2.7 % of GDP (on a comparable basis, i.e. not including UST). The increase is planned partly to compensate for changes in taxation entering into force at the start of next year. The changes will decrease tax income going to the regions. The most important change affecting regional budgets will be the abolition of the road tax and the tax on vehicle owners. Compensatory measures also include the introduction of a new regional transport tax and increasing the regional shares of profit tax and land tax.

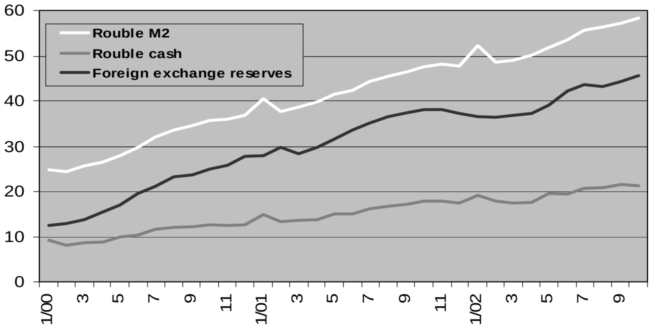
Oil income boosts foreign reserves

Thanks to high international oil prices, the Central Bank of Russia's foreign currency and gold reserves rose in the autumn to $46.8 billion as of end-October. This, combined with the government's stringent fiscal policies, has helped to ease Russia's "2003 problem," i.e. a debt repayment peak exceeding $20 billion that had accumulated for next year. Thanks to its large foreign reserves, Russia should now be able to manage the payment peak with less than $18 billion as a result of early repayments made during the past year.

The external value of the rouble has continued its path of gradual nominal depreciation against the dollar in accordance with the monetary policy strategy for 2002. Nominal depreciation vis-à-vis the dollar amounted to 5.4 % over January-October 2002. In real terms, the rouble appreciated 2.5 % against the dollar during January-September. Given the euro's strengthening against the dollar on international markets in the second quarter in particular, the rouble depreciated 6.4 % in real terms against the euro during January-September.

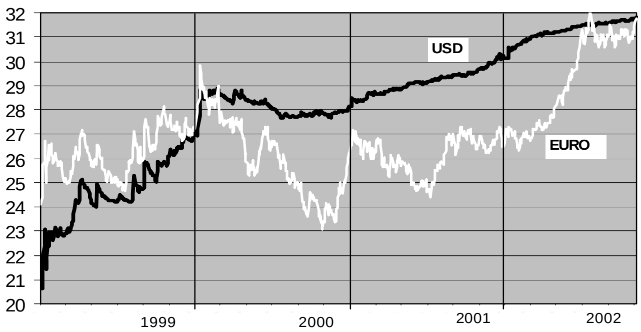
Monetary policy has continued to be relatively restrictive as can be seen in the deceleration of money supply growth during the current year (measured by M2, i.e. rouble cash in circulation and rouble bank deposits). At the end of September, the on-year growth in M2 was 30.6 %, compared to growth of 42.5 % a year earlier.

Foreign reserves, rouble money supply, and rouble cash in circulation, Jan 2000–Oct 2002, US$ billion



Source: CBR

Rouble/dollar and rouble/euro daily exchange rates, 1999–2002



Source: CBR

International acceptance to Russia's new legislation

In September the Duma toughened the anti-money-laundering act, which came into force in February, in response to demands from the OECD's Financial Action Task Force (FATF), which coordinates internationally measures against money laundering. As a result, the FATF voted in October to remove Russia from its list of non-cooperating countries. The move was seen as international recognition of Russia's efforts to improve its business climate. However, it is not yet clear when the new law and related regulations will be fully operational.

Russian government and the Central Bank reached in early November an agreement on further liberalisation of currency controls. According to the draft law under preparation, currency control will be markedly eased in the near future and abolished almost totally by 2007.

Fiscal indicators (per cent of GDP, unless otherwise indicated; end-year figures for debt)

	1995	1996	1997	1998	1999	2000	2001	2002	2002	2003
Federal government								Jan-Aug	budget	budget draft
- revenues	12.9	12.5	12.3	11.0	12.6	15.5	17.6	20.4 [1]	19.4 [1]	18.5 [1]
- expenditures	18.6	20.9	19.4	16.9	13.9	14.3	14.6	17.2 [1]	17.8 [1]	18.0 [1]
- balance	-5.7	-8.4	-7.1	-5.9	-1.4	1.2	3.0	3.1	1.6 [1]	0.6 [1]
- external debt	36.8	31.6	30.2	50.1	87.7	55.3	44.4	40.5 [2] [3]		
- external debt, $ billion	128.0	136.1	134.6	158.2	154.6	143.4	133.1	128.3 [2]		

1) Including social tax channelled via the federal budget (2.6 % of GDP in the 2002 budget; in Jan-Aug 2002 3.3 % of GDP in revenues and 2.7 % of GDP in expenditures) 2) June 2002 3) In % of July 2001- June 2002 GDP

Sources: Budget figures: IMF 1995-98, Economic Expert Group 1999-2002. Debt: IMF 1995-99, Minfin 2000-02.

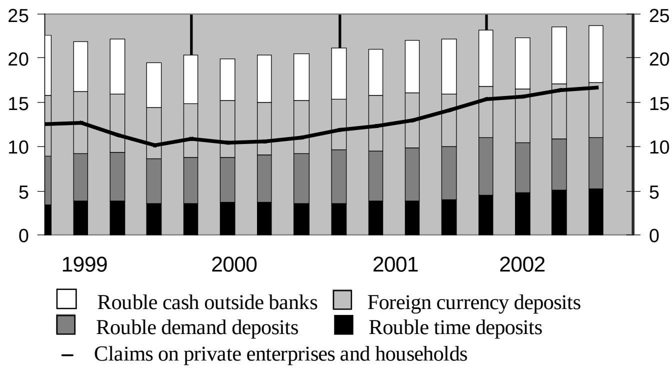
Growth of bank credit still brisk, but slowing

The rapid revival of banking in Russia may be cooling a bit. The stock of all rouble and foreign currency deposits entrusted to banks by households and companies rose over 10 % y-o-y in 3Q02, i.e. at about the same pace as during the preceding year (all percentage changes in real terms, deflated by consumer price index). Total rouble deposits rose 15 %, driven by rouble time deposits, which were up 40 %. Rouble demand deposits fell from a year earlier. Growth of foreign currency deposits picked up to 10 %. The growth of rouble cash in circulation outside banks, which had been running at around 20 % y-o-y from 2001 and until last summer, slowed to 10 % in 3Q02.

Expansion of bank lending slowed, however. This could be seen in banks' claims on private companies and households, which grew 24 % in 3Q02 from a year earlier, the slowest rate since spring 2000. The stock of bank claims on publicly owned enterprises (only 6 % compared to bank credit to the private sector) rose slightly quicker, after declining until last spring. Still, bank credit as a whole expanded on-year considerably faster than banks' total assets in 3Q02. The CBR recently gave indications that the expansion of bank credit may be too fast and some credit decisions less than prudent.

At the end of 3Q02, Russia's money supply (rouble M2 + foreign currency deposits) amounted to 24 % of GDP, including over 17 % of deposits and 6.5 % of rouble cash (see chart). The claims of banks on private firms and households climbed to around 16.5 % of GDP.

Russian banks' deposits and claims on private firms and households, and rouble cash in circulation, Jan 1999 – Oct 2002, stocks as % of GDP



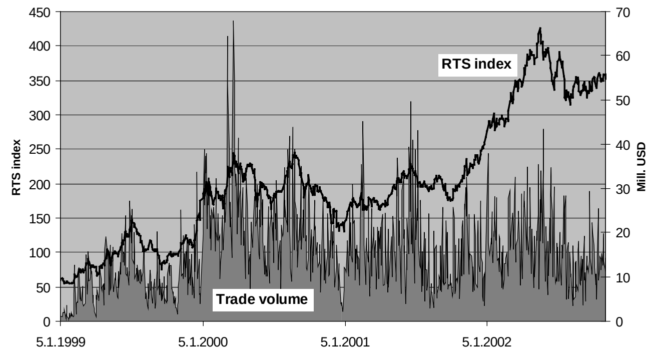
Source: Central Bank, Goskomstat

Stock markets still strong

Russian stock market prices continue to resist the generally downward trends of international stock exchanges. Although trading volumes in RTS stocks have been on the low side – averaging close to $16 million per day in October – the benchmark RTS index has hovered around 330-350 points with a slightly growing trend during the autumn. This compares with an index value of some 270 at the start of the year.

High oil prices on international markets partly explain the Russian stock exchange's relatively strong performance. For example, in October over 70 % of market turnover was accounted for by the four biggest oil companies. Energy companies were also leading the list of companies with the largest stock price increases during October.

Share prices in RTS index and RTS daily trading volume, Jan 1999 – Nov 2002



Source: RTS

Corporate governance gains importance

Many important laws connected with business activity and corporate governance were passed during the last nine months. After several years of preparation and a veto last summer from president Vladimir Putin, a new *bankruptcy act* was approved in October. It aims at improving the protection of debtors against being declared bankrupt for minor reasons. The law does not apply to credit institutions (which are governed by a 1999 act) or state-owned enterprises. The amendments to *competition law*, also adopted in October 2002, could be crystallised as ones clarifying the controlling function of the state in restricting monopolistic activity.

A *corporate conduct code* was adopted by government at the end of 2001 and by Federal Securities Commission in April 2002. It is unclear whether the document will be legally binding or normative as currently. Oil companies Sibneft and Yukos were the first Russian enterprises to publish their own rules on corporate governance in 1998. Other major Russian companies joined them last year. The Russian Union of Industrialists and Entrepreneurs recently adopted its own rules on corporate ethics, which are to become an ideological basis for arbitration between union members. The importance of transparent functioning and proper, public rules on corporate governance is gradually gaining wider acceptance in Russia. This is in line with the conclusion of the latest quarterly survey of the Institute of Corporate Law and Corporate Governance, which also noted most of Russia's largest enterprises still committed statutory and shareholder rights violations.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.0	10/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	30.6	9/02
Average wage, €, period avg, except last	79	122	145	97	58	86	126	152	9/02
Interest rates, period average									
- deposit rate, %	102	55	16.8	17.1	13.7	6.5	4.9	4.6	8/02
- lending rate, %	320	147	32.0	41.8	39.7	24.4	17.9	14.9	8/02
Forex reserves, USD billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	46.8	10/02
RUB/USD, end of period	4640	5560	5960	20.65	27.00	28.16	30.14	31.74	10/02

Sources: Goskomstat, CBR

Emerging industrial clusters in Northwest Russia

by Hannu Hernesniemi*

Industries in Northwest Russia involved in energy, metals, forest products, food, and information technology and communications (ICT) have bright future prospects. Production within these industrial clusters forms the backbone of Northwest Russia's economy. Broadly speaking, these clusters are the same ones that power the Finnish economy. However, their business activities differ substantially, so industries within these clusters in Northwest Russia and Finland do not so much compete as complement each other. Logically, we can expect cross-border networking of firms in these sectors to increase.

In a recent survey made with my colleagues Grigori Dudarev and Pavel Filippov, we considered Northwest Russia's emerging industrial clusters in terms of their success in export markets and the Russian market's demand potential. We also evaluated available resources, particularly legacy of production technology, labour and education investments, and access to raw materials.

The energy, metals and forest clusters of Northwest Russia focus on exports and their competitiveness is founded on large supplies of raw materials. Food industries, in contrast, serve local and national markets. The high-tech ICT cluster is experiencing rapid growth. We infer that the development of transportation infrastructures will parallel development in these key clusters. Construction activity should also remain brisk as long as the real standard of living in Russia continues to rise.

Four traditional, one new

The *energy cluster* comprises industries involved in production of energy raw materials, generation and distribution of electrical power and heat, and energy technology production. Two factors amplify the importance of energy businesses in Northwest Russia. First, Russia's largest unexploited energy reserves are located in or near Northwest Russia. Second, Northwest Russia is close to the EU, a huge net importer of energy. About 70 % of Russia's energy technology was once manufactured in the St. Petersburg area. Thus, important questions arise as to the revival of energy technology manufacturing and the significance of technology transfer from foreign technology providers.

The *metals cluster* of Northwest Russia covers companies involved with ferrous and non-ferrous metallurgy, as well as downstream fabrication and aluminium production. After the collapse of socialism, many domestic customers disappeared. A shift to new markets abroad, however, has partly corrected the situation.

The *forest cluster* enjoys a unique competitive strength: Russia has the world's largest unexploited timber resources. Moreover, the forests of Northwest Russia are easiest to exploit due to relatively functional infrastructure compared to the rest of the country. Development of forest industries would also promote balanced regional development. At the moment, Northwest Russian forest product processors and forestry equipment manufacturers are technologically antiquated.

The *food cluster* grew at a lively pace after the rouble's devaluation in 1998 because food imports became expensive. Moreover, Russians are rather loyal to domestically produced products that cater to traditional tastes. Northwest Russia has spawned many food industry success stories, which has encouraged investment from both foreign and domestic companies. Northwest Russia, and particularly St. Petersburg, has become a centre for food production despite the fact that natural conditions for agriculture are less than optimal.

The *ICT cluster* has its regional anchor in St. Petersburg. As software producer St. Petersburg is not as big as Moscow, but it is much more internationally oriented. St. Petersburg and Northwest Russia are, for example, pioneers in Russian mobile communications. Data communication networks to Western Europe also go through St. Petersburg. Telecom equipment production was concentrated in St. Petersburg during the Soviet period. Today, this industry is in difficulties, but small, specialised companies have emerged within the large old ones. Prospects for software localisation and content production are promising, since companies in St. Petersburg are well poised to offer software products to large Russian-speaking markets.

From export specialisation to networking

Russia's emerging industrial structure is distinctly different from its Soviet predecessor. We propose that there will be more active utilisation of local production factors and tighter regional and cross-border networking. Thanks to clear differences in the structure of Finland's exports to Russia and Russia's exports to Finland, we see few conflicts arising. Russian exporters focus on raw material inputs for industry and power production. The share of these products in Russian exports to Finland is nearly 90 %. In contrast, Finnish exporters focus on high-end value-added products for world markets and export a significantly wider range of products to Russia. Finland is an important technology supplier for Russia – in mining, metals and forest industries, as well as power production and phone networks. Exports of Finnish consumer products, e.g. mobile phones, and intermediate products such as high-performance papers, should also grow.

What will replace Russia's current narrow export specialisation? We predict a significant increase in foreign direct investments, at least from Finland to Russia. Firms in Finland's strongest clusters will utilise their comparative – and even absolute – advantages of nearby production factors for producing products with higher value-added in Russia for Russian and export markets. There is also a willingness to increase subcontracting in Russia. We see this already in software programming. In traditional industries, Russia's lack of small and medium-sized enterprises will be an obstacle to finding such subcontracting sources.

Foreign direct investment flows from Finland to Russia in 2001 amounted to 144 million euros, or 46 % of cumulative investments since the collapse of the Soviet Union. Most investments were directed to Northwest Russia. Despite this strong growth in FDI, high risk has held back the big investments. These small investments, however, have provided investors with good opportunities to learn local working methods, identify reliable workers and partners, and test the operating environment.

** The author is research director at Etlatieto Ltd. The article is based on the book* 'Emerging Clusters of the Northern Dimension; Competitive Analyses of Northwest Russia – A Preliminary Study' *by Grigori Dudarev, Hannu Hernesniemi and Pavel Filippov.*

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RUSSIAN ECONOMY
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Economic Developments

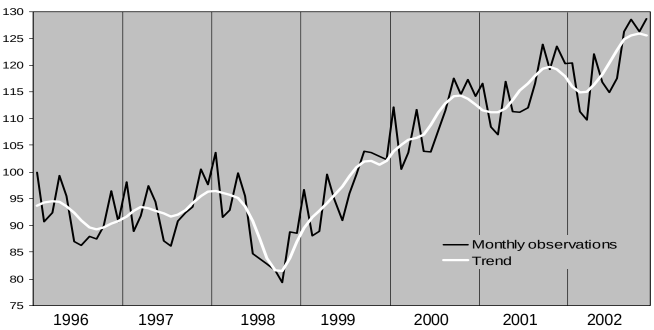
Good harvest boosts autumn growth

Growth of the composite index tracking developments in the five basic sectors of the Russian economy accelerated to 4.1 % y-o-y in October, mainly driven by increased agricultural production from a good harvest. Other main sectors had mixed performances. Industrial production growth decelerated to around 4 % and freight transportation to around 3 %, while growth in construction remained below 2 %. Retail trade continued its rapid growth of around 10 %.

Growth in industry has slowed since summer; for the last three months the seasonally adjusted trend for industrial output has remained practically unchanged.

Russia will likely end the year with annual GDP growth of about 4 % (5 % in 2001).

Industrial output, December 1995 (100) – October 2002



Source: Goskomstat

Growth prospects not too bright

International organisations generally expect no significant acceleration in economic growth next year. Sluggish growth in investment, increased dependence on energy and primary product exports and slow improvement in the business environment all work against enhancing economic efficiency and improving growth performance. These circumstances also put the long-term sustainability of growth at question.

The broad consensus among Russian and foreign expert organisations making forecasts on the Russian economy is that GDP will increase some 4 % in 2003. Consumer prices are expected to grow more than 12 % y-o-y by December 2003. In the revised version of its 2003 monetary policy guidelines submitted to the Duma in late November, the CBR predicted GDP growth of 4 – 4.2 %. The 2003 federal budget assumes GDP growth of around 4 % and end-year inflation of 10 – 12 %.

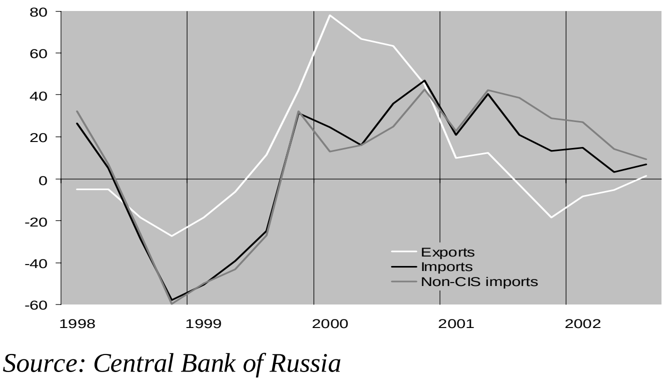
Exports up, growth of Western imports slows

While Russia's export income in dollar terms remained unchanged in January-September compared to a year earlier, it rose 12 % y-o-y in 3Q02. Imports grew well over 10 % in January-September as their growth picked up markedly in 3Q02. The acceleration came from CIS imports, which increased for the first time since mid-2001. Non-CIS imports continued to grow at 20 %. Exchange rate movements again blurred the real picture, however. In euro terms, growth of Russia's non-CIS imports slowed to about 10 % in 3Q02.

The increase of export earnings in 3Q02 resulted from rising export volumes and higher prices for major commodities. The export price on crude oil was clearly up, both from 2Q02 and a year earlier. The price of natural gas also rose sharply from 2Q02. In January-September, the export volume of oil products climbed 17 % y-o-y, crude oil grew 13 % and gas was up over 3 %. Export volumes of some metals and basic forestry products also increased briskly.

As recorded in Russia's customs statistics, imports of machinery and equipment (excluding passenger cars) rose 25 % from a year earlier in January-September, and their imports from outside the CIS countries expanded 30 %. This was despite slow growth of investments in the Russian economy this year. The share of machinery and equipment (excluding cars) rose to a third of total imports. The share of food products and ingredients fell below one quarter. Growth of food imports may be slowing as the domestic food industry continued to grow while the rouble's real exchange rate depreciated in 3Q02.

Russian exports and imports 1Q 1998 – 3Q 2002, % change of the euro value from a year earlier



Source: Central Bank of Russia

Economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-14.5	-8.7	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	3.9	H1/02
Industrial production, %	-18.2	-14.2	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	4.0	1-10/02
Fixed investments, %	-40.0	-12.0	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.5	1-10/02
Unemployment, % (end of period)	4.9	5.5	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.1	10/02
Exports, € billion[1]	41.2	51.0	57.0	63.2	71.3	78.8	66.9	70.7	114.7	112.9	79.4	1-9/02
Imports, € billion[1]	33.1	37.9	42.4	47.8	53.6	63.7	51.8	37.0	48.8	59.7	44.3	1-9/02
Current account, € billion[1]			7.0	5.7	9.2	1.8	0.6	23.1	51.4	38.5	16.5	H1/02

Source: Goskomstat, CBR. [1] *Before 1999 values in ECU.*

2003 budget without the final seal

The 2003 budget won a clear majority approval in its third reading last month. The fourth and final reading, which is basically a formality, will take place in the first half of December. The third reading brought no major changes to the budget. Indeed, changes worth mentioning were included in a separate decree with some non-binding recommendations to the government. Among the changes, the Duma sought more funding for antiterrorist activities and again obliged the government to set the ceilings on natural monopoly tariff hikes for 2003 by the end of 2002 (the government need not return the decision for another Duma reading).

Federal budget surplus continues

In January-September, the federal budget surplus amounted to 3.1 % of GDP or 5.5 % of GDP excluding debt-servicing costs. VAT remained the main source of income, accounting for 35 % of total federal income. Customs duties decreased their share from 22 % in 1Q – 3Q01 to 14 % as world market prices for oil and gas averaged lower than in 2001. Excise taxes brought in 10 % and natural resource payments 9 % of total income. The share of profit taxes fell to 8 % from almost 15 % a year earlier, presumably due to changes in profit taxation. The collection of the unified social tax (UST), which is transferred to the Pension Fund, exceeded all expectations and accounted for 16 % of all revenues.

Social and cultural activities took a lion's share of expenditures (29 %). However, excluding UST, the share drops to 14 %, which is in line with the situation last year. Transfers to regional budgets remained high, and accounted for some 17 % of total expenditures. Defence and interest payments on debt each had a share of about 14 %. Both defence expenditures (excluding funds for army reform) and interest payments decreased as a share of all expenditures (by 4 and 8 percentage points, respectively).

At the end of 1H02 the reserve fund, designed to cushion the impact of changes in the world market energy prices on budget performance and assure Russia's debt-servicing capability, accounted for only a quarter of the year-end target of RUB 197 billion (over $6 billion). By the beginning of October the share had increased to 49 % (equalling $3 billion). The sudden sale of a 6 % stake in oil company LUKoil at the beginning of December added $775 million to the fund. The earlier announced sale of a Slavneft stake is due to be completed in mid-December. Its minimum price is set at $1.7 billion, but the actual price may reach some $2.2 – 2.4 billion. If the price nears the upper limit, the year-end target seems reachable. Prime Minister Kasyanov has further suggested that the leftover funds at the end of 2002 in the accounts of different ministries (now estimated to amount to almost RUB 100 billion) be transferred to the reserve fund.

Russia's credit rating boosted

The Russian government moved in November to convert into eurobonds its remaining commercial debt of Soviet-era foreign trade organisations to foreign goods suppliers. The terms of the deal are similar to Russia's debt restructuring agreement with the London Club of commercial creditors in 2000, i.e. about a third of the debt will be forgiven and the remainder will be converted to eurobonds maturing in 2010 and 2030. The total debt involved, including accrued interest, is estimated at $4 – 6 billion. Restructuring of this last remaining part of the Soviet-era debt is an important step in Russia's efforts to improve its image on international financial markets.

This month, international credit rating agency Standard & Poor's upgraded Russia's sovereign rating on the basis of the country's positive macroeconomic development and structural reforms. Russia's decision to restructure its Soviet-era debt was also a factor enhancing its credibility. Also Moody's has been considering upgrading Russia's rating. In October a group of holders of the Soviet-era debt turned to Moody's with a request not to upgrade Russia's credit rating before the restructuring deal was implemented.

Even after the hike in Standard and Poor's rating, Russian credit is still rated by all agencies as bearing high risk. This means many investment banks and funds are prevented by their regulations and bylaws from holding Russian debt securities.

CBR reintroduces monetary policy instruments

Russia's 1998 financial crisis and its default on domestic and foreign obligations deprived Russian financial markets of T-bills and other paper the Central Bank could use in its monetary policy operations. Until recently, the Central Bank only offered commercial banks overnight loans and allowed banks to make deposits for various periods. Interest rates of both deposits and loans were fixed and administratively set by the CBR. These instruments have proven too rigid and limited for the CBR to steer liquidity, particularly in light of the CBR's need to sterilise large inflows of foreign currency resulting from Russia's current account surpluses.

In September, the CBR expanded its monetary policy tools by launching regular currency swaps and in November it reintroduced repo and reverse repo deals, which were discontinued in the aftermath of the 1998 crisis. Deposit auctions were also started last month. Interest rates on these instruments are based on market supply and demand. In conjunction with the introduction of the new instruments, the CBR has suspended its fixed-rate deposit facilities for maturities exceeding one week and unified the interest rate on all other fixed rate deposits.

These moves act to increase the role of market-based instruments in CBR monetary policy. They also provide commercial banks with more flexible instruments for their liquidity management.

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

	1996	1997	1998	1999	2000	2001	2002	as of	2002 Budget	2003 Budget draft
Revenues	12.5	12.3	11.0	12.6	15.5	17.6	20.0 [1]	1-9/02	19.4 [1]	18.5 [1]
Expenditures	20.9	19.4	16.9	13.9	14.3	14.6	16.9 [1]	1-9/02	17.8 [1]	18.0 [1]
Balance	-8.4	-7.1	-5.9	-1.4	1.2	3.0	3.1	1-9/02	1.6 [1]	0.6 [1]
External debt	31.6	30.2	50.1	87.7	55.3	44.4	40.5 [2]	6/02		
External debt, USD billion	136.1	134.6	158.2	154.6	143.4	133.1	128.3	6/02		

[1] Including social tax channelled via the federal budget. [2] In % of July 2001 – June 2002 GDP.

Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2002. Debt: IMF 1995-1999, Minfin 2000-2002.

Enterprise profits low

Goskomstat information on large and medium-sized enterprises showed net profits (profits minus losses) in January-September were about 17 % lower in nominal terms than a year ago and stood at RUB 730 billion (€23.5 billion). The decline in net profits, which began in the second half of 2001, slowed during 3Q02. The Goskomstat sample covers nearly 111,000 enterprises. It excludes small enterprises, banks, insurance companies and budgetary organisations.

The 2002 decline of net profits reflects both an increase in the number of unprofitable enterprises and a general increase in losses. In January-September, 45 % of enterprises showed losses – an increase of 8 percentage points from a year earlier. The decline in net profits has mostly affected industrial enterprises. In the first three quarters of this year, industrial enterprises earned some 40 % of net profits, whereas a year earlier their share was 54 %. The trade and catering sector increased its share as a generator of net profits from 19 % to 26 %. Other branches raising their share include transport (mainly pipelines) and communications. Although industry net profits were hardest hit, the individual branches with the highest proportion of unprofitable enterprises in 1Q – 3Q02 were housing, electricity and agriculture. In these branches, 50 – 70 % of enterprises made losses.

Among the main factors driving the decline in net profits were rising real wages and higher domestic energy prices. Enterprises involved in oil production and oil refining (their net profit position has a considerable impact on the net profits of the entire Goskomstat sample) saw their profits erode due to lower world market prices than in 2001. Despite the drop in world market prices, however, net profits of the gas industry rose in 1Q – 3Q02 over 600 %.

Investment structure still heavily biased

A major worry for the Russian economy remains the slow growth of fixed investment, which grew in October only 2.7 % y-o-y. For January-October, fixed investment increased 2.5 % from the same period a year earlier. Growth has slowed markedly – the respective rate for January-October 2001 was over 8 % y-o-y.

The high share of investment going to energy and related sectors is also a concern. Although the energy sector is in need of investment given its outdated production facilities, other sectors also need modernisation. The fact that the growth in investment in recent years has taken place almost solely in energy and energy-related sectors has hampered the long-needed diversification of the economy's production base. High international energy prices in recent years have further caused Russia's economy to become even more dependent on the production and export of energy.

In 1Q – 3Q02, 21 % of all investments went to the fuel sector and 20 % to transportation (largely related to pipelines). However, the share in investment of fuel sector and transport declined by almost 2 and 3 percentage points y-o-y respectively. The next biggest sector for investment was housing and utilities with a 15 % share. Communications, the food industry, non-ferrous metallurgy and machine building each received 3 – 4 % of total investment.

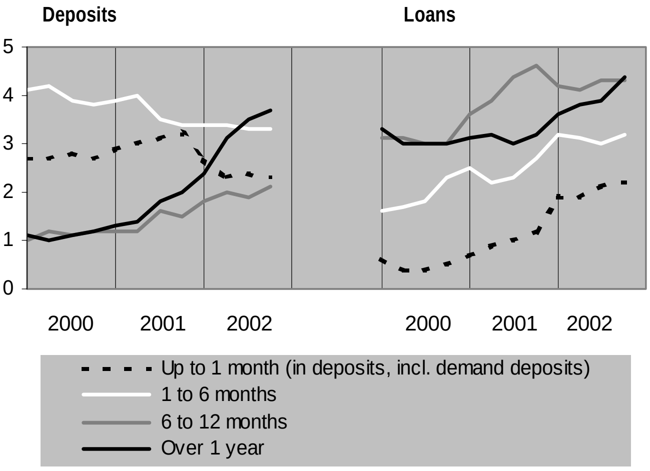
Deposit and loan maturities continue to lengthen

The Central Bank's bank deposit and loan data for 3Q02 (which excludes Vnesheconombank) suggest that households continued to increase their bank deposits while corporate deposits continued to fall. Since summer household deposits have been slightly larger than corporate deposits and other corporate accounts at banks.

In real terms, household deposits were up a third from a year earlier. Foreign currency deposits of households continued to grow fast. Both regarding rouble and foreign currency deposits, longer maturities (between six months and three years) gained ground (see chart). Household deposits at Sberbank rose one quarter, whereby the bank's share of the total further declined to 69 % at the end of 3Q02. The 29 next largest banks combined held over 15 % of household deposits.

Loans to households were up over 40 % y-o-y in real terms at the end of 3Q02, and they now stand at almost one tenth compared to the banks' corporate loan stock. Corporate loans, up 25 %, increasingly focused on maturities between one year and three years, as well as on shortest-term rouble loans. Sberbank's stock of loans to the corporate sector seems to have grown slightly more slowly than the total extended by all banks. At the end of 3Q02, Sberbank's corporate loan stock accounted for about 30 % of the total, while the 29 next largest banks held some 40 %.

Maturities of bank deposits and corporate loans, 1 January 2000 – 1 October 2002, stocks as % of GDP



Source: Central Bank of Russia

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.2	11/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	30.8	10/02
Average wage, € (period avg, except last)	79	122	145	97	58	86	126	148	10/02
Interest rates (period average)									
- deposit rate, %	102	55	16.8	17.1	13.7	6.5	4.9	4.2	9/02
- lending rate, %	320	147	32.0	41.8	39.7	24.4	17.9	13.5	9/02
Forex reserves, $ billion (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	48.2	11/02
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.84	11/02

Source: Goskomstat, CBR.

Proximity Policy – Just Another Slogan?

by Pekka Sutela*

In two recent speeches, Romano Prodi, the President of the European Commission, argued that the European Union needs to develop a 'Proximity Policy.' This policy would form the basis for EU relations with its geographic neighbours 'from Russia to the Maghreb,' i.e. countries that are unlikely to become EU members in the foreseeable future. The idea seems to be that after the current enlargement, Bulgaria, Romania, the Balkans and possibly Turkey might become members. But the EU cannot enlarge indefinitely without risking becoming merely a free trade area, Prodi observed. Although further enlargement cannot, as a matter of principle, be excluded, there are European countries for which membership is presently inconceivable. Thus, he said, the EU needs a 'Proximity Policy for a Wider Europe.'

As the current eastern enlargement is in the pipeline, discussion must shift to the next set of issues. European opinion strongly rejects consideration of countries like Russia and Morocco for EU membership for a number of reasons. However, another view reasonably argues (see e.g. Month in Review 2000/3) that even improbable accession candidates deserve a shot at membership if they fulfil the EU acquis. This prospect of membership provides the conditionality needed for policy consistency. Accession countries have had such conditionality and have been rewarded by their economic and social performances. Russia, in contrast, has lacked such an external policy anchor. WTO accession, despite much legislative work, does not seem to provide such a strong conditionality.

A heterogeneous area

Prodi's Proximity Policy is a new approach that faces several challenges. Many countries will protest being bundled in with so many strange bedfellows. Indeed, Russia and Morocco, or Ukraine and Libya have little in common. Certainly, others might feel degraded just to be included in this bunch. Ukraine, which likes to see itself as a future EU member, could protest at being defined as merely a part of Wider Europe. Russia might fear – especially in a time of strained EU-Russia relations – a loss of its special relationship with the EU, based on the Partnership and Cooperation Agreement (PCA), the Northern Dimension and the Common Russia Strategy. Finland would surely wonder whether Proximity Policy implies a common financing instrument for all neighbouring countries and whether resources that could be used in Northern Dimension will end up being used in Southern and South-Eastern Dimensions. A fair point can be made, after all, that the EU faces challenges in the Balkans and Northern Africa far more demanding than anything apparent in Russia.

Two of the main ingredients of Proximity Policy will be the goals of free trade and approximation of legislation and norms. These were the two-pronged aims of the 1994 PCA between the EU and Russia. EU-Russia free trade is conditioned on Russia's WTO accession. Although good progress has been reported recently, it is uncertain whether negotiations could be concluded before the WTO meets next autumn. If the talks are not completed, Russia's WTO accession could be postponed several more years.

Russian preferences

Much depends on developments inside Russia. So far, it has seemed that too many Russian actors suspect that their country will be unable to benefit sufficiently from increased competition. Fear of globalisation is an almost certain recipe for failure in free trade.

The little-remembered Article 55 of the PCA says that Russia endeavours to ensure that its legislation is consistent with the EU acquis. Thus, already eight years ago, normative approximation was seen as one-sided. This creates three problems. First, what are Russia's incentives to comply? An uncertain perspective of higher welfare due to better laws is a much weaker incentive than the financial transfers promised to future members. Second, Russia will not take the European Economic Area road of Norway, Switzerland and Liechtenstein and commit itself to accepting all existing and future acquis, and, in particular, without playing an explicit role in deciding upon them. In other words, Russia will at best adopt selected parts of the acquis. This creates the third problem. For instance, Russia finds EU norms on the environment and social affairs too demanding and does not adopt them. In this case, adopting other parts of the acquis will not ensure improved access to EU markets, because Russia is seen to engage in ecological and social dumping.

While issues such as human rights remain topical, current problems in EU-Russia relations are largely related to trade policy, transport and customs. Many of these problems have existed for years without any visible improvement. Such nitty-gritty is burdensome without offering a basis for fancy political declarations. It seems, all too often, that both sides have a tendency to compensate for the everyday labours of practical relations by engaging in politically motivated sloganeering. After all, we still have the PCA, Northern Dimension, Common Strategy and Common European Economic Space. Perhaps it would be excessively cynical to see Proximity Policy as just a further slogan, conveniently invented partly in reaction to enlargement tensions, and partly to paint over practical problems in relations.

Demanding tasks ahead

To avoid letting Proximity Policy become just another slogan, many acts are needed. The EU must notably improve its ability to form and implement genuinely common strategies of foreign relations. Much thinking is needed to determine the degree to which the Wider Europe is an area of relevant homogeneity. Russia must enhance its understanding of and resources for European developments. The experiences of cooperation so far must be thoroughly considered. Finnish experiences of cross-border cooperation must have a key role as the EU border with Russia (as well as Belarus and Ukraine) lengthens. Future forms of cooperation must be determined jointly, rather than dictated by the Union. Finally, all thinking and action must proceed from an honest understanding of the fundamental asymmetries that exist, and in most respects will continue to exist, between the EU and Russia.

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