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Russian Economy - The Month in Review

Yearbook 2003

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
Editor-in-Chief **Seija Lainela**

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Bank of Finland
Institute for Economies in Transition (BOFIT)

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

Russian Economy - The Month in Review 2003

Contents - 4th page

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RUSSIAN ECONOMY
The Month in Review
1•2003

Economic Developments

Strong 3Q GDP growth, industrial production slows

Russian GDP growth remained steady in 3Q02. Preliminary Goskomstat figures indicate GDP grew 4.3 % y-o-y, compared to 4.1 % in the second quarter and 3.7 % in 1Q02. The official estimate for GDP growth in 2002 is slightly above 4 %. GDP increased 5 % in 2001. Last year's growth was based mainly on strong energy exports and a brisk rise in private consumption.

Russia's production structure continued to converge with market economies. In the first nine months of 2002, services represented 58 % of total output and goods production 42 %. Services increased their share in economic activity three percentage points from the same period a year earlier. Trade and catering accounted for 22 % of GDP, while transportation and telecommunications represented 11 %. Industry made a 28 % contribution to GDP, construction accounted for 7 % and agriculture 6 %.

Growth of industrial output continued to slow. The workday-adjusted figure for output growth in November was 2.4 % y-o-y, down from the 3.9 % rates posted in September and October. For the first eleven months of the year, industrial output was up 4 % y-o-y. Growth during the period was led by non-ferrous metallurgy, the food industry and the fuel industry. On-year growth slowed substantially during the year in both the food industry and non-ferrous metallurgy. The fuel industry accelerated production growth, as producers were eager to take advantage of favourable price developments on international commodity markets.

The paradoxes of a good harvest

At the beginning of November the 2002 grain harvest was estimated at some 86 million tonnes in clean weight – up from 85 million tonnes a year earlier. After lousy harvests in 1998 and 1999, the successful harvest was welcomed. However, it also created problems. The abundant 2001 grain harvest left grain in storage, causing prices to collapse in 2002 and forcing the government to intervene to prop them up. Since mid-November, the state has been purchasing wheat and rye on seven exchanges. It plans to continue the interventions until mid-January. To finance interventions, the government has guaranteed a six-billion-rouble loan from Sberbank to the relevant state agency. The interventions have helped prices rebound by some 20 – 30 % in Western Siberia and by 10 – 20 % in Central and Southern Russia. The subdued rise in Central and Southern Russia prices reflects the fact that they were originally higher due to increasing grain exports from these areas. The EU established grain import quotas for 2003 on Russia and Ukraine to stem the flow of cheap grain, which will curb Russia's export opportunities. Therefore, Russia is presently seeking new markets; e.g. the country has signed a letter of intent to export wheat to Brazil.

Current account surplus steady

For 3Q02 and January-September 2002, Russia's current account surplus stayed at about 10 % of GDP (13 % a year earlier). Compared to the first nine months of 2001, the trade surplus decreased, mainly due to increased imports. The deficit of service balance stayed roughly the same despite a significant rise in both export and import.

The negative value of net errors and omissions, which partly reflects unrecorded capital outflows, jumped in 3Q02 from the level of first and second quarters. However, the figure for the first nine months of 2002 was still much lower than for the same period of 2001. This indicates capital flight from Russia continues to decline.

Balance of payments, $ billion

	2000	2001	2002 Q1-Q3
Current account	**47.3**	**34.6**	**24.0**
Trade balance	60.7	47.8	33.8
Exports, f.o.b.	*105.6*	*101.6*	*76.5*
Imports, f.o.b.	*-44.9*	*-53.8*	*-42.7*
Services balance	-6.7	-8.5	-6.6
Exports	*10.0*	*10.9*	*9.5*
Imports	*-16.7*	*-19.4*	*-16.1*
Investment income	-6.7	-4.0	-3.0
Received	*4.3*	*6.2*	*4.5*
Paid	*-11.3*	*-10.3*	*-7.5*
Other items, net	0.1	-0.8	-0.2
Capital and financial account	**-21.5**	**-17.2**	**-8.9**
Capital Account	11.0	-9.4	-7.0
Received	*11.8*	*2.1*	*6.7*
Paid	*-0.9*	*-11.5*	*-13.7*
Financial account	-32.5	-7.8	-1.9
Direct investment to Russia	*2.7*	*2.5*	*1.8*
Portfolio investment to Russia	*-9.9*	*-0.7*	*0.4*
Other items, net	*-25.3*	*-9.6*	*-4.1*
Net errors and omissions	**-9.7**	**-9.2**	**-5.3**
Change in reserves	**-16.0**	**-8.2**	**-9.8**

Source: CBR

Economic indicators

	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	4.1	1-9/02
Industrial production, %	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	1-11/02
Fixed investments, %	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.5	1-11/02
Unemployment, % (end of period)	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.1	11/02
Exports, $ billion	67.4	82.4	89.7	86.9	74.4	75.6	105.0	101.6	95.8	1-11/02
Imports, $ billion	50.5	62.6	68.1	72.0	58.0	39.5	44.9	53.8	54.0	1-11/02
Current account, $ billion	7.8	7.0	10.8	-0.1	0.2	24.6	46.8	34.8	24.0	1-9/02

Source: Goskomstat, CBR.

2003 budget – surplus again

The Duma passed the fourth and final reading of the 2003 budget bill in mid-December. At 0.6 % of GDP, the planned surplus is considerably smaller than the 2002 budget's estimated 1.4 % of GDP and will be used to pay down debt and build up financial reserves. According to the draft financial plan for the years 2003 – 2005 to be presented to the government by mid-April 2003, the budget will continue to show surpluses of 1.5 – 1.7 % of GDP in 2004 and 2005.

Federal budget plans, RUB billion, unless otherwise noted (figures in parentheses, % of GDP)

	2003		2002	
Revenues	2,418	(18.5)	2,126	(19.4)
Expenditures	2,346	(17.7)	1,947	(17.8)
Interest payments		*(2.1)*		*(2.6)*
Surplus	72	(0.6)	179	(1.6)
Average exchange rate (roubles per dollar)	33.7		31.5	
Inflation (year-end, %)	10–12		12–14	
Average oil price, Urals (dollars per barrel)	21.5		23.5	
GDP	13,050		10,950	

Source: Federal budget 2003, Russian government

Debt servicing on track

Russia successfully managed its debts in 2002. In addition to making all scheduled foreign debt payments in timely fashion and in full, Russia met its financial reserve target of $6 billion. Moreover, when revenues from large privatisation deals at the end of 2002 are received, the amount will reach nearly $8 billion, enough for debt management in 2003 even if oil prices fall substantially.

The CBR reported that the federal government's external debt stood at $105.5 billion at the end of September 2002, $7 billion less than at the start of the year. The Russian Federation owed some $48 billion, while $57 billion was debt inherited from the former Soviet Union. The post-Soviet debt is mainly foreign currency bonds and debt to multilateral creditors such as the IMF. The bulk of the Soviet-era debt is owed to Paris Club creditors. Last year Russia made about $7 billion in payments on principal and a near-equivalent amount in interest payments. According to the Ministry of Finance, federal government's external debt at the end of September 2002 was $119 billion, which exceeds the CBR's debt figure due to different definitions of debt.

Finance ministry figures indicate that Russia's internal debt exceeded RUB 600 billion ($19 billion) at the end of September, up from RUB 530 billion at the beginning of 2002. Last autumn, the finance ministry informed it would increase its domestic borrowing substantially, so the final amount of internal debt at the end of 2002 may be much higher. The ministry also said it wants to concentrate on issuing longer-term securities; in 2002, it introduced securities with a six-year maturity for the first time.

Russia will not issue any new debt in 2003 if oil prices remain above $18 – 20 per barrel. The planned budget surplus materialises if the price of Urals-grade crude averages above $21.5 per barrel. If oil prices collapse, the 2003 budget still provides for an over-one-billion-dollar bond issue. Russia plans to issue $3 billion in 2004 and $4 billion in 2005 to replace expensive debt issued earlier.

Coherent monetary policy marks the year

An important achievement in Russia's economic policy in 2002 was the continuation of prudent monetary and fiscal policies helped in part by positive external developments, i.e. high international energy and raw material prices. Upbeat appraisals of economic policy led to recent upgrades of Russia's sovereign credit rating by both Standard and Poor's and Moody's. The optimistic evaluation was also affected by Russia's increased foreign reserves and declining foreign indebtedness. Even after the upgrades, however, Russia's credit ratings remain below investment grade.

While the CBR's new leadership, which started its work last spring, deserves credit for implementing sound policies, they have yet to make operational an array of new monetary policy tools, particularly those for sterilising large foreign currency inflows. Rouble money in circulation (broad money M2) at end-November was 34 % higher than a year earlier and inflation at the end of 2002 was still running above target.

The rouble lost 5.5 % of its nominal value against the dollar last year, and traded at about 31.8 roubles to the dollar at year's end – less than the CBR's target of 33 roubles to the dollar. In real terms, the rouble appreciated 5.7 % y-o-y against the dollar. The rouble also followed the dollar's nominal depreciation against the euro on international markets. Thus, the rouble depreciated in real terms against a basket of Russia's major foreign trade currencies last year. At the end of 2002, the on-year depreciation was 2.4 %.

Gold and foreign currency reserves continued to grow rapidly in 2002, reaching $47.8 billion at the end of December ($36.6 billion a year earlier). Strong export earnings and reduced capital outflows supported growth.

Economic policy in 2003 is expected to continue along the same lines set out in 2002. In mid-December, the Duma approved a CBR document outlining the main principles of monetary policy for 2003. The CBR set its target for base inflation (i.e. inflation, excluding prices of natural monopoly products) at 8 – 8.5 % for the year, based on the government's December decision on the price increases for natural monopoly products for 2003. The rouble should continue its smooth real appreciation against the dollar in 2003. The CBR will further expand its arsenal of monetary policy instruments to improve 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	2003 budget
Revenues	12.5	12.3	11.0	12.6	15.5	17.6	20.2 [1]	1-10/02	18.5 [1]
Expenditures	20.9	19.4	16.9	13.9	14.3	14.6	17.3 [1]	1-10/02	17.7 [1]
Balance	-8.4	-7.1	-5.9	-1.4	1.2	3.0	2.9	1-10/02	0.6 [1]
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	35.0	9/02	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	119.1	9/02	

[1] *Including social tax channelled via the federal budget.*

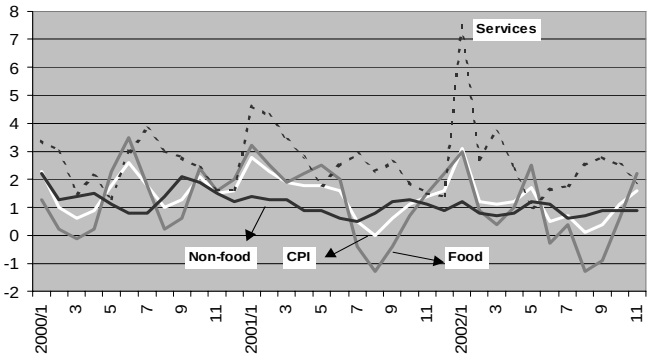
Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2002. Debt: IMF 1995-1999, Minfin 2000-2002.

2002 inflation higher than forecast

On-year consumer price inflation amounted to 15.1 % at the end of 2002, exceeding the government's target of 12–14 %. Although annual inflation has steadily fallen since the 1998 crisis year, single-digit rates remain elusive. A modest reduction in inflation is foreseen for 2003; the budget act assumes consumer prices will rise 10 – 12 %.

Prices of both food and non-food products increased 11 % in 2002, which is somewhat less than in the year before. Among non-food goods, highest growth was recorded in motor fuel (20 %) and pharmaceuticals (15 %). Services prices continued their rapid rise in 2002, matching the 36 % pace of 2001, and accounted for a large part of last year's higher-than-expected inflation figure. Price growth was the fastest in housing and utilities (49 %). Communications, child day care, cultural activities and medical services all posted growth rates above 30 %, while passenger transportation and education costs rose at rates above 20 %.

CPI and components, m-o-m % change



Source: Goskomstat

FDI down, total foreign investment up

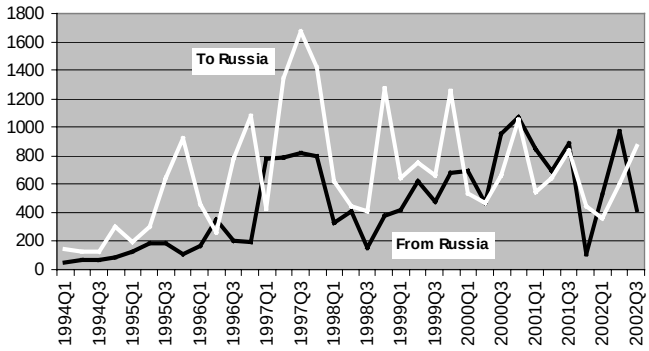
CBR balance-of-payments data indicate Russia received $1.8 billion in foreign direct investment (FDI) in the first three quarters of 2002, or 10 % less than in the same period in 2001. While Goskomstat figures record $2.6 billion in FDI inflows to Russia for the first nine months of 2002, the data reflect a similar 10 % decline in FDI inflow from the previous year.

The differences in the two sets of data are mostly due to the fact that the CBR records net inflows and outflows (deducting e.g. repatriated investment from FDI inflows), while Goskomstat meters gross flows. This largely explains why Goskomstat figures are consistently higher than the CBR's. On the other hand, the CBR includes several items missing from Goskomstat FDI statistics, e.g. investment to and from the banking sector and FDI related to production-sharing agreements.

Goskomstat data show that the inflow of total foreign investment (FI) to Russia amounted to $12.9 billion in January-September 2002, exceeding the figure of January-September 2001 by 33 %. A fifth of the total was formed by FDI, while the share of portfolio investment was less than 2 %. The rest was made up by other investment, a category consisting mainly of enterprise borrowing and trade credits. They grew by 54 % y-o-y as Russian enterprises found it easier than before to get financing from abroad given improvements in the country's credit position.

Goskomstat, the only agency providing FI breakdowns by industrial sector and country, reports that in 1Q – 3Q02 38 % of total FI went to industry and 41 % to trade and catering. In industry, the largest share (10 %) went to the fuel industry, followed by nonferrous (7 %) and ferrous metallurgy (6 %). In services, 23 % of the total FI inflow went to foreign trade. FDI was concentrated on trade and catering, fuel industry, food production, machine building and general commercial services. Their combined share of total FDI was 69 %.

Foreign direct investment inflow to and from Russia, $ billion



Source: CBR

Stocks and bonds gain

Despite a slow second half, the Russian stock exchange was one of the world's top performers in 2002. The RTS index fell considerably from its spring peak, following downward trends on international markets. The RTS index finished the year at 358, which was 38 % higher than a year earlier. Share prices of Russia's large oil companies, which enjoyed high export incomes last year, drove the market. Six of the RTS' ten largest companies by capitalisation are involved in oil or energy.

Improvements in Russia's international debt position also boosted prices of Russian foreign currency bonds and reduced the spread to US treasuries. The yield of the benchmark Russia-30 bond was slightly above 9 % at the end of 2002 (the yield of corresponding US treasuries was 5 %).

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	12/02
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	34.1	11/02
Average wage, $ (period avg, except last)	104	154	164	108	62	79	111	150	11/02
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.2	10/02
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	13.7	10/02
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	12/02
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	12/02

Source: Goskomstat, CBR.

Are we transitioned yet?

by David Lehrer *

The 'Model' model

Transition began, unexpectedly, by design. In the early 1990s, received wisdom assumed a market economy goal for the post-communist countries to be self-evident; 'transition' entered use as shorthand for 'transition to a market economy.' Many professed belief in a window of opportunity for reformers to choose financial and industrial structures, corporate governance regimes and social welfare systems from a menu of OECD 'models': Anglo-American, German, Nordic or Japanese. Privatisation, with few dissenters, was viewed as inevitable and as essential to transition. Advocacy of economic reforms paralleled expectations of a general convergent trend toward consolidated democratic polities. Various privatisation programs were undertaken on a simple premise: *Transition countries privatise their enterprises and banks because private banks and enterprises underpin a market economy*. The form and timing of privatisations were constrained primarily by the financial sector model variant chosen by each country; the domestic technical capacity (institutional structures, legal and regulatory frameworks, and professional skills base) available for deployment by each country in pursuit of the market ideal; and the political will (the level of venality and authoritarianism of both rank and file bureaucracy and political elites) of each country to reform; in short,

Model choice + domestic capacity – official venality = speed and purity of privatisation…= completeness of transition.

As the assumptions underpinning such implicit models eroded, social scientists turned their attention from advising and predicting, to explaining why outcomes have so lagged expectations and diverged. Proposed causes for the delays, failures, limits and unpredictability of transition now proliferate.

What went wrong?

Institutionalist explanations preserve the market-focused, neoliberal economic paradigm, but point out the necessity of first laying the groundwork essential to privatisation in each country. Such accounts describe a daunting range of supporting institutions, both formal (bankruptcy laws) and informal (trust), prerequisite to the transition to a market economy. Accounts of these 'potholes' on the road to market represented by insufficient institutional infrastructure, have been supplemented by complementary analyses of the 'roadblocks' to marketisation represented by the corrupt activities of government officials and enterprise managers in post-communist countries. Some analyses cast 'corruption' or 'kleptocracy' themselves as abstract, independent systems of a status similar to that imputed to 'the market,' and as contending with 'the market' for supremacy as the organising principle of post-communist economic life.

Another explanation of GNP per capita's growth in some postcommunist countries and contraction in others – geographic proximity to the West, or eastwardliness correlated with slowness to reform – is a rule riddled with exceptions. Why, for example, did the Czech and Croatian economies grow while Slovakia's and Albania's did not? And how does a country as vast as Russia fit into such a proximity argument?

Some explanations have relied on various forms of (distant or recent) historical determinism to demonstrate that what is was meant to be. Historicist explanations hold that reforms were constrained by prior conditions ranging from the 'legacy' of relative autonomy that soviet republics and satellite states were allowed by Moscow, to the differing 'path-dependent,' 'contingent,' or 'lock-in' effects of communism's immediate aftermath (for example the rapidity with which national elections were held after 1989). Such determinisms accord little self-determination to those now living in postcommunist countries.

Transition, in transition

The debate on how transition went also concerns who really does transition. Some views distinguish which countries are truly in transition and which are not by whether they have implemented a Western-advised reform program, and of which type ('shock therapy' or gradualism). Thus Poland diverges from Russia on the 'type' criterion; and both from Belarus on the 'whether' criterion, with countries such as Bulgaria and Romania perhaps in the process of migrating from unreformed to reforming camps. Many now speak of transition's 'winners' and 'losers.' Others hold that the trauma of postcommunism overwhelms such distinctions. Nor do all agree on what the outcomes have been, or on how to measure them. Some claim that Russia is now a functioning market economy; others, that such claims are made only for reasons of political expediency, ideological commitment, or professional face-saving by international advisors.

The emergent EU-enlargement paradigm of the late 1990s draws a line between 'transition' (read: accession) and non-transition postcommunist countries: the former, preordained success (defined as implementation of a prescribed set of institutional reforms); the latter, doomed. Brussels' Consensus, like Washington's, renders Western advisors the chief protagonists of institutional transformations occurring in the postcommunist countries. Accession potential and Brussels tutelage fail, however, to explain wide variations in speed in conforming to the *acquis* among candidate countries, and beg the question of why some were short-listed and others long-listed in the first place.

A new dialectic?

As with any unprecedented social transformation, many causal factors have contributed to divergent postcommunist country outcomes. Explanations could be improved by more comparative data – on outcomes, but also on such inputs as domestic policy-making and perceptions; by a willingness to begin analysis with questions rather than answers; by the discipline to distinguish *ex post*, theoretic and explanatory models from *ex ante*, applied, and aspirational ones; and by greater tolerance for complexity. If we have learned anything over the past decade or so, it is that transitions, like economies, don't always go according to plan.

** The author is visiting researcher at BOFIT.*

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

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RUSSIAN ECONOMY
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2•2003

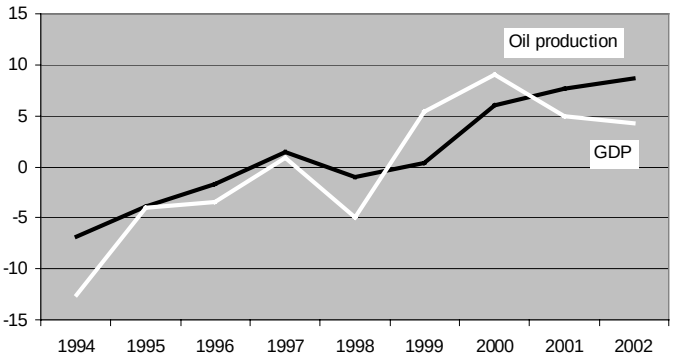
Economic Developments

Healthy pace for overall production growth in 2002

Fresh statistical data on last year's economic developments in Russia confirm the earlier picture of robust growth, which was slightly lower than in 2001. Goskomstat's initial estimate puts GDP growth for the whole of 2002 at 4.3 %. However, growth was not evenly distributed among economic sectors or within the industrial sector.

Goskomstat reports goods production increased 3.2 % and services production 5.4 % in 2002. Growth in industrial output decelerated to 3.7 % from nearly 5 % in 2001. Slowing growth was pronounced in construction, where the growth rate fell from almost 10 % in 2001 to 2.7 % last year. The same trend was observed in agriculture, where production – thanks to good harvests – expanded only about 2 % last year after recording 11 % growth in 2001. Growth in the transport and communications sector remained close to last year's level of around 5 %. Retail trade also sustained its approximately 9 % growth pace set in 2001.

GDP and crude oil production, y-o-y %-change



Source: Goskomstat

Strong consumption vs. weak investment in 2002

Goskomstat's initial estimates show fixed investment in 2002 accounted for some 18 % of GDP with its share declining slightly from 2001. The share of private consumption in GDP was 50 % and that of government 17 %. Private consumption increased its share over the year by two percentage points while the share of public consumption grew less than one percentage point. The share of net exports was 11 %, which was 2 percentage points less than in 2001.

Concomitant changes were registered in the income structure of GDP, where labour remuneration increased its share from 43 % in 2001 to some 46 % at the expense of aggregate taxes and profits. These changes were brought about by a rapid rise in real wages, which according to preliminary information amounted to almost 17 % in 2002. This was due in part to explicit government policies to raise wages in the extremely low-paid public health care and education sectors. Real disposable income of the population grew almost 9 % over the year.

Enterprise profits declined for second year in a row after a boom in 2000. Goskomstat surveys indicate aggregate profit of large and medium-sized non-financial enterprises fell almost 12 % during January-October 2002 compared to the same period a year earlier. This was due to diminished profits in industry. Indeed, natural gas production was the only industrial sector enjoying higher profits. In contrast, most service industries saw profits rise significantly.

Oil extraction and exports boom

The Ministry of Energy says Russian crude oil production rose to nearly 380 million tonnes in 2002, an average of about 7.6 million barrels a day. Growth from the previous year was nearly 9 %. 2002 was the fourth consecutive growth year for the oil industry. In January 2003, output growth continued at almost 12 % y-o-y.

State-owned Transneft, which operates the country's oil pipelines and handles most crude exports, exported 157 million tonnes of crude oil in 2002 – a contribution of about 3.1 million barrels a day to world markets. The volumes include oil from Azerbaijan and Kazakhstan transported via Russia. Transneft's oil exports rose 4 % y-o-y last year.

Oil exports are expected to further rise this year, even in the face of transport capacity constraints. Russian oil companies have requested that Transneft improve the efficiency of its transport capacity, e.g. by increasing the volume of shipments through Latvia's Ventspils oil transhipping terminal. Shipments moving through the Gulf of Finland via the Primorsk oil terminal, which was completed last year, substantially decreased shipments via Ventspils. Transneft has not announced any plans to use Ventspils in the first quarter of this year, despite unusually thick ice in the Baltic this winter. Russia's largest oil companies are considering construction of additional pipelines, but the state's role in the ownership of new pipelines has caused disputes.

As a result of increased supply on Russian markets, caused by transport capacity constraints, the domestic price of crude declined markedly in early 2003.

Macroeconomic indicators

	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %	-12.6	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	4.3	
Industrial production, %	-20.9	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	
Fixed investments, %	-24.0	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	
Unemployment, % (end of period)	7.5	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.1	
Exports, $ billion	67.4	82.4	89.7	86.9	74.4	75.6	105.0	101.6	95.8	1-11/02
Imports, $ billion	50.5	62.6	68.1	72.0	58.0	39.5	44.9	53.8	54.0	1-11/02
Current account, $ billion	7.8	7.0	10.8	-0.0	0.2	24.6	46.8	34.8	31.7	

Source: Goskomstat, CBR.

Tax reform gets going

The government discussed joint suggestions for tax reform from the Finance Ministry, Ministry of Economic Development and Trade and the Tax Ministry early this month. Although no decisions were reached, the government seemed willing to radically revise Russia's current tax structure and will give tax reform the highest priority as a means to boost economic growth. Future budget surpluses would be used primarily to further reduce the tax burden. During the period 1999 – 2002, tax revenues (excluding unified social tax, or UST) amounted to 32 – 34 % of GDP. This share should decline to less than 31 % of GDP by the end of 2003.

The ministries' proposal includes a wide variety of tax reform measures. Perhaps the most extensive – and most discussed – are decreases in the UST and value-added tax. Both measures have major repercussions on budget income as they together represent some 50 % of federal budget revenues. Cutting the effective rate of the employer-paid UST by 5 % to about 30 %, while simultaneously lowering the wage level, where the maximum tax rate is applied, is expected to convert a greater proportion of unofficial income into official income. UST's regressivity would be sharpened, so that as more unofficial incomes are revealed, the tax rate would rapidly drop from the maximum to the mid-level 15 % and even to the minimum 2 %. It is still unclear how non-budgetary funds – especially the Pension Fund – would be credited for losses likely to result at least in the short run. The Finance Ministry has proposed the use of financial reserve funds for this purpose.

The VAT remains by far the largest and most stable source of income of the federal budget. According to ministries' proposal, the VAT regime will be revised this year to speed up reimbursements for exporters. The proposal also suggests cutting the VAT rate from 20 % to 15 – 17 % in 2005. The reduced 10 % VAT rate for certain products would be retained as long as economic conditions permit.

One of the most debated tax reform topics in 2002 was the question of how to compensate regional and local budgets for their losses from the tax changes planned for 2003 – 2004. The new transport tax, introduced at the beginning of 2003, is unlikely to bring in as much revenue for regions as the taxes it replaced. Despite federal promises of full compensation for losses, it remains unclear where the money will come from. The ministries' proposal suggests losses from abolishing the sales tax at the beginning of 2004 will partly be covered by unifying property taxes (taxes on property of physical persons, property of enterprises and the land tax) into a single real estate tax. This new tax, which is expected to increase property-related tax revenue, will be based on the market value of the taxed property.

Pros and cons of meat import quotas

Although officially described as not being retaliation for the EU's recently announced grain import quotas, Russia's decision to restrict imports of poultry, pork and beef from April hits EU producers hardest. The quotas are expected to reduce imports of beef, pork and poultry by 16 – 30 %, while increasing domestic production by 5 – 20 %. The decision was rationalised in terms of Russia's need to assure some degree of self-sufficiency in food production and retain growth in the agriculture sector. According to agriculture minister Alexei Gordeyev, almost 40 % of meat products sold in Russia are of foreign origin.

In the short run, at least, quotas may actually lead to higher meat prices, due to the inelasticity in domestic meat production caused by capacity constraints. There is also the threat of increased illegal imports through CIS countries (notably Ukraine), which are exempt from quotas. It has also been suggested that the meat quotas may harm Russia's WTO accession negotiations. The EU wants to revisit the meat quota decision.

Moves to liberalise currency regulation

In early February, the Duma approved a repeated third and final reading of an amendment to the bill on currency regulation, easing customs procedures for foreign travellers. The amended law allows both non-residents and residents to take a maximum of $3,000 in cash foreign currency out of the country without declaring it at the border. Furthermore, residents and non-residents can expatriate up to $10,000 by declaring it. Amounts exceeding $10,000 can be taken out of the country only by a bank transfer. Under prevailing rules, non-residents are forbidden from taking any amount of foreign currency out of Russia without producing a document declaring the origin of the money. Russian residents can take out $1,500 in foreign cash without declaring it.

The amendment was made in response to repeated appeals from foreign businesses and other organisations, complaining about the bureaucratic hurdles at Russia's borders. The decision has been welcomed as a measure that will promote business and tourism in Russia. An earlier version of the amendment allowing the expatriation of up to $10,000 without a declaration was passed by the Duma in December 2002, but subsequently rejected by the Federation Council.

Russia also made a small step at the start of 2003 towards currency liberalisation with the abolition of the 1 % tax on purchases of foreign currency.

A major overhaul of Russia's currency control system is under preparation. The aim is near-complete liberalisation of capital movements by 2007. The Duma is expected to take up that bill sometime this spring.

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

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**as of**	**2003** budget
Revenues	12.5	12.3	11.0	12.6	15.5	17.6	20.1 [1]	1-11/02	18.5 [1]
Expenditures	20.9	19.4	16.9	13.9	14.3	14.6	17.5 [1]	1-11/02	17.7 [1]
Balance	-8.4	-7.1	-5.9	-1.4	1.2	3.0	2.6	1-11/02	0.6
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	35.0	9/02	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	119.1	9/02	

[1] *Including social tax channelled via the federal budget.*

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

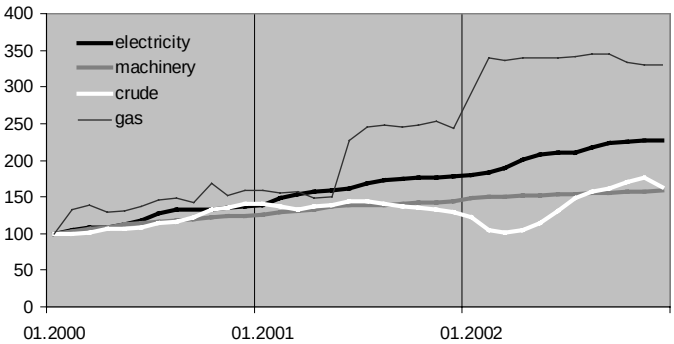
Consumer and producer price inflation rapid

Consumer prices continued their rapid growth in January with an on-month increase of 2.4 %. The rise was mainly due to hikes in rents, municipal services and public transportation fees introduced at the start of the year. During the past twelve months, consumer prices rose 14.3 %. Officials expect 12-month inflation to slow to around 10 – 12 % by the end of this year.

The State Statistics Committee began publishing a figure for base inflation in January. The number describes the change in consumer prices, omitting effects of price changes from one-time administrative decisions and seasonal factors. Russia's base inflation rate in January was 1.2 %.

Industrial producer prices increased 17 % in 2002. Highest inflation was recorded in gas and electric energy production and crude oil extraction, where prices rose 26 – 30 %. In December 2002, however, crude oil prices declined month-on-month, reflecting increased domestic crude supply. Coal prices rose 9 % for the year. Prices rose 11 % in machine building and 5 – 6 % in light industry and food production.

Selected producer prices, Jan. 2000 = 100



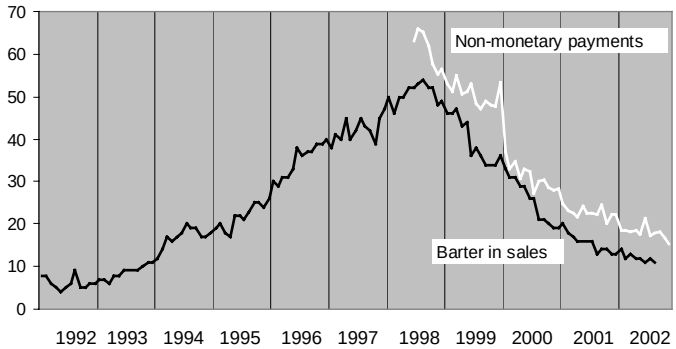
Source: RTS

Use of money surrogates by large firms declines

Goskomstat reports that the share of money surrogates (IOUs, offsets, barter and others) of the largest taxpayer enterprises and monopoly firms peaked after the 1998 crisis at about two-thirds of sales. The use of money surrogates has since declined quite steadily. As of November 2002, some 15 % of sales were still paid for with non-monetary forms of payment. The year-earlier figure exceeded 22 %.

Offsets and IOUs were the most common money surrogates during January-November 2002. They represented about 13 % of total sales and 74 % of non-monetary payments. Goskomstat further claims the share of barter was less than 2 % of all sales. However, the Russian Economic Barometer survey, which is based on information from several hundred firms, produced a different figure for barter. It found that the share of barter hovered at around 11 – 12 % of sales during January-August 2002. Presumably, the differences in the importance of barter reflect differences in research target groups.

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



Source: Goskomstat, Russian Economic Barometer

Banking reform goes in small steps

Banking reform, broadly outlined in a joint strategy document of the Finance Ministry and the CBR approved at the end of 2001, has made slight progress during the past several months. Ownership issues have advanced a couple of notches. The 12 % ceiling on aggregate foreign ownership in the banking sector (which was meaningless due to low attraction of the Russian banking market) was abolished last autumn. The CBR also transferred last autumn its virtually full ownership in Vneshtorgbank, Russia's second largest bank in total assets, to the government. The CBR has subsequently lowered its stake in three major banks abroad by selling their shares to Vneshtorgbank. The big question – ownership changes in Sberbank, which is majority-owned by the CBR – has been kept off the table "for the time being." Reasons for the omission include the bank's relative size, social importance and regional service.

The government recently reviewed a general accounting reform and called for closer definition of entities that must prepare consolidated financial statements according to international standards (IAS) from 2004. It is now expected that banks will move to IAS – a challenge even for many firms in Europe – in 2007. Meanwhile, Russian banks would make their accounts in Russian standards and in parallel transform them to IAS. Over 100 Russian banks claim they already apply IAS.

As regards protection in banking business, legislative changes are in progress. For example, a law on enforcing collateralised mortgages was adopted, and improved legislation on bank bankruptcies is proceeding in the Duma. Laws on household deposit insurance, disclosure requirements for actual owners of banks and the quality of bank management are on their way through the government or the Duma.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	14.3	1/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3		
Average wage, $ (period average)	104	154	164	108	62	79	111	142		
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.2		11/02
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	14.7		11/02
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	49.3	1/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	31.82	1/03

Source: Goskomstat, CBR.

Reforming Russia's educational system

by Abdur Chowdhury and Inna Verbina*

The Russian Federation inherited a fairly well-developed, mature educational system from the Soviet Union. Most school-age children had access to general education; literacy was almost universal. Transition exposed weaknesses in this system tailored to the needs of a centrally planned economy. Specifically, it had limited abilities to respond to the changing economic structures of a market economy.

With a view to bringing greater efficiency and accountability, a large part of the education sector was decentralised under the 1992 Education Act. Under this law, responsibility for general education and school finance was entrusted to regional (*oblast*) and local (*rayon*) level authorities. This rapid decentralisation attempt proved to be poorly designed. It lacked the commensurate transfer of resources and never spelled out the levels of government responsibility.

State of education

Reform attempts since 1992 have encountered three major obstacles. First, in terms of budgetary provisions for educational needs, there has been a decrease in financial transfers from the federal to regional governments – both in absolute and relative terms and relative to what the regions themselves spend. Second, as a consequence of this regionalisation policy, many ethnic republics sought to establish their own educational systems and launch their own education reforms, creating a dissonance between the key elements of the federal and regional approaches to educational change. Third, the real incomes of teachers and educators have declined. As a result, many qualified managerial and teaching staff have left schools for better paying jobs.

There is genuine concern that the emphasis on educational decentralisation and diversity is creating greater inequities and contributing to a narrowing of educational choices and opportunities. Today, the education system faces growing social stratification, differentiation among educational institutions and the emergence of a system of paid educational services. All these developments are making education less accessible to low-income citizens. Sixteen of the country's 89 regions now spend at least a third more per student on compulsory education than the eighteen regions at the bottom of the spending scale.

The federal government has recently adopted programs that provide for a set of measures to modernise educational institutions and improve the quality and efficiency of education. The program provides for a transition to a 12-year education, introduction of a single state examination and inclusion of more technical subjects in the basic high school curriculum. The government also plans to shift the responsibility for financing school teachers' salaries from the municipal level to the regional level, while local budgets will still be responsible for maintenance of the infrastructure of educational institutions. The 2002 consolidated budget saw a 60 % increase in allocation for education relative to the previous year.

Unfinished agenda

While these are steps in the right direction, much more needs to be done. Specific reform options worth consideration include giving schools increased financial autonomy for higher efficiency, implementation of a per capita financing formula and raising teacher qualifications. The government must also ensure that schools are geographically accessible, affordable and equipped with educational resources that meet minimum standards. Further, schools need to deliver a curriculum that does not handicap the student's access to higher education. This process could be promoted by a fair, affordable, and enforceable mechanism of compensatory finance between and within regions based on the interregional equalisation mechanism introduced in the mid-1990s.

Other authorities could also help out with various measures. For example, schools have to find innovative ways to attract private money to supplement public outlays. While there is a huge shadow market for educational services (about 1.5 % of GDP), public schools are unable to tap into this market due to their rigid policies. Indeed, money given by parents to school officials for various projects is seldom properly accounted for. Transparency of income flows and efficiency in spending are essential for an education system to flourish. Schools could also raise funds from private sources to finance targeted, well-designed programs. Various means could also be explored for attracting business funding for vocational and higher education.

Moreover, the government should make sure that students in all regions enrol in a minimum number of core courses to assure a common basis for educational assessment. Civil society could also be more involved in planning a merit-based education system where superior academic achievements are rewarded. Since spending on primary education is considered a means to improving the general welfare and reducing inequality, the distributional aspect should be stressed in any strategic plan, i.e. money should first and foremost be allocated to providing every child with a sound education. Finally, in lieu of the current state-financing of educational infrastructure, Russian education needs a targeted approach that rewards schools for providing high quality education. In places where parents can choose among several schools, the attractiveness of individual schools will depend on what they offer students.

An education system based on accessibility, quality, and merit is essential to ensure that Russia has the high quality human capital necessary for sustaining economic growth.

** Abdur Chowdhury is a Senior Researcher at BOFIT; Inna Verbina is a Research Associate at WIDER.*

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

Editor-in-Chief Seija Lainela

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RUSSIAN ECONOMY
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Economic Developments

Incomes and unemployment up, population down

Income growth continued brisk last year. In real terms, wages rose almost 17 %, pensions 16 % and disposable incomes nearly 9 %. The average wage was about 4,500 roubles (126 euros), while the average pension was 1,400 roubles (39 euros) a month. The monthly average money income was 3,900 roubles (111 euros) per inhabitant. Income growth was an important contributor to retail growth, which was up 9 % y-o-y.

Income distribution, on the other hand, remains highly disproportionate. In 2002, some 36 million people – a quarter of the population – had monthly incomes below the official subsistence minimum (about 1,800 roubles in 1Q – 3Q02). Russians tend to remain in the their income categories, and upward mobility involves overcoming substantial barriers. Wage disparities remain large among sectors of economy and the lowest wage categories usually have the highest wage arrears. Indeed, about 30 % of total wage arrears are owed to low-paid agricultural workers. In February 2003, wages in agriculture averaged just 43 % of the national average wage. In January 2003 wage arrears were in real terms down compared to year earlier. However, in February they turned into growth again.

The number of *unemployed* fell last year until autumn, when it began to rise. At least part of the increase was due to the fact that in September 2002 Goskomstat began to adjust its unemployment figures with results of a separate study. In January 2003, Russia reported about 6.1 million unemployed, up from 5.2 million in August 2002. The figure corresponds to about 9 % of workforce. The labour ministry says unemployment in Russia is mainly structural – last year there was a deficit of blue-collar workers, whereas white-collar workers found it tough to find jobs corresponding their education.

The unfavourable *demographic trends* in Russia showed no signs of reversing in 2002. Goskomstat reports Russia population decreased over 800,000 to about 143 million in 2002 due to the highest death rate since World War II and despite the highest birth rate in a decade. Since the early 1990s, Russia's population has shrunk by about 5 million. Moreover, the majority of deaths in 2002 were attributed to cardiovascular disease, which was especially common among men. Male life expectancy has dropped from 64 years at the start of 1990s to 57, while for women the drop has been much smaller (from 74 to 72).

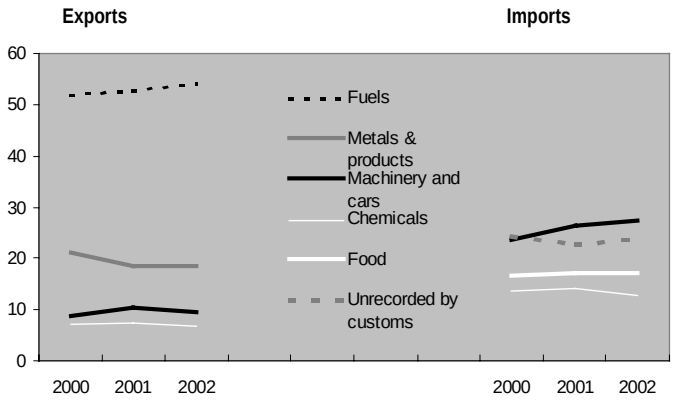
Exports pick up, import growth slows

Thanks to a rapid rise in 2H02, Russia's export earnings rose 5 % in dollar terms last year. Imports increased over 10 %. Non-CIS imports rose almost 20 %, but that change was blurred by major exchange rate shifts. In euro terms, non-CIS imports rose about 10 % and slowed to around 5 % in 2H02.

Rising oil prices and higher oil export volumes drove strong year-end export growth. For the year, the export volume of crude oil was up 14 % and oil products nearly 20 %; both grew almost as fast in 2001. Natural gas deliveries also recovered (up 2 %). Russia continues to focus heavily on energy exports – crude oil accounted for a quarter of exports, gas 15 % and oil products 10 %. Exports of certain metals and basic forest products were up, and Russian grain exports rose six-fold.

Imports, at least those captured by Russian customs statistics, are increasingly made up of machinery and equipment, which, excluding passenger cars, accounted for a third of the customs total. Such imports rose 15 % overall and 20 % from countries outside the CIS, although the pace was down significantly in the last quarter reflecting Russia's slow investment growth. Imports of food and agricultural raw materials retained their share at over one fifth. As in the past, about a quarter of imports reported by the CBR were not recorded by the Russian customs. Thus, Russia may likely be importing much more for consumption than suggested by customs data.

Major Russian exports and imports, % shares



Source: State Customs Committee, Goskomstat, CBR

Macroeconomic indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	4.3		
Industrial production, %	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	4.9	1/03
Fixed investments, %	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	7.9	1/03
Unemployment, % (end of period)	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.6	1/03
Exports, $ billion	82.4	89.7	86.9	74.4	75.6	105.0	101.6	107.0		
Imports, $ billion	62.6	68.1	72.0	58.0	39.5	44.9	53.8	60.5		
Current account, $ billion	7.0	10.8	-0.0	0.2	24.6	46.8	34.8	31.7		

Source: Goskomstat, CBR.

Railway reform gets legal basis

The legal basis allowing the implementation of railway reform is gradually taking shape. At the end of last December, the Duma approved four bills on railway reform. The most important – the act on railway traffic in Russia – specifies general rules for railway transport. It guarantees equal access to the railway infrastructure for all market players that fulfil the general quality requirements set by law.

The division and administration of the assets of the railways ministry was agreed upon, as a corresponding law was approved by the Duma early last month. The law calls for the creation (hopefully during the first half of 2003) of a joint stock company, Russian Railways, which will assume control of property closely related to functioning of the national railways. All other assets will be divested by end-2005. The new company must lease the land in its use. The railways ministry, in turn, will be responsible for administering development of the rail sector, drafting laws and tariff policy.

Last year, the railways ministry's losses amounted to RUB 55 billion (€1.5 billion), a rise of almost 50 % from 2001. The main loss leader was passenger traffic, which has long been supported by hikes in cargo tariffs. Beginning this year, the ministry aims to gradually eliminate cross-subsidies.

Power sector restructuring proceeds

Last month, after several years of preparation, a package of six bills on power sector reform passed smoothly in the Duma. The legislation gives the government greater authority in deciding the details and timing of power sector reform.

The reform seeks to split up the state power energy monopoly UES into state-controlled enterprises responsible for the power grid and transmission, while letting private enterprises handle generation and distribution. The promotion of competition in the sector is intended to secure investments and increase efficiency and transparency. Experts estimate that, without change, the lack of investment in the sector could cause a deficit in power generation capacity within four years. To secure investments before complete market liberalisation has been achieved, the federal energy committee (FEC) has demanded the creation of a special state investment fund.

Power prices in the wholesale market will remain regulated at least until July 2005. According to the government, regulation of consumer prices could last until 2008. During the transition, power trade in some parts of Russia will be liberalised to get experience with deregulated markets. The ministry of economic development and trade says a trial electricity wholesale market could be introduced already this year. It would comprise 5 – 15 % of Russia's electricity generation capacity.

Retail electricity price hikes in over half of Russia's regions in the past two months already exceed the ceiling of 14 % set by the government for the year. President Putin strongly opposes the hikes and has called for urgent measures. The FEC suggests reducing retail prices at the expense of industrial consumer prices, which would be go up by as much as 30 %. The ministry of economic development and trade is drafting measures to solve the situation.

Privatisation revenues set to double in 2003

If the government approves suggested amendments to the 2003 privatisation program, the volume of state property to be sold in 2003 will increase markedly and privatisation revenues will double from RUB 35 billion (€1 billion) in 2002 to RUB 60 – 70 billion. The emphasis of privatisation this year is on divesting the state's minority stakes in hundreds of enterprises. Of the over 4,000 joint stock companies in which the Russian state has stakes, its share is below 2 % in some 400. Other priorities include selling state stakes in the banking sector. The finance ministry, together with the economy ministry, is responsible for drafting a strategy on banking sector development for 2003 – 2007. The state plans to sell share packages in over 100 banks this year. The share packages were transferred to the state from state unitary enterprises.

Renewed guidelines for economic reform

In February, the government preliminarily approved the economy ministry's proposed program to guide Russia's economic reforms in 2003 – 2005. The plan seeks to continue the policies laid out in the previous program for 2002 – 2004, while taking into account changes that have taken place in the Russian economy since that program was adopted. The government will revisit the program in April.

Last year's extensive legislative reforms – including the adoption of agricultural land code, bankruptcy law and many others – were outlined in the previous program. However, many of its goals were not reached. The new version entails ambitious targets for further institutional reforms seen as necessary for putting the economy on a path of sustainable growth.

Decreasing Russia's dependency on exports of energy and other primary products through diversification of the economy is seen as key to sustainable growth. For that, the government plans to shift the tax burden from the manufacturing sector towards primary producers. It would also reduce the role of the state in the economy by e.g. easing regulatory pressures.

The program aims at output growth of 4.2 – 5.5 % annually in 2004 – 2008, and somewhat higher growth thereafter. Real disposable income growth would slow from the current 9 % to 6 – 7 % annually. The annual increase in fixed investment would climb to 7 – 9 % from less than 3 % last year.

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

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**as of**	**2003** budget
Revenues	12.5	12.3	11.0	12.6	15.5	17.6	20.3 [1]		18.5 [1]
Expenditures	20.9	19.4	16.9	13.9	14.3	14.6	17.9 [1]		17.7 [1]
Balance	-8.4	-7.1	-5.9	-1.4	1.2	3.0	2.3		0.6
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	35.0	9/02	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	119.1	9/02	

[1] *Including social tax channelled via the federal budget.*

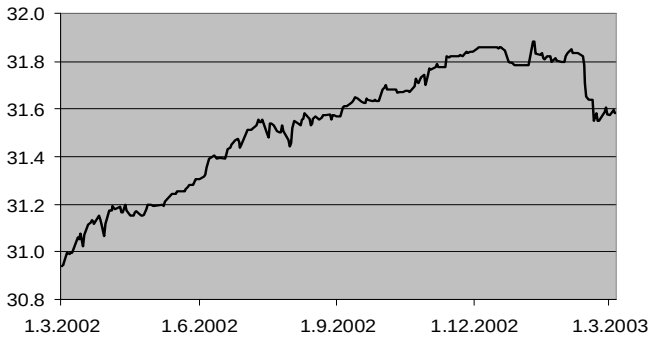
Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2002. Debt: IMF 1995-1999, Minfin 2000-2002.

Rouble strengthens as monetary policy changes

In mid-February, CBR governor Sergei Ignatiev announced a shift in monetary policy emphasis away from steering the external value of the rouble and towards fighting inflation. Consumer price inflation in 2002 exceeded by 1 percentage point the upper limit of 14 % set by the government and the CBR. For the current year, the year-end target range of inflation is 10 – 12 %. The CBR expects the rouble to appreciate this year 4 – 6 % in real terms against a basket of currencies of Russia's main trading partners. Last year, the rouble lost 2 % of its value against the currency basket.

The rouble strengthened immediately after the announcement as the CBR refrained from buying dollars in earlier amounts. Moreover, high oil prices have boosted inflows of dollars. The policy change altered the trend of moderate nominal depreciation of the rouble vis-à-vis the dollar that has prevailed since the 1998 financial crisis. The initial appreciation of the rouble was partially related to speculation, and since late February the external value of the rouble has stabilised. In early March, the rouble's nominal value vis-à-vis the dollar was about the same as in autumn 2002.

RUB/USD exchange rate

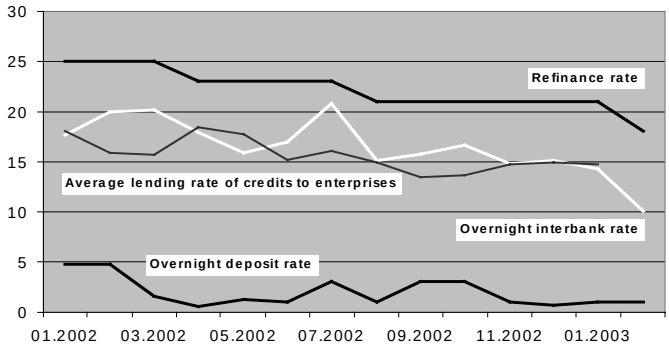


Source: CBR

Interest rates continue to fall

Since last autumn, the CBR has introduced several monetary policy tools with a view to make more active use of open market operations in liquidity management. In mid-February the CBR cut its refinancing rate from 21 % to 18 % to bring it closer into line with market rates, which have been trending downward due to slowing inflation. However, the refinancing rate is largely redundant as a monetary policy tool as the CBR does not extend credit to banks at that rate. Instead, the refinancing rate is used as a reference rate in calculating penalty rates for overdue payments and defining certain taxable interest income. Interest rates on the more relevant CBR deposit facilities were cut by one percentage point to 1 % for overnight deposits and 2 % for one-week deposits.

Selected interest rates, % p.a.



Source: CBR

Financial flows to Russia increasing

February saw several important financial deals between western countries and Russia. The first was British Petroleum's investment in a joint venture with Russian oil companies TNK and Sidanco. BP will own 50 % of the new company, for which it will pay $6.75 billion. The company will be Russia's third largest oil producer with a daily production of around 1.2 million barrels. The investment boosted optimism on the markets about Russia's improved business climate and was followed by rises in Russian stock and bond prices. Renault followed with announcement of a plan to invest $250 million in a joint venture in Moscow for the production of a new passenger car model.

Gazprom also enjoyed a successful eurobond flotation on February 21. Due to over-subscription, the size of the 10-year bond issue was increased from $1 billion to $1.75 billion. The yield is 9.625 %, which is considered favourable for a Russian borrower. In general, yields on Russian debt papers have been declining recently, reflecting both perceived improvements in the Russian economy and the fact that other emerging market investment opportunities have been losing their appeal due to the generally grim world economic situation.

According to Goskomstat, foreign investment inflow to Russia amounted to $19.8 billion in 2002, a 39 % rise from 2001. The increase was almost entirely due to borrowing, while the other main categories, foreign direct investment and portfolio investment, stayed practically unchanged. In the borrowing category, loans with maturities exceeding 180 days more than doubled and trade credits went up by 22 %, pointing to foreign investors' increased confidence in the creditworthiness of Russian entities. The growth in borrowing continued in January 2003, when Russian companies attracted $1.1 billion from abroad in the form of loans and bonds.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	14.8	2/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	34.9	1/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	153	1/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.8	1/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	14.7	1/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	53.1	2/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	31.58	2/03

Source: Goskomstat, CBR.

Registered unemployment in Russia: Does it matter?

by Eugene Nivorozhkin*

One of the most striking features of the Russian labour market is the gap between the unemployment figure measured by labour force surveys (general unemployment) and official registered unemployment. Between 1992 and 2000, registered unemployment as a percentage of the total labour force averaged just 23 % of general unemployment rate. In most countries of Central and Eastern Europe, this relationship was in fact inverse.

The formation of the labour market in Russia was accompanied by the creation of an institutional infrastructure to deal with unemployment. Public Employment Offices (PEOs) were created by government decree in 1991 to assist in maintaining employment and render financial support to the registered unemployed persons. However, not all unemployed individuals choose to register with PEOs, so government statistics report two indicators of unemployment, i.e. registered unemployment based on information provided by PEOs and general unemployment based on surveys undertaken according to International Labour Organization (ILO) methodology.

Most observers attribute the huge difference between registered and general unemployment to the unattractiveness of registering with a PEO. Some doubt the effectiveness of PEOs in the provision of meaningful assistance to unemployed persons. Others are sceptical of the efficacy of PEO-sponsored training programs. Although these criticisms may have a basis in fact, most discussions of unemployment in Russia do little more than superficially recite on registered unemployment and PEO weaknesses. A common assumption is that registered unemployment is insignificant in the economic system and thus does not warrant serious investigation.

Why registered unemployment matters?

The following discussion reviews a few issues related to comparing registered and general unemployment in Russia. Hopefully, it provides some argument for making greater use of PEO data.

First, the comparison of registered and general unemployment is not wholly valid due to methodological considerations. Under Russian legislation, general unemployment includes individuals 15 to 75 years of age. The age of registered unemployed is 16 to retirement age (55 years for women and 60 for men). Full-time students also do not qualify as registered unemployed. Moreover, the indicator of registered unemployment only includes those individuals inquiring to PEOs who qualify for unemployment status by meeting the criteria specified by law. Based on the end of the year figures for the period 1996–2000, an average of only 89 % of non-working individuals inquiring with PEOs were recognised as unemployed and included in the registered unemployment indicator.

Second, any comparison of registered and general unemployment is hampered by the structure and composition of job vacancies available at PEOs. Most available jobs tend to be low-paid and low-skilled jobs – a problem well recognised in most industrialised countries.

Third, most individuals laid-off as a result of bankruptcies or enterprise liquidation are automatically registered with PEOs. In addition to unemployment befits, the registration provides these unemployed with medical insurance, continued accumulation of length of service benefits towards retirement and several other social benefits. In other words, one function of PEOs is to assist marginal groups of unemployed, and particularly, those who have suffered most during Russia's economic and political transformation.

The factors mentioned above indicate that studying general and registered unemployment may imply studying rather distinct groups of population with varying professional and socio-demographic characteristics and differing motivations towards employment.

Furthermore, the magnitude of registered unemployment and the efficiency of PEOs may be underestimated given Russia's high labour turnover. The total number of non-working individuals inquiring to PEOs has always been much greater than the number of non-working individuals registered with PEOs at the end of a given year. This difference steadily increased so that by the end of 2000 the total number of inquiring individuals exceeded the number of registered individuals by almost three-fold. During the period 1995–2000, each year an average of 3.6 % of Russia's labour force obtained employment through PEOs, even though registered unemployment only averaged 2.6 % of the labour force at year-end during the period.

From the policy standpoint, studying registered unemployment is important because the financial resources allocated by the Russian government (and international organisations like the World Bank) aim at dealing with registered unemployed. As these resources are limited and cannot be used for other social purposes, the studies of the incentives of the registered unemployed and the effects and efficiency of labour market programs conducted within PEOs are justified. Surprisingly, no evaluations of active labour market policies have yet been performed for Russia.

The data collected by PEOs is the only source of complex and systematic information available to study the behaviour of Russia's unemployed population. A few studies tantalisingly suggest that the data contained in individual registration cards on file with PEOs is quite rich and possible to study extensively using various empirical methods. Some examples of the areas for investigation are the determinants of unemployment duration and evaluation of the effects of labour market programs.

** The author is visiting researcher at BOFIT.*

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

Editor-in-Chief Seija Lainela

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RUSSIAN ECONOMY
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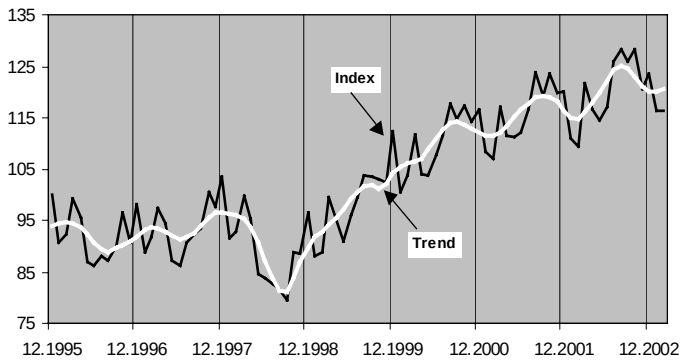
Economic Developments

Growth accelerates

Aggregate growth in five base sectors of the Russian economy (industry, construction, agriculture, transport and retail trade) picked up to 6.3 % y-o-y in January-February. The high figure is partly due to the low comparison base, reflecting the poor performance in these sectors early last year.

Industrial production growth accelerated to 5.7 % y-o-y in January-February 2003. Growth continued higher than the average in key export sectors, i.e. energy and metallurgy. Among individual commodities, crude oil production was up 11 % y-o-y, iron ore 15 % and coal 16 %. In contrast, sectors producing for domestic markets – light industry, in particular – faced tough conditions. After contracting 3 % in 2002, light industry fell 2.5 % y-o-y in January-February. The shift in the production structure away from value-added domestic market products towards commodity exports has further reinforced Russia's dependence on primary products.

Industrial output, December 1995 (100) – March 2003



Source: Goskomstat

Construction was up significantly in January-February 2003, leaping from a mere 3 % in 2002 to growth of nearly 14 % y-o-y. The on-year increase in the transport sector was about 7 %, somewhat higher than in 2002. Although brisk, the 8 % growth recorded in retail trade in January-February was slightly lower than in 2002.

Encouraged by the recent production boom and high world energy prices in the first quarter, some observers have increased their forecasts for Russia's economic growth. Most estimates of GDP growth in 2003 now range between 4 and 5 %. The government forecasts GDP to grow 4.5 %. Growth this year would be spurred by essentially the same factors as last year – high earnings from energy exports and rapidly growing real personal incomes. The factor that should make this year different from 2002 is higher investment. However, some experts – the IMF, in particular – are worried about the negative impact that Russia's slowness in structural reform has on the sustainability of the growth. In April, IMF cut its 2003 GDP forecast for Russia from 4.9 % to 4 %.

Structure of investment changing

Goskomstat has released detailed data on investment in 2002. It shows industry last year received 43 % of total fixed investment, while transport and communications received 23 %, housing and utilities 15 % and agriculture and construction 3 % each. Within the industrial sector, 21 % of total fixed investment went to the fuel sector. Indeed, the share of investment going into that sector is actually larger as much of investment in the transport sector is going to oil and gas pipeline construction.

There were some notable changes in the structure of investment in 2002 with the transport and fuel sectors losing (4 and 1.5 percentage points, respectively), while the housing and utilities sector rose 2 percentage points. Producers serving domestic markets, e.g. light industry, food producers and machine building, also increased their shares marginally. Imported machinery and equipment accounted for 25 % of all machinery investment in 2002. This share remained unchanged from 2001.

The structure of investment financing changed slightly as external funding increased its share at the expense of enterprises' own funds. Accordingly, 52 % of fixed investment was financed from external sources. Banks continue to play a distinctly minor role in enterprise financing. The proportion of bank credits in fixed investment financing amounted to about 5 % in 2002, slightly up from the previous year. The share is low even compared with other transition economies, where it ranges from 15 to 30 %. Federal and regional budgets were the largest source of outside financing for Russian enterprises, accounting for 22 % of total fixed investment financing. The rest, 25 % of investment, was financed from a variety of sources, mainly from other organisations. Foreign funding financed 4 % of total fixed investment.

After growing less than 3 % in 2002, fixed investment enjoyed a spectacular 9.5 % on-year increase in January-February 2003. Although the high rate partly results from the low comparison base of January-February 2002, it is clear that investment is picking up from last year's low levels, spurred by growth in export earnings.

Macroeconomic indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-4.0	-3.4	0.9	-4.9	5.4	9.0	5.0	4.3		
Industrial production, %	-3.0	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.5	2/03
Fixed investments, %	-10.0	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	10.9	2/03
Unemployment, % (end of period)	8.2	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.5	2/03
Exports, $ billion	82.4	89.7	86.9	74.4	75.6	105.0	101.9	107.2	29.9	Q1/03
Imports, $ billion	62.6	68.1	72.0	58.0	39.5	44.9	53.8	61.0	15.3	Q1/03
Current account, $ billion	7.0	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	11.9	Q1/03

2002 consolidated budget surplus shrinks

In 2002, the *consolidated budget* (includes federal, regional and local budgets) surplus shrank to 1 % of GDP from the almost 3 % in 2001. The reduced surplus reflects decreasing federal budget revenues and considerably increased non-interest expenditures in relation to GDP. The *consolidated regional budget* (combined regional and local budgets), which was balanced in 2001, was slightly in deficit (0.4 % of GDP) in 2002.

As a share of GDP, *federal budget* revenues from profit tax decreased most. Profit tax revenues have declined steadily since the beginning of 2002, when the rate was cut from 35 % to 24 %. The decline is expected to continue this year. Revenues from customs duties also decreased markedly, returning to their 2000 level. A substantial increase in natural resource payments (unified as a single tax at the beginning of 2002) nearly offset shrinking tax revenues (excluding the unified social tax or UST). While interest payments on foreign and domestic debt declined, spending on the social sphere and law enforcement increased, as well as transfers from the federal budget to regional budgets.

The decline of profit tax revenues was also apparent in the *consolidated regional budget* as profit tax revenues are shared among the various administrative levels. These losses were more than compensated by increases in financial transfers from the federal budget, natural resource payments and the income tax. Although total revenues in relation to GDP were higher than in 2001 (14.8 % of GDP vs. 14.3 % of GDP), they were still inadequate to cover rising expenditures. The strongest spending increases in 2002 went to education, health care and social policy. Housing expenditures as a share of GDP declined, hinting at possible progress in housing reform. Nevertheless, housing remained the second largest expenditure item for regional and local budgets. The spending on transport, telecommunications, agriculture and fishing in relation to GDP fell.

The *2003 federal budget* envisages falling revenues and non-interest expenditures in relation to GDP. For revenues, this is due to a continued decline in revenues from customs duties, profit tax and excise taxes. In contrast to the situation in 2002, natural resource payments are expected to contract. The aim is to rationalise (i.e. lower) non-interest expenditures this year and going forward. A commission dealing with these issues notes that expenditures remain heavily weighted to the social sphere, defence and regional transfers. The commission concedes wide-scale structural reform of these sectors will require massive amounts of money, but argue that costs need to be more closely analysed and controlled.

Federal budget: Realised 2001– 2002 and approved 2003

	2001			2002			2003		
	RUB billion	% of total [5]	% of GDP	RUB billion	% of total [5]	% of GDP	RUB billion	% of total [5]	% of GDP
Revenues incl. UST	**1591**		**17.6**	**2202**		**20.3**	**2418**		**18.5**
Revenues excl. UST	**1591**	**100.0**	**17.6**	**1862**	**100.0**	**17.1**	**2052**	**100.0**	**15.7**
Tax revenues	1461	91.8	16.2	1696	91.1	15.6	1892	92.2	14.5
of which									
VAT	*639*	*40.2*	*7.1*	*753*	*40.4*	*6.9*	*946*	*46.1*	*7.2*
Customs duties	*332*	*20.9*	*3.7*	*323*	*17.3*	*3.0*	*336*	*16.4*	*2.6*
Profit tax	*214*	*13.5*	*2.4*	*172*	*9.2*	*1.6*	*178*	*8.7*	*1.4*
Excise taxes	*203*	*12.8*	*2.2*	*215*	*11.5*	*2.0*	*228*	*11.1*	*1.7*
Natural resource payments	*50*	*3.1*	*0.6*	*214*	*11.5*	*2.0*	*183*	*8.9*	*1.4*
Other tax revenues	*23*	*1.4*	*0.3*	*19*	*1.0*	*0.2*	*21*	*1.0*	*0.2*
Non-tax revenues	115	7.2	1.3	151	8.1	1.4	146	7.1	1.1
Budgetary funds	15	0.9	0.2	15	0.8	0.1	14	0.7	0.1
Unified social tax [3]	-	-	-	340		3.1	366		2.8
Expenditure incl. UST	**1326**		**14.7**	**2046**		**18.8**	**2346**		**18.0**
Expenditure excl. UST	**1326**	**100.0**	**14.7**	**1714**	**100.0**	**15.8**	**1980**	**100.0**	**15.2**
Domestic debt service [1]	46	3.5	0.5	37	2.2	0.3	58	2.9	0.4
Foreign debt service [1]	185	14.1	2.0	186	10.9	1.7	220	11.1	1.7
Non-interest exp.	**1095**	**82.6**	**12.1**	**1491**	**87.0**	**13.7**	**1702**	**86.0**	**13.0**
Defence [4]	252	19.0	2.8	311	18.1	2.9	360	18.2	2.8
Social sphere [2]	204	15.4	2.3	286	16.7	2.6	314	15.9	2.4
Unified social tax [3]	-	-	-	332		3.1	366		2.8
Transfers to regional budgets	230	17.3	2.5	318	18.6	2.9	348	17.6	2.7
Law enforcement	149	11.2	1.6	190	11.1	1.7	245	12.4	1.9
Other expenditures	260	19.6	2.9	386	22.5	3.6	435	22.0	3.3
Balance	**265**		**2.9**	**148**		**1.4**	**72**		**0.6**

[1] *Includes only interest payments.*

[2] *Social sphere expenditures include education, health, social policy, mass media and culture, and the arts.*

[3] *The part of the unified social tax to be transferred to the state pension fund.*

[4] *Includes expenditure on national defence and on defence sector reform.*

[5] *Revenue and expenditure shares calculated excluding unified social tax.*

Source: Goskomstat, EEG / MinFin

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

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2003 budget
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.8	1/03	18.5
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	14.6	1/03	18.0
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	6.2	1/03	0.6
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2			
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5			

[1] *Since 2002 social tax channelled via the federal budget.*

Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2003. Debt: IMF 1995-1999, Minfin 2000-2003.

More bank intermediation in 2002

Continuing the trend of 2001, Russian banks last year enhanced their role in performing the basic banking function of transforming deposits into credits. Growth of bank *deposits* accelerated and was 18 % y-o-y in real terms for the stock of deposits at year's end (14 % in 2001). The level of bank deposits remains relatively low at about 20 % of GDP (for example, in almost all EU accession countries in Central and Eastern Europe the ratio is 35-70 %). Growth of rouble cash in circulation slowed to 13 % (nearly 18 % in 2001). The rouble cash share is 7 % of GDP. On an encouraging note, the growth of deposits continued fastest in the realm of household deposits and rouble time deposits, and was particularly rapid for term deposits over six months. Household deposits at Sberbank continued to increase a bit slower than at other banks, bringing the dominant bank's share of this market segment down to around two-thirds. Deposit growth was fastest by far at the next four largest banks (ranked by total assets).

Banks in Russia also continued to increase their *lending* to companies, although the pace of growth slowed to 18 % y-o-y in real terms (from over 30 % in 2001). Domestic bank credit to private companies is still only about 15-16 % of GDP (some 25-40 % in virtually all EU accession countries in Central and Eastern Europe). Observers continue to voice concerns about the potential for low quality of bank credit arising from the insufficient capacity of credit risk assessment at various banks. Corporate lending by Sberbank grew slower than the total, giving the bank a market share of about 30 %. Lending increased faster in the next four largest banks and in particular in the smallest 1279 banks. Bank credit in foreign currencies expanded faster than rouble credit, and growth focused mostly on maturities over one year. Lending to households was up 30 % in real terms. Sberbank increased lending in this emerging market segment by 50 % and raised its market share to well over 35 %.

Domestic public debt up – foreign down

The finance ministry announced Russia's public debt at the end of 2002 was $145 billion, or 42 % of GDP. Of that, foreign currency debt accounted for $124 billion, equalling 36 % of GDP – a healthy external financial position by international standards. Russia's domestic public debt, however, has increased during the past few years to $21 billion.

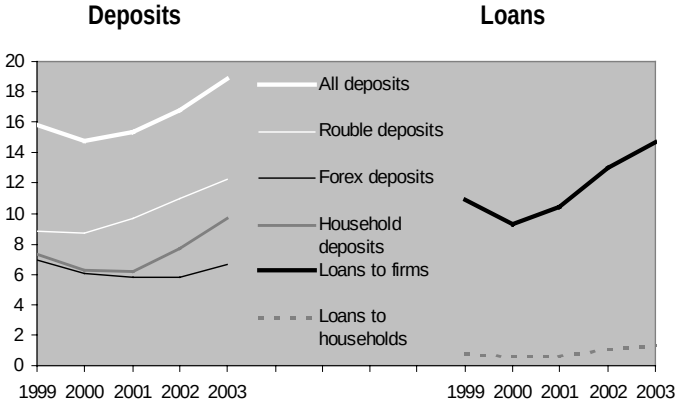
This trend reflects the finance ministry's goal of gradually increasing the share of domestic public debt as against foreign borrowing. In addition to reducing risks related to exchange rate movements, it provides domestic financial markets with a wider and more varied selection of financial instruments and is conducive to the overall development of the markets.

In March, the government approved the main principles of Russia's debt policy for 2003 – 2005. The general target is to reduce the overall public debt to 29 – 30 % of GDP by the end of 2005. The government aspires to have an investment-grade credit rating for Russia's sovereign debt in 2005. To achieve this, the government seeks in the near future to regulate the remaining Soviet debt and convert it into tradable Russian debt that it will honour without exception. The abolition of these irregularities in external financial relations would pave the way to Russia's full-fledged membership in the Group of Eight.

The new debt policy emphasises diligence in new borrowing. Following criticism aired in Russia over the past couple of years on the effectiveness of tied credits from OECD member countries and loans from international organisations such as the World Bank, the government decided to significantly restrict its reliance on such financing.

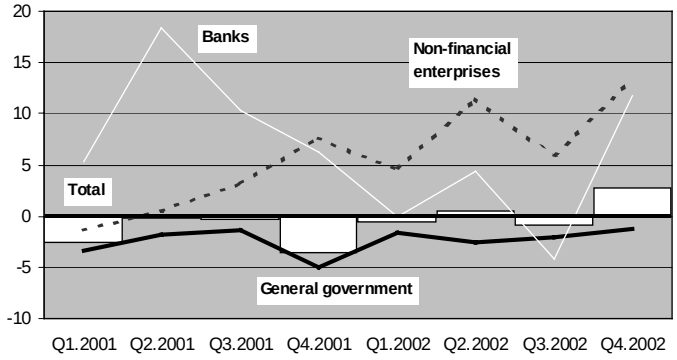
The graph below depicts the evolution of the components of Russia's overall external debt based on CBR figures. Banking sector debt grew over 2002 by 12 % to $15.2 billion, while non-financial corporate sector debt surged 40 %, reaching $33.6 billion at the end of the year.

Stock of bank deposits and loans at the year's start, % of GDP



Source: CBR

Russia's external debt, USD, % change from the previous quarter



Source: CBR

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	14.8	3/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	38.4	2/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	147	2/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.6	2/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	14.6	1/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	55.5	1/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	31.38	3/03

Source: Goskomstat, CBR.

Banking reform in Russia: A window of opportunity?

by Abdur Chowdhury*

The situation of Russian banks has improved markedly since the dark days following the 1998 financial crisis. Banks have grown in terms of assets, equity, deposits, loans and profits. Many of these key indicators, measured as a percentage of GDP, now exceed pre-crisis levels. These positive developments have taken place in step with Russia's general economic recovery.

Nevertheless, the banking sector reflects major structural weaknesses in the Russian economy. Assets, loans and total deposits account for just 35 %, 18 % and 19 % of GDP, respectively. Corresponding figures are much higher in other transition economies. Because Russia lacks a functioning banking industry, the sector fails to provide financial intermediation. Most private banks simply perform treasury functions for their owners' other (usually industrial) interests.

Although widespread agreement exists among analysts and policymakers on the need for reform in the banking sector, there is much disagreement on how to approach reform. Opinions range from imposing stiff capital requirements on domestic banks to removal of all restrictions on the activities of foreign banks.

Unfinished agenda

In the absence of a clear strategy, the process of bank restructuring in recent years has been slow, uncoordinated and inefficient. As piecemeal reform can only prolong the agony, the issue of overall reform needs to be confronted now.

First, the monopoly position of Sberbank, the state savings bank, should be reviewed as its sheer size restrains competition. Given the bank's relative size, social importance and regional service, any radical change in its operations could have negative and far-reaching effects. Therefore, authorities need to proceed with caution. Efforts should also be made to provide incentives to Sberbank's competitors to grow and increase the volume and spectrum of services to clients.

Second, state-owned banks dominate the sector in terms of volume of activity and number of branches nationwide. The involvement of state-owned banks should be reduced, along with the withdrawal of the Central Bank of Russia (CBR) from direct participation in the commercial banking business.

Third, as 1,329 credit institutions are currently licensed to conduct business transactions, greater trust in the system would be promoted by consolidation, i.e. fewer banks that have greater viability and are run more prudently.

Fourth, unlike in most central and eastern European countries, the Russian banking sector remains unattractive to long-term investment by foreign banks due to the small size of the market and lack of retail banking opportunities (banks only finance about 5% of investment in the country, compared to 15 – 30% in other transition economies). Future reform need to address this issue.

Finally, transparency and accountability should be established for improving public confidence in the banking industry. This calls for stronger supervisory and regulatory framework for banks, strengthened bankruptcy procedures, better creditor and depositor protection measures and reform of the judiciary system so that regulatory decisions can be implemented fully and enforced quickly.

Recent reforms

The change in the CBR's top management last spring offered hope of a clear political desire to implement long overdue structural changes in the sector. The new management team, with broad political support, has developed a reform agenda and a number of specific steps have already been taken. These include a decision to switch to International Accounting Standards (IAS) by 2007, a reduction of the profit tax on banks, transfer of full ownership in the country's second largest bank, Vneshtorgbank, from the CBR to the government, and a decision to sell off CBR's minority stakes in over 500 small and medium-sized banks. In addition, beginning in 2007, minimum capital adequacy requirements for all banks will be raised to €5 million. Legislative measures are also in progress with respect to the introduction of deposit insurance by 2005 and creditor and depositor protection in banking business. Collectively, these measures will force banks to be more transparent, weed out hundreds of small and unreliable banks, and inject competition by encouraging the consolidation of the sector around a few larger and more reliable banks.

Winds of change

Given the thin equity market and low foreign direct investment, banks must be the bridge that will connect available resources with those willing to invest, and this is why banking reform in Russia is so critical right now. The chances for reform are better now than at any time during the last decade. Political and economic conditions have created an unusual window of opportunity. There is a clear sign of change in the attitudes of bank owners and management, who have started to recognise the value of their businesses as a long-term source of income that requires commitment of significant financial and managerial resources. The political leadership and the monetary authorities have also shown an honest willingness to complete banking sector reform. Such reform will not be a quick fix. Similar attempts in the past were met with stiff resistance from many vested interests. However, with changed political attitude, it may be different this time.

** The author is a Senior Researcher at BOFIT.*

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

Editor-in-Chief Seija Lainela

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Economic Developments

GDP methodology revised, new figures published

In late April, Goskomstat published amended figures for Russia's gross domestic production from 1995 to 2002. The revisions were based on ongoing work to improve the methods of compiling GDP statistics and bringing them into conformity with international practices. The changes relate, among other things, to measurement of the output of certain services and their distribution among sectors of the economy, as well as statistical coverage of production in small enterprises. The methodology of compiling series in fixed prices was also upgraded.

The new figures reveal larger annual variations in GDP growth than seen earlier. For instance, GDP rose 1 percentage point faster in 1999 and 2000 than previous figures indicated. Conversely, the plunge in output induced by the 1998 financial crisis was steeper than earlier thought. The 2001 and 2002 annual growth figures remained unchanged.

GDP structure, %, in 2000 prices

	2000	2001	2002
GDP	100	100	100
By source			
Industry	32	32	31
Agriculture	6	7	7
Construction	7	7	7
Services	55	54	55
By use			
Consumption	61	62	64
Total investment	19	21	21
Fixed investment	*17*	*18*	*18*
Net exports	20	17	15

Source: Goskomstat

GDP, % change y-o-y

	1998	1999	2000	2001	2002
GDP	–5.3	6.4	10.0	5.0	4.3
By source					
Industry	–4.8	10.2	11.1	4.9	3.7
Agriculture	–18.8	17.1	12.7	11.2	1.6
Construction	–6.3	6.0	11.4	9.9	2.7
Services	–3.4	2.3	6.9	3.5	5.3
By use					
Consumption	–2.1	–1.2	5.6	6.9	7.1
Total investment	–45.2	–6.6	75.2	16.5	1.7
Fixed invesment	*–12.4*	*6.4*	*18.1*	*10.5*	*3.0*
Net exports	131.8	79.2	–15.9	–13.6	–4.5

Source: Goskomstat

Growth accelerates, boosted by the Iraq effect

In the final quarter of 2002, GDP increased some 5 % y-o-y, exceeding the growth rates of previous quarters. Growth continued briskly throughout the first quarter of 2003, as witnessed by the combined production of the five base sectors of the economy, which grew almost 7 % y-o-y. In the first quarter, the quickest pace, 14 %, was recorded in construction, followed by the retail trade at 9 %, transport at 7 % and industry at 6 %.

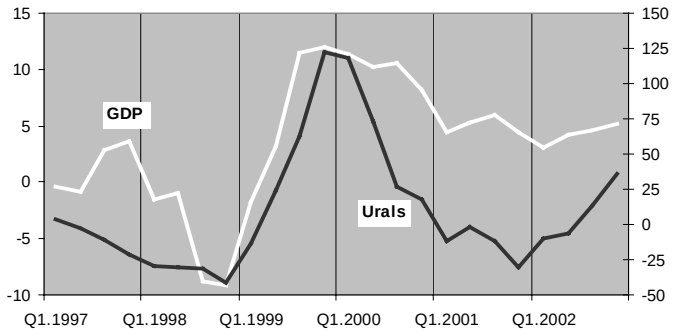
Russia is currently one of just a few of the world's economies that can boast such high growth figures. Given the significance of energy exports for its economy, Russia has benefited from the uncertain international situation and high energy prices on world markets. On the other hand, vulnerability to such external developments remains one of the weakest points of the Russian economy.

In the fourth quarter of 2002, the world market price of Urals crude averaged $26 per barrel. In the first quarter of this year, it was $29 per barrel. Notably, crude oil, oil products and natural gas accounted for 63 % of Russia's exports in the first quarter, while the value of Russia's oil exports grew 38 % y-o-y and totalled $30 billion.

The volume of crude exported by the state-owned Transneft pipeline monopoly increased almost 5 % y-o-y. Some experts estimate that total oil exports from Russia (including oil transported by rail) reached around 4 million barrels per day in the first quarter. Transneft plans to boost exports this year by 16 %.

Russian crude oil production was up 11 % y-o-y in the first quarter, beating 9 % growth in 2002. The government foresees an 8 – 10 % increase in crude production for the whole of 2003.

GDP (left scale) and Urals crude price ($ per barrel, right scale), % change y-o-y



Source: Goskomstat, Bloomberg

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3		
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.0	Q1/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	10.2	Q1/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.4	3/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	29.9	Q1/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	15.3	Q1/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	11.9	Q1/03

Source: Goskomstat, CBR.

Robust growth foreseen – if oil prices hold

Recent months have witnessed some fierce cabinet debates and hectic work at key ministries preparing documents on the economic outlook and economic policy. Much of this work is now completed.

In late April, the government considered a revised version of growth scenarios prepared by the economy ministry for 2004 – 2006. The ministry suggests two basic scenarios for Russian economic growth. As oil prices are a major factor affecting the economy, the main difference between the scenarios lies in assumptions about world market oil prices. If the Urals crude price rises gradually from $22 per barrel in 2004 to $23 per barrel in 2006, GDP will grow 4.7 – 5.3 % annually. In the pessimistic scenario, where the oil price averages $18.5 per barrel in 2004 – 2006, Russian GDP will grow 3.5 – 4.3 % annually. Tax reform is singled out as an effective structural measure to give an immediate boost to the economy. Growth rates in both scenarios increase by 0.3 – 0.7 percentage points if the government's proposed tax reforms are implemented.

Tax cut proposals

In late April, the government approved two documents prepared by the finance ministry that outlined fiscal policy for the next few years. The first document deals with the reform of Russia's tax system. In recent years, tax reform has seen an overhaul of personal and company taxation systems. Looking ahead, tax policy will emphasise reducing the tax burden and shifting the focus of enterprise taxation from manufacturing industries towards extraction. The overall tax rate in the economy would be cut during the next two years from 35 to 33 % of GDP.

The government wants the VAT rate cut from the current 20 % to 18 % at the start of 2004, as well as cuts in rates of the regressive unified social tax at the start of 2005. The excise tax on natural gas and the 5 % regional sales tax will be phased out at the start of 2004. To compensate the decrease in budget revenues, the government proposes raising the export duty of natural gas from 5 to 20 %, as well as higher fees for extracting natural gas and crude oil.

The Duma is expected to discuss the proposed measures before its summer recess.

Prudent fiscal policy to continue

Following intensive debate this spring, the government also approved the financial plan for 2003 – 2005.

The fiscal policy document sets guidelines for the 2004 and 2005 federal budgets. The cornerstone of the plan is to continue the prudent fiscal policy the government has pursued recent years. The federal budget is expected to show a surplus of 0.6 % of GDP in 2004, provided that the price for the Urals crude averages $22 per barrel. In 2005, the federal budget would have a surplus of 0.9 % of GDP. Budget expenditures are set so that the surplus emerges when oil price exceeds $20 per barrel.

Under the finance ministry's plan, surpluses will be transferred into a special stabilisation fund to be established at the start of 2004. The legislation governing the accrual and use of resources in the fund is currently under preparation.

To date, budget surpluses have been held in a "financial reserve." This reserve, however, lacks strict regulations on accrual and application of the money. At the end of the first quarter of 2003, assets in the financial reserve had reached RUB 230 billion or $7.4 billion. A large part of the resources is to be used for external debt repayments during the current year.

The surplus targets of the federal budget together with tax cuts proposed by the government necessitate a reduction in budget spending during the coming years. The government plans to cut non-interest expenditure relative to GDP from an estimated 13 % this year to 11.9 % in 2005.

Investment plans in oil transportation proliferate

The Russian government and private oil companies are seeking additional transport capacity to allow Russia to export more oil and benefit from current high world market prices. In March, the government approved plans from state-owned crude oil transport company Transneft to expand its capacity at the Primorsk oil terminal on the Gulf of Finland from the 0.24 million barrels per day the port has handled since its opening in 2001 to 0.6 million barrels per day by 2005. An option for a further expansion to 1 million barrels per day is also envisaged.

While the state remains unwilling to surrender Transneft's monopoly on Russian oil transport, there have been recent indications this attitude may be changing. In April, the government announced its willingness to cooperate with oil companies in the construction of new transport capacity while retaining operative control of new pipelines. The government gave a green light to the construction of a pipeline from Western Siberia to Murmansk on the Barents Sea. This new oil terminal would be dedicated mainly to exporting Russian crude to the US. Russia's largest oil companies (Lukoil, Yukos and others) originally proposed the project. A feasibility study on the project should be made during the current year.

Russian authorities and oil companies are also planning a new pipeline from Angarsk near Lake Baikal eastwards to either China or to the Russian port of Nakhodka by the Pacific Ocean. The first route is backed by Lukoil, while the second, which would mainly be used for exporting crude to Japan, is supported by Transneft. The government recently aired statements supporting Lukoil's proposal.

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

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**as of**	**2003** budget
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.6	Q1/03	18.5
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	16.5	Q1/03	18.0
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	4.2	Q1/03	0.6
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2			
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5			

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

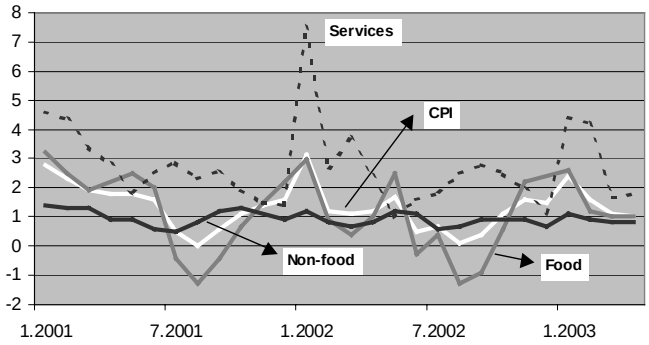
Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2003. Debt: IMF 1995-1999, Minfin 2000-2003.

Rapid rise in prices continues

The task of taming inflation has proven difficult for Russian authorities. April consumer price inflation was 14.6 % y-o-y, slowing only marginally from the 14.8 % recorded in February and March. During January-April, prices rose 6.2 %, i.e. by more than a half of the government's target rate of 10 – 12 % for all of 2003. A large part of inflation continues to be accounted for by a fast rise in administratively set prices on services, mainly housing and utilities. This reflects the government policy of bringing these prices gradually closer to cost-recovery levels.

High inflation has also been stoked by the huge oil export incomes that flow into the economy and increase the stock of money in circulation. Since its February policy focus alteration, the CBR has paid greater attention to fighting inflation and less to stemming real appreciation of the rouble. However, the CBR's available tools for sterilising currency inflows – currency swaps, reverse repos, and deposit auctions – have not yet shown much effect. Hence, the role of fiscal policy in fighting inflation becomes more important.

CPI and its components, m-o-m % change



Source: Goskomstat

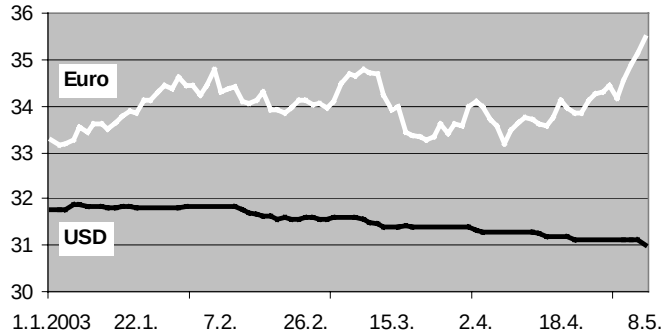
Rouble strengthens further against the dollar

Since February's monetary policy change, when the CBR reduced its dollar purchases, the rouble has made gains in value against the dollar both in nominal and real terms. In nominal terms, the rouble in early May was about 2 % stronger than at the start of the year. In real terms, the rouble has appreciated even more. At end-March, it was almost 5 % stronger than at the start of the year.

The rouble has continued its nominal depreciation against the euro, although with significant fluctuations. In early May, it was some 6 % weaker against the euro than at the start of the year. The real effective exchange rate of the rouble, which is calculated on the basis of the main currencies used in Russia's external trade, was 1.6 % higher at the end of March than at the start of the year.

Developments in the rouble exchange rate together with Russia's foreign trade structure affect the country's terms of trade. As most of Russia's exports – particularly energy and raw materials – are paid for in dollars, the strengthening of the rouble has decreased the rouble value of export earnings. On the other hand, a large share of Russia's imports come from Europe and are paid for in euros. Hence, the strengthening of the euro has increased import payments in rouble terms.

Rouble exchange rate against dollar and euro



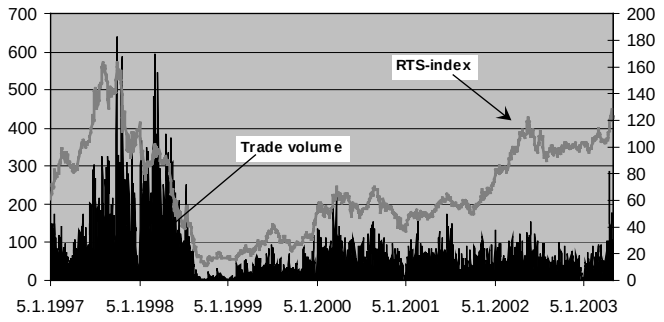
Source: CBR

Stock markets spurred by oil

Russian stock markets have also been boosted by higher oil prices, which have increased the attractiveness of Russian oil companies for investors. Furthermore, a reshuffle in the ownership structure of the sector is in progress with major players acting to consolidate their positions. Russian oil majors, Yukos and Sibneft, agreed in April to a merger that would create the world's fourth largest private oil producer.

Russia's main stock index, the RTS, climbed to around 430 points in early May – its highest value since 1997. Since the start of this year, the RTS has risen 20 %.

RTS index (left scale) and trade volume, $ million (right scale)



Source:RTS

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	14.6	4/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	41.4	3/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	163	3/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.6	2/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	14.1	2/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	55.5	3/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	31.10	4/03

Source: Goskomstat, CBR.

Economic welfare effects of EU and CIS integration

Pekka Sulamaa and Mika Widgrén*

EU enlargement will change European trade relations significantly. Much of the continent will be subject to the EU trade policy regime, which means the question of how an enlarged EU organises its trade relations with the rest of the continent is destined to be a major issue. One key aspect will be the relationship between the EU and Russia. Full EU membership is not an option in Russia's case. To avoid Russia's marginalisation, the EU will need to adopt an open attitude towards the rest of the continent in its external commercial policy.

If we imagine rings of influence, we might describe European integration with EMU forming the inner core. It is surrounded by the Single Market, then the Customs Union with a possibility for unilateral membership for EU outsiders and, finally, the EU free trade area with the rest of Europe.

Trade agreements that create hub-and-spoke patterns of trade tend to marginalise the "spoke" countries, as trade barriers between spokes typically remain higher than for trade between the hub and a spoke. After the eastern enlargement, it is likely that Russia and other CIS countries become spokes, with trade focused on the enlarged EU.

In Russia's case, a free trade agreement seems an obvious starting point. However, there is the potential that such an arrangement diverts trade and investment away from other CIS countries, as well as a further danger that if the EU adopts a Russia-oriented approach, it may marginalise other CIS countries. Hence, the EU needs to adopt a broad approach. This suggests an EU–CIS free trade area as the apparent candidate for future trade relations.

In a recent simulation study, we sought to assess both the impact of *EU eastern enlargement* on the CIS and the impact of *further integration between the EU and CIS* on both blocs.[1] Our simulations distinguished among three degrees of integration effects. The two baseline integration scenarios (eastern enlargement and EU–CIS free trade area) only considered reductions in trade barriers. For the next simulations, we assumed increased substitution between imported goods and their domestic counterparts. The third pair of simulations assumed productivity gains by new EU entrants (eastern enlargement) or gains by new entrants and CIS countries (EU–CIS free trade area).

Our *eastern enlargement* scenarios confirm the familiar view that incumbent EU countries gain very little, while new entrants benefit substantially from accession. The integration effect amounts to a 4 – 5 % boost in GDP for new entrants. It is worth noting that part of this gain has already materialised under their Europe Agreements. For CIS countries, we obtained both positive and negative welfare effects. Summing these effects resulted in an overall positive effect. The same holds for the rest of the world.

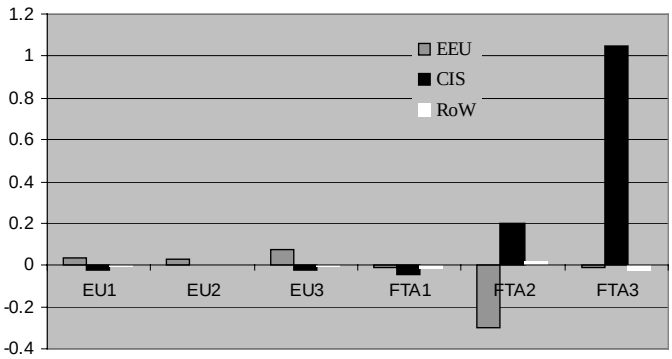
Our findings on the impact of *the EU–CIS free trade area* were quite different. The baseline scenario decreases world welfare, and causes the EU, CIS and the rest of the world to incur small economic welfare losses. Only Finland and Germany benefit from the agreement.

Other integration effects, i.e. enhanced substitution and improved productivity of the EU–CIS free trade area, are insufficient to make the arrangement beneficial. By increasing substitution between imports and domestic goods, we obtain a welfare gain for CIS countries at a considerable welfare loss to the EU (particularly for the southern EU and new entrants). If we only consider increases in productivity, the EU–CIS free trade area is beneficial for CIS countries, Finland and Germany. It still decreases economic welfare for the rest of the EU and the rest of the world.

In summary, free trade between the EU and CIS countries requires productivity gains, either from better institutions or increased foreign direct investment, in the CIS to be beneficial. Even with the improvements, however, the agreement is not beneficial for most of the EU, which makes the feasibility of such an arrangement questionable. Notably, Finland and Germany gain in all the EU–CIS free trade area scenarios, while the rest of the EU region loses. For the rest of the world, the EU–CIS free-trade area yields a welfare loss.

Welfare effects of different trade agreements on the enlarged EU (EEU), CIS and countries outside the arrangement (RoW) are illustrated in the figure below. The percentage changes are relative to baseline total output.

Welfare effects of various trade agreements, % change



EU = EU enlargement; FTA = Free trade area of the enlarged EU and CIS; 1 = Baseline scenario; 2 = Increased substitutability; 3 = Increased productivity.

* *Pekka Sulamaa, ETLA, Helsinki; Mika Widgrén, Turku School of Economics, ETLA, CEPR and CESifo*

[1] Sulamaa, P. & Widgrén, M. (2003), "Eastern enlargement and beyond: A simulation study on EU and CIS integration," CEPR Discussion Papers 3768.

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

Editor-in-Chief Seija Lainela

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RUSSIAN ECONOMY
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6•2003

Economic Developments

Putin envisions a doubling of GDP in ten years

In his annual state-of-the-nation address to the Russian parliament on May 16, president Putin covered various issues ranging from Russia's international standing to its demographic problems and the situation in post-referendum Chechnya. With regard to the development of democracy and the country's multiparty system, Putin raised the possibility that after the forthcoming Duma elections the next government could be based on the parliamentary majority.

As before, Putin's state-of-the-nation speech paid particular attention to economic issues. Speaking of the government's achievements to date, he listed a number of reforms that have been passed. Furthermore, Putin noted Russia has become a net exporter of grain for the first time in half a century and per capita consumption is now higher than at any time in the country's history. Despite this, the president warned, the economy is still very weak and vulnerable to fluctuations in world market prices. In particular, he was worried about the poor competitiveness of Russian firms and the growing role of inefficient monopolies in the economy.

Concerning reform policy, he highlighted the need for administrative reform. As in his speech last year, Putin strongly criticised Russia's bureaucracy for failing to work out and implement appropriate measures for the country's present-day needs. According to Putin, the competence of Russian bureaucracy does not match its powers. Thus, there is an urgent need to reduce substantially the functions of state bodies. Putin promised his strong support to push through ongoing administrative reforms.

The president set a very ambitious goal for policymakers – doubling Russia's GDP within ten years. In practice, this would imply an average annual growth rate of 7.2 %. While this is doubtless an ambitious target, it is somewhat lower than the 8 % growth rate Putin called for earlier. Aside from acceleration of administrative reforms and a call for a collective effort on the part of various groups of society, the speech offered no details on how current economic policy should be tuned to promote growth.

Economy continues to grow

In January-April, the Russian economy grew 6.9 % y-o-y according to preliminary information based on the combined production index of five base sectors of the economy – industry, agriculture, construction, freight transport and retail trade. Growth has accelerated steadily this year, reaching 7.5 % y-o-y in April. The economy ministry estimates Russian GDP increased 6.4 % y-o-y in the first quarter of 2003. The official figure for first quarter GDP from Goskomstat has yet to be published.

Domestic demand continues strong. Fixed investment was up 11 % y-o-y in January-April, and in April fixed investment exceeded its volume a year earlier by almost 13 %. The 9 % y-o-y growth in retail trade in January-April reflects continued robust consumer demand.

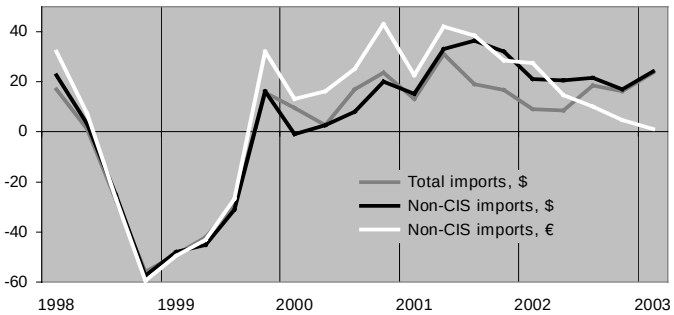
Oil production has also grown steadily in 2003. In May, it was up 11 % y-o-y and totalled 8.06 million barrels per day. Growing oil production has caused freight transport volumes to increase, too. Total freight transport increased 7 % y-o-y in January-April, while rail transportation of crude was up by 16 %.

Fuel exports climb, import growth continues

Russia's export earnings increased 40 % y-o-y in 1Q2003. This was due in part to a notable on-year decline in the value of the unit of measurement, the US dollar. Measured in a currency basket of Russia's main trading partners, exports were still up over a quarter. Substantially higher export prices for crude oil, oil products and natural gas than 1Q2002 drove the increase. Exported volumes of these three items also grew (crude oil was up 8 %). Export income from the three increased some 45 % in currency basket terms, and their share of Russia's total goods exports rose to about 60 % in 1Q2003. Other exports grew 7 %.

Goods imports to Russia continued to rise in 1Q2003. They were up almost 25 % y-o-y in dollar terms and well over 10 % measured by the currency basket. Non-CIS imports also increased about 25 % in dollars, but only one per cent in euros. The actual pace of Russia's import demand growth for non-CIS goods was probably around 10 %. Imports of machinery and equipment increased slower than total imports.

Imports to Russia, % change from four quarters previous



Source: CBR, Bofit

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3		
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.3	1-4/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	10.9	1-4/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.9	4/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	29.9	Q1/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	15.3	Q1/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	11.9	Q1/03

Source: Goskomstat, CBR.

Budget continues to show surplus

For the first quarter of 2003, Russia's federal budget showed revenues of RUB 581 billion (21 % of GDP) and expenditures of RUB 490 billion (17 % of GDP). Thus, the budget surplus was RUB 91 billion or 3.2 % of GDP, a decline from 4.6 % of GDP in the first quarter of 2002. Budget expenditures were pushed up from last year because of higher non-interest spending, mainly on defence and transfers to regions. This reflects the continued relaxation in fiscal policy that started in 2001. Budget revenue, for its part, exceeded the target set in the 2003 budget act. Revenue from oil exports surged as the first quarter average oil price per barrel exceeded by $8 the price assumed in the budget act.

Under the budget act, the federal budget surplus for the current year as a whole will be 0.6 % of GDP. However, due to the prospects of continued high world market oil prices and fast production growth in Russia, observers expect the surplus to be bigger. For instance, the IMF estimates that the surplus in 2003 will reach 1.5 % of GDP if oil averages $25 a barrel. The finance ministry increased its surplus forecast in late April to 1.4 % of GDP.

Several administrative reforms going on

The need for a reform in the state administrative structures is acute, but few concrete measures to remedy the situation have been taken so far. Some progress may be coming; in mid-May the government discussed a proposal of the economy ministry to reform all levels of administration. The reform aims at cutting bureaucracy and abolishing overlapping functions of authorities. The economy ministry's proposal lists more than 250 government functions that can be lifted. The government ordered the ministry to present by mid-June concrete recommendations on how to carry out the reform. According to the economy ministry, the reform could result in significant cuts in administrative staff.

Reforms targeted at improving Russia's business environment have been going on for a couple of years. Their results have been unimpressive due to poor implementation. In 2002 a package of three laws was adopted, aiming at limiting the state's role in corporate oversight, simplifying business registration and reducing the amount of economic activities requiring licensing. However, e.g. enterprise registration with the tax ministry has not occurred in the five-day time frame set by the law, nor is such registration possible under the "one stop" practice envisioned. Likewise, a 2001 law that limits the number of inspections that authorities are allowed to make in a company during a year has not yet been properly enforced. This is because some 20 related laws specifying the functions of various inspectors have not been amended accordingly. In late May, the government gave the economy ministry four months to finalise the necessary changes in the law.

Surveys conducted regularly by CEFIR (www.cefir.ru) among small enterprises in Russia show that certain improvements have taken place during the past two years. Polled companies report on easing of state controls and simplified procedures for licensing. Nevertheless, the barriers confronting enterprises in Russia are still huge compared with developed countries.

The reform in regional and local administration that passed its first Duma reading in February will probably get new boost soon. In mid-May, the finance ministry submitted to the government budget act amendments necessary for altering the budgetary allocations at federal, regional and local levels. Local and regional administrations currently have few possibilities to decide their own budgets and administrations lack equal footing in budget matters.

Russia's energy production to increase

The Russian government approved in May the energy ministry's proposal for a long-term energy strategy that extends to 2020. It replaces a 1999 program that failed to anticipate the sharp rise in world energy prices and rapid growth in Russian energy production. The main goals of the strategy are to increase energy production and promote efficient energy production and use in order to enhance GDP growth. These goals will be achieved through the formation of a functioning energy market in which the state plays a diminished role as market participant and an increased role as market regulator.

The energy strategy foresees steady growth in both energy production and energy exports in coming years. Growth is envisaged in production of all forms of energy. Annual crude oil output is expected to reach 450 – 520 million tonnes by 2020, up from about 380 million tonnes in 2002. Production increase would be attained partly by opening new oil fields in e.g. Eastern Siberia, Russia's Far East and the arctic continental shelf. The rate of growth in production will depend on the state of the global economy and development of the Russian economy. Energy exports are expected to increase 35 – 56 % by 2020, which will require construction of new transport capacity in the northern, eastern and southern parts of Russia. This obviously implies the implementation of all currently planned oil pipeline projects. Priority in construction will go to expansion of the Baltic Pipeline System, which leads to the Gulf of Finland. Its annual capacity will increase to 50 million tonnes from the current 12 million tonnes. Another prioritised project is the construction in Murmansk of a port for oil exports and an oil pipeline from Western Siberia serving it.

The energy strategy does not detail current reforms in the natural gas sector. The magnitude of hikes in natural gas prices also remains open. The government is expected to receive a finalised version of the energy strategy in June.

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

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2003 budget
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.6	Q1/03	18.5
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	17.4	Q1/03	18.0
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	3.2	Q1/03	0.6
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2			
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5			

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

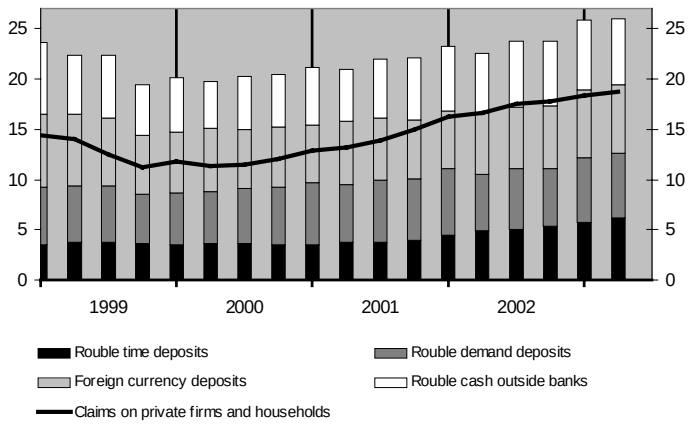
Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2003. Debt: IMF 1995-1999, Minfin 2000-2003.

Deposit growth gains speed, credit growth eases

Growth of household and corporate deposits at Russian banks was considerably higher in 1Q2003 (23 % y-o-y in real terms) than during any quarter since late 2000. Sberbank's share of household deposits slid to little over 66 % at the end of 1Q2003. Rouble time deposits continued to increase briskly (33 %) and rouble demand deposits turned to growth (up 20 %). One factor behind this may have been the rouble's strengthening in nominal terms against the dollar since the start of this year. Foreign currency deposits also grew rather rapidly, as did rouble cash in circulation (18 % each). Russia's overall money supply stayed at over 26 % of GDP (including foreign currency deposits, see chart).

Credit from banks in Russia to private companies and households continued to grow at the same pace as late last year, i.e. the stock was up 17 % y-o-y in real terms. Nevertheless, credit growth was slower than in any other period since late 1999. Credit from Sberbank increased 14 %. Growth in loans to state-owned enterprises accelerated considerably to 38 %, even if it is a relatively small item (6 – 7 % of the amount of bank credit to the private sector).

Stock of bank deposits, banks' claims on the private sector, and rouble cash in circulation, % of GDP



Source: CBR

IMF gives positive appraisal of Russia

In its Article IV consultation with Russia, the results of which were released in May, the IMF noted that the government's prudent economic policies and high world energy prices have contributed decisively to positive developments in the country's economy. Russia continues to display strong GDP growth, sizeable current account and budget surpluses, rising international reserves and a reduction of its public sector debt.

The Fund warned, however, that the Russian economy is susceptible to threats. Pursuit of the two goals of economic policy – low inflation and a stable exchange rate – is difficult and the results to date have been unimpressive. The inflation rate, in particular, has not fallen quickly enough. The IMF regards subduing inflation as the top priority of Russia's monetary policy. For this, the Central Bank of Russia will need to develop its range of monetary policy instruments. Given this policy emphasis, larger swings in the exchange rate will have to be tolerated in the future. As fiscal policy will be important in containing the strengthening of the rouble by sterilising foreign currency inflows, it needs to be tightened. The IMF warned that recently planned tax cuts would loosen the fiscal stance unduly unless they are offset by measures to broaden the tax base and reduce budget spending.

The IMF expressed disappointment with the recent slowdown in the pace of structural reforms, which are needed to secure sustainable long-term economic growth even in an environment with lower energy prices. The main goals of structural reform should be improving the investment climate, diversifying production, raising productivity and continuing growth of real wages.

Credit rating up

Positive developments in Russia's economy have also improved its international creditworthiness. On May 13, the international credit rating agency Fitch boosted Russia's long-term sovereign debt rating by two notches. Fitch justified the higher rating by noting Russia's strong economic growth and consistent economic policies that have led to growth in real incomes and reduced indebtedness to such an extent that current debt-servicing risks are small. Moreover, Fitch expects Russia's favourable economic situation and robust economic growth to continue for the rest of this year. Fitch remained cautious, however, over medium and long-term developments due to structural weaknesses in the economy. Fitch said structural reforms are unavoidable if Russia is to achieve sustainable economic growth.

Russia's new sovereign rating lifts it into the same class as Egypt, Kazakhstan and the Philippines. The Fitch classification is presently one notch higher than the sovereign ratings of Standard & Poor's and Moody's, which upgraded Russia's ratings in December. Fitch's rating is still one notch below investment grade. Large institutional investors such as pension funds are allowed to invest only in papers issued by entities with an investment-grade rating, which makes the attainment of such a rating important for a debtor. None of the three credit rating agencies are expected to increase their ratings on Russia to investment grade soon. Such a move requires further structural reforms in Russia.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	13.6	5/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	42.6	4/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	161	4/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.3	3/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	13.4	3/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	59.8	4/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	30.71	5/03

Source: Goskomstat, CBR.

Why favour incumbent firms?

by Laura Solanko*

Russia's present industrial landscape remains dominated by large, formerly state-owned enterprises. While small and medium-sized businesses (SMEs) tend to rate various government regulations and inspections as their major headaches, large firms often collude with politicians e.g. to avoid bankruptcy or optimise tax payments. Consequently, new domestic companies and foreign-owned firms are still rarities in Russia. SMEs employ only about 10 % of the workforce, compared to an average of 50–60 % in advanced industrial countries.

In contrast, small businesses today are the engines of growth in the successful transition economies in Central and Eastern Europe. International experience also shows medium-sized businesses often form the cornerstone for continued support of economic and political reforms. One may thus argue that until the SME sector starts to grow, achieving stable long-term economic growth in Russia will be extremely difficult. Why do new SMEs still face such great difficulties in Russia?

A recent line of research has focused on the consequences of state capture, i.e. the situation where a society or some of its sectors are subject to powerful oligarchs that influence government decisions. Survey evidence suggests capture economies have emerged in many transition countries, which are characterised by insecure property rights and weak firm performance. Others argue that this business-government relationship, especially in Russia, is a form of elite exchange, whereby both parties benefit at the expense of the rest of the economy. This view of the interaction between politicians and firms coincides with much of the literature on lobbying.

When politicians deciding on taxes, subsidies and regulations value their private benefit as well as social welfare, firms in the economy have an immediate interest in lobbying. Any profit-maximising firm will find it profitable to lobby for preferential treatment in exchange for payments (formal or informal) to politicians. Large incumbent firms typically have the connections and resources necessary for lobbying that SMEs lack. Further, as SMEs come in many varieties, lobbying action is difficult to coordinate. The typical outcome of a lobbying game in such a framework is one characterised by excessive subsidies for the lobbying industries that makes life in non-lobbying sectors extremely difficult.

In Russia, what prevails, especially at the regional level, are close connections between incumbent firms and politicians and an uneven economic playing field tilted in favour of large formerly state-owned enterprises. In recent years, the influence of big business in regional politics has grown. One reason for this may be that it is easier to organize industry-wide lobby groups at regional or local levels than at the federal level. Only a few sectors (e.g. car manufacture, oil and gas) are sufficiently concentrated and financially endowed to lobby at the federal level. Lobbying at the local level is likely to bring only limited benefits for any industry. Conversely, local governments are highly dependent on regional governments for their financing; they have virtually no economic policy tools at their disposal.

Regional governments have substantial de facto autonomy in their economic policies. During the 1990s, they decided on regional trade barriers and tax practices to such an extent that it provoked a discussion on emerging industrial feudalism in Russia. The typical regional economy in Russia is characterised by a limited number of large enterprises, representing a handful of industrial sectors. These incumbents have inherited the connections and social capital needed for lobbying the regional government.

It is in the interest of incumbent firms to continue lobbying for special benefits as long as they face no credible threats from new entrants. From a policy perspective, if the federal government wants to promote SMEs and decrease subsidies to incumbent firms, it must change either the incentive structure of regional decision-makers or the incentive structure of lobbying firms. The lobbying model predicts that demolishing regional barriers to trade and entry may be a way to influence the lobbying decisions of incumbent firms. Such policies could also bring other benefits. Empirical results from transition economies suggest that high barriers to new business entry and soft budget constraints on incumbent firms are significant institutional factors engendering corruption.

Influencing the incentives of politicians is an enormous task anywhere. Experience globally suggests that the strong rule of law, democracy and civil society are efficient factors limiting politicians from pursuing their private benefit. Further, as seen in China, linking regional tax revenues to the success of new firms can create powerful incentives for favouring such firms. Even if the incumbents continue to lobby, the emergence of a new SME sector as an important regional revenue source could greatly level the economic playing field.

** The author is economist at BOFIT.*

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

Editor-in-Chief Seija Lainela

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RUSSIAN ECONOMY
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Economic Developments

Russian economy grows fast

Unlike most countries, Russia is enjoying a period of robust economic growth – growth that actually accelerated during the spring. Recently published official Goskomstat figures show Russian GDP rose 6.8 % y-o-y in the first quarter. The combined production index of five base sectors of the economy was up 7.2 % y-o-y for the first five months of the year. For May, the index of five base sectors rose 8.5 % y-o-y. Business surveys show that the growth of the economy continued apace in June.

Due to the Russian economy's good showing, the majority of observers anticipate growth of around 6 % this year. The most optimistic forecasts go as high as 7–7.5 %.

Exports and investment thrive

The basic reason behind Russia's economic growth is the high world market oil price, which, in turn, has pushed Russian oil companies to boost their export volumes. In volume terms, Russia exported in the first quarter 8 % more crude oil than a year earlier; in value terms, crude exports were up 61 %. Export volumes of certain other raw materials have increased, too. For instance, coal export volume was up by 45 % and iron ore by 35 %. On the other hand, the global economic downturn has hit other traditional Russian export goods such as aluminium, nickel and copper, which all saw their export volumes diminish. The share of energy in Russia's total exports thus climbed to 61 % in January-March, from 56 % a year earlier.

The oil income effect is visible in the growth of investment. Total fixed investment rose 11 % y-o-y in January-April, a significant acceleration from the 2 % growth recorded a year earlier (although due in part to the low comparison basis of early 2002). The structure of fixed investment shifted in favour of industry, which in the first quarter accounted for slightly more than a half of the total. Sectors that increased their share in fixed investment during the year include natural gas production (a share increase of 2.4 percentage points), foodstuffs (up 1.4 p.p.), construction, and wood processing. The sectors losing their position included the oil industry (down 1 p.p.), ferrous metallurgy, machinery, agriculture and transport. The continued growth in investment shares of food production and wood processing serves as a sign of certain investment diversification to sectors outside traditional energy production. Investment in energy sectors accounted for 31 % of total fixed investment in the first quarter.

High export earnings also boosted household incomes and private consumption. The average wage in real terms in January-May 2003 was over 9 % higher than in January-May 2002.

Balance of payments strengthens further

According to fresh information from the Central Bank of Russia, the surplus on the goods trade account totalled $15.3 billion in the first quarter of 2003. This exceeds the surplus in the same period last year by as much as 66 %. The current account surplus reached $11.5 billion, an increase of 74 % from a year earlier.

In addition to the current account surplus, Russia received $1 billion in net foreign currency inflows from foreign direct investments and a net $0.9 billion in other investment forms (mainly private credits taken from abroad). Portfolio investments caused a net outflow from Russia of $2.6 billion as a result of both repatriation of investment from Russia by non-resident investors and new Russian portfolio investments abroad. The 'errors and omissions' item, which consists of unregistered currency outflows and partly reflects illegal capital exports showed –$3.2 billion. Traditionally, this figure decreases later as more exact information on other items on the balance of payments gradually becomes available. A total of $7.6 billion of the currency inflow was transferred to the CBR's foreign currency reserves. On June 20, the reserves amounted to a record sum of $64.9 billion.

Balance of payments, $ billion

	2002	2002 Q1	2003 Q1
Current account	**31.1**	**6.6**	**11.5**
Trade balance, goods	46.3	9.2	15.3
Exports, f.o.b.	*107.2*	*21.6*	*30.6*
Imports, f.o.b.	*-61.0*	*-12.3*	*-15.3*
Services balance	-9.1	-1.8	-1.9
Investment income, net	-6.1	-0.7	-2.1
Other items, net	0.0	-0.2	0.1
Capital and financial account	**-11.2**	**-4.9**	**-0.6**
Capital Account	12.4	-0.1	0.0
Financial account	1.2	-4.8	-0.7
Direct investment to Russia	*3.0*	*0.6*	*1.6*
Portfolio investment to Russia	*3.3*	*0.4*	*-1.2*
Other items, net	*-5.1*	*-5.8*	*-1.0*
Net errors and omissions	**-8.5**	**-1.2**	**-3.2**
Change in reserves [1]	**-11.4**	**-0.5**	**-7.6**

[1] *A negative figure represents increase in reserves.*

Source: CBR

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	6.8	Q1/03
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.7	1-5/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	11.8	1-5/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.6	5/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	40.5	1-4/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	21.0	1-4/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	11.5	Q1/03

Source: Goskomstat, CBR.

Duma's spring session ends

As usual, the Duma's spring session got increasingly hectic before adjourning for the summer. This year, however, the session was prolonged by only one day to allow the deputies to finalise several important pieces of legislation.

The spring session produced somewhat mixed results. Certain essential laws were approved. Nevertheless, as the spring proceeded, it became clear that several long-overdue initiatives were left untouched (in part because of the upcoming parliamentary elections in December 2003 and presidential elections in March 2004). The failures include postponements of discussion on bills concerning deposit insurance and bankruptcy of credit institutions – both of which are crucial for the development of Russia's banking industry.

Disappointments also include a stalemate on reform of Gazprom. Despite observers' high expectations linked to the new management of the monopoly, the government was unable to launch any changes. Also, the long-awaited reform of government structures, which includes abolition of several ministries, will start only after the elections.

Several taxes amended

The most important decisions that the Duma made before its summer recess concerned a number of tax code changes, which were crucial for the preparation of next year's budget. Now that the amendments are in place, the government can start drafting the 2004 budget. The aim of the amendments was to decrease the tax burden and move it from taxing manufacturing in the direction of taxing extraction of natural resources. This would encourage investment and create conditions for sustained economic growth.

The major change was a controversial reduction of value-added tax from 20 % to 18 %, effective from the start of 2004. Several observers, including the IMF, have expressed fear that fiscal policy may be relaxed too much by this measure. The losses from the tax cut will be partly compensated for with an increase in the oil extraction tax and the introduction of a natural gas extraction tax. Other taxes on the gas industry were amended. The excise tax on natural gas will be eliminated, while the export tax on natural gas will be raised to 20 %.

Another controversial change concerned the 5 % sales tax that has produced a significant revenue stream for regional budgets. The Duma decided to eliminate the tax as proposed by the government in the face of strong resistance from regions. Lost revenues will be made up e.g. by shifting a larger share of the company profit tax to regional budgets.

The Duma also agreed to raise the maximum company property tax to 2.2 %. Regional authorities, however, will retain the discretion to set a tax rate lower if they choose.

2004 budget policy outlined

In late May, president Putin gave his annual budget speech outlining the basic features of next year's federal budget.

The president stressed the continuation of the reforms of the tax system and relations between the centre and the regions, which will be reflected in the federal budget. An important aim is to decrease tax burden further. A related goal is the cutting of budgetary expenses, which should take place in conjunction with the reappraisal of federal sector responsibilities. Certain efforts have been made in this direction during the current year, although so far with little success.

A week after the president's 2004 budget address, the government approved the basic parameters of the budget, whereby economic growth next year will be 5 % and inflation 10 %. The average exchange rate of the rouble against the dollar will be 31.9 and the oil price will be 22 dollars per barrel. Using these assumptions, the budget yields a surplus of 0.6 % of GDP. It has to be noted that the budget is extremely sensitive to oil prices and hence to developments beyond Russia's control on international commodity markets.

The estimated budget surplus would be transferred to a stabilisation fund created to replace the current informal financial reserve. The government's plan foresees the finance ministry overseeing the stabilisation fund. Special rules would be established to govern the accrual and use of the fund's assets. The financial reserve was about RUB 230 billion (€6.4 billion) in April 2003.

Tariff hikes ahead

The government also decided last month on next year's tariff increases for the production of natural monopolies – gas, electricity and railway transport – the prices for which are set administratively. The price of natural gas will go up 20 %, electricity 16 % and rail transport 12 %. The hikes broadly match this year's increases.

Although the negotiation process went rather smoothly this year, tariff increases are always a compromise between a government that wants to limit inflation and natural monopolies that lobby for large increases to cover e.g. their huge investment needs. However, other factors are also in play. The EU, for instance, demands that Russia substantially increase its allegedly artificially low natural gas prices that give an unfair competitive edge to Russian industry. On the other hand, some observers opposing large increases claim that as long as the monopolies remain unreformed, their tariffs should not be significantly increased as there is no way to control how the additional money will be spent.

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

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2003 budget
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.9	1-4/03	18.5
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	17.6	1-4/03	18.0
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	3.3	1-4/03	0.6
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	34.1	3/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	124.8	3/03	

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

Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2003. Debt: IMF 1995-1999, Minfin 2000-2003.

New customs code adopted

The new customs code represents key legislation passed by the Duma this spring. The long overdue law was under preparation for several years; its first reading in the Duma occurred in 1999.

The code the president signed in late May comes into force at the start of 2004. It is hoped to bring Russia's customs practices closer in line with those of western countries. Opaque and arbitrarily applied regulations have caused great difficulties to enterprises engaged in foreign trade in Russia and abroad. The code addresses these problems by limiting the authority of the Customs Committee to issue special rules, shortening the maximum time for customs clearance and defining more clearly documentation required by the customs authorities. Business organisations, however, criticise the new law for being overly vague and hence doing less than it might to improve the position of companies engaged in foreign trade.

The approval of the code was also important from the point of view of Russia's planned entrance into the WTO as it brings Russia's customs procedures closer to WTO standards.

Currency liberalisation on the horizon

In June, the Duma decided to postpone until autumn further discussion on the act on foreign currency regulation, which passed its first reading in March. The law, which has been under preparation for a long time, would replace the current currency control act, which sets out a restrictive regime that in today's global financial conditions has proven impossible to enforce. The new law implies a major liberalisation of Russia's currency controls. Capital movements would be unrestricted from the start of 2007. Although consensus has been reached on the principle of liberalisation of currency movements, differing views exist on the details of how the law should spell out restrictions that the authorities may introduce in special circumstances.

When it became clear that the currency control law would not be adopted in the spring, a section of the law on reducing the amount of compulsory currency sales was adopted separately in a fast-track procedure on June 21. The sales requirement for export earnings was lowered from 50 % to 30 %. Under the bill, the central bank may cut the requirement further. The aim of the amendment is to ease pressure on the strengthening of the rouble against the US dollar, which has been caused by large inflows of export earnings to Russian financial markets.

It is worth noting that the repatriation requirement of export earnings remains at 100 %, i.e. exporters are still required to transfer to Russia all export proceeds, but they now only have to change 30 % of those earnings into roubles.

Changes in sovereign debt structure foreseen

Last month, the Russian government adopted a federal borrowing plan for 2004, which is one of the basic documents related to the preparation of next year's budget. To limit exchange rate risks in connection with foreign borrowing, next year's debt policy aims at increasingly replacing foreign debt with domestic debt. Furthermore, the average maturity of loans is to be lengthened. The third goal is to provide domestic financial markets with a greater volume of government debt instruments with a view to assisting the ongoing pension system reform. Pension funds are expected to invest pension savings in first-rate domestic securities, including government papers. Concern has been expressed in some quarters over a possible lack of suitable debt instruments on domestic markets when the investment funds launch their operations next year.

The government's borrowing plan envisages gross domestic borrowing by the federal government in 2004 in the amount of RUB 263 billion ($8.7 billion). Of this, RUB 118 billion ($3.9 billion) is to be used for repayments, while RUB 145 billion ($4.8 billion) represents new borrowing. The volume of new borrowing exceeds the volume foreseen for the current year by almost three times. The plan features first issues of rouble-denominated bonds with a 20-year maturity. The longest maturity currently available is 15 years. More than 80 % of borrowing will be medium and long-term.

According to finance ministry figures, Russia's rouble-denominated government debt totalled RUB 674 billion ($22.3 billion) at the end of March 2003, while foreign-currency-denominated government debt totalled $124.8 billion. Although the Russian government has not resorted to new foreign borrowing this year, the weakening of the US dollar has raised the valuation of public foreign debt from $123.5 billion at the start of this year. The government has no plans to take new loans from abroad during the current year.

Russia's foreign public-debt-servicing costs this year will reach slightly more than $17 billion, of which $9.5 billion has already been paid. Initially, Russia's planned debt-servicing costs for 2003 well exceeded $20 billion, which led to doubts as to whether the country could meet its repayment obligations. In anticipation of this upcoming peak in debt payments, Russia began to pay down debt ahead of schedule a couple of years ago. This policy was possible thanks to higher-than-expected revenues from oil exports due to high world oil prices. Russia continued such buy-backs this year.

In contrast to the government's external borrowing policy, Russia's big corporations and banks are boosting their external borrowing, encouraged by low interest rates on international markets and squeezed margins for Russian borrowers.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	13.6	5/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	44.3	5/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	168	5/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.6	4/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	15.7	4/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	64.9	5/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	30.35	6/03

Source: Goskomstat, CBR.

Russia – a grain exporter?

by Merja Tekoniemi*

Russian agriculture could, with good reason, be named one of the slowest reforming sectors of the Russian economy. During the 1990s, agricultural production halved due to such reasons as a fall in the area of land under cultivation, as well as declining productivity and investments caused by greatly diminished agricultural subsidies and a drop in demand for certain agricultural products. Agriculture began to revive only after the 1998 financial crisis. The large devaluation of the rouble increased the competitiveness of domestic products against imported ones. Favourable weather conditions in the past three years also helped foster the upturn.

Agriculture has not been an important source of foreign currency earnings for Russia. In 2001, the share of foodstuffs and agricultural raw materials in Russian exports was less than 2 %, whereas imports in the same category (led by meat and sugar) accounted for about a fifth of all imports. Moreover, in the last ten years, Russia has been a negligible player in world agricultural export markets. However, a bumper 2001/2002 crop allowed Russia to increase its grain export volume six times, which in volume terms amounted to over 10 % of world's grain exports (wheat and coarse grains, excluding rice). Has Russia suddenly become a major player in this field? What are Russia's strengths, weaknesses, opportunities and threats in agriculture?

Strengths and weaknesses

The key strengths of Russian agriculture relate to geography. Russia has vast potentially arable lands, including its especially productive black soil region. Production costs are low thanks to cheap labour and energy (although energy prices continue to increase).

The weaknesses derive mostly from Soviet-era legacies. Most farms operate ineffectively and unprofitably. They survive only because of the Russian state's distaste for large-scale bankruptcies in agriculture. In 2000, Russia had almost three times more agricultural workers than the US, while the cultivated land area per worker was about a quarter of the American equivalent. The approximately 13 % of Russia's labour force employed in agriculture generates only about 7 % of GDP. The need for investment in machinery and equipment is vast.

Other weaknesses relate to agricultural markets. The ideal of economic self-sufficiency has in many regions created a situation where a reasonable division of labour and specialisation is impossible. Specialisation is further hindered by deficiencies in market distribution and information systems, which makes it hard to match buyers and sellers of agricultural raw materials and products. The 2002 act governing the sale of agricultural land allows regions to supply some of the details of such sales and gives them the pre-emptive right to buy agricultural land. In practice, this means that the markets for agricultural land may end up functioning quite differently from region to region

Opportunities and threats

The basis for Russia's bright future in agriculture lies in the implementation of right-minded reforms with clearly stated goals. Although some state support may be a precondition for a basic level of self-sufficiency in certain agricultural products, state intervention needs to be diminished and unprofitable farms need to be reorganised through bankruptcy. The market should, to a greater extent, determine what gets produced and where it is sold. In this light, Russia's current quest for WTO membership serves as a challenge and opportunity to integrate with world markets. Until now, the state has discouraged the creation of new private family farms, e.g. by burdening such farms with stricter tax rules than those applied to other farms. The increase of investments in agriculture in recent years appears to come mainly from huge firms. Their main activities may have little to do with agribusiness; rather they are pursuing a strategy of investing in a vertical production chain that runs from the field to the supermarket – an approach that allows them to circumvent the deficiencies of infrastructure and lack of market information.

If Russia wishes to establish itself firmly as a net exporter of agricultural raw materials or products, its slowly advancing reforms need to be accelerated with a view to increasing productivity and efficiency. Officials should also remember that agriculture is a particularly onerous export business. It can be readily torpedoed by protective measures. Indeed, we have already seen an example this year when the EU imposed grain import quotas.

The sudden appearance of Russia as a major exporter of grain is essentially the result of fortuitous weather, not successful reforms. Russia's strong showing in world's grain markets was further made possible by the difficulties of other major grain exporters. When the situation normalises (which according to estimates will happen already in the 2003/2004 crop year), Russia will face much tougher competition. As Russian wheat is of lower quality than its American equivalent, Russia will also be unable to compete in high-end markets. Lower quality also means lower prices. Finally, even if markets were open to Russian grain, there is always at least one uncontrolled factor affecting exports – the weather. In this respect, Russia is in the same position as any country.

** The author is an economist at BOFIT.*

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

Editor-in-Chief Seija Lainela

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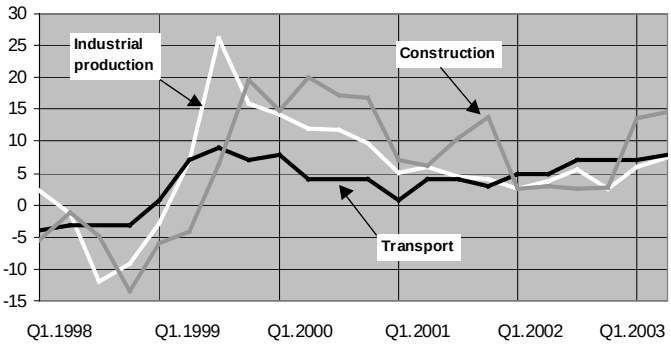
Economic Developments

Fast growth continues into second half of 2003

On-year growth of combined production in the five main sectors of the Russian economy was 7.1 % in January-July 2003. The robust growth has remained steady for three consecutive months. Construction, in particular, grew rapidly – over 14 % y-o-y for the first seven months of the year. Retail trade increased almost 9 %, while both industry and freight transport were up about 7 % y-o-y. Agricultural production declined somewhat.

The government forecasts GDP will increase 6 % over the current year.

12-month change in output volume (industrial, construction and transport), %



Source: Goskomstat

Outlook for medium-term growth also strong

The Russian government adopted in August several key documents defining economic policies for next year and the medium term. The documents included the 2004 budget draft, the economic program for 2003–2005, economic forecast for 2004–2006 and the 2004 monetary policy guidelines.

The medium-term economic program concedes that much of the rapid growth of the Russian economy after the 1998 crisis was due to a deep devaluation of the rouble and the possibility of fast mobilisation of idle domestic production capacities without new investment. It further notes the impact of historically high international energy prices. As the first two of these factors have now lost much of their significance and the third is highly volatile, none of these factors can be relied on to secure sustainable economic growth. Thus, the program stresses the need to diversify the Russian economy towards manufacturing at the expense of extractive industries. For that the program envisions improvements in the operating environment of businesses. Several concrete tasks are listed, including the simplification of enterprise registration and protection of enterprises' legal rights. However, the program remains vague on the methods to achieve these tasks.

The economy ministry's forecast for the Russian economy, which is based on the assumption that the price of Urals-grade crude remains in the range of $22–23 a barrel, anticipates GDP growth will slow next year to around 5 % and recover to 6 % in 2005. If the price during the next two years averages $18.50 a barrel, GDP growth would fall below 4 % in 2004 and below 5 % in 2005. Investment growth is forecast to slow from an expected 9 % this year to 7–8 % in 2004. Despite robust economic growth, unemployment would persist at around 8 % in the coming years.

Export growth slows, import growth unchanged

Russian customs figures show growth in Russia's export earnings in dollar terms slowed in the second quarter of 2003 to 20 % y-o-y from 40 % in the first quarter. Growth was only about 10 % when measured in terms of a basket of currencies of Russia's main trading partners (down from nearly 30 % in 1Q03). The slowdown was due primarily to the crude oil export price, which was essentially the same as a year earlier. Export earnings growth was mainly supported by two factors. First, volume growth of crude oil exports accelerated in the second quarter and was over 10 % for the first half of the year. Second, the lag in gas export price changes meant that the price was still a third higher in the second quarter than a year earlier. The volume of gas exports rose 2–3 % y-o-y in the first half. The share of fuels in exports was over 55 %, i.e. higher than a year earlier.

Growth in goods imports in the second quarter continued at the same pace as in the first quarter, i.e. over 20 % y-o-y in dollar terms and over 10 % as measured by the currency basket. Imports from non-CIS countries rose at the same pace, implying that in euro terms the on-year growth of non-CIS imports was stagnant both in the first and the second quarter. Total imports of machinery and equipment were up well over 20 % y-o-y in dollar terms in the first half. Comparison with CBR foreign trade figures for the first half shows that, as usual, around a quarter of all imports went unrecorded by the customs.

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	6.8	Q1/03
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.8	1-7/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	11.9	1-7/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	7.8	7/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	62.0	H1/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	33.3	H1/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	21.3	H1/03

Source: Goskomstat, CBR.

2003 federal budget well in surplus at mid-year

Thanks largely to rapid growth of the economy and high international energy prices, the federal budget surplus was 3 % of GDP in the first half of 2003, compared to 2.6 % a year earlier. For the whole of 2003, the surplus is expected to reach 1.2 % of GDP, while the initial target in the 2003 budget act was 0.6 % of GDP.

Budget revenues were equivalent to 20.6 % of estimated GDP in the first half of 2003. Excluding social tax contributions transferred via the federal budget to the state pension fund, revenues were up nearly one percentage point of GDP from a year earlier.

The value-added tax continued to generate the largest revenue stream to the federal budget (nearly 7 % of GDP). Export duties were the fastest growing category, with revenues from export and import duties reaching 3.4 % of GDP.

Budget expenditures also rose slightly from the previous year, equalling 17.5 % of estimated GDP in the first half of the current year. Non-interest expenditure, which does not include interest on debt and social tax transfers to the state pension fund, increased its share 0.7 percentage points of GDP from 1H02, reflecting the government's looser fiscal stance.

Draft federal budget for 2004 sent to Duma

The Russian 2004 budget process is well on track. The government finalised its federal budget proposal in mid-August, and the first of four necessary Duma readings takes place on September 19. The Duma is expected to pass the budget by the end of November, i.e. before finishing its session ahead of December's parliamentary elections. While the draft budget will likely provoke high-profile disputes as Duma deputies and factions appeal to voter sentiments, the budget's passage has actually been smoothed already through a series of preliminary readings that gave the government a chance to iron out some of the biggest conflicts with various Duma factions.

The draft budget aims at a surplus for the fifth year in a row. The surplus equals 0.5 % of GDP. The surplus target is smaller than in the past few years, and several observers, including the IMF, have stressed the need for a tighter fiscal policy in the current favourable economic situation.

Although annual budget acts for the last couple of years have purported to reduce non-interest expenditure of the federal budget as a share of GDP, its share has actually been growing. For the current year the government estimates non-interest expenditure at 13.3 % of GDP, which would be the same as last year. The draft 2004 budget sets non-interest expenditure at 12.6 % of GDP. Security, defence, health care, culture and the justice system are the key sectors receiving additional financing. Overall expenditures of the federal budget (including interest payments and social fund expenditure) are to equal 17.4 % of GDP.

Federal budget initial parameters, % of GDP unless otherwise noted

	2004 draft	2003	2002
Revenues	17.9	18.5	19.4
Expenditures	17.4	18.0	17.8
Interest payments	*1.9*	*2.1*	*2.6*
Surplus	0.5	0.6	1.6
Average exchange rate (roubles per dollar)	31.3	33.7	31.5
Inflation (year-end, %)	8 – 10	10 – 12	12 – 14
Average oil price, Urals (dollars per barrel)	22.0	21.5	23.5
GDP (RUB billion)	15,300	13,100	11,000

Source: Russian government

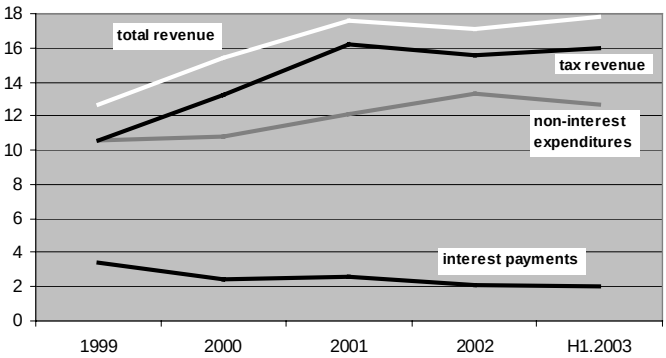
Federal budget revenues in relation to GDP are also set to decline next year from the current year, reflecting the government's policy of decreasing the tax burden on the economy. The sweeping tax reform, which was largely finalised this spring, features e.g. a reduction of VAT rate from 20 to 18 % from the start of 2004. While the reform aims at increasing tax income over the long run, it anticipates the tax take next year will suffer. Tax income of the federal budget under the proposal will total 13.5 % of GDP next year, while overall federal budget income will amount to 17.9 % of GDP. Total income of the consolidated budget (the combined federal budget and regional and local budgets) will amount to 29.7 % of GDP.

Tariffs on the production and export of oil and natural gas presently constitute about 35 % of total federal budget revenues, which means that the budget is very sensitive to fluctuations in world market prices for energy. According to government calculations, a one-dollar decline in the world market price of Urals-grade crude leads to a cut in federal budget revenue equal to 0.35 percentage points of GDP.

The budget will be balanced at a world market price for Urals crude of 20 dollars a barrel. Any additional oil revenue will be transferred to an off-budget stabilisation fund, which acts as a buffer against swings in global energy prices.

The draft budget is based on estimated GDP growth of 5.2 % over 2004.

Federal budget revenues and expenditures (% of GDP)



Source: Economic Expert Group

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

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2003 budget
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.6	H1/03	18.5
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	17.5	H1/03	18.0
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	3.0	H1/03	0.6
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	34.1	3/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	124.8	3/03	

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

Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2003. Debt: IMF 1995-1999, Minfin 2000-2003.

2004 monetary policy outlined

In late August, the government adopted guidelines, prepared by the Central Bank, for next year's monetary policy. The document singles out combating inflation as the main objective of the CBR, confirming the government-set target for 12-month consumer price inflation of 8–10 % for year-end 2004. The other main objective for the CBR is to limit appreciation of the real effective exchange rate of the rouble to a maximum of 7 % over the year.

The CBR will continue the managed float of the rouble in order to dampen its real appreciation. The Bank has repeatedly stressed that in the current situation the government is primarily responsible for fighting inflation through more stringent fiscal policies.

The CBR has been less active in its interventions on currency markets this year. It has allowed the rouble to gain strength under the pressure of currency inflows from energy exports and corporate borrowing from abroad. Over the first seven months of the year, the rouble appreciated 5 % against the dollar in nominal terms and 12 % in real terms. Over the same period, the rouble has depreciated 1 % in nominal terms and appreciated 4 % in real terms against a basket of currencies of Russia's main trading partners. This was essentially due to the appreciation of the euro against the dollar on international currency markets.

Over the first half of 2003, broad money (rouble cash and bank deposits) was up 23 %, i.e. much more than planned in the 2003 monetary policy guidelines (20–26 % for the year as a whole). The monetary policy tools currently at the disposal of the CBR are relatively ineffective at sterilising currency inflows. On the other hand, some of the growth in broad money indicates an increased preference by Russian households to hold roubles rather than weakened dollars. Hence, not all of the increase in broad money will necessarily feed inflation.

The 2004 monetary policy guidelines provide for a growth of 18–25 % for broad money over the year.

Double-digit inflation continues

Consumer price inflation slowed somewhat in August, recording an on-year increase of 13.3 % as against 13.9 % in July. Compared with July, however, prices declined 0.4 %. While this was largely due to seasonal price reductions on foodstuffs, it also reflected a slowing in the rise of prices for utilities and other services. Consumer prices rose 8.3 % between the start of the year and end-August. The government's inflation target for all of 2003 is 10–12 %.

Producer prices were 14 % higher in June 2003 than a year earlier. Growth was brisk in ferrous metallurgy, which saw June producer prices increase 47 % y-o-y. One of the largest price jumps was in industrial pipe, reflecting a boom in crude oil pipeline construction. Producer prices for electricity rose 23 % y-o-y in June. A building boom drove up prices of construction materials 20 %.

The rise in producer prices slowed in the fuel industry (with natural gas price actually falling 6 % y-o-y). Producer prices for crude oil were up 4 % and coal 9 %. This moderate growth in crude oil prices reflects the fact that production has increased faster than domestic demand. Constraints in pipeline and port capacity make it impossible for Russia to export all its additional production.

Freight shipments were 16 % more expensive than a year earlier. The cost of rail freight drove the increase (18 %), followed by pipeline transport (15 %). Much of these increases was related to crude oil deliveries.

Yukos case rocks the markets

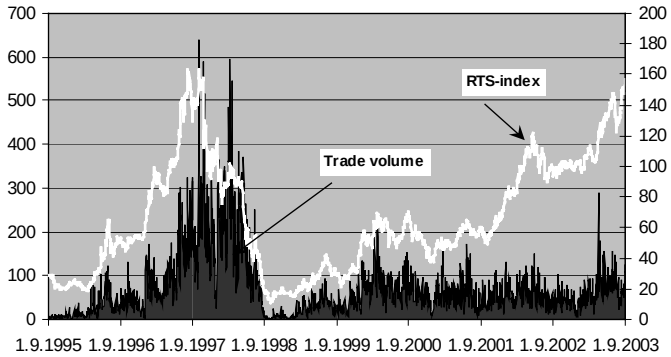
The biggest piece of negative news this summer broke in early July when the General Prosecutor's Office announced it was looking into possible criminal acts involving oil major Yukos and its owners. The suspicions of malfeasance arise from the 1994 privatisation of the Apatit mining company. Several Yukos subsidiaries have also been accused with tax evasion.

There were fears at the time the process was launched that these investigations would adversely affect foreign investor interest in Russia. The immediate repercussions were short lived, however. What happens in the longer term will depend on how the case develops. Investor fears could also be heightened if investigations against other companies are launched.

By mid-August the Russian stock market had recovered from its July drop from the Yukos announcement. On September 1, the RTS index surpassed 540 points for the first time since 1997. The index has risen more than 50 % since the start of the year. Stock markets were boosted by two important oil sector arrangements. The mergers of Russian oil majors Yukos and Sibneft and Russian TNK and British Petroleum were approved by Russian competition authorities in late summer.

Although the RTS index is now close to its 1997 all-time high, trading volumes are far below peak levels.

RTS index (left scale) and trade volume ($ million, right scale)



Source: RTS

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	13.3	8/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	47.8	7/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	186	7/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.6	6/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	11.8	6/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	62.8	8/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	30.50	8/03

Source: Goskomstat, CBR.

Labour market adjustment in Russia

by Natalia V. Smirnova*

Labour market adjustment is a major driver of economic transformation. Some common features of such adjustment for all transition countries can be identified. For instance, during transition, lower-educated single individuals, women and young people are more likely to be unemployed than others. Furthermore, these groups – except young people – tend to stay unemployed longer than others.

As to women, married women are worse off in terms of job loss and length of unemployment than single women. A positive feature is that returns to education have increased while the gender gap in education premia has narrowed. On the other hand, returns to experience have declined.

Finally, transition apparently does not decrease regional asymmetries in employment.

Aside from these common features, the labour market adjustment paths in the transitional arena are quite different. A peculiarity of the Russian labour market has been the accumulation of wage arrears, which allow wages rather than employment to adjust downwards. In contrast, it was employment that adjusted in CEE countries, which in turn contributed to faster structural change.

To put Russian labour market development in a global perspective, the table below compares indicators among European Union countries (EU), countries acceding to the EU in 2004 (ACC), the United States and the Russian Federation.

Labour market indicators for selected countries and regions

Indicator	EU 2002	ACC 2002	US 2002	Russia 2001
Population, million	374.8	66.7	281.4	144.2
Employment rate, %	64.2	56.1	62.4	58.6
Unemployment rate, %	7.6	14.8	6.0	8.9
Unemployment duration				
less than 6 months, %	42	25	82	45
6 to 11 months, %	18	21	10	18
12 months or longer, %	40	54	8	37

Source: Eurostat, US Census Bureau and Bureau of Labour Statistics, Goskomstat.

The expectation is that a decade after the end of the Soviet era, during which full employment was the norm, employment in Russia should be higher than in industrialised countries. However, as seen from the table, employment in Russia is actually lower than in either the EU or the US.

Russia's unemployment rate is higher than in the EU or US, but lower than in ACC. The duration of unemployment in Russia is similar to EU countries, where approximately 40 % of people are unemployed for less than 6 months and 40 % are unemployed for longer than a year. This pattern is quite different from the US, where 80 % of unemployed persons find jobs within first six months of unemployment, and from ACC where 50 % of people are unemployed for over twelve months.

Job search strategies

The job search process, i.e. the speed and methods by which workers are matched with jobs, is a key factor influencing the level and duration of unemployment. Job search strategies differ across socio-economic groups. According to the initial results of our ongoing study, the most efficient way of finding a job in Russia is through personal contacts (relatives, friends and acquaintances), while the use of public and private employment agencies is just gaining momentum. In the metropolitan areas of Moscow and St. Petersburg, in particular, people generally are likely to use their personal contacts and direct applications to firms rather than employment agencies. However, people with professional experience are more likely to use direct applications to enterprise and advertisements rather than personal contacts for their job leads. Women are more likely to look for jobs through employment agencies rather than use other search strategies.

More than half of successful job searchers in Russia use more than one job search method. Approximately 17 % of searchers exclusively use personal contacts as their job leads, 13 % use state and private employment agencies, and 12 % apply to firms on the basis of advertisements or directly.

Overall, sex differences and residence in Moscow and St. Petersburg metropolitan areas are consistently important for job search behaviour. Women are significantly less active than men in all stages of job search. Part of this may be explained by the traditional family arrangement still cultivated in Russia, whereby women are expected to perform most household duties in addition to being employed full-time. However, the movement of Russia into a market-oriented society might have allowed women to choose not to gain employment or to be employed part-time. When women are less likely to engage in job search, they pursue their job search less intensely than men and tend to rely on different search strategies.

Job search behaviour of workers living in metropolitan areas of Moscow and St. Petersburg differs significantly from the behaviour of workers living in other regions. The concentration of employers, information infrastructure, density of personal contacts and other specifics of the labour market in Moscow and St. Petersburg encourage the activity of market participants.

** Department of Economics, University of Connecticut, USA.*

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

Editor-in-Chief Seija Lainela

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Economic Developments

Economic growth accelerated in second quarter, slowed slightly in July and August

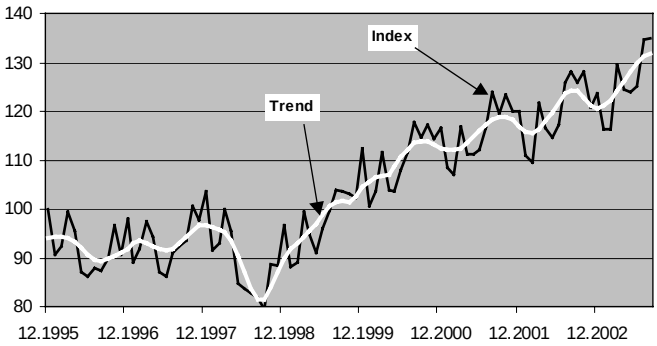
Goskomstat reports Russian GDP grew 7.2 % y-o-y in the second quarter of 2003, outpacing first quarter growth of 6.8 %.

The combined production index of five base sectors of the economy rose 6.2 % y-o-y in July. Growth slowed somewhat in August to 4.2 %. For the first eight months of this year, on-year production was up 6.6 %. The slowing growth partly reflects the fact that economic growth was faster in the second half of 2002 than in the first half, which makes the basis for comparison higher for the second half of the current year than for the first half.

The government presently forecasts GDP will rise about 6 % this year, up from 4.3 % last year.

Workday-adjusted industrial output climbed nearly 7 % y-o-y in January-August. Growth in energy production remained particularly strong. Crude oil production increased 11 %, coal 10 % and natural gas 4 %. Among industries focused on the domestic market, the food industry in particular improved its position. Foodstuff production rose nearly 5 % in January-August.

Industrial output, December 1995 (100) – August 2003



Source: Goskomstat

Investment continues strong growth

According to Goskomstat, fixed investment rose 12 % y-o-y in the first eight months of the current year. The rapid growth has continued since the start of the year, in part compensating for the extremely slow growth of 2.6 % during the whole of 2002.

Goskomstat also released figures on the structure of fixed investment for the first half of 2003. The breakdown by sectors of the economy shows that transportation received the largest share, i.e. 17 % of investment. Next were oil production and refining, and housing and utilities; both categories had 16 % shares. Natural gas accounted for 6 % of investment and the food industry 4 %, while construction, nonferrous metallurgy and machine building each received 3 % of investment. Compared to the first half of 2002, the largest increases were seen in the shares of housing and utilities, the food industry and construction. There was a particularly large drop in transportation's share.

Russian companies have grown slightly less dependent on financing their investments out of retained earnings or with public money, although these sources of finance continue to be much more important for Russian enterprises than for their Western counterparts. In the first half of this year, Russian companies financed 47 % of their fixed investments out of retained earnings, down from 52 % in 1H02. The largest external financing sources were federal and regional budgets, which accounted for 18 % of total investments. Some 14 % of fixed investments were financed by parent companies and organisations.

The undeveloped state of Russia's financial sector is reflected in the fact that less than 5 % of investment was financed with bank loans. Furthermore, the share has grown only marginally over the past year. Less than 0.5 % of investments were financed by corporate bonds and share issues.

Stock markets soar after Moody's blesses Russian bonds with "investment grade" status

The index of the main Russian stock exchange RTS hit an all-time high of 629 points on October 8 after the international credit rating agency Moody's upgraded its rating of Russia's foreign currency bonds and notes to Baa3, the lowest investment grade. The RTS index had been rising steadily ahead of Moody's credit rating boost. In mid-July, it recovered from a slump caused by the Yukos investigation and in late September it broke above the previous record high set in October 1997.

Moody's move came as a surprise to the markets, which did not expect any increases at least before Russia's parliamentary and presidential elections. The other two main rating agencies, Fitch and Standard & Poor's, continue to rate Russia one and two notches below investment grade, respectively.

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	7.0	H1/03
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.6	1-8/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	12.0	1-8/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	7.6	8/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	95.7	1-9/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	52.4	1-9/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	29.3	1-9/03

Source: Goskomstat, CBR.

Local administration bill approved

The adoption of the law on local administration in mid-September concluded part of a larger realignment of relations among the central government, regions and municipalities. The law aims at a more efficient and transparent local administration, which in turn is intended to increase citizen participation in local decision-making.

Under the new law, which enters into force at the beginning of 2006, the assignment of duties to municipalities is to be accompanied by guarantees of corresponding financing. This is to eliminate the familiar problem of unfunded budget mandates. A further administrative impact is that the law increases the financial dependence of localities on higher levels of administration. This most likely reflects a general tendency to get away from Yeltsin's liberal line of granting sub-national administrations extensive freedom of manoeuvre. The most important tax revenue sources for local administrations continue to be shares of federal taxes, the tax base and rate of which are decided at the federal level. However, the new law stipulates that the division of tax shares must be agreed for longer periods, which should make it easier to prepare sub-national budgets. At present, these shares change each year.

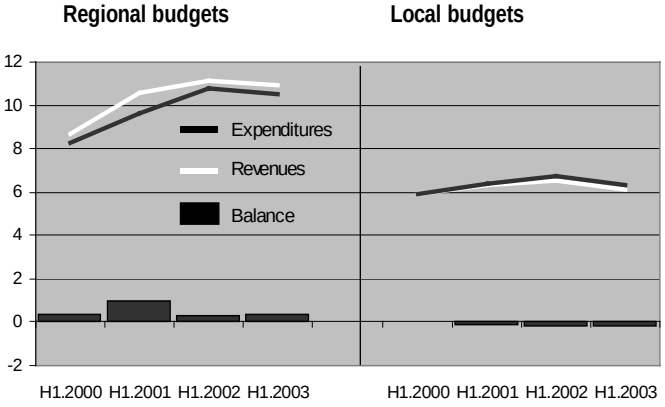
The surplus of regional budgets continues, local budgets stay in deficit

The combined regional budget in 1H03 showed a slight surplus (0.4 % of GDP), whereas the combined local budget stayed in deficit (-0.2 % of GDP). A similar pattern has been seen in earlier years also (see figure).

The most important revenue sources for both regional and local budgets are financial transfers and revenues from income and profit taxes. They account for slightly less than two-thirds of all revenues in regional budgets, while in local budgets their share is almost 80 %. In recent years, the importance of financial transfers and income taxes has grown markedly, while revenues from profit taxes have fluctuated. In addition to the usual variations in profit tax intake, the fluctuation has been augmented by a change last year in the profit tax rate, as well as by year-to-year changes in the allocation of revenues between different levels of administration.

Financial transfers to local budgets are the most important expenditure item for regional budgets. The sum regions pass on to municipalities nearly equals the amount they receive from the federal budget. Compared to previous years, industry, energy and construction received clearly more funds from regional budgets in 1H03. This was partly compensated for by a slight reduction in housing expenditures. At the local level, some 80 % of expenditures concentrate on education, housing, health care and social policy. The reduction of expenditures directed to housing at the local level has been even more pronounced than at the regional level. Housing expenditures accounted for 25 % of all local expenditures in 1H00, compared to 19 % in 1H03.

Consolidated regional and local budgets in 1H00–1H03, revenues, expenditures and balance in % of GDP



Source: BOFIT calculations from MinFin data.

Major revenue sources and expenditure items of regional and local budgets in 1H03 (%)

Regional budgets		Local budgets	
Revenues		**Revenues**	
Financial transfers	27	Financial transfers	43
Profit tax	19	Profit tax	9
Income tax	16	Income tax	24
Other	38	Other	24
Expenditures		**Expenditures**	
Financial transfers	25	Education	35
Industry, energy, constr.	12	Housing	19
Budgetary funds	10	Health care	15
Health care	9	Social policy	8
Housing	6	Other	23
Other	38		

Source: BOFIT calculations from MinFin data.

2004 budget passes first reading

As anticipated, the first Duma reading of the 2004 federal budget in mid-September proceeded smoothly. A clear majority of deputies accepted the general budget framework (see Month in Review 9/03). Compared to 2003, budget revenues, expenditures, as well as surplus relative to GDP are to decline in 2004. The revenue projection is affected in particular by lower taxation, due mainly to the reduction of the VAT rate from 20 % to 18 % at the beginning of 2004. The second reading of the 2004 budget is set for October 17 and the final two readings are planned to take place before the December 7 parliamentary election.

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

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2004 budget draft
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.4	1-7/03	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	17.4	1-7/03	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	3.0	1-7/03	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	30.6	6/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	120.8	6/03	

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

Source: Budget: IMF 1995-1998, Economic Expert Group 1999-2003. Debt: IMF 1996-1999, Minfin 2000-2003.

Railway reform kicks off

Autumn saw an important step forward in the reform of the railway sector. The reform has great significance for the Russian economy because railways carry about 80 % of Russian freight which is an extremely high share by international standards. Furthermore, the country's vast size and its underdeveloped road network dictate continued reliance on the railways in the foreseeable future. This also applies to passenger transport.

The reform kicks off in earnest this month when the state-owned Russian Railways Corporation (RZD) commences operations. RZD will handle commercial railway functions, i.e. passenger and freight transportation, which until now have been run by the railways ministry. The new corporation inherits from the ministry all rolling stock and social assets such as schools and health care facilities. The total assets of RZD will amount to as much as $50 billion. According to plans, all non-core activities of the railways will be privatised. Several other entities will also later be spun off from the corporation and privatised wholly or partially.

Regulatory functions will remain with the railways ministry, which will be transferred to the transportation ministry. The unification of the two ministries should improve the coordination of the country's transportation policies, which at times have seriously suffered from conflicts between the two powerful ministries.

At present, private freight agents have a significant share in Russian rail transport, managing over 20 % of all freight and accounting for almost a third of rolling stock. However, this does not necessarily mean that these private companies are bringing competition into the sector. On the contrary, in many cases they have close links with the railways ministry. Private companies typically "cherry pick," carrying the most profitable cargo such as oil products, fertiliser and vehicles, and leaving the railways ministry with low-profit cargo such as coal.

Gas sector reform held up

Reforming the state natural gas monopoly Gazprom has proved to be extremely complicated. Although the government had finally set aside time in late September to discuss a program prepared by the economy ministry on the reform of Gazprom, prime minister Mikhail Kasyanov unexpectedly dropped the topic from the government agenda. The same thing happened in December 2002. It is now expected that discussions on Gazprom's reform will not occur until after the parliamentary and presidential elections.

Gazprom opposes the reform, claiming that breaking up the monopoly would lead to lower gas production and investment in the sector would suffer.

According to the reform blueprint of the economy ministry, gas pipelines would be separated from Gazprom in the first phase. Later certain production units would become independent. The reform program stretches over several years.

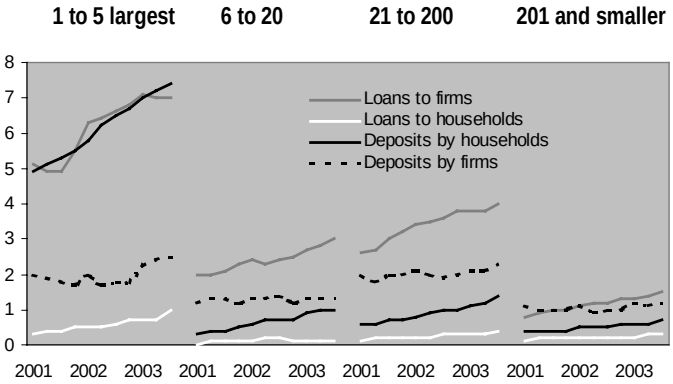
Deposit and loan deconcentration proceeds

Confidence in Russian banks (over 1,300) and the rouble continues to gradually revive. Growth of household and corporate deposits went on briskly through 2Q03 so that the stock of deposits was up 25 % y-o-y in real terms at the end of the quarter. Rouble deposits were up 35 %, while growth of foreign currency deposits slowed to 5 %. Reflecting a similar switch, arising from the large holdings of foreign currency cash, rouble cash also rose 25 %.

The reviving trust in Russian banks has promoted a process of deposit deconcentration. Sberbank's share of household deposits fell to 65 % at the end of 2Q03 from around 70 % a year earlier, while banks in all other size categories (based on total assets) have expanded their household deposit base much faster than Sberbank. Moreover, the four next largest banks and many medium-sized banks have increased their focus on acquiring corporate deposits.

Growth of bank lending continues to grow briskly: the loan stock was up well over 20 % y-o-y in real terms at the end of 2Q03. Loans are also experiencing deconcentration. Right after the largest banks, relatively large banks, based mostly in Moscow, as well as medium-sized banks, partly outside Moscow, have enhanced efforts in the corporate loan segment. Numerous small banks have also increased their share of corporate loans, which suggests many banks working de facto as extensions of financial structures of real sector firms are trying to swim against the mainstream vision that foresees consolidation in the banking sector. The relatively small household loan segment expanded 50 % overall with the largest banks and medium-sized banks leading the way.

Deposits and loans in Russian banks (grouped by size of total assets), 1.1.2001–1.7.2003, stocks as % of GDP



Source: CBR

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	13.2	9/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	48.0	8/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	183	8/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	5.0	7/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	11.9	7/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	62.1	9/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	30.61	9/03

Source: Goskomstat, CBR.

Corporate governance in Russia slow to emerge

by Seija Lainela*

Russian companies have been notorious for poor corporate governance. Even big companies may fail to observe the most elementary requirements of good corporate conduct. This is partly an outcome of the Russian approach to privatisation, which permitted accumulation of ownership and concentration of decision-making power in the hands of company managers and members of the social elite. Despite voucher privatisation programs, ownership structures based on a vast number of active shareholders were never realised.

Indeed, until recently there has been little incentive for companies to pursue transparent, responsible policies. Nothing in business environment compelled companies to open up: domestic banking operations remain fairly primitive so enterprises keep their own pocket banks, Russian stock markets play a meagre role in raising new capital, and companies continue to lack access or feel reluctant to engage in foreign borrowing.

The situation has begun to change as several of Russia's largest corporations aim at increasing their capitalisation, sometimes with a view to subsequent selling of part of the company abroad. Also, the floating of foreign loans and international acquisitions stipulate compliance with international standards for good corporate governance.

Rules on conduct exist, but enforcement weak

Russian business legislation, most notably the law on joint-stock companies, sets out the main requirements for good corporate governance. What has been lacking is enforcement. Also, new legislation has often bogged down. For example, a bill on the use of insider information has been in the Duma for two years. As a result, the activity of market agents and professional organisations has become a driving factor in establishing corporate governance principles in the business sector.

The Federal Commission for the Securities Markets published in the spring of 2002 a corporate governance code that was approved by the Russian government. The code is aimed at enterprises with at least 1,000 shareholders, but also provides guidelines for smaller companies. It covers all aspects of good corporate conduct, including requirements for disclosure of information, protection of shareholders' rights and an enumeration of good board practices.

Like similar codes in other countries, the Russian code is not legally binding. Its significance has, however, been boosted by the fact that since February 2003 Russia's main stock exchanges have required that companies quoted on their A1 lists comply with the corporate governance code in its entirety. Companies on the A2 lists are required to comply with the chapter of the code concerning information disclosure. Again, enforcement of these requirements is spotty as practical methods for verifying compliance are still lacking.

Most corporations remain ignorant

According to surveys by the Russian Institute of Directors (www.rid.ru), corporate conduct is improving, although slowly and unevenly. The areas that have seen the most progress include conducting of shareholders' meetings, formation of boards of directors and disclosure of information on company financial results.

The best performers among large companies are those that seek to meet international standards of corporate conduct. Yet, even in this group, many enterprises observe only certain aspects of the code. Requirements concerning disclosing information on members of the board of directors and senior managers, as well as their compensation, are among the issues where compliance is particularly weak. Moreover, companies lack adequate internal control systems and criteria for evaluating the performance of board members and senior management.

Most large companies have made very little, if any, progress in corporate governance. This group comprises many enterprises with significant federal or regional ownership.

While perhaps 10–20 companies in Russia observe the corporate governance code to a high degree today, it is hoped that within the next few years the number will rise to 200 and cover all of Russia's most important corporations. The code carries less direct significance for the bulk of small and medium-sized enterprises, which do not need or want large-scale outside financing. Here the task is mainly to ensure that such companies follow the law on joint-stock companies.

Wider issues at stake

The improvement of corporate behaviour in Russia is likely to take a long time, as it is a much wider issue than simply making companies comply with certain rules. The key condition for improved corporate behaviour is a normalisation of the operating environment for companies. Here, reforms of the judicial system and public administration are the top priorities. Rooting out corruption and stopping the arbitrary interference of officials in enterprise affairs are huge issues that need tackling.

In this respect, recent developments in Russia are discouraging. Transparency International's latest survey shows that corruption in Russia increased during the past year. Moreover, the recent raids on the company offices of Yukos oil provide little evidence of a stabilising business environment. Hopefully these developments do not nullify the motivation of companies to continue improving their corporate conduct.

** The author is economist at BOFIT. The article benefits from the OECD roundtable on corporate governance in Moscow in October 2003.*

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

Editor-in-Chief Seija Lainela

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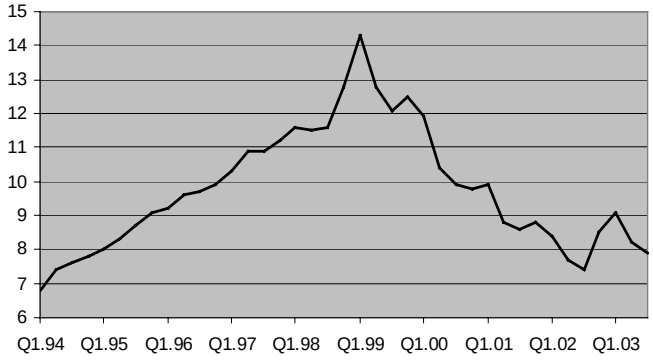
Economic Developments

Unemployment on the rise

Russia had 5.7 million unemployed persons at the end of September. The unemployment rate, calculated using ILO methodology that allows international comparison, was 7.9 %, up from 7.6 % a year earlier. After falling year-on-year for three consecutive years, the number of unemployed began to rise at the end of 2002.

Unemployment rate (ILO methodology)



Source: Goskomstat

According to Goskomstat estimates, the total number of employed persons in August was 66.7 million, which is 0.2 percentage points less than in August 2002. Of that, employment in large and medium-sized enterprises totalled 41.0 million. It decreased 2.8 p.p. from a year earlier. Hence, small enterprises have increased their employment.

Goskomstat only provides detailed employment data on large and medium-sized enterprises. Industrial employment in such firms diminished 6 % over August 2002–August 2003. Among the sectors with largest declines were light industry (–15 %), oil extraction (–8 %), coal production (–7 %), forestry and wood processing (–7 %), and oil refining (–6 %). The drop in employment in oil and coal production evidences marked improvement in labour productivity; crude extraction increased some 12 % and coal production 10 % during the period. Improved labour productivity was observed also in light industry, where the decline in employment was much larger than the 3 % decline in output.

Agricultural employment in large and medium-sized enterprises saw a significant decrease of 13 % in the period August 2002–August 2003.

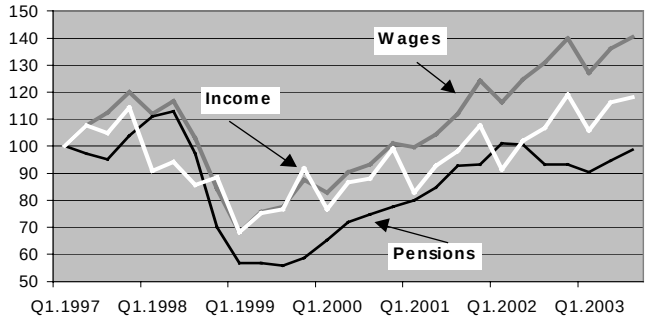
The only enterprises to increase employment were in the services sector. Employment increased most (11 %) in financial, banking and insurance services. Next came tourism with almost 3 % growth. Employment in administration increased 2 %.

Income growth remains brisk

Income growth has been strong during the past few years. Goskomstat figures show that real wages increased some 20 % in 2000 and 2001 and 16 % in 2002. To a large extent, this rapid growth reflects recovery from the deep slump in real wages in 1998 and 1999 in the aftermath of Russia's financial crisis. During this year, growth has slowed; in September, real wages were 9 % higher than a year earlier.

Growth in real pensions has followed a similar pattern. By September 2003, the on-year growth of real pensions had slowed to 6 %.

Real average monthly wages, pensions and disposable income, 1Q1997=100



Source: Goskomstat

Income inequalities remain large in Russia, and the situation does not seem to be improving. Official Goskomstat statistics show that in January–September 2003, the poorest 20 % of population received less than 6 % of all monetary income, while the wealthiest 20 % received 46 % of income. Furthermore, there was a slight increase in the income share of the wealthiest group over the year.[1]

Poverty, on the other hand, has been declining during recent years. Nevertheless, a quarter of the Russian population lived below the official subsistence minimum in the first half of 2003. The figure had declined by 4 percentage points from a year earlier.

[1] For comparison, the respective income shares in Finland in 2001 were 10 % for the poorest quintile and 36 % for the wealthiest quintile.

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	7.0	H1/03
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.8	1-9/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	12.1	1-9/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	7.9	9/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	95.7	1-9/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	52.4	1-9/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	29.3	1-9/03

Source: Goskomstat, CBR.

Expenditure structure of 2004 budget similar to 2003

In light of the forthcoming parliamentary elections, the budget process in the Duma continued amazingly smooth in October. The expenditure structure of the 2004 budget approved in the second reading essentially matches the current budget. The main spending areas are traditional – defence (16 % of all the expenditures), transfers to regional and local budgets (14 % not counting the unified social tax) and expenditures on law enforcement and national security (12 %). As a share of GDP, the last item will be the sole expenditure class receiving increased funding. Interest payments on domestic and foreign debt (11 %) should decrease, while the rest will remain unchanged in relation to GDP.

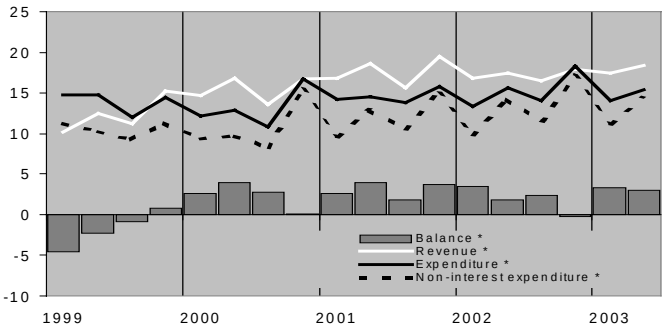
The third budget reading, which focuses on allocation of spending within budget categories, will be held on November 21.

Fiscal stance more relaxed

Following the IMF mission's visit to Moscow at the beginning of October, the Fund representatives again expressed their concern over the loosening of Russia's fiscal policy during the last couple of years. This year's supplementary budget approved by the Duma at the end of October represents a further relaxing of fiscal stance. Despite the expenditure increases of nearly RUB 70 billion (about $2 billion or 0.5 % of GDP), however, the surplus for 2003 is estimated to reach RUB 150 billion (1.1 % of GDP), which is more than double the amount originally foreseen for 2003.

In the 2004 budget draft, expenditures have been cut by 0.8 percentage points of GDP, compared to the estimated 2003 budget at the end of the year (including supplementary expenditures). A special commission has been working during the past year on rationalisation of non-interest expenditures, which in the 2004 budget draft are set at 12.6 % of GDP – slightly less than estimated for this year. The planned introduction of a new stabilisation fund from the beginning of next year, which should function on stricter rules than the present one, would also direct funds away from increasing non-interest expenditures when oil prices remain high.

Federal budget revenue, expenditure and balance, % of the quarterly GDP



* Excluding the social tax revenue in 2000-2003

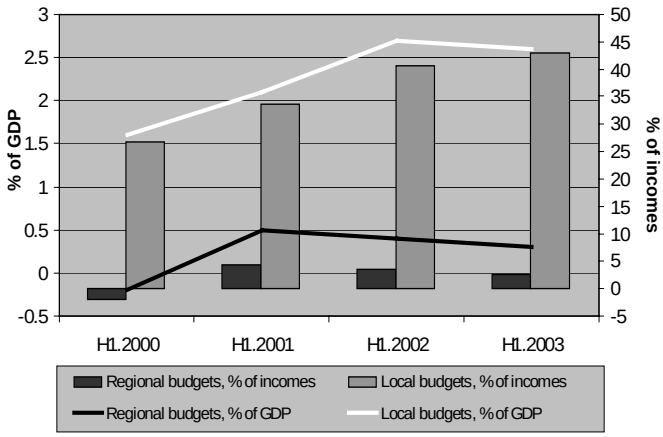
Source: Economic Expert Group

New principles planned to be introduced in domestic financial relations

In this decade, local budgets have become increasingly dependent on financial transfers from federal and regional budgets. While the dependence of regional budgets on federal transfers has changed over the years, localities have seen the share of transfers from upper administrative levels rise constantly (see chart below). Recent plans to reform the fiscal relations at various administrative levels are vague on how this dependence will develop in the future. The changes to budget code submitted by the government to the Duma, however, call for more equitable principles in delivering federal transfers and demand stricter and more efficient use of such funds.

The government proposal seeks to balance the financial stance of regions and municipalities. Under the principle of negative transfers introduced in the proposal, a municipality would pay subventions to upper level budgets when its tax revenues exceeded the average level in the region by a factor of 2.5. On the other hand, if the debts of a municipality or region amount to over 30 % of its own budget income (i.e. excluding transfers), federal arbitration courts may decide to appoint a special financial administration to operate for up to one year. In Russia's regions and municipalities, both principles have been met with mixed feelings. Negative transfers could prevent rich municipalities from increasing tax revenues – at least officially – when they approach the critical level. Financial administrations are considered to be fair in some financially very weak regions, where debts exceed budget revenues. On the other hand, some regional representatives think that appointing financial administrations instead of trusting elected officials violates the rights of representation of regional residents.

Net budget transfers to regional and local budgets, %



Source: Ministry of Finance

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

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2004 budget draft
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.0	1-8/03	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	17.4	1-8/03	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	2.7	1-8/03	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	30.6	6/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	120.8	6/03	

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

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

Yukos case escalates

Although the prosecutor general's office had been keeping close scrutiny on some people and entities related to the Russian oil major Yukos since summer, the arrest of chief executive Mikhail Khodorkovsky on October 25 took many in the Russian and international business communities by surprise. The charges against Khodorkovsky, including tax evasion, document forgery and embezzlement, stem in part from privatisation of large corporations in the mid-1990s, when Khodorkovsky and other Russian oligarchs built their fortunes.

The situation escalated on October 31, when the prosecutor general authorised the freezing of 44 % of Yukos shares allegedly belonging to Khodorkovsky, but actually owned by foreign entities.

On November 3, Mikhail Khodorkovsky resigned as Yukos chairman to protect the firm from charges against him. Soon after his nomination, Yukos' replacement chairman Simon Kukes announced that Yukos was not seeking foreign partners. Prior to Khodorkovsky's arrest, Yukos was engaged in talks with US majors ExxonMobil and ChevronTexaco over the sale of large stakes (purportedly up to 40 %) in Yukos.

Speculation abounds over possible reasons

Some observers note that the charges against Khodorkovsky may have been provoked by his company's support for opposition parties in the upcoming Duma election. Another suggestion is that the move was a reaction to keep ownership of natural resources in Russian hands. The importance of the latter suggestion was highlighted by interior minister Boris Gryzlov who when speaking about Yukos underscored that Russia's natural resources and profits from them belong to all citizens.

The events surrounding Yukos are generally acknowledged to show the increasing ascendancy of people within the Kremlin with backgrounds in the country's "power" structures (security service and the military). This group emerged in Kremlin under president Putin and is in opposition to reformists (including the oligarchs), who emerged during the Yeltsin era. The severity of disagreements in the Kremlin was reflected by the fact that Kremlin chief of staff Alexander Voloshin resigned October 31 in protest to Khodorkovsky's arrest. President Putin nominated in his place deputy chief of staff Dimitri Medvedev, a St. Petersburg lawyer, who lacks a power structure background. Observers consider his appointment an indication that the power structure group has yet to triumph over the reformist group.

Critical statements on the handling of the Yukos affair, made by highly positioned individuals, including the newly nominated Medvedev, prime minister Mikhail Kasyanov and deputy economy minister Arkady Dvorkovich, indicate some dissention on the Yukos case in the presidential administration and the government.

More firms to be targeted?

The Yukos case has incited questions on whether investigations of other Russian companies will be launched and whether privatised property might even be re-nationalised. Russia's privatisation sales in the 1990s rarely adhered to the letter of the law or legal principles. Hence, many people involved in the privatisation of large enterprises could conceivably be charged as Khodorkovsky for similar crimes.

Earlier this autumn, president Putin gave assurances that completed privatisations would be allowed to stand. Moreover, on several recent occasions, he has stressed that the investigation only targets Khodorkovsky and his business partners, not Yukos or other large enterprises. However, natural resources minister Vitaly Artyukhov said on November 5 that some of Yukos' oil-drilling licenses could be revoked if the company was found to have failed to operate fully within the scope of its licences, or if it is incapable of doing so under the current circumstances. The next day, president Putin expressed displeasure with the strong measures suggested by Artyukhov.

Worries on Russia's business climate mount

Conflicting statements of Russian authorities on the Yukos criminal case have created increasing uncertainty among foreign investors over the future of democracy in Russia and the Russian economy. Khodorkovsky's arrest and the freezing of Yukos shares, in particular, have damaged Russia's reputation among international investors. One clear indication of that was the fact that the two large US oil companies that were in negotiations on acquiring stakes in Yukos have halted the negotiations.

Furthermore, the behaviour of officials in the Yukos investigation has raised questions about Russia as a law-abiding state as some of the measures taken by officials are considered to fall outside the law. Also, there are fears over the arbitrariness of decisions on who gets targeted for investigation. The achievements of Mr. Putin in improving Russia's image internationally as a transparent business environment are rapidly evaporating.

Yukos shares fall on RTS

The unrest is well reflected in the recent volatility of Russian stock markets, and particularly in the price of shares of Yukos and another oil company, Sibneft, which is being merged with Yukos. The price of Yukos shares on the Moscow RTS stock exchange fell 19 % between October 24 and November 7, while the price of the shares of Sibneft was down by 22 %. The RTS index fell 10 % in the same period.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	13.1	10/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	48.0	9/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	181	9/03
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Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	11.8	8/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	64.9	10/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	29.86	10/03

Source: Goskomstat, CBR.

WTO accession: What's in it for Russia?

by Abdur Chowdhury *

Serious negotiations on Russia's accession to WTO started only after President Putin declared WTO accession as a goal of his presidency. As one of the largest economies aspiring to join the WTO, Russia's accession has great potential to increase trade that would benefit current WTO members, as well as Russia itself. On the other hand, Russia's relative size and importance among former Soviet Union countries, many of whom are also in the WTO accession process, mean that Russia's entry terms have important implications for other countries.

By joining the WTO, Russia gains access to foreign markets and receives non-discriminatory treatment for its exporters. Accession could create a more favourable climate for foreign investments in Russia and enhance growth of domestic production quality and competitiveness as a result of increased inflows of foreign goods, services and investments. Membership would also increase opportunities for Russian investors in the WTO-member countries.

The latest rounds of trade negotiations have raised a number of key issues to be addressed in the near future. The main areas of dispute relate to tariff and non-tariff barriers and a number of trade-related distortions.

In early 2001, Russia undertook a major effort to reduce the number of tariff rates in use and lower the average rate. These changes have brought the average tariff rate down to 10.7 %. In view of demands for further reduction in the tariff rate, Russia is experiencing a strong domestic protectionist movement as a number of strong lobbying groups are, in fact, insisting on an increase in tariffs during the accession to WTO. An example in point would be the auto industry. Russian automakers have proposed the retaining of high import duties on foreign cars after WTO accession for a transitional period of up to ten years.

Another area of contention is the issue of state control over energy prices. The EU and US insist that Russia's domestic prices for energy resources must be closer to world prices and that Russia's energy sector requires significant reform. Russia contends that lower energy prices are due to its comparative advantage and that raising the domestic price of energy to world-market levels would make Russian manufacturing uncompetitive. This proposal also faces strong opposition from various lobbying groups within Russia.

By international standards, Russia's relatively low levels of agricultural subsidies during recent years (around US$ 13 billion per year) create a peculiar problem for the Russian side at the WTO negotiations. Australia, New Zealand and certain other countries want the late 1990s to be used as a reference point so that the upper limit to the subsidy levels that Russia commits to would be low. Russia, on the other hand, wants to use the late 1980s as the reference point when subsidy levels were much higher than at present.

Most WTO members would like to see a significant opening of the Russian service sector to foreign-owned business and capital. Most of the service sector, e.g. the financial sector, is either new to the Russian economy or performed a different role during the Soviet period. Resistance to opening up these sectors is the result of political lobbies that prevent compromise rather than respond to the real economic challenges.

Much work also needs to be done in the area of intellectual property rights. Copyright piracy in Russia is rampant and often run by organised crime syndicates. Laws for protecting intellectual property are weak, lack strong criminal sanctions and are poorly enforced. Hence, active steps have to be taken by the state to draw up new laws and implement and enforce both the new and existing laws before acceding to the WTO.

Prospect for membership better than ever

Prospects for Russia's WTO membership now look better than at any point since accession negotiations started. Relatively good progress with economic and legal reforms within Russia has left the country's economy better prepared for membership.

The original timetable of WTO entry in 2003 has slipped. But this timeframe always looked ambitious, and all the more so given the last few rounds of tough negotiations on reducing tariffs in key sectors such as cars, aerospace and pharmaceuticals, as well as on lifting restrictions on foreign entry into the domestic financial market. The necessary Russian concessions would mean overcoming powerful vested interests at home.

For all their sensitivity, the negotiations on the import tariff levels and access to Russia's service sectors are the least problematic, since the parties can quickly come to an agreement provided there is sufficient political will on both sides. Delays here will be mainly due to negotiating tactics.

Much more difficult will be non-tariff barriers and the general trade-related legislative framework. Here, the key issues are Russia's low energy tariffs and agricultural subsidies. The Duma has to address relevant legislation for WTO accession, including the Customs Code, the liberalisation of currency controls, and, in the area of non-tariff barriers, the law of technical regulations.

The advantages of membership ultimately outweigh the disadvantages. As many analysts note, the disadvantages are mostly tactical, short-term and immediate, while the advantages are strategic. By making the necessary reforms in conjunction with its WTO accession, Russia can reap the full benefits of free trade. This would be a logical continuation of Russia's advance towards a full market economy.

** The author is the Director of Economic Analysis Division in United Nations Economic Commission for Europe.*

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

Editor-in-Chief Seija Lainela

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RUSSIAN ECONOMY
The Month in Review
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Economic Developments

GDP forecasts raised

Growth of the combined production index of five base sectors of the Russian economy, which provides advance information on GDP dynamics, accelerated this autumn and was up 8.5 % y-o-y in both September and October. For the period January–October, on-year growth in the five sectors averaged 6.9 %. Growth has exceeded most forecasts made at the start of the year, mainly thanks to higher-than-expected world market prices for oil and other commodities.

Some deceleration in growth is expected for the rest of the year. Most observers now forecast Russian GDP will grow at least 6 % for all of 2003. The Russian economy ministry increased in November its 2003 GDP growth forecast to 6.6 %. For 2004, most experts forecast GDP growth around 5 %.

Some observers express the fear that the negative impact on the Russian business climate of the continuing difficulties surrounding the Yukos oil company may reduce the pace of investment and hence overall growth in the country.

Inflation close to the end-year target

This autumn, Russian authorities have made statements in favour of a reduction in world market oil prices. Their view is based principally on the negative effects of high oil incomes on domestic inflation and the rouble's exchange rate.

The continuing depreciation of the dollar on international markets has to some extent served to decrease Russia's oil export income in rouble terms. However, export incomes have been extremely high and boosted the amount of money in circulation, which has grown significantly faster than last year. At the end of October, broad money (M2) was up 45 % compared to October 2002. The rapid growth has for its part sustained Russian inflation.

On-year inflation decelerated markedly in November with consumer prices 12.4 % higher than a year earlier. Conceivably, Russia could attain the upper limit of the 10–12 % inflation rate target set by the government for the end of the year.

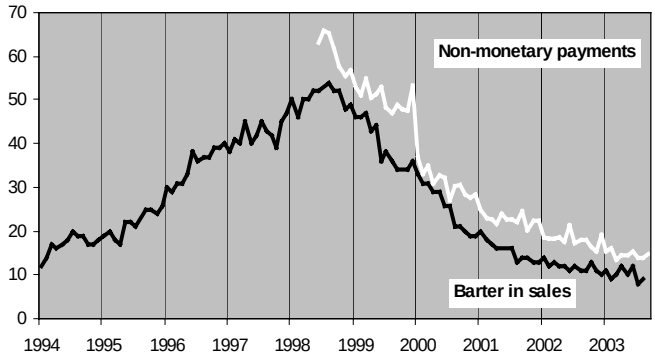
The deceleration of inflation seems to be in part due to administrative measures. As in October, November inflation was driven largely by food prices. The approach of parliamentary and presidential elections was reflected in the slowing rise of administratively set prices on municipal services and utilities. These prices rose in the first half of the current year much faster than prices on average. Their rapid rise will likely resume in 2004, given the declared policy of gradually raising utility charges to cost recovery levels.

Use of money surrogates steady in 2003

According to Goskomstat, the use of money surrogates (various debt papers, offsets, barter, etc.) as forms of payment to the largest taxpayer enterprises and monopoly firms saw a very rapid decline after the 1998 financial crisis. In 2002, however, the speed of decline slowed and in 2003 there has been almost no change in the share of payments to large enterprises effected in money surrogates. During January–September 2003, some 15 % of their sales transactions involved non-monetary forms of payment.

The most common monetary surrogates are offsets and various debt papers, which in September 2003 represented about 11 % of total sales and 73 % of non-monetary payments. Barter remained insignificant (accounting for less than 1 % of all sales), which probably reflects the composition of Goskomstat's research target group, i.e. largest enterprises. A survey by the Russian Economic Barometer, which uses information from several hundred firms including smaller ones, produces quite different figures for barter. According to that survey, barter was used as payment in some 10 % of sales – down from over 50 % after the 1998 crisis.

Share of barter in industry sales and share of non-monetary payments to large enterprises, %



Source: Goskomstat, Russian Economic Barometer

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	7.0	H1/03
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	6.8	1-10/03
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	8.7	2.6	12.2	1-10/03
Unemployment, % (end of period)	9.3	9.0	11.8	11.7	10.2	9.0	7.1	8.3	10/03
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.2	108.6	1-10/03
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	59.0	1-10/03
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	35.0	32.8	29.3	1-9/03

Source: Goskomstat, CBR.

Duma elections a victory to Putin

Movements supporting president Putin were the great winners in the December 7 Duma elections. This together with the defeat of liberal forces will strengthen the position of president Putin and his closest circles – including representatives from the power structures. It remains to be seen how reform policies will be affected by these developments. Voter turnout remained around 50 %, reflecting the vast indifference of population towards the country's political development.

Banking sector reform to finally move forward

There was a rush in Duma to pass legislation in November before winding up the autumn session. The key pieces of legislation included passage of the deposit insurance act, which had been under preparation for several years. The act is a crucial element in the reform of the Russian banking sector as it establishes an overall deposit insurance system for banks, with a transition period for the state-owned Sberbank. Until now Sberbank has been the bank enjoying deposit insurance, a fact that served to reinforce its dominant position in the markets.

Stabilisation fund and 2004 budget approved

The Duma approved both the 2004 federal budget and a new stabilisation fund before it adjourned. The 2004 budget is the fifth in a row to show a surplus. Unlike the present reserve fund, the new stabilisation fund will be strictly regulated. In addition to the federal budget surplus, the fund will hold revenues from export tariffs on oil and oil products, as well as oil extraction taxes, when the price of Urals-grade oil is above 20 dollars a barrel. Conversely, when world oil prices are low, fund assets can be used to cover budget deficits. The resources can also be applied to other uses if they exceed RUB 500 billion ($17 billion). The Russian government will report quarterly on the amount of money paid into the fund, as well as placement and use of the funds.

The finance ministry reports that the present reserve fund, the resources of which will next year be transferred to the stabilisation fund, amounted to about RUB 140 billion ($4.7 billion) at the beginning of October. According to the Duma Budget Committee, the new stabilisation fund is expected to reach RUB 200 million ($6.7 billion) by mid-2004.

Oil revenue taxation under scrutiny

The Yukos case has focused broad attention on Russia's system of taxing oil income. Given vague legislation, oil companies have efficiently exploited tax optimisation to decrease their tax burden. Transfer pricing has also been common. Furthermore, loyal deputies in the Duma have been used by the companies to push through favourable tax legislation or block unfavourable legislation.

Although tax optimisation is not illegal, its extensive use by certain companies has significantly lowered their taxes. A study by the Russian finance ministry in 2000 found that Sibneft and Yukos paid the least taxes in relation to production. A fresh Brunswick UBS study shows similar results for 2001 and 2002, when the effective income tax rate for Sibneft was some 10 % and for Yukos 14 %. The respective figures were 31 % for Lukoil and around 24 % for both Surgutneftegaz and Tatneft.

In recent years, the government has attempted (although not very successfully) to boost the tax take on oil income. The government has now tasked both the finance ministry and economy ministry to prepare proposals during 2004 for a new tax that would direct windfall profits from high international oil prices from oil producers to the state. A bill should be submitted to the Duma in 2005, and, if passed, it would enter into force at the start of 2006. The economy ministry is working on a tax model that would amend the current flat tax on natural resource extraction. Under the new system, the tax rate would vary according to the quality of the field with the easy-access, high-profit fields facing heavier taxation.

Russian regions not to grant new tax concessions

In order to close one important loophole for oil companies to reduce their taxes, a law was passed in the Duma in late November eliminating the right of Russian regions to grant enterprises concessions on the regional and local components of the profit tax. The law will be effective from the start of next year. Also existing concessions will lose their validity at the start of 2004.

Originally the purpose of concessions was to encourage investment, but today enterprises often use regions granting concessions as places to register their activities, while investing elsewhere. All together about 20 regions have given full or partial tax exemptions to enterprises. Enterprises enjoying maximum benefit have paid only a 6 % profit tax – the part to be transferred to the federal budget.

Some 90 % of the estimated value of granted profit tax concessions is concentrated in the Kalmykia, Mordovia and Chukotka regions, where many domestic oil firms are registered. Also foreign-owned enterprises have settled in certain regions because of tax concessions. In some cases, regions have pledged to honour the concessions for several years to come. Such regions now face the problem of whether and how to compensate investors for their losses. Some regions have promised to cover the losses from their budgets, although this is prohibited for regions classified as budget beneficiaries, i.e. receiving net subsidies from the federal budget.

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

	1996	1997	1998	1999	2000	2001	2002	2003	as of	2004 budget
Revenues [1]	12.5	12.3	11.0	12.6	15.5	17.6	20.3	20.0	1-8/03	17.9
Expenditures [1]	20.9	19.4	16.9	13.9	14.3	14.7	18.8	17.4	1-8/03	17.4
Balance	-8.4	-7.1	-5.9	-1.4	1.2	2.9	1.4	2.7	1-8/03	0.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	30.6	6/03	
Foreign currency debt, $ bln	136.1	134.6	158.2	154.6	143.4	133.1	123.5	120.8	6/03	

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

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

YukosSibneft merger on hold, markets react

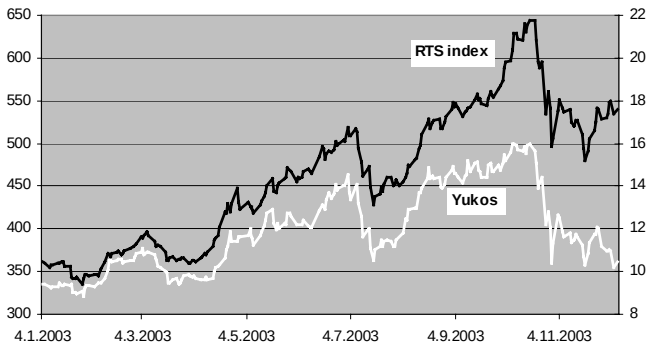
In November, news on the Yukos case ruled the front pages of the newspapers, with the crowning announcement coming late in the month with Sibneft's declaration it was pulling out of the merger of the two companies (already agreed on in April and for the most part carried out). The announcement came as a surprise to both Yukos and the markets. Some observers think Sibneft wants to avoid involvement with the ongoing troubles and falling share value of Yukos. Others report a rumour that the main personalities behind Sibneft, including Roman Abramovich, may be attempting a take-over of Yukos. According to further rumours, the Kremlin may have been involved.

The markets saw the merger break-off as a further manifestation of the uncertainty gripping the Russian business environment. The drastic change in the atmosphere is reflected by the fact that just two months ago oil giants ExxonMobil and ChevronTexaco were still in talks with YukosSibneft on acquiring a stake in the company. Those plans are also now on hold.

Russian stock markets have fluctuated along with the Yukos developments. On December 8, the Moscow Stock exchange's RTS index was off 9 % from its level of October 24, the day before Mikhail Khodorkovsky was arrested. In the same period, Yukos shares depreciated 27 % and the shares of Sibneft fell 12 %. Market reactions to the results of the Duma elections were moderately positive with the RTS index moving up a bit.

Since the start of the current year, the RTS index is still up a hefty 50 % in spite of the effects of the Yukos affair, making Russia one of the best performers among world's stock exchanges.

RTS index (left scale) and Yukos share price (USD, right scale), 1.1.–8.12.2003



Source: RTS

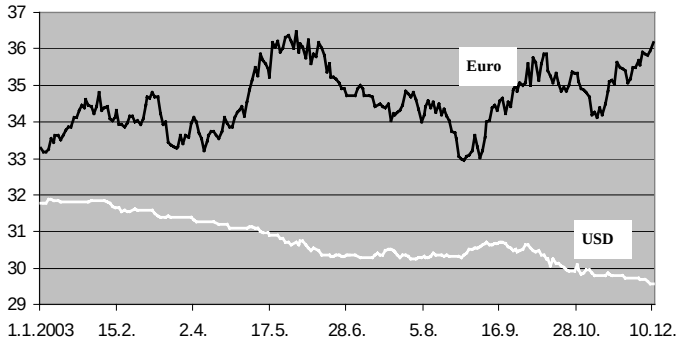
Rouble up

The rouble has continued to strengthen against the dollar since the spring of the current year. On December 5, it hit a high of 29.55 roubles per dollar. The rouble was last at that level in October 2001. The CBR has at times actively intervened in the markets by buying dollars to keep the rouble from appreciating too sharply, hence augmenting its foreign currency reserves.

In nominal terms, the rouble appreciated 7 % against the dollar between January and November. In real terms, the appreciation was 16 %. During the same period, the rouble depreciated 1 % in nominal terms against a basket of currencies of Russia's main trading partners, while in real terms it appreciated against the currency basket 5 %.

The CBR has indicated that, although it is determined to gradually ease its interventions on the currency markets, for the time being it is necessary for it to continue with them in the face of large export revenue inflows.

Nominal rouble exchange rates against the dollar and euro



Source: CBR

Russia's foreign reserves swell in spite of Yukos

The value of Russia's gold and foreign currency reserves hit a record of $68.2 billion on December 1, up from $64.9 billion on November 1 and $62.1 billion on October 1. High world oil prices, which have boosted export earnings, are the main reason for the growth in reserves. The euro's strengthening against the dollar on international forex markets is another factor contributing to some of the rise in Russian reserves, which are denominated in dollars.

In autumn, the CBR began to publish a monthly breakdown of its gold and foreign currency reserves. As of mid-November, some $3.7 billion (6 %) of total reserves were held in gold. Of the currency holdings, 69 % was dollars, 26 % euros and 4 % British pounds. The remaining 1 % consisted of other currencies. The CBR has boosted its euro holdings during the current year, while reducing its dollar position.

According to preliminary balance-of-payments data, capital exports from Russia by the private sector increased significantly in the third quarter of 2003 ($7.7 billion for the third quarter, compared to $8.2 billion for all of 2002) and it was feared that the Yukos case would boost capital exports in the fourth quarter. However, the rapid growth of the central bank's international reserves in October and November would indicate that the outflow of capital has not accelerated.

Monetary indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
Inflation (CPI), 12-month, %	131	22	11.0	84.4	36.5	20.2	18.6	15.1	12.4	11/03
M2, 12-month growth, %	113	30	29.5	36.3	57.2	62.4	40.1	32.3	45.4	10/03
Average wage, $ (period average, except last)	104	154	164	108	62	79	111	142	190	10/03
Deposit interest rate, % (period average)	102	55	16.8	17.1	13.7	6.5	4.9	5.0	4.0	9/03
Lending interest rate, % (period average)	320	147	32.0	41.8	39.7	24.4	17.9	15.7	13.2	9/03
Forex reserves, $ bln (incl. gold)	17.2	15.3	17.8	12.2	12.5	27.9	36.6	47.8	68.2	11/03
RUB/USD (end of period)	4640	5560	5960	20.65	27.00	28.16	30.14	31.78	29.74	11/03

Source: Goskomstat, CBR.

Reform of the Russian forest sector

by Pertti Veijola*

Russia possesses about 23 % of the world's forest resources, including about half of all boreal coniferous forest. Nevertheless, Russia does not belong to the major players in the global forest industry. Its share of the world's trade of forest industry products was just 3 % in 2002.

In the early 1990s, forest industry output, like Russian production generally, collapsed. The annual volume of cuttings of industrial round wood in 1990 was about 300 million m³. By 1998, it had fallen 70 % to 90 million m³. After the rouble's devaluation in 1998, competitiveness of forest industry improved, but now that advantage has been exhausted and new strategies are needed.

Development strategies

Discussion of a new national forest policy started in 2001. At the end of that year, representatives of administration, industry and science compiled a draft of the new policy. Unfortunately, the draft was not elaborated and strategy development proceeded separately in two ministries.

The government approved the industry ministry's proposal on main strategies for development of forest industry in November 2002. The ministry wants to increase production volumes and boost the share of high value-added products. By 2015, production capacity should be four times higher than now and high quality products should dominate the product slate. Implementing this programme, however, will require the construction of new mills and total investments of about $26.5 billion. Moreover, if Russia goes through with the programme as planned, it will seriously disrupt international markets.

Meanwhile, the natural resources ministry has compiled a set of main principles for development of forestry for the period 2003–2010. The government approved these principles in January 2003. They cover a wide variety of measures, including the reform of laws and norms, promotion of research, training and international cooperation, and reform of state forest administration (e.g. intensification of silviculture and forest protection). The annual volume of final fellings is targeted at 200 million m³. The forestry should also be profitable and self-financing by 2010.

Revision of forest code

Revision of the forest code is a major mechanism for implementing the new strategies. The government discussed the draft forest code in September 2003 and sent it on for further preparation. Nearly all the basic principles of forestry are under consideration, including ownership, leasing and administration of forest, as well as pricing of wood. It seems that the state will retain full ownership of the forest fund until 2010. Partial privatisation, approved in principle, would start later. The forest industry will get harvesting rights through long-term leases or concessions. Harvesting companies will be expected to transform their activity from harvesting to sustainable multiple-use forestry – a challenging task, given the needs for investment and training. A generally supported division of responsibility would give Russia's large vertically integrated companies the leading role in forest sector, while state organisations would concentrate on public authority tasks such as supervision and monitoring.

The idea of natural resource use fees has been approved as the basis for development of the stumpage price system. A method for simulating market pricing will be implemented through special legislation that complements the forest code. Currently, minimum prices are set by decree and are treated as taxes instead of prices. The average stumpage price level is very low, only one to three euros per cubic metre. Higher stumpage prices are needed for financing of forest regeneration, fire fighting and forest administration. However, the economy of harvesting enterprises is weak and their representatives claim companies cannot bear additional costs.

A new forest sector model?

Comparisons are often made with other countries when new forest strategies for Russia are pondered. Some Russian specialists are ready to adopt Finland's national forestry model. However, Finns have the long tradition of private forestry with long term planning and investment, which obviously differs markedly from the Russian tradition. On the other hand, the Baltic countries have been quick in adopting forestry reforms along the lines of Scandinavian models. Given their shared Soviet heritage, such models may not be entirely out the question in Russia's case. Canada is seen as another alternative by some experts. Canada has a similar structure of forest ownership and leasing as Russia, and shares many common features in harvesting technology.

However, national models from other countries seem less applicable to Russia. Indeed, the new model for the forest sector has to come from Russian traditions. Ultimately, any successful model will need to promote market-driven structures for commercial forests over the long term. However, most Russian forests will continue to be located in places where possibilities of forestry business are limited or nonexistent, and thus what they produce for society is mainly valuable from the ecological and public services standpoint. In these non-commercial forests, state forest administration is the only choice. Thus, one of the most fundamental distinctions to be made is between commercial forests and those producing other services.

** The author is D. Sc. (For) and counsellor at the embassy of Finland in Moscow.*

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