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IN TRANSITION*

***RUSSIAN
ECONOMY
in 1996***

**TRENDS AND
OUTLOOKS**

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Section 1

Political Processes and Macroeconomics in 1996

Introduction

There exists a peculiarity of the post-communist evolution in general, and in Russia in particular: this is the strong dependence of the economic processes upon the political ones. A natural indicator of this dependence is the modification of the basic macro-economic indexes (first of all, inflation, dynamics of production volumes, budget deficit, etc.) resulting from the political situation. Moreover, in contrast to the countries with the stable market economy, where the political changes lead to the changes of the economic parameters by percents or their shares, the choice (or the change of its probability) of one of the economical and political alternatives existing in the today's Russia may lead to the change of the macro-economic indexes by times.

Under such conditions, the 1996 Presidential elections formed a key factor for not only the political, but also for the economic life of Russia. Indeed, one of the two variants of the nation's evolution was to be chosen, and the necessity to choose was fully perceived by the political elite, the economy agents, and the voters themselves. Furthermore, the situation itself influenced the behavior of the economic agents, thus predetermining the main problems of the economic policy of 1996-97.

The correlation between the economic policy and elections was analyzed in sufficient detail in the Western economic literature beginning from the mid-70's; the especially deep analysis belongs to the last two decades. The two contrasting approaches to the contemplation of the relevant problems have formed. The first one is based on the hypothesis that any politician (government, ruling party) is inclined to use, notwithstanding the doctrines or ideological preferences, the elements of the economic populism during the period immediately preceding the elections, i.e., activate the production growth and reduce the unemployment by a more indulgent monetary policy and incitement of the inflation¹. The other approach shows the two types of cycles depending on the ideological preferences of the party at power: the left-oriented forces are more inclined to stimulate of the aggregate demand, and, hence, the inflationism, while the right-oriented ones are, rather, inclined to the macro-economic stability². As the democratic processes and procedures are developing in Russia, and the clear dependence of the economic life upon the political one shows itself, the natural issue arises: whether such models are usable to explain the causal relations and, in a more general manner, whether any stable relations even exist.

Of course, when speaking of Russia, one can only come to a very approximate analysis. The 1996 Presidential elections were, in essence, the first to any extent politically significant ones. In 1991, the elections were for the President of a republic forming a part of the USSR, without real economic or political sovereignty. The Parliamentary elections of 1993 and 1995 could not, either, be considered significant for the economic life, due to the very limited possibilities for the legislators to influence the formation and implementation of the economy course.

¹ Nordhaus W. The Political Business Cycle // *Review of Economic Studies* 42 (April). 1975; Rogoff K., Sibert A. Equilibrium Political Business Cycles // *Review of Economic Studies* 55 (January). 1988; Persson T., Tabellini G. *Macroeconomic Policy, Credibility and Politics*. 1990: Harwood Academic Publishers.

² Hibbs D. Political Parties and Macroeconomic Policy // *The American Political Science Review* 7 (December). 1977; Alesina A. *Macroeconomics and Politics* // NBER Working Annual. Cambridge: MIT Press, 1988; Alesina A., Roubini N. *Political Cycles in OECD Economies*. NBER Working Paper. 1990. N3478.

Nevertheless, the influence of the elections to the State Duma on the Russian economic policy shows a certain interest for an analysis. Our previous researches have shown the presence of a distorted political and business cycle as applied to the correlation between the Parliamentary elections and the Government course³. As for the experience of 1993-95, a stricter macro-economic (first of all, financial and monetary) policy was characteristic before the elections, while the populist trend in the Government's activity became stronger immediately after them. Thus, in autumn 1993 and during the whole year 1995, the executive power was taking, more or less consecutively, a whole set of measures of orthodox stabilization; this reduced the popularity of the Government and reflected itself on the results of the Parliamentary elections. On the contrary, in 1994, after the defeat of the reformers at the elections, the Government tried to follow the way of the "non-monetary methods of struggle against inflation". This resulted, the same autumn, in an aggravation of the economic crisis and forced the Government to return to the orthodox stabilization measures for the pre-election period.

The exclusive role the Russian Constitution gives to the President, including the practically unlimited possibilities in selection of the economic course and formation of the Government, as well as the fact itself of existence of the realistic political and economic alternatives predetermined the dependence of all the aspects of the 1996 economic life on the June elections. Moreover, this influence turned out more complex than one could suppose and showed itself much longer than the first six months of the year forming the pre-election period itself.

First of all, from the very beginning, the issue of the pre-election economic course surged, or rather the issue of the effect of the electoral struggle on the policy of the Federal power. The second issue, not less important, was the one of the expected changes of the policy after the Presidential elections. Thirdly, the economic decisions dictated by the election reflections effected the economic evolution for the period after the elections. At last, fourthly, the illness of Boris Yeltsin immediately after the elections extended the actual election period, in what concerns both the inconsistent character of the economic policy of the Government and the possibility of the new, before term, Presidential elections. In other words, the Presidential elections became a most important factor of the Russian economic life and policy for the whole year 1996. This influence continues in 1997, as well.

1.1. Political Incertitude and Economy

The incertitude is the most characteristic feature and, at the same time, the most general problem of the economical and political life of the electoral period. Moreover, the incertitude as a socio-economic factor of the 1996 evolution in Russia differs significantly from the common electoral incertitude characteristic for the market democracies. This is due to the insufficient experience of participation in the elections, and, hence, forecast of their results, as well as with the absence of the confidence, so characteristic for the today's western societies, in the solidity of the democratic process; all these allow to think about any current elections as about episodes in the political life of a country. The feeling that the 1996 elections could become the last free elections in the foreseeable future was an important factor forming the economic behavior in Russia.

However, within the framework of our analysis, the problem of the pre-election incertitude is narrower. We speak of the pre-election incertitude effecting the economic policy of the Government, for the one hand, and the behavior of the economic agents, for the other hand.

³ Mau, V., Sinelnikov-Murylev S., Trofimov G. **Macro-Economic Stabilization: Trends and Alternatives of the Russian Economic Policy**. Moscow: IET, 1996. P. 46-53.

From the viewpoints of the both sides (Government and economic agents) of the economic and political process, the pre-election incertitude showed itself in at least three aspects.

First of all, it was the incertitude itself. It is important that the standard criteria based on the runners ratings did not favor the clarity of the situation in the Russian electoral campaign at all. From the very beginning the only thing was clear that the elections would be, most probably, bipolar (without accounting for the ambiguous position of Aleksandr Lebed) and that the main struggle would be between B. Yeltsin and Guennadi Ziuganov. Formally, the development went on from January when Ziuganov's popularity was much higher than the Yeltsin's one to May when the ratings of the both runners became practically equal (see Table 1.1).

However, the situation was significantly complicated by the answers to the question characteristic for the political life of the today's Russia: in the same polls where most Russians preferred Ziuganov, a significant share of the voters (approximately equal to the CPRF's electorate) was sure that, in any event, the acting President would safeguard his power⁴. To the above, the rumors not stopping up to the end of June (i.e., even after the first round) on a possible coup d'etat, with the consequences vague for Boris Yeltsin himself and for his economic policy. This aggravated the incertitude, both as for the elections results and for the economic policy which could have been carried on by the non-legitimate regime at power.

Table 1.1.

**Results of answer to the question:
“If Yeltsin and Ziuganov get to the second round of the elections, for which would you
vote?”, (% of polled)**

Terms of field	Yeltsin	Ziuganov	Against both	Undetermined yet
19 - 22.01.	17.7%	33.3%	21.7%	27.3%
16 - 19.02	20.9%	33.5%	21.5%	24.1%
7 - 11.03	24.4%	32.3%	21.3%	22.0%
22 - 25.03	28.9%	30.0%	16.7%	24.4%
5 - 8.04	28.4%	29.3%	17.6%	24.7%
19 - 22.04	31.1%	28.7%	17.0%	23.2%
1 - 5.05	36.9%	30.8%	14.6%	17.7%
17 - 20.05	39.7%	29.2%	12.3%	18.8%
31.5 - 3.06	43.0%	28.3%	11.4%	17.2%
7 - 10.06	44.6%	30.3%	10.7%	14.3%
18 - 20.06	46.0%	29.5%	5.1%	19.4%
21 - 24.06	45.9%	25.5%	5.9%	22.7%
25 - 27.06	44.6%	26.9%	6.3%	22.1%
28 - 30.06	45.0%	29.8%	6.3%	18.9%

Source: Presidential Elections of 1996 and Public Opinion, Moscow, VCIOM, 1996. pp. 109, 113.

Secondly, the outlooks for the post-elections economic policy seemed vague, as well. Of course, in general, one could suppose the safeguard of the existing course in the event of the B. Yeltsin's victory or the transition to the left nationalist model (combination of strict protectionism with attempts to stimulate the demand by the money printing) in the event of the G. Ziuganov's victory⁵. But the refusal, up to the end of May, of the both runners to publish their economic programs, the ambiguity of the declarations of the left economic

⁴ Levinson A. Will of Electorate and Expectations of People // Ethics of Success. Tiumen'-Moscow. 1996.

⁵ See the comparison of the alternative models of the Russian policy in the IET's review "Russian Economy in the First Half of 1996. Trends and Outlooks".

advisors combined with the extreme medley of the acting President's team gave no clearness as for the outlooks for the economic course.

Thirdly (especially in the first quarter of 1996) the problem of the character of the B. Yeltsin's pre-election economic policy stayed unsolved. Furthermore, this incertitude related to not only the economic agents, but the Members of Cabinet, as well, because everything depended, finally, on the choice of the Head of the State. The political heterogeneity of the executive structures, the coexistence therein of the adherents to not only different, but opposite political and economic doctrines, the contradictory declarations of B. Yeltsin himself at the beginning of the year, the aggravation of the struggle between his nearest supporters, capable to bring in the most unexpected results, including the dismissal of the Prime Minister just before the elections - all these increased significantly the incertitude of the course and put the Government in an ambiguous position.

The situation of the economic and political incertitude influenced both the behavior of the economic agents and the policy of the Government. The issues of this strategic interaction are discussed with more detail below.

1.2. Parliamentary Elections of 1995 and Financial Stabilization

The role of the State Duma in the formation of the economic policy is limited enough. The main tools of influence of the lower Chamber on the executive power include the approbation of the Prime Minister, the possibility of distrust to the Government, and the legislative (first of all, approval of the Federal budget) practice itself. Nevertheless, all the above forms of the legislative activities are efficiently counterbalanced by the President: the President submits for approval the Head of the Government, has the choice between the Cabinet dismissal and the Parliament dissolution in the event of distrust, and, at last, the President, using vetoes and decrees, can efficiently influence the economic life in the event of his or her disagreement with legislative acts. It should be also noted that the 1993 Constitution relates the formation of the new Cabinet not to the Parliamentary, but to the Presidential elections.

Within this Constitutional framework, the electoral struggle of 1995 did not become a factor significantly influencing the economic evolution. Despite certain forecasts, the participation of the NDR, the party at power, did not result in any significant correction of the financial stabilization policy. No additional expenditure decisions for the Budget were implemented, no sharp unforeseen growth of the State Debt or acceleration of the monetary mass occurred.

As a result, the macroeconomic stabilization program planned for 1995 could be implemented. In 1995, the Federal Budget deficit made 2.9% of the GDP against the 10.9% of 1994, and was financed from the interior sources for 1.41% of the GDP (moreover, no direct credits of the Central Bank to the Government were used) and from the exterior sources for 1.53% of the GDP. Taking into account the expenditures on servicing of the State interior debt (complete estimate of the secondary deficit), the Budget deficit made 4.2% of the GDP (see Table 1.2).

Table 1.2

Execution of Russian Federal Budget in 1995 (% of GDP)

	1.02.95	1.03.95	1.04.95	1.05.95	1.06.95	1.07.95	1.08.95	1.09.95	1.10.95	1.11.95	1.12.95	1995
Incomes												
Tax on profit	1.7	1.8	2.2	2.6	3.0	2.8	2.7	2.9	2.7	2.6	2.5	2.5
Income tax	0.0	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
VAT, special tax, excise tax	7.0	6.1	5.8	6.0	5.8	5.7	5.8	5.5	5.5	5.9	6.0	5.8
Tax on foreign trade and foreign	0.9	1.3	1.4	1.7	1.7	1.6	1.6	1.5	1.5	1.5	1.5	1.5

economy transactions												
Other taxes, levies, and payments	0.4	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.5	0.4	0.4	0.3
Total taxes and payments	10.0	9.6	10.0	11.0	11.2	10.8	10.7	10.5	10.4	10.6	10.6	10.3
Non-tax inflows	2.0	3.0	3.2	2.9	2.4	2.1	2.1	2.1	2.2	2.1	2.6	2.5
Total incomes	11.9	12.6	13.2	13.9	13.7	13.0	12.9	13.3	13.4	13.5	14.0	13.7
Expenditures												
State administration	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
International activities	0.7	0.7	0.6	0.8	0.8	1.1	1.1	1.0	1.0	1.0	1.2	1.3
National defense and law enforcement	2.4	4.1	4.5	4.6	4.6	4.3	4.1	3.8	3.6	3.8	4.2	4.1
Fundamental research	0.1	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Services to national economy	1.4	2.0	2.7	2.3	2.7	2.7	2.4	2.4	2.2	2.3	2.3	2.2
Social services	0.5	0.9	1.2	1.0	1.3	1.3	1.2	1.1	1.1	1.1	1.2	1.1
Servicing of State Debt	2.4	1.4	2.1	3.2	2.1	2.0	1.9	1.6	2.4	1.6	1.5	1.5
Aid to other power levels	1.0	1.4	1.7	1.6	1.5	1.3	1.2	1.2	1.2	1.7	1.8	1.8
Other expenditures	1.7	1.2	1.0	0.9	1.3	1.3	1.6	2.2	2.3	2.1	2.5	2.6
Total expenditures	10.5	12.3	14.5	15.3	14.9	14.6	14.1	13.9	14.4	14.2	15.3	15.2
Loans minus repayments	3.3	1.5	1.8	1.8	1.5	1.6	1.5	1.3	1.6	1.6	1.3	1.4
Expenditures and loans minus repayments	13.8	13.8	16.3	17.1	16.4	16.2	15.6	15.3	16.0	15.8	16.6	16.6
Budget deficit	-1.9	-1.2	-3.1	-3.1	-2.7	-3.1	-2.7	-1.9	-2.6	-2.4	-2.6	-2.9
Total financing, incl.	1.9	1.2	3.1	3.1	2.7	3.1	2.7	1.9	2.6	2.4	2.6	2.9
interior financing	0.2	1.5	3.8	2.9	2.4	2.2	1.8	1.2	1.9	1.4	1.4	1.4
exterior financing	1.7	-0.4	-0.7	0.3	0.3	0.9	0.9	0.7	0.7	1.0	1.2	1.5
Information: GDP (Rbl. trln.)	78.2	161.0	255.1	356.1	476.4	615.6	769.7	938.7	1110.7	1288.7	1469.7	1658.9
Budget deficit (accounting for the net servicing of the debt for the GKO)	-2.9	-2.1	-4.2	-4.2	-4.0	-4.4	-3.9	-3.1	-3.7	-3.5	-3.8	-4.2

Source: Ministry of finance, State Fiscal Service, Goscomstat of Russia.

Due to the continuation of the strict control over the monetary mass M2, in 1996, its growth made 32.5% against 126% in 1995 and 200% in 1994. As a result, the annual inflation reduced from 216% in 1994 and 131% in 1995 to 21.8% in 1996. Nevertheless, despite the successes of the first stage of the financial stabilization, the sluggish Budget crisis remained; it saw its expression in the continuing erosion of the tax discipline and growth of the tax arrears. As for the results of 1995, the tax arrears for the consolidated Budget amounted to 29% of the December GNP (17% of the month GDP for December 1994). The arrears for the Federal Budget grew up to 16% of the GDP (11% of the GDP for December 1994). In whole, the growth of the arrears for 1995 amounted to 2.4% of the annual GDP; in other words, if the arrears accumulated since 1992 are accounted for, the consolidated Budget could have received the additional 3.3% of the GDP in the event of their repayment (see Table 1.3).

Table 1.3.

Dynamics of Arrears for the 1995 Russian Federal and Consolidated Budgets.

Dynamics of arrears for the 1995 Russian Federal Budget												
	January	February	March	April	May	June	July	August	September	October	November	December
GDP (Rbl. trln.)	78,2	161	255,1	356,1	476,4	615,6	769,7	938,7	1110,7	1288,7	1469,7	1659
Total arrears (Rbl. bn.)	11319,6	12339,4	12884,8	16326,6	19444,2	20303,8	23491,4	28427,9	28368,2	30923,9	33807,5	30016,6
Inflation, % of December 1991	893,7	992,1	1081,3	1173,3	1265,9	1350,8	1423,7	1489,2	1556,2	1629,3	1702,7	1757,2
Increase of arrears	2050,2	1019,8	545,4	3441,8	3117,6	859,6	3187,6	4936,5	-59,7	2555,7	2883,6	-3790,9
GDP, monthly	78,2	82,8	94,1	101	120,3	139,2	154,1	169	172	178	181	189,2

Monthly increase of arrears, GDP	2,62	1,23	0,58	3,41	2,59	0,62	2,07	2,92	-0,03	1,44	1,59	-2,00
Increase of arrears, deflated	0,43	-0,23	-0,52	2,00	1,44	-0,33	1,47	2,59	-0,86	0,75	0,88	-2,77
Total arrears, deflated	12,67	12,44	11,92	13,92	15,36	15,03	16,50	19,09	18,23	18,98	19,86	17,08
Total monthly arrears, % of the GDP	14,48	14,90	13,69	16,16	16,16	14,59	15,24	16,82	16,49	17,37	18,68	15,87
Dynamics of arrears for the 1995 Russian consolidated Budget												
	January	February	March	April	May	June	July	August	September	October	November	December
GDP (Rbl. trln.)	78,2	161	255,1	356,1	476,4	615,6	769,7	938,7	1110,7	1288,7	1469,7	1659
Total arrears (Rbl. bn.)	19087,6	20055,0	20539,5	28508,6	38082	37705,0	40122,3	52685,0	51273,6	53694,4	63190,9	54995,7
Inflation	893,7	992,1	1081,3	1173,3	1265,9	1350,8	1423,7	1489,2	1556,2	1629,3	1702,7	1757,2
Increase of arrears	3974,7	967,4	484,5	7969,1	9573,8	-377,4	2417,3	12562,7	-1411,4	2420,8	9496,5	-8195,2
GDP, monthly	78,2	82,8	94,1	101	120,3	139,2	154,1	169	172	178	181	189,2
Monthly increase of arrears, GDP	5,08	1,17	0,51	7,89	7,96	-0,27	1,57	7,43	-0,82	1,36	5,25	-4,33
Increase of arrears, deflated	1,40	-1,14	-1,22	5,30	5,78	-2,17	0,27	7,20	-2,43	0,01	4,16	-5,81
Increase of arrears, deflated	21,36	20,22	18,99	24,30	30,08	27,91	28,18	35,38	32,95	32,95	37,11	31,30
Total monthly arrears, % of the GDP	24,41	24,22	21,83	28,23	31,66	27,09	26,04	31,17	29,81	30,17	34,91	29,07

Source: Russian Goscomstat, State Fiscal Service

Table 1.4

Dynamic of indebtedness of enterprises in 1995

	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Indebtedness for payment of labor remuneration (as of the end of the month), Rbl. bn	5534	5644	5687	5508	6037	6441	7158	8057	9913	11568	13569	13380
GDP (Rbl. trln.)	78.2	161	255.1	356.1	476.4	615.	769.7	938.7	1111	1289	1469	1659
GDP by months (Rbl. trln.)	78.2	82.8	94.1	101	120.3	139.2	154.1	169	172	178	181	189
Debtor's indebtedness as for the end of the month (Rbl. trln.)	158.8	173.8	197.7	223.3	245	263.6	285.1	303.1	326.5	333.8	353.9	362
Creditor's indebtedness as for the end of the month (Rbl. trln.)	186.8	206	237.6	268.3	290.2	324.2	349.7	368	406.8	434.4	454.8	482.8
Inflation (from	893.7	992.1	1081.3	1173.3	1265.9	1350.8	1423.7	1489.2	1556.2	1629.3	1702.7	1757.2

	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
December 1991)												
Indebtedness for payment of labor remuneration (as of the end of the month), % of GDP of the month	7.08	6.82	6.04	5.45	5.02	4.63	4.65	4.77	5.76	6.50	7.50	7.07
Debtor's indebtedness as for the end of the month, % of GDP of the month	203.07	209.90	210.1	221.09	203.66	189.37	185.01	179.35	189.83	187.53	195.52	191.33
Creditor's indebtedness, % of GDP of the month	238.87	248.79	252.5	265.64	241.23	232.90	226.93	217.75	236.51	244.04	251.27	255.18
Indebtedness for payment of labor remuneration (as of the end of the month), deflated	6.19	5.69	5.26	4.69	4.77	4.77	5.03	5.41	6.37	7.10	7.97	7.61
Debtor's indebtedness as for the end of the month, deflated	177.68	175.19	182.83	190.33	193.53	195.15	200.25	203.53	209.81	204.87	207.85	206.01
Creditor's indebtedness, deflated	209.01	207.65	219.73	228.68	229.24	240.01	245.63	247.11	261.40	266.61	267.11	274.76

Source: Goscomstat of Russia, Ministry for economy

It should be noted that, despite the decrease of the inflation rate in 1995, the profitability of the GKO's could not be reduced. In December 1995, the real interest in the GKO's-OFZ's market was 33% in annual expression. The temporal structure of the State debt in favor of the medium and long-term instruments⁶.

The non-payment crisis of enterprises continued growing gradually. As for the results of the year, the creditor's indebtedness in real indication grew by 31%, the indebtedness in payment of labor remuneration grew by 23%, and the debtor's indebtedness grew by 16% (see Table. 1.4).

The above data show that, in whole, the electoral campaign for the State Duma did not influence substantially the process of financial stabilization. The main negative result of these elections was that they gave a negative political signal, having shown that the public opinion had additionally shifted to the benefit of the left and nationalist forces. Besides, the new Duma which, according to the Constitution, could not be dissolved during the first year after election, got a good field for the populist activities, using them for both strengthening the propaganda of the oppositional electoral programs and for inciting the executive power to similar (but already practical) measures. Before the Presidential elections, the legislative process slowed down: for the obvious reasons, its efficiency was fully dependent upon the result of the Presidential elections.

1.3. Macro-economic Problems of Electoral Struggle of 1996

Alternatives of the economic policy before the elections

⁶ At the end of January 1995, the duration of the GKO's and OFZ's for all the issues was about 60 days, while in December 1995 it was 107 days, i.e., formally grew significantly. However, from the viewpoint of the debt servicing cost, the OFZ's should be considered short-term instruments, because the coupon rate depends on the current profitability of the GKO's. Hence, more indicative is the insignificant change of the GKO's duration from 47 days as of the beginning of the year to 67 days as of its end.

Based on the fact itself of the pre-elections uncertainty and taking into account the absence of a real experience of the economy functioning under the conditions of politically significant elections, one could suppose that, in 1996, in Russia, the conditions maximally corresponding to the “electoral short-sightedness of the electorate” (including the economic agents we discuss) would form. For the one hand, the voters did not have experience of participation in politically significant elections and it seemed they could not fully realize the responsibility for their results. For the other hand, practically all the runners participated in free Presidential elections for the first time, as well. Hence, the voters could not compare the promises of the runners with the real policy of the previous years. The latter was true for the CPRF, as well, because it had had, in the visible past, no experience of the economy management in market conditions. For the first glance, the absence of the political experience must mean the “short-sighted behavior” being the most important prerequisite of the “political-business cycle by Nordhaus”. However, the real course of events does not give reasons to accept this thesis, and, hence, unequivocally use this model of the economic policy formation. Let us discuss this issue in more detail.

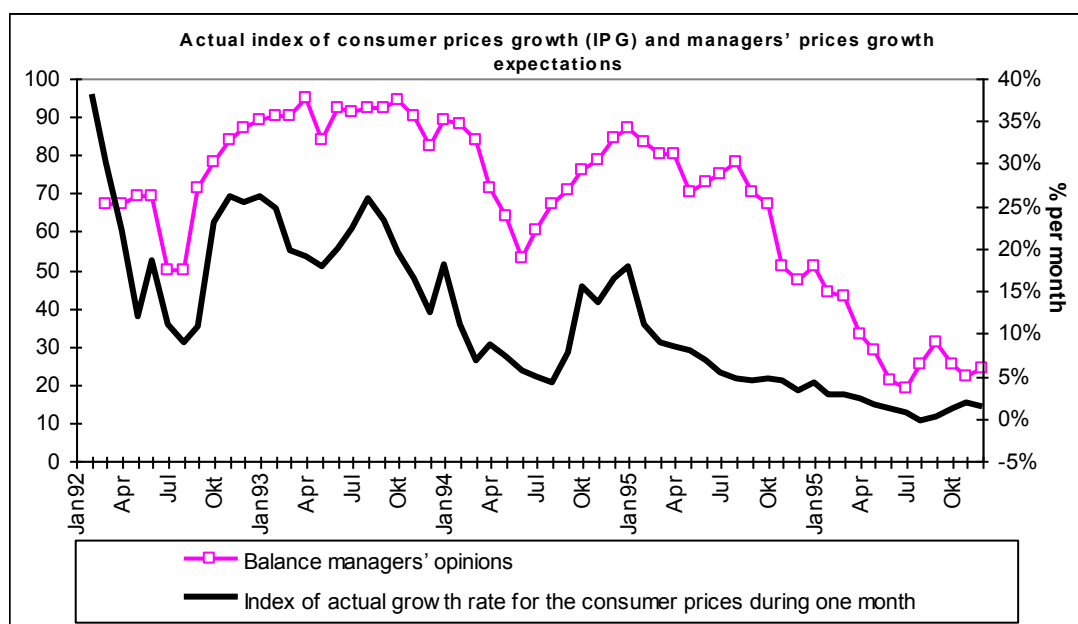
The economic policy expected for the beginning of 1996, was the inflationism resulting from both the pre-elections policy of Yeltsin and the possible post-elections policy of Ziuganov. Certain factors allowed to expect a sharp growth of the populist accents in the activities of B. Yeltsin. Moreover, these factors were understandable for the voters in whole and the economic agents in particular.

First of all, the cadre President’s solutions of January-February 1996 were significant, namely: the dismissal of A. Čubais who had symbolized the strict stabilization course; the actual weakening of the political position of the Prime Minister having implemented this course; and the strengthening of the roles of O. Soskovets and N. Yegorov, advocates of the inflationism and protectionism policy. This brought from the memory the process of 1994, when the Duma elections success of the left forces incited the President to reject the stabilization course implemented by Ye. Gaidar and B. Fedorov in autumn 1993. It seemed the situation could repeat. Moreover, it was B. Yeltsin himself to be elected, i.e., the logic of the electoral inflationism corresponded to the logic of decisions-making in the “inside-out political-business cycle”.

This conclusion was supported by the results of the Duma elections. During them, the Governmental course to the macro-economic stabilization was opposed by the forces proposing the two though interrelated but different alternative variants of the economic policy: the inflationist (left) and the protectionist (right) ones. At the elections, the obvious victory came to the followers of the first variant, including, for the obvious program reasons, the CPRF, the agrarians, and “Yabloko”. Many partisans of the inflationist course were also in other fractions, including the pro-Government NDR.

At last, the tonality of the B. Yeltsin’s electoral campaign having begun in February clearly showed his inclination to the economic populism. The travels in regions, accompanied with the promises of significant money payments, the obviously populist campaign for the payment of the labor remuneration debts (without delimiting between the debts of the Federal Budget, local budgets, and enterprises to their workers), the sudden proposal to allot Rbl. 16 trln. from the Federal Budget to Chechnia - all these and other decisions were to launch the inflation mechanism if implemented.

Fig. 1.1



Differences in behavior of economic agents in financial and goods markets

A standard reaction on the declaration of the power on the possible money expansion should be the growth of the inflation expectations and the relevant change of the pricing policies of corporations (amended contracts). Nevertheless, this did not happen in a direct way: the enterprises did not follow way usual for such event of the prices growth accounted for in the contracts.

E.g., the polls (carried out during the last year) of the managers of enterprises as for their own activities and behavior of their counter-agents showed a stable trend toward the decrease of the inflation expectations; moreover, the actual decrease has turned out deeper than the expected one. The above conclusion does not exclude certain hesitations; nevertheless, the above lie within the limits of the possible measure errors. In spite of that, in such event, the fact is characteristic that the expected (in contrast with the actual) prices growth comes out not in the pre-elections period, but in the 1996 autumn, thus reflecting the seasonal growth of the inflation index. Anyway, the electoral struggle in no practical way influenced the inflation expectations. This shows the formation of very rational behavior stereotypes of the economic agents whose activities are oriented rather toward the indexes of the Governmental macro-economic policy than toward the promises of various politicians. (see Fig. 1.1). The above figure shows the prices growth expectations index based on the monthly polls (carried out by IET since 1992) of the industrial enterprises following the relevant representative panel⁷.

The regression analysis reveals the presence of a significant correlation between this index and the actual inflation ($R^2 = 0,65$, F-statistics: 96.8, t-statistics for the variable: 9,84 и -4,01 for the free term). The year 1996 showed a stable decrease of the inflation expectations except the above autumn surge corresponding to the growth of the actual inflation.

The same is shown by the comparisons of the inflation estimates based on the regression model⁸, accounting for the actual prices growth trend. The first half of 1996 showed a stable

⁷ Tsukhlo S., Gerschmann. R. Situation in Industry // Economis and Political Situation in Reussia: June 1996. Moscow, IET, 1996 P.10.

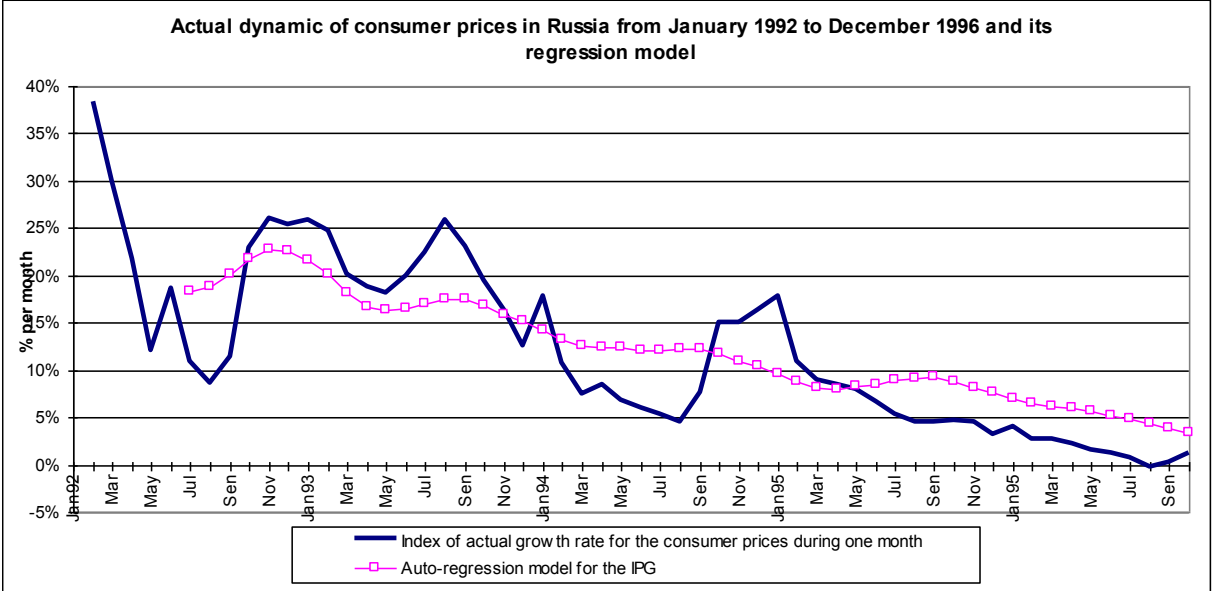
⁸ See Russian Economy in the first Half of 1996. Trends and Outlooks. Issue 15. Moscow, IETR, 1996. P. 57; Mau V.A., Sinelnikov S.G., Trofimov G.Yu. Economic Policy Alternatives and Inflation in Russia // Communist Economies and Economic Transformation. 1996. Vol. 8. N 3. P.307, 313.

The analysis of the relationship between the money mass M_2 and the actual inflation level from June 1992 to December 1996 has allowed to form the following dependence:

discrepancy between the forecast of inflation based on the dynamics of the monetary mass and the actual trend, while the latter shifted toward the lower values. As the deviation of the actual inflation from the monetary forecast may be interpreted, at certain conditions, as the dynamics of demand of economic agents for the real cash remnant,⁹ the above may also lead to the conclusion that the pre-elections acceleration of the inflation had not been expected (see Fig. 1.2).

The rational behavior of the economic agents has shown itself, the most obviously, in the exchange market. Under the political uncertainty, it was quite natural to expect an aggravation of the investment crisis; indeed, the latter characterized the first half of 1996. Nevertheless, at a conservative enough attitude to the investment activities the activities of the economic agents show the obvious enough trend to the “anticipation”, the readiness to take part in the more risky transactions supposing the capacity of an effective pursue of the political situation. From this viewpoint, the activation of the stock market observed since march was an unexpected though a well explainable phenomenon. I.e., it began at the time when the trend to the growth of the B. Yeltsin’s rating in the public opinion polls showed itself (see Fig. 13 and Table 1.1).

Fig. 1.2



The dynamic of the stock market in the pre-elections period reveals the two significant moments. The first one is end of March when, following the publishing of the results of the public opinion polls, the slow growth of the business activities began. The second one is the end of May showing the sharp activation coinciding with the turn of the public opinion in favor of B. Yeltsin.

Of course, the economic role of this dynamic should not be overestimated. The very narrow limits of the Russian stock market (in the absolute indication and as compared with the GKO market) do not allow to speak of any serious scales of the absolute risks. Moreover, as one can

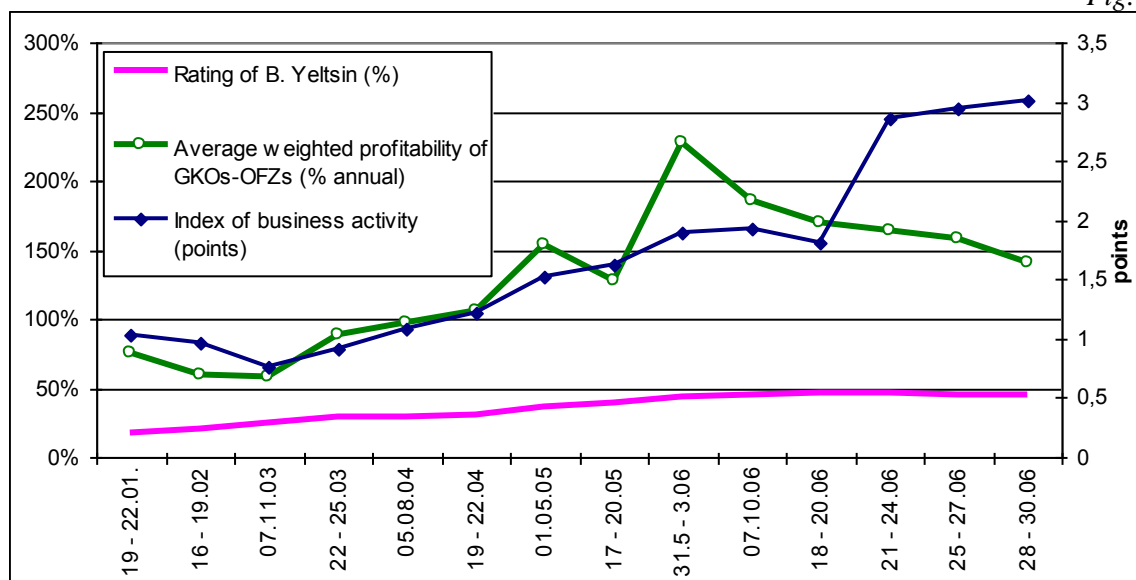
$$\pi_t = a\pi_{t-1} + bm_{t-6,t-1} + \varepsilon_t,$$

where π_t is the inflation in the month T, $m_{t-1,t-6}$ is the average rate of growth of the money mass for the precedent six months, ε_t is the random variable reflecting the influence of the inflation expectations and the effect of the non-monetary factors. As for the regression parameters the following estimates were obtained: $a = 0.7394$, $b = 0.2771$. The multiple regression factor is as follows: $R^2 = 0.879$, the values of the t-statistics are 11,12 for the a parameter and 3,61 for the b parameter.

⁹ Of course, to interpret the shifts of the actual data from the estimates of the retro-prognosis, one needs to understand that these shifts include not only the errors resulting from the undue account for the demand for the money but also the errors relative to the modelling of the lags structure.

judge, the main agents in the corporate papers markets are the foreign investors whose share of investments in Russia is not large; hence the low level of risk. However, even with the above side effects, the dynamic of the stock market is quite indicative, showing the adequacy and rationality of the behavior of economic agents in the situation of the political uncertainty.

Fig. 1.3.



To generalize the above, the conclusion can be made that, judging by the real process of events, the behavior of the economic agents reflected clearly enough their understanding of the inflation mechanism. The economic agents well estimated the macro-economic situation, taking into account that the monetary power had enough reserves to hold the inflation under control for a long enough time (at least till the end of the year), the ratio of forces in the Government, and the limited possibilities of its inflationist wing, made some rational steps to ensure themselves against risks resulting from the risks aimed to anticipate the longer term consequences of the inflationist policy and (or) the political changes possible as results of the Presidential elections.

The political risks consisting in the possibility of the communist restoration had the maximal influence on the State bonds and foreign currencies markets situations. The dynamic of the inflation expectations showed that the economic agents understood the variants of the actions of the Government and the limitations of its policy. The relative independence of the inflation from the political processes may be explained by the differences in the mechanisms linking the risks estimations and the dynamic of the relevant parameters. The high level of the half-year risk in the first half of 1996 incited the change of the financial portfolios structure in favor of the US\$ assets. The inclination of the economic agents to reduce the shares of the Ruble deposits and State bonds while increasing the share of the cash and non-cash hard currency resulted in the sharp growth of the interest rates and higher pressure on the exchange rate. This is confirmed by the data on the hard currency purchase by the population in the dynamic of the exterior reserves. Thus, the share of purchase of the cash hard currency in the expenditures of the population grew from 12.8% as of December 1995 up to 16.9% as of June 1996. At the same time, the share of the population's expenditures directed to the growth of the accumulations in form of deposits and securities dropped from 7.3% as of December 1995 down to 3% as of June 1996. (see Table 1.6). The decrease of the net exterior international reserves from US\$ 5.9 bn as of December 1995 down to US\$ 4.1 bn as of June 1996 and to US\$ 2.5 bn as of November 1996 is also significant.

At the same time, the high risk of alteration of the monetary policy in the second half of 1996 (in the event the candidate of the opposition wins the Presidential elections) did not influence or influenced in a low extent the expectations of the future inflation, and, hence, the level of the real cash balances and prices in the electoral period. The level of demand for money in the first half-year continued growing despite the approaching elections, though, maybe, faster than it could be in a normal political system.

We believe that the difference of the intensity of the reaction on the political incertitude is due to the fact that the first effect of the alteration of the portfolios structure was due to the economic agents acting based on the choice of the optimal structure of savings, while the second process of the change of the demand for money was relative to the change of the general demand for the consumer and investment goods. While the precautionary measures in the field of change of the savings structure can be realized relatively quickly and without significant transaction costs, the reduce of the demand for money at the anticipation of the inflation growth needs more serious and expensive decisions. At the same time, the currency and money markets react on the changes or anticipated changes of the economic policy much quicker than the commodities markets (due to the commodities stocks, inertia of contracts, etc.). In the other words, the crisis of the currency and money markets may immediately follow the transition to the proinflationist policy. Yet, this does not mean a sharp and unexpected beginning of the inflation. The possible inflation of 1996 could have been foreseeable for the economically active agents, and, hence, harmless for them. Hence, without the precautionary measures for the event of a sharp transition to the proinflationist policy, the risk of loss for the savings of the economic agents placed in the financial and currency assets is much higher than the risk of the losses from the inflation tax on the real cash balances.

Pre-election situation of the State securities market

The market of the State bonds turned out the most sensitive to the political incertitude situation. Here, the relatively low inflation expectations, the comprehension of the impossibility of the sharp changes of the macro-economic situation within the framework of the pre-elections half-year, and the fear of a radical alteration of the economic situation after the elections showed themselves clearly.

As of the beginning of 1996, the aggregate volume of the circulating GKO and OFZs reached Rbl. 76.5 trln. (see Table 1.5). The average profitability to redemption, calculated after the aggregated data, was 94% annual at the moment. The first half of January showed the trend to the decrease of the GKO and OFZs profitability. The quotations growth is explained by the moderate, if compared with December, volumes of new issues in January and the before term redemption of certain issues of the GKO and OFZs by the Ministry of finance. As itself, this fact means that the Ministry of finance wanted to revise the temporal structure of the GKO portfolio in order to reduce the costs of the interior debt servicing. To the last week of the month, the average profitability for the issues with the maturities 30 to 90 days was 4.3% per month, which was close to the inflation level of January. In some extent it was explainable by the decision to accept, in February 1996, foreign investors to the GKO-OFZs market. As of the beginning of February, the expected rate of profitability for all the issues was 82.7% with 56.2% as of the end of the month.

Nevertheless, from the mid-March, the growth of the GKO quotations was replaced by the opposite trend of a sharp growth of profitability, due, firstly, to the decrease of the Budget incomes in the first two months of the year and, secondly, to the necessity to make, in March and April, large redemptions of the preceding issues (see Fig. 1.4). Both these factors induced a new turn of expansion of the GKO offer. The amounts of the necessary redemptions in May turned out much lower than in the previous months; nevertheless, a significant growth of the

social expenditures necessary for the electoral struggle took place. This predetermined the high cost of loans in the domestic market.

Table 1.5

	Average weighted rate of profitability for the GKO-OFZs in the secondary market (% annual)	Volume of the GKO-OFZs in circulation as of the end of the month (Rbl. bn)	Growth of the volume of the GKO-OFZs in circulation	Duration as of the end of the month (days)
Dec. 1994		10443.80		58.03
Jan. 1995	256.00%	13564.25	29.88%	59.72
Feb. 1995	220.56%	17095.73	26.04%	61.28
Mar. 1995	187.23%	21477.99	25.63%	73.19
Apr. 1995	145.59%	25329.77	17.93%	70.06
May 1995	111.54%	31973.66	26.23%	77.75
Jun. 1995	84.15%	36609.86	14.50%	74.15
Jul. 1995	124.88%	39271.58	7.27%	73.77
Aug. 1995	156.67%	43468.97	10.69%	70.92
Sep. 1995	103.68%	50186.04	15.45%	87.08
Oct. 1995	93.45%	58525.87	16.62%	88.13
Nov. 1995	86.73%	67343.46	15.07%	94.88
Dec. 1995	93.92%	76496.28	13.59%	107.36
Jan. 1996	82.72%	81140.97	6.07%	97.30
Feb. 1996	56.24%	89961.78	10.87%	147.65
Mar. 1996	87.11%	106731.84	18.64%	156.44
Apr. 1996	130.02%	121243.04	13.60%	151.64
May 1996	161.74%	141172.78	16.44%	133.64
Jun. 1996	230.16%	155715.10	10.30%	128.17
Jul. 1996	94.29%	170984.42	9.81%	135.76
Aug. 1996	86.58%	184947.12	8.17%	138.25
Sep. 1996	72.44%	197719.26	6.91%	140.87
Oct. 1996	67.80%	212169.96	7.31%	145.57
Nov. 1996	45.62%	224698.42	5.90%	148.32
Dec. 1996	43.70%	233986.29	4.13%	150.16

The significant volume of the GKO redemption in April and the need for the money to finance the Budget made the Ministry of finance energetically place the new issues with the maturity date after the Presidential elections. The price of servicing of such issues grew sharply. Thus, in the mid-April, the auction rate grew up to 188.9% for the three-month and up to 235.1% for the six-month GKO, i.e., to the level of December 1995. At the same time, the ministry of finance had to reject up to 90% of the applications in order to avoid even lower quotations. The second half of April showed the growth of the profitability up to 245% and 271% (for the three-month and for the six-month GKO, respectively).

Fig. 1.4

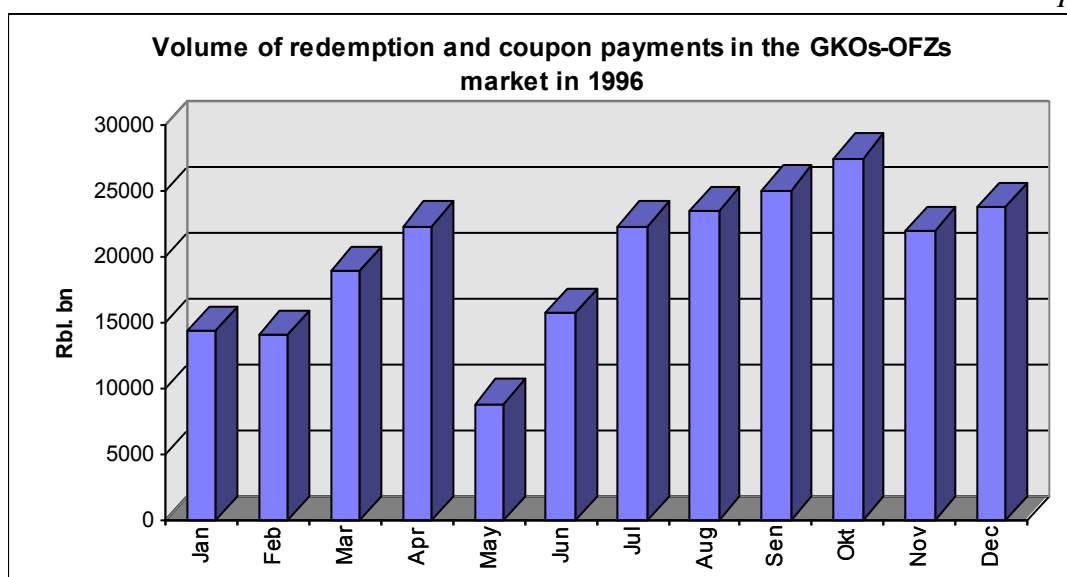
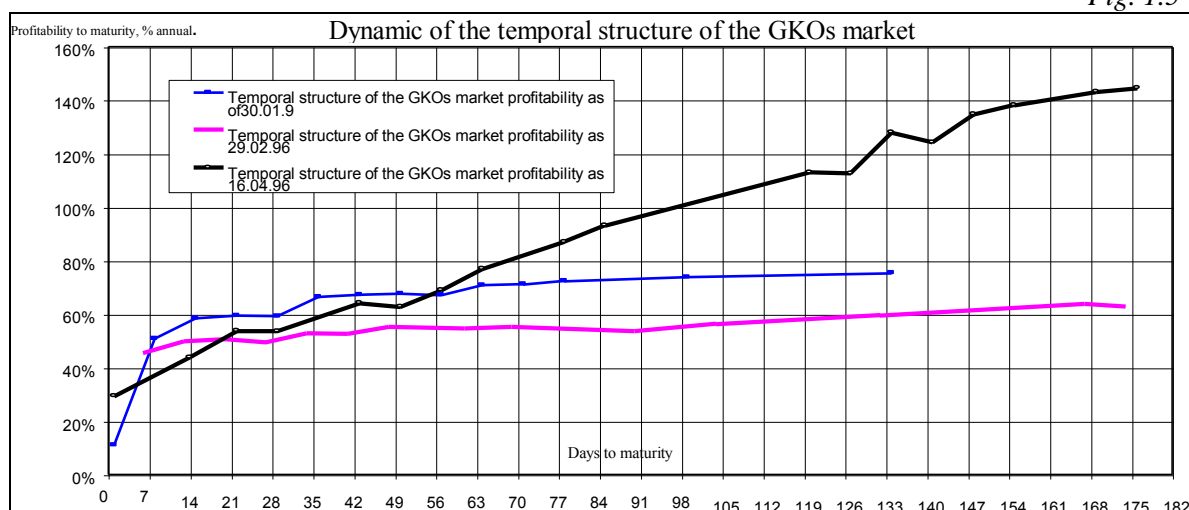


Fig. 1.5



Already in April, the profitabilities of the different maturities GKO issues well reflected the degrees of the political risks. The average weighted profitability for the bonds to be redeemed before 16 June was 40.6% annual. The profitabilities for the GKO with the maturity terms between the first and second rounds were at the level 58.4% annual. The profitability for the securities with the maturity date after 10 July was 89.6% annual (see Fig. 1.5).

Analyzing the dynamic of profitability of the GKO-OFZs at the end of May - beginning of June, three periods may be separated: 16 to 31 May; 1 to 14 June; and after the first round of the Presidential elections. The first period was characterized by the growth of the average profitability rate for all the issues from 160% up to 230% annual.

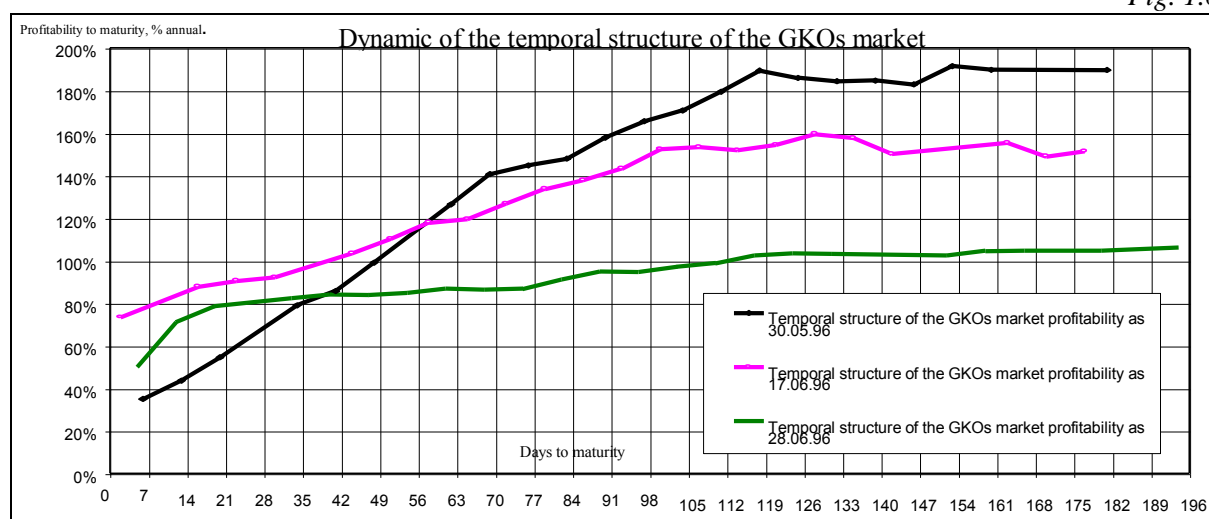
During the following fortnight the growth of the GKO profitability in the secondary market continued, though at much lower rates. We believe, this slow down was due to the growth of B. Yeltsin rating as candidate for Presidency (see Fig. 1.3).

Nevertheless, the average rates for the GKO continued growing due to the growth of the share with the maturity in the post-elections period. As of 12 June, the average rate of this market reached 240% annual. The peak of profitability was reached at the auction for placement of the six-month GKO of the 36th series, on 13 June (327.4%). This was due to

the lack of the Ruble assets conditioned by the dollarization of assets before 16 June (date of elections).

After the first round, the process of growth of the turnover and quotations of the State securities began. Already on 17 June, the average profitability of the circulating GKO-OFZs reduced compared with the last business day before elections (14 June) by 30% to 50% annual for various series. The results of the secondary tenders in the following days reflected the trend of further growth of prices for these securities. Thus, to the end of June, the profitability at maturity reduced to 70% to 110% annual for the three-month and 110% to 150% annual for the six-month GKOs, with the simultaneous reduction of the slope of the temporal profitability structure curve. The above situation is illustrated by the dynamic of the GKOs temporal profitability structure in June 1996 (see Fig. 1.6).

Fig. 1.6



During the period after the second round of the Presidential elections, the tendency to the growth of the State securities quotations increased. To the mid-July, the profitability for different series was at the level 60% to 100% annual.

All the above confirms our assumption that it is the securities (both State and corporate) market that became the most sensitive indicator of the political conjuncture before the elections. Already in the end of May, these markets signaled the probable victory of B. Yeltsin, though the rating of the two main runners had just become equal at the time. As for the June's approach of the profitabilities of the State securities with different maturities, in emphasized again the role of the political factors in the functioning of this market.

Situation of the currencies market before the elections

A significant moment from the viewpoint of implementation of the monetary program for 1996 was the Joint Declaration of the Russian Federation Government and Central Bank of 16 May "On the Policy of the Ruble Exchange Rate", fixing the new principles of control of the exchange rate. The second half-year 1995 saw the inclined corridor with the limits from 5,000-5,600 Rbl./US\$ as of 1 June to 5,500-6,100 Rbl./US\$ as of 31 December. The rate of the nominal fall in value of the Ruble was, hence, fixed within the limits 1.3% to 3% per month. Hence, for the whole 166, the growth of the official US Dollar exchange rate was fixed within the limits 18.5% to 31.5%; the actual rate was 19.8%.

The eve of the Presidential elections showed the process of redollarization of the economy. In such conditions, the value of the Ruble was to fall quicker than in the second half of 1996. But the RF CB pursued the currency policy intended to hold down the rates of the Ruble

nominal exchange rate decrease. The main reasons for this were the following: firstly, the danger of growth of the inflation expectations; secondly, the possibility of use by the opposition of the swift inflation of the national currency for the political purposes; and, thirdly, the necessity to sterilize the growth of the monetary mass due to the significant purchase of the State securities by the Central Bank. Due to this purchase, the growth of the net domestic assets was 41.7% in the first half-year. As a result, in the first half of 1996, the net international reserves decreased from Rbl. 27.3 trln. to Rbl. 21 trln. The fall of the NIA reached 23% during this period (see Table 1.16).

Table 1.6.

1995	Expenditures on purchase of hard currency (%)	Increase of savings in deposits and securities (%)	1996	Expenditures on purchase of hard currency (%)	Increase of savings in deposits and securities (%)
January	24,9	5,9	January	13,5	7
February	15	4,8	February	13,4	7
March	17,8	5,3	March	15,7	4,8
April	12,4	6,2	April	16,9	3,8
May	9,7	7	May	19	1,9
June	9,8	7	June	16,9	3
July	14,3	3,8	July	18,4	5,6
August	15,7	2,6	August	19,4	4,6
September	14,9	3,1	September	20,5	3,8
October	14,7	3,3	October	21,3	4,2
November	15,2	4,1	November	21,9	2,1
December	12,8	7,3	December	21,8	4,1

The stable demand for the hard currency, having broken the trend characteristic for the autumn and winter 1995 to the dedollarization of the economy reflected basically the expectations of the population inclined, in the conditions of political risk, to hard currency and not on the more profitable GKO. This process also confirmed the rational character of the activities of the economic agents adequately estimating the capacity of the power to support the general macro-economic balance before the elections but doubting the post-elections stability of the governmental course, notwithstanding whether due to the results of the elections (i.e., potential victory of G. Zuiganov) or exhaustion of the hard currency reserves.

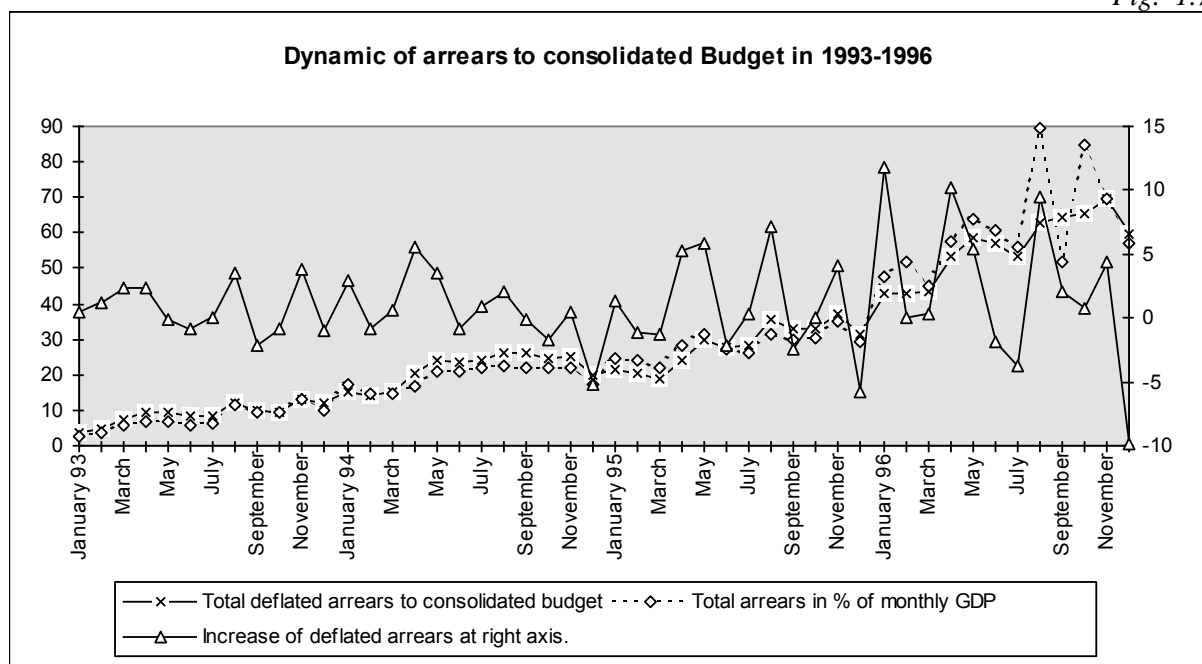
Fiscal behavior of enterprises

The crisis of the taxation system was one more important phenomenon of the pre-elections economy. The problem of the taxes non-payment did not come from 1996, either from the political (reaction on elections) or purely economic (mass actual collapses of enterprises and lack of money to pay the taxes) viewpoints. An attentive study of the tax arrears of the past years indicates the close links of this phenomenon with the political crises in Russia in general and the weakening of the Federal power, and limitation of the field of its possible manipulation in particular.

Beginning from the summer 1993 and up to the middle of 1994 the volume of arrears was sharply growing: it grew from the level of about 6% of the monthly GDP to 21% of the monthly GDP in June 1994. Besides, the monthly variation of the arrears growth grew. Further on, the relative stability of the share of arrears in the GDP was observed till the beginning of 1996.

The significant growth of the tax arrears began in January 1996 due to the two interrelated circumstances.

Fig. 1.7.



Firstly, the electoral campaign of the acting President (in January it was already clear that B. Yeltsin would take part in the elections) could not be accompanied by stricter actions of the executive power to the future voters. I.e., no decisive measures relative to the arrears were not foreseen. Moreover, by the non-payment of the taxes, the Government obtained the new mechanism of the electoral softening of the monetary policy, characteristic for the market economy countries

Secondly, the fiscal behavior of enterprises was influenced by the clear enough demonstration of sympathy by the CPRF ideologists to the non-payers of taxes to the “Government of national treason”¹⁰. This, combined with the reality of presidency of G. Ziuganov supported the relevant economic attitudes among the economic agents. It was understandable that in the event of victory of the CPRF the arrears would be, most probably, written off (this was fully within the ideology of the left forces on the necessity to help enterprises with replenishment of the circulating assets). Even in the event of victory of B. Yeltsin it was hardly possible to expect prosecution for the undue fiscal discipline¹¹.

So, enterprises, waiting for the elections, reduced the transfer of taxes to the Budget hoping for both the possible indulgence with the populist purposes during the electoral struggle, and the probable fiscal amnesty in the event of victory of the communist forces.

A certain reduction of the State incomes level in the first months of a year was characteristic for Russia since 1992¹². However, in 1996, the incomes were just falling down. In January 1996, compared with January 1995, the tax inflows to the Federal Budget reduced by 3.5% of the GDP (from 10.3% to 6.8%, see Tables 1.2 and 1.9), due, first of all, to the

¹⁰ E.g., on 9 April 1996, during the hearings in the State Duma on the issues of the socio-economic policy, T. Kariagina, economic counselor of G. Ziuganov, said literally the following, “It should be said also to the business people that everybody who is today even cheating, deceiving, evades tax paying, but is really a patriot of Russia, also a State supporter by nature, should not be afraid” (the communist coming to power).

¹¹ Ye. Yasin, Minister of economics, explained the tax crisis under the fierce electoral struggle and uncertain results of it as follows, “Some do not pay because they wait for theirs to come. Other do not want to create the financial basis for the communist if they come to power.”

¹² To a certain extent, this is explained by the purely technical condition: the order of accountancy for the so-called “final turnovers” of the Budget supposes to relate a share of the incomes coming in the first ten days of December to the December incomes. A certain role is played by the seasonal character of the tax inflows showing itself in a certain underestimate, compared with the actual, of the advance settlements in profit, the low activity in the external trade at the beginning of the year, and the significant number of the days off.

profit tax (by 1.5% of the GDP) and the taxes on goods and services (by 1.2% of the GDP). The tax inflows to the consolidated Budget reduced from 21.7% of the GDP in 195 to 14.4% of the GDP in January 1996.

In the first quarter of 1996, the incomes of the consolidated Budget were only 69.7% of the planned, incl. 62.8% for the tax inflows. In the first quarter of 1996, the tax inflows stayed at the level of January and February 1996 (16.4% of the GDP), i.e., by 29% lower than in first quarter of 1995 (23% of the GDP). In the second quarter-year, the situation with the taxes continued being determined by the coming Presidential elections and was characterized by the low tax inflows: 17.9% of the GDP in the first half of 1996 against 24.7% in the first half of 1995 (see Fig. 1.8). The reduction of the inflows to the Federal Budget went on similarly. In January to June 1996 the payments to the Federal Budget made 7.7% of the GDP against 10.8% of the GDP for the first half of 1995.

Fig. 1.8.

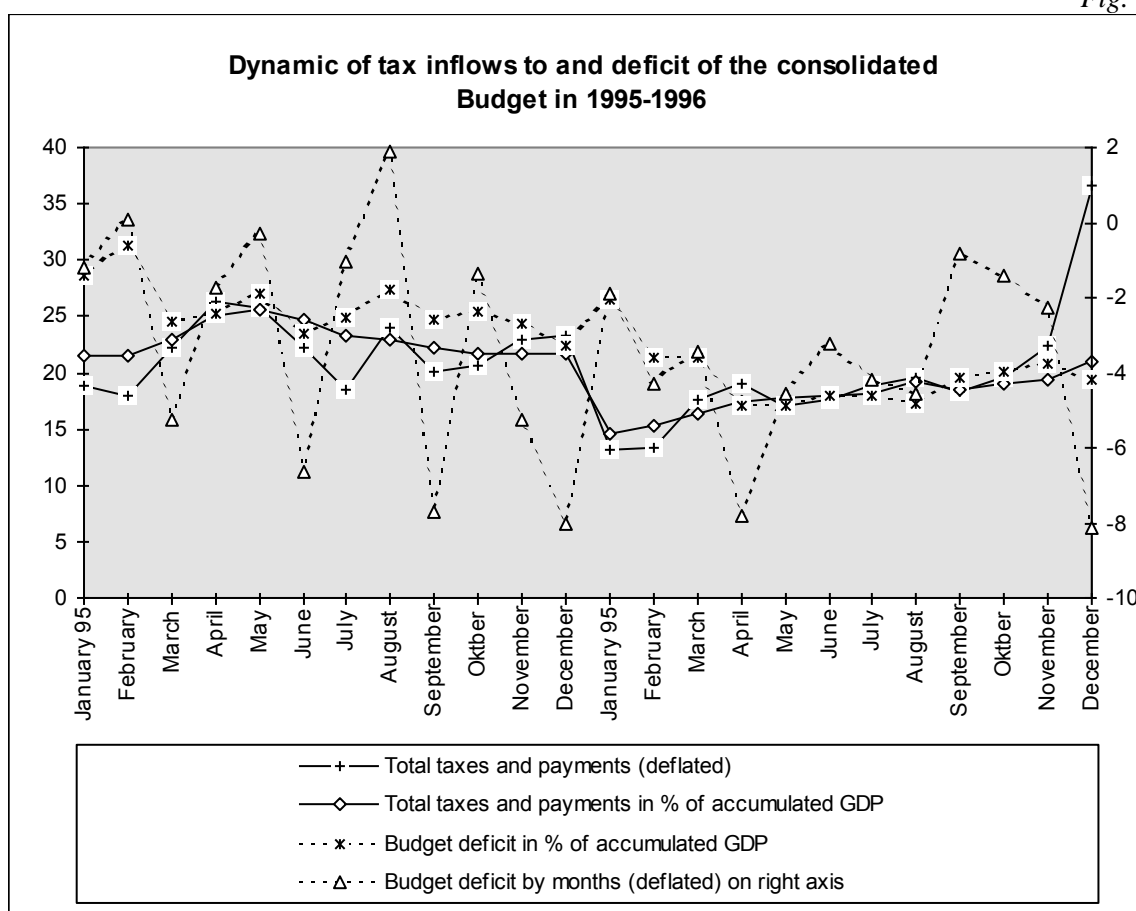


Table 1.7.

Dynamic of arrears to Federal Budget of Russia in 1996												
	Jan. 96	February	March	April	May	June	July	August	Sept.	October	Novem.	Decem.
GDP (Rbl. trln.)	166	322	508	691	876	1066	1260	1403	1659	1819	2031	2256
Arrears total. Rbl. bn*	44454.1	45818.2	48383.0	58938.5	61338.3	61430.9	62523.7	65804.4	72004.6	76884.7	78971.3	70532.8
Inflation in % to December 1991	1829.2	1880.4	1933.1	1975.6	2007.2	2031.3	2045.5	2041.4	2047.5	2072.1	2111.48 3	2141.04
Arrears increase	12958.2	1364.1	2564.8	10555.5	2399.8	92.6	1092.8	3280.7	6200.1	4880.1	2086.6	-8438.5
Monthly GDP	166	156	186	183	185	190	194	143	256	160	212	225
Arrears increase in % of monthly GDP	7.81	0.87	1.38	5.77	1.30	0.05	0.56	2.29	2.42	3.05	0.98	-3.75
Arrears increase deflated.	7.22	0.06	0.66	4.80	0.73	-0.32	0.32	1.67	2.93	1.94	0.30	-4.46

Arrears total in % of monthly GDP	26.78	29.37	26.01	32.21	33.16	32.33	32.23	46.02	28.13	48.05	37.25	31.35
Arrears total deflated	24.30	24.37	25.03	29.83	30.56	30.24	30.57	32.23	35.17	37.10	37.40	32.94
Dynamic of arrears to consolidated Budget of Russia in 1996												
	Jan. 96	February	March	April	May	June	July	August	Sept.	October	Novem.	Decem.
GDP (Rbl. trln.)	166	322	508	691	876	1066	1260	1403	1659	1819	2031	2256
Arrears total, Rbl. bn*	78717.9	80979.0	83740.8	105642	118040	115600	108655	127692	132311	135335	147138	128185
Inflation in % to December 1992	1829.2	1880.4	1933.1	1975.6	2007.2	2031.3	2045.5	2041.4	2047.5	2072.1	2111.	2141.04
Arrears increase	21928.4	2261.1	2761.8	21901.6	12398.5	-2440.8	-6944.9	19037.7	4618.9	3023.3	11803.7	-18953
Monthly GDP	166	156	186	183	185	190	194	143	256	160	212	225
Arrears increase in % of monthly GDP	13.21	1.45	1.48	11.97	6.70	-1.28	-3.58	13.31	1.80	1.89	5.57	-8.42
Arrears increase deflated	11.74	0.03	0.26	10.15	5.33	-1.90	-3.79	9.43	2.07	0.69	4.37	-9.81
Arrears total in % of monthly GDP	43.03	43.06	43.32	53.47	58.81	56.91	53.12	62.55	64.62	65.31	69.69	59.87
Arrears total deflated	47.42	51.91	45.02	57.73	63.81	60.84	56.01	89.30	51.68	84.58	69.41	56.97
* The arrears were calculated using the methodology differing from the one used before.												

Several factors of the reduction of the tax inflows may be separated¹³.

1) The main reason for the reduction of the Budget incomes was the growth of the tax arrears. The real volume of arrears for January 1996 (see Table 1.8) grew by 42.1%. However, in January, the RF State Fiscal Service changed the methodology of calculation of the tax arrears. If the older methodology is used to estimate the January growth, the calculations yield 18.1%; if the new methodology is used for the months compared it yields 35.7%. The accumulated volume of arrears to the consolidated Budget in constant prices grew by 37.4% in January 1996, compared with January 1995. It should be noted, that, in January 1995, the growth of the real volume of arrears made 3.5% for the Federal Budget and 7.1% for the consolidated Budget. To a large extent, this seasonal growth effect is due to the growth of the volume of the taxes charged in the first month of the following quarter-year; this leads to the growth of the arrears at the lack of liquid assets.

The quantitative estimate of the contribution of the arrears growth in the reduction of the tax inflows at the beginning of 1966 is also complicated by the lack of the information on the structure of the arrears growth. The latter, besides the taxes not transferred to the Budget for the liabilities of the current month, includes the penalties for the non-fulfillment of the fiscal liabilities of the previous periods.

The growth of the arrears was additionally activated by the badly thought over mechanism of grant of tax deferment fixed by the Presidential Decree of 19 January 1996. About 30,000 tax payers were granted the deferment. Not less important was that the indebtedness newly created in the first quarter of 1996 did not influence the decision on the deferment for the arrears accumulated before 1 January 1996.

However, even taking into account the change of the methodology, the seasonal character of their dynamic, and the mechanism of grant of the deferment, one can say that the growth of the arrears in January 1996 was conditioned by the high political incertitude and was an important factor for the taxation crisis.

2) The growth of the scales of the illegal evasion from the taxes payment in any ways, including, very important, by transactions sing cash and not reflected in the accountancy, also

¹³ A certain role here could have been played by the changes in the fiscal laws. In particular, on 1 January 1996, certain alterations of the fiscal legislation promulgated in 1995 took force: the tax on the excess of the labor remuneration over the normalized value and the special tax were abolished. According to our estimates, these changes were to reduce the tax inflows by 0.6% to 0.7% of the Gdp. Some other measures, e.g., relative to the simplified system of taxation and accountancy for the small businesses, changes of the VAT privileges list, could not have a great effect on the tax inflow.

became a factor of the tax inflows growth. An indirect confirmation of this is the growth of the share of cash in the money aggregate M2 in the first half year of 1996 by 2.5 percentage points (see Table 1.16).

3) Due to the serious enough growth of the debtor's indebtedness, the taxation basis for the profit tax and VAT reduced. As Table 1.8 shows, at the beginning of 1996, the volume of the debtor's indebtedness grew sharply (from 191% of the GDP in December 1995 to about 280% of the GDP in the first half of 1996). One of the possible factors having accelerated the growth of the mutual non-payments was the ban, introduced at the beginning of the year, to cut the electric power supply to consumers in the event they fail to pay the suppliers.

Table 1.8.

1996	January	February	March	April	May	June	July	August	Sept.	October	Nov.	Dec.
Indebtedness for payment of labor remuneration (as of the end of the month), Rbl. bn	20804	22488	24325	24748	28476	29926	33950	36022	40235	43110	46624	47151
GDP (Rbl. trln.)	166	322	508	691	876	1066	1260	1403	1659	1819	2031	2256
GDP by months (Rbl. trln.)	166	156	186	183	185	190	194	143	256	160	212	225
Debtor's indebtedness as for the end of the month (Rbl. trln.)	379,8	408,9	464,5	502,6	518,8	542,2	567	578,9	608,4	637,8	664,8	-
Creditor's indebtedness as for the end of the month (Rbl. trln.)	521,3	547,2	616,2	658,9	691,8	749,3	782,9	802	857,6	888,5	918,2	-
Inflation (to December 1991)	1829,2	1880,4	1933,1	1975,6	2007,2	2031,3	2045,5	2041,4	2047,5	2072,1	2111,5	2141
Indebtedness for payment of labor remuneration (as of the end of the month), % of GDP of the month	12,53	14,42	13,08	13,52	15,39	15,75	17,50	25,19	15,72	26,94	21,99	20,96
Debtor's indebtedness as for the end of the month, % of GDP of the month	228,80	262,12	249,73	274,64	280,43	285,37	292,27	404,83	237,66	398,63	313,58	-
Creditor's indebtedness, % of GDP of the month	314,04	350,77	331,29	360,05	373,95	394,37	403,56	560,84	335,00	555,31	433,11	-
Indebtedness for payment of labor remuneration (as of the end of the month), deflated	11,37	11,96	12,58	12,53	14,19	14,73	16,60	17,65	19,65	20,80	22,08	22,02
Debtor's indebtedness as of the end of the month, deflated	207,63	217,45	240,29	254,40	258,47	266,92	277,19	283,58	297,14	307,80	314,85	-
Creditor's indebtedness as of the end of the month, deflated	284,99	291,00	318,77	333,52	344,66	368,88	382,74	392,86	418,84	428,79	434,86	-

4) The growing process of the economy "barterization", the fast propagation of the multistep schemes of the cash-less mutual settlements of debts between suppliers and their customers is also a hypothesis explaining the causes of the tax crisis. Last year, the Russian Ministry of finance vigorously engaged in this process, using the treasury bonds, tax exemptions, commodities credit, etc. As a result, lots of enterprises act at minimal money, but the lack of the assets at the settlement accounts leads to the growth of the arrears to the Budget. The distortions of the prices used at settlements between the tax payers, Budget and recipients of the budgetary money lead to reduction of the taxation basis. However, the existing statistics does not allow to determine the range of these operations and their significance in the economy.

Hence, the taxation crisis in the economy, aggravated at the end of 1995 - beginning of 1996, turned out a complex phenomenon as for its consequences. Had everything been limited only by the influence of the elections, the taxes collection would, in the second half-year, have, more or less automatically, returned to, at least, the initial level. Nevertheless, the situation turned out quite different. The tax problem, having softened in the middle of the year, aggravated again in the autumn, as we will demonstrate below. The explanation limited to the political incertitude remaining due to B. Yeltsin's illness seems insufficient. Moreover,

the arguments on the low efficiency of the fiscal system, really requiring a deep and integral reform, are insufficient (though also true), either.

The massive evasion from the taxes payment, grown sharply in 1996, meant, at the same time, the beginning of the new stage of the taxation crisis. In 1995-1996, the scale of the so-called “negative selection” among the tax payers grew significantly. Before, the taxation breaches had been only methods for enterprises to reduce their expenses without influencing the general competition situation in the market. After this, the grown volumes of the taxation breaches and the numerous individual tax privileges brought to the situation when the observance of the fiscal laws puts the conscientious business people in the certainly disadvantageous conditions breaking the possibilities of efficient business activities. Before, a tax evasion or a tax privilege gave to enterprises the incomes above the medium level (this may be interpreted as the bonus for the risk of penalties). With the new practice, the observance of the fiscal laws does not ensure this medium level anymore. This is due to that the prices level is formed accounting for the dominating level of the tax evasion. The result is the negative selection: the conscientious tax payers are either pushed away from the market or (which is more frequent) assume the new rules of the game consisting in running for privileges, deferments and in simple tax evasion.

1.4. Government in Situation of Political Incertitude

Political factors of formation of electoral policy

The pre-elections behavior of the Government was determined by a series of factors of which some are universal for all the market democracies, while other are typical for the politically weak and inclined to populism regimes (these may be weak democracies as well as weak dictatorship), while the third factors showed themselves obviously in the specific situation of the elections in the post-communist Russia, basically important from the economic policy viewpoint.

In the most general form, the actions of the Government should have been aimed to the conservation of the Presidency for B. Yeltsin, as the basis for continuation of formation of the today’s Cabinet. Even more, this motivation should have been predominant for Viktor Chernomyrdin who had refused from participation in the electoral struggle in exchange for the understandable political guarantees. This is the motivation of the Prime Minister which is the most significant and has to be considered the expression of the aggregate position of the Government¹⁴.

The tools in the hands of the Government were limited enough and were reduced, almost completely, to the monetary and budgetary policies measures, because they could play a role of any significance only in the short pre-elections period. The determination of the route consisted in the search for the optimal set of measures capable to yield the positive results perceptible for the voters without destabilizing the political situation so that to let it get out of control of the executive power and lead to an acute political crisis in the second half of the year. The latter would have inevitably brought the replacement of the Government management notwithstanding any pre-elections agreements.

¹⁴ The actual situation was a bit more complex. The pre-elections Government, which had characteristic qualities of a coalition, included certain politicians hoping (at least at the beginning) to save their offices even under another President. especially as such signals from G. Ziuganov and his closest fellow-fighters were obvious. Nevertheless, soon, it became clear enough that such a “soft” transformation of the regime would be impossible in any way. For the one hand, when the leading team of the CPRF outlined itself more clearly, the absence of offices inside it for the representative of the acting executive power became distinct enough. For the other hand, the potential “collaborationists” from the active Cabinet had no practical possibilities too influence the economic policy fully controlled by the Prime Minister and his economic team having no chances for the political survival in the event of victory of the opposition at the elections.

The typical reaction of the Government on the acuteness of the political situation in general and of the electoral situation in particular is to soften the monetary policy. This was even more true for the 1996 Presidential elections campaign. The main problem here, the most urgent from the electoral viewpoint and shown as this by B. Yeltsin was the delays with the labor remuneration payment associated with both the indebtedness of the budgets of all levels (about 20% of all the debt) and the debts of enterprises to their workers and employees. If compared with the end of 1995, in the first half of 1996, the indebtedness for the labor remuneration in real calculation grew by more than 85% (see Table 1.8).

Nevertheless, the standard policy of animation of the business activities (unemployment reduction) by use of the inflation obtained another form. In Russia, due to the high hidden unemployment, the effect of the monetary policy on the labor market situation is weak enough. The inflation “shocks” have the purpose not to stimulate the employment, but to reduce the indebtedness for the labor remuneration. Here, the replacement of the struggle against unemployment by the struggle against non-payments of the wages reduces abruptly the lag between the extension of the monetary mass and the expected positive shifts in the economy. This was clearly seen at the beginning of the summer when the indebtedness in the budget sphere really sharply reduced. Nevertheless, this did in no way change the essence of the pre-elections inflationism.

Actually, the process was different. The Government did not dare for an accelerated extension of the monetary mass to solve its political (supporting B. Yeltsin’s victory) and economic (mastering the budget crisis) problems. These were due to several reasons, mainly political.

Firstly, the steady reduction of the inflation supported from spring 1995 was the practically only visible achievement of the Government after the 1992 victory over the commodities deficit. It was clear that a U-turn for this trend would not be accepted by the electorate and politically compensated by the payment of the debts for wages and pensions¹⁵.

Secondly, under the strict IMF’s control over the implementation of the monetary program, such softening would have meant the failure of the policy not only in the short but also in the medium term, because it would have inevitably worsened the post-elections situation of the Government. And as the chances for the B. Yeltsin’s victory were growing, the latter reasoning was becoming more significant.

Thirdly, the Government had no sufficient experience of a fine enough regulation of the monetary mechanisms. The dynamic of the post-communist economy was not enough forecastable for risky experiments in the monetary policy. The currency crisis of October 1994 revealed clearly the problem of the temporal lags under the mobile institutional changes in the markets (financial, first of all) and this had a great effect on the future economic decisions of V. Chernomyrdin.

In such situation, it would have been quite natural to construct the monetary policy in such a way that all the positive consequences of its softening reflect with guarantee (i.e., taking into account the possible incertitude as of the time lags issues) during the pre-elections period with the positive ones showing themselves after the elections. The Government followed the way it thought the safest. The growth of the money offer was maximally approached to the elections and was compressed in time. In May to June, the monthly rates of the monetary mass M2 growth grew somehow: they made, in average, 3.1% for the two months. The effect of the powers on the monetary situation was limited by the monetarization of the deficit of the extended budget, in whole, within the limits of the monetary program. The main channels of the money offer were the purchases of the State securities by the Central Bank from the open

¹⁵ See the detailed validation of this conclusion in Appendix 1.

market and the purchase of hard currency, precious stones, and metals from the Ministry of finance¹⁶.

Hence, when making choice between the softening of the monetary policy and softening of the budgetary policy, the power has selected the second variant. This meant that the Government has accepted the “rules of the game” including the worse collection of taxes combined with the expansion of the State expenditures and sharp expansion of the loans from the domestic market. In some aspects, this variant was worse than the direct emission, because it deprived the powers of the freedom of maneuver and of the seignorage; in other aspects it was better. At a certain flexibility of the Government, this tactics allowed to maintain the process of the inflation reduction, implementing, at the same time, certain populist measures aimed to attract the electorate.

In addition to the purely economic conclusions, one more conclusion, of the generally political character, as for the role of the macro-economic stabilization problems may be made. There exists the wide-spread idea that the democracy creates a less favorable environment for a stabilization process than a firm dictatorship due to the understandable vulnerability of the former to the short-term interest of struggle for the votes¹⁷. Nevertheless, the practical experience of the Russia stabilization allows for an equally right conclusion. The elections at which a voter needs to see the reasonings in form of the results of the current economic policy favor the selected process, not its rejection. Moreover, the experience of the first three years of the Russian reforms shows that the absence of real strategic alternatives for the stabilization policy make it more vulnerable before various inflationist forces with clearly expressed lobbying interests¹⁸. After a series of abortive attempts of the macro-economic stabilization, during 1992-1994, the powers could become more decisive in their approach to these problems, just awaiting the Presidential elections. It is also important that the stabilization showed its results to the beginning of 1996, thus yielding the most obvious political reasoning.

Financing of State expenses

The results of implementation of the Federal Budget in the first quarter-year became the most crucial topic for discussions in the Parliament, mass media, and economic circles, in spring 1996. The reasons for this were both the extremely low level of implementation of the Budget for the incomes and expenditures (see Table 1.9) and the special pre-elections political situation. The opposition tried to use the aggravation of the budget crisis to show the incapacity of the B. Yeltsin’s team to lead the country away from the economic depression. At the same time, the President, tried to normalize the situation by both separating the exact priorities of financing (unconditional repayment of the budget debts for labor remuneration before 1 April, repayment of debts for pensions before 1 May, etc.) with sequestering the other expenditure items, and by developing and implementing the measures aimed to increase the tax inflows to the Budget (drafting of a series of Presidential Decrees, activation of the taxation service, etc.).

¹⁶ When the State securities are purchased by commercial banks, the growth of the money mass is also possible in the event their excess reserves, and, hence, the money multiplier, reduce.

¹⁷ The article (Why voting is good for you // *The Economist*, 27.08.1994) gives a comparative study of 13 economic reforms in different countries and underlines that the success of a reform is independent of the State structure. Nothing proves that reforms are more difficult to implement for democratic countries. Nevertheless, the decisive factor is that the political regime must be strong enough for the success of the reforms because they require unpopular measures affecting the interests of different layers of society.

¹⁸ It should be noted that in such situation the Russian executive power acted following the logic of a “weak dictator” forced, to hold his power, to balance constantly between the influential groups of interests. (See for more detail: Alesina A. *Political Models of Macroeconomic Policy and Fiscal Reform*. Washington: The World Bank, 1992. P. 14-15).

The reduction of the State expenditures of the Federal Budget at the beginning of the year was even greater than the incomes reduction. If compared with the end of 1995, the same level remained only for the servicing of the State debt due to the wish of the President to fulfill strictly the Russia's liabilities to foreign creditors. All the other items were reduced, in January 1996, from 15,2% of the GDP to 7,1% of the GDP¹⁹ (see Table. 1.9). B March, compared with February, the total volume of the Federal Budget expenditures grew (in aggregate) by 2% of the GDP. Nevertheless, if compared with the plan, the volume of the quarter-year financing of the Federal Budget expenditures made only 75.9%, of which a significant share was used to repay the debts for labor remuneration.

Table 1.9.

Execution of the Russian Federal Budget for 1996 (in % of the GDP)													
	1.02.96	1.03.96	1.04.96	1.05.96	1.06.96	1.07.96	1.08.96	1.09.96	1.10.96	1.11.96	1.12.96	1996	% of law
Incomes													
Tax on profit	0.94	0.94	1.11	1.27	1.28	1.34	1.34	1.36	1.32	1.29	1.31	1.44	56
Income tax	0.19	0.2	0.21	0.22	0.21	0.22	0.22	0.23	0.23	0.23	0.22	0.23	107
VAT, special tax, excise tax	4.6	4.42	4.64	4.59	4.52	4.71	5.06	5.44	5.57	5.57	5.80	6.64	87
Tax on foreign trade and foreign economy transactions	0.92	0.98	1.33	1.27	1.24	1.29	1.18	1.16	1.10	1.07	1.03	1.01	77
Other taxes, levies, and payments	0.13	0.17	0.15	0.16	0.16	0.17	0.18	0.21	0.20	0.29	0.33	0.38	161
Total taxes and payments	6.78	6.71	7.44	7.51	7.41	7.73	7.98	8.40	8.42	8.45	8.69	9.70	80
Non-tax inflows	1.11	1.78	1.69	1.08	1.73	2.23	2.94	2.83	2.68	2.58	2.49	2.80	107
Total incomes	7.89	8.49	9.86	9.37	9.96	10.79	10.92	11.2	11.1	11.03	11.18	12.5	86
Expenditures													
State administration	0.09	0.29	0.33	0.33	0.28	0.33	0.33	0.28	0.26	0.25	0.24	0.24	54
International activities	0.68	0.64	0.62	0.62	0.61	0.68	0.69	0.70	0.88	0.93	0.90	1.18	99
National defense and law enforcement	2.39	3.44	3.6	4.17	4.05	4.03	3.97	4.10	4.0	3.89	3.83	4.10	80
Fundamental research	0.04	0.24	0.26	0.32	0.28	0.28	0.28	0.28	0.28	0.29	0.27	0.29	64
Services to national economy	1.19	1.63	1.46	1.61	1.63	1.61	1.53	1.61	1.51	1.52	1.56	1.84	69
Social services	0.52	0.96	1.19	1.41	1.45	1.51	1.40	1.32	1.25	1.22	1.20	1.22	65
Servicing of State Debt	1.5	1.27	1.54	1.36	2.26	2.09	2.07	2.04	1.93	1.89	1.85	1.98	83
Aid to other power levels	0.2	1.23	1.66	1.53	1.50	1.45	1.44	1.53	1.55	1.57	1.74	2.05	85
Other expenditures	0.49	0.78	1.38	1.22	1.36	1.7	1.95	2.02	1.93	1.81	2.11	1.93	120
Total expenditures	7.1	10.48	12.04	12.57	13.42	13.68	13.66	13.88	13.59	13.37	13.46	14.83	82
Loans minus repayments	2.26	0.81	1.19	1.15	0.87	1.13	1.33	1.57	1.23	1.14	0.99	0.96	
Expenditures and loans minus repayments	9.36	11.29	13.24	13.72	14.29	14.81	14.99	15.45	14.82	14.51	14.44	15.79	
Budget deficit	-1.48	-2.8	-3.37	-4.35	-4.32	-4.01	-4.07	-4.23	-3.71	-3.48	-3.26	-3.29	91
Total financing, incl.	1.48	2.8	3.37	4.35	4.32	4.01	4.07	4.23	3.71	3.48	3.26	3.29	91
interior financing	0.57	1.69	2.34	2.34	1.94	2.19	1.95	2.61	2.34	2.11	1.76	1.82	81
exterior financing	0.91	1.12	1.03	2.01	2.38	1.82	2.12	1.62	1.4	1.37	1.50	1.47	107
Information: GDP (Rbl. trln.)	166	322	508	691	876	1066	1260	1403	1609	1819	2031	2256	
Budget deficit (accounting for the net servicing of the debt for thy GKO)	-3.4	-4.8	-5.6	-6.7	-6.5	-6.1	-6.1	-6.5	-6.2	-6.2	-6.1	-6.2	

Despite the critical situation with the execution of the Budget implementation, the State Duma always attempted to promulgate the laws increasing the load on the Budget. Some of these were reflected in the laws on the amendments to the Budget of 1996.

¹⁹ In particular, indicative are the reductions of the expenditures on the national defense and law enforcement to 2,4% of the GDP, on the services to the national economy to 1,19% of the GDP, and on the aid to other levels of power to 0,20% of the GDP.

These convulsiveness and absence of a distinct and economically valid policy could not help influencing the situation with the Budget implementation.

The eagerness of the Government to repay, in accordance with the promises of the President, the indebtedness for the labor remuneration for the people employed in the Budget-financed branches became an important factor influencing the structure of the Federal Budget expenditures in the first half of 1996. During the above period, the specific weight of the labor remuneration in the total expenditures made 30% against the planned 15%; moreover, by branches the actual values of the Budget execution shifted significantly from the planned ones. The priority items of financing, for which the planned values were exceeded were the national defense (by almost 10%), the coal industry (by more than 20%), the rural economy (by almost 20%), and the transfers to the pension fund (by more than 100%). At the same time, the investments in the industry (75% less than planned), transport and telecommunications (60% less than planned), culture and art (60% less than planned), public health and fundamental research (40% less than planned), and education (30% less than planned), were sequestered.

Besides the properly economic sense, these data may serve an indirect characteristic of the comparative lobbying forces of certain groups in the today's system of the Russia's economic policy interests. The power of the coal industry and rural economy is especially indicative in comparison not only with the other branches of the national economy but also with the comparatively lower level of excessive implementation for the defense items. As for the branches having received insufficient financing, the gap between the economic and social spheres is obvious. The latter, with a lesser lobbying potential, turned out the most affected at allocation from the constantly decreasing mass of the Federal Budget resources.

Federal Budget deficit and its financing

The growth of the Federal Budget deficit in the first quarter-year (from 2,8% of the GDP in January and February to 3,37% of the GDP to 1 April) was financed, mainly, by the growth of the domestic loans (from 1,69% of the GDP to 2,34% of the GDP for the same period) by mobilizing assets in the GKO-OFZs market (see Table 1.5,1.9). According to the reports for May and June, the deficit of the Federal Budget calculated in accordance with the methodology of the Ministry of finance had the trend for decrease by about 0,3% of the GDP; in the first half-year it made about a little more than 4% of the GDP. In the absolute figures, the deficit made 70% of the value approved by the law for 1996.

The dynamic of estimation of the secondary deficit taking into account the interests on the GKOs²⁰ was similar: 6,7% of the GDP for January to April; 6,5% of the GDP for January to May; and 6,1% of the GDP for January to June. In the first half-year, the primary deficit was financed, approximately equally, from the interior and exterior sources (the exterior financing reduced by almost 0,4% of the GDP).

The above growth of expenditures on servicing of the State debt was determined by the dynamic of the profitabilities of the State securities which was, as shown above, greatly influenced by the pre-elections factors and the necessity of a massive expansion of the Ministry of finance in the domestic loans market under the conditions of the crisis of the tax inflows to the budget. In such situation, the Ministry of finance had to have recourse to the high scale placements of the GKOs notwithstanding the market situation. A natural result of this was the excessive reduction of the State securities quotations. In the first half of 1996, at the nominal 2-fold increase of the circulating GKOs volume (see Table 1.5), the actual increase was also significant: by 86.9%.

²⁰ The estimated values of the secondary deficit, taking into account the expenses on the servicing of all the kinds of State securities in whole for 1996 are shown in Table 1.10.

This means that, during the electoral campaign, the Government choose between the fiscal reform aimed to increase the tax collection and the further increase of the State debt in favor of the second strategy. This was predetermined by the taxation crisis occurred during the electoral campaign when it was absolutely necessary to finance certain expenditures from the political viewpoint. At the same time, this process was, as we think, a logical consequence of the political incertitude²¹. In Russia, due to the economic, and, mainly, political unexpediency of the rejection of the strict financial policy, the above reasons resulted not in a softer budgetary policy but in rejection of the fiscal reform (or, more specifically, the active position of the Government as for the tax evasion issue) in favor of growth of the interior debt.

The political efficiency of the expansionist budgetary policy aimed, first of all, to repay the debts for the labor remuneration, was minimal. Our analysis of influence of a series of socio-economic parameters on the results of the elections in certain Federation subjects may serve a certain confirmation of the hypothesis on the absence of links between the repayment of the debts for the labor remuneration and the results of elections in regions. However, an interesting result of the above study is the observation that a more close link exists between the results of payment and the January, not June, indebtedness. Hence, the pre-election repayments of debts had practically no influence on the voting results in regions.

Monetary policy

One more prerequisite for the careful financial activity of the Government should be noted. The Russian laws ensure the real independence of the Central Bank, whose management, formed at the end of 1995, was inclined to the stabilization policy and would not have cooperated with the Government in the clearly inflationist course. Nevertheless, one cannot say that the Central Bank was fully neutral in the electoral run. Objectively, its activities in the securities market and in support of the currency corridor in favored the campaign of the acting President. Nevertheless, this can be explained by at least two groups of factors. Firstly, its actions did not break the limits of the solution of the macro-economic stabilization task. (And when one of the actions of the Government, namely the confiscation of the Rbl. 5 trln. of its profit contradicted, by the Central Bank's opinion, such policy, it was decisively against). Secondly, the oppositional team had clearly enough signaled its disagreement with the course for stabilization of the national monetary unit; hence, this reflected in the position of the Central Bank.

According to the monetary program approved for 1996, the RF Central Bank was to ensure the growth of the monetary mass M2 by 20% during the first half of 1996. Actually, from 1 January to 1 June, the monetary mass M2 grew by 20.9% (see Table 1.16). The average rate of the M2 growth for the first half of 1996 was 3.2%. Thus, from January to June 1996 inclusive, the emissional activity of the RF Central Bank was practically consisted with the milestones fixed in the monetary program coordinated with the IMF.

As a result of this policy, in the first half of 1996, the trend to reduction of the prices growth continued. While in January the consumer prices index was equal to 4.1%, in June the consumer prices grew by only 1.2%. In whole, during the first six months, the inflation made 15.6% which is 5-fold lower than the prices growth in the first half of 1995 (see Fig. 1.10).

Nevertheless, the electoral campaign had a significant influence on the monetary policy. The partial implementation of the promises made by the President in January and February led

²¹ (Cukerman A., Edwards S., Tabellini G. Seigniorage and Political Instability // *The American Economic Review*, Vol. 82, 1992, pp. 537-555.) gives the theoretical validation and empirical confirmation of the fact that the political instability and polarization of the political platforms of the main competing parties brings to the rejection of the fiscal reform in favor of the monetary emission, increasing the share of the seigniorage. The analogy between the above model and the situation of the Russian economy of 1996 is obvious.

to, though insignificant, breach of the program coordinated with the IMF. The actual increase of the monetary base in the first half of 1996 made 24.7% (see Table 1.16).

The most important negative consequence of the Presidential elections for the monetary situation was the formation of the high interest rates in all the domestic financial markets. This became another factor complicating the crediting of the real sector enterprises²².

* * *

Let us sum up the above. For the whole first half of 1996, Russia was under influence of the coming Presidential elections.

Firstly, due to the political incertitude, the fiscal discipline reduced sharply. This showed itself in the sharp growth of the non-payments to the Budget and in the expansion of the tax payment evasion process.

Secondly, the electoral campaign of B. Yeltsin led to the growth of the expenditure obligations of the Budget and a significant shift of the expenditures structure toward the repayment of the debts for the labor remuneration, allowances, pension, scholarships (financed from the Budget).

Thirdly, with the low tax inflows and the necessity to finance the priority expenditures, the need in financing of the grown Budget deficit grew. At the same time, the political incertitude led to the significant growth of the premium for risk, mainly, in the GKO and OFZs markets. As a result, the expansion of the State securities led to a significant increase of the expenditures on servicing of the State debt.

Fourthly, the burden of expenses, for which the sequestering was performed, was postponed for the later periods.

Fifthly, the political incertitude had the greatest influence on the financial markets, while the commodities markets showed the continuing reduction of the inflation expectations. In contrast to numerous expectations, it was the growth of the interest rates at the economy redollarization, not the inflationist monetary policy, that became the main negative consequence of the electoral run.

Sixthly, the problem of the interior debt is not, yet, so acute to have a significant influence on the macro-economic situation, in contrast with the processes observed in certain developed and underdeveloped countries²³.

Nevertheless, in 1996, the real value of the debt began growing. To the beginning of 1997, it reached 16.2% of the GDP which is not so small for a country practicing the loans from the financial market for only three years. The future dynamic of the interior debt will depend upon the degree of the political stability and the sufficient will of the Government to increase the tax inflows to the Budget.

Hence, the electoral economic policy showed the obvious inclination of the executive power to choose between two evils. The evils were to deteriorate either the budgetary policy or the monetary one; the power selected the first one. This predetermined, quite naturally, the main outlines of the economic problems of the post-elections period for both the second half of 1996 and the whole 1997. The budgetary crisis was deemed to become the main problem of the Government, the source of tension in both the economic and political spheres.

However, this process was within the limits of the common regularities of evolution of post-communist countries.

Table 1.10.

State interior debt of the Russian Federation in 1993-1997

²² The gap between the rates of the money market and the rates of crediting for the real sector enterprises is determined, mainly, by the risk of non-return of the credits which are extremely high due to the absence of an effective legal system of the contracts enforcement in the Russian economy. As a result, the premium for risk is included in the credits cost and the interest rates grow to practically prohibiting values.

²³ Within the period between 1 January 1994 and 1 January 1996, the value of the interior debt, expressed in shares of the GDP, reduced more than 2-fold, coming to 11.4% of the GDP. This is explained by the relatively faster depreciation of the Government's indebtedness for direct credits compared with the growth of the volume of the loans from the financial market (see Tables 1.5, 1.10).

DEBT	1 January 1994		1 January 1995		1 January 1996		1 January 1997	
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP
State interior debt	35196.6	21.7	88400	14	188543.6	11.4	365548.2	16.20
1. Indebtedness to Central Bank	29156.7	18.0	58752.3	9.30	62986*	3.8	59583.27	2.64
2. Indebtedness to commercial banks (guarantees issued by Government)	1899.8		1700	0.3	5793	0.3	17057.17	0.76
3. Indebtedness for securities, incl.	329.5	0.2	18917.4	3	85196.9	5.1	249034.7	11.04
State loan of 1992	15	0.009	22	0.003	53	0.0	55	0.00
State Russian interior loan of 1990	0.35	0.0002					-	
State interior loan of 1991	80	0.04	80	0.01	80	0.0	79.7	0.00
GKOs	185	0.1	10594	1.7	66118.7	4.0	203600	9.02
OFZs					7597	0.5	37300	1.65
Treasury bonds			6681.4	1.1	7348.2	0.4	-	
Treasury bills			1540	0.2			-	
Golden certificates	49.1	0.03			1000	0.1	-	
State saving loan					3000	0.2	8000	0.35
4. Indebtedness of former USSR for commodity debts, incl.	3204	2	3100	0.5	2500	0.2	5300	0.23
Goal-oriented loan of 1990	2500	1.5	2400	0.4	1850	0.1	2300	0.10
Goal-oriented deposits, checks for automobiles, debts to workers of the agro-industrial complex	704	0.4	700	0.1	650	0.0	3000	0.13
5. Indebtedness to the agro-industrial complex transferred into treasury bills	0		5441.6	0.9	30040**	1.8	4480	0.20
6. Indebtedness for the centralized credits and charged interests of the agro-industrial complex organizations carrying out the "Northern import"							25000	1.11
7. Indebtedness to AO KamAZ transferred into bills of Ministry of finance							1745.5	0.08
8. Indebtedness of the textile industry of the Ivanovo region for unpaid interests							560	0.02
9. Indebtedness for financing of the expenditures on formation of mobilization reserve							2389.5	0.11
10. Other, incl.	276.6	0.2	153.6	0.02	2028	0.1	398.027	0.02
Indebtedness to Gosstrakh	23.8	0.01				0.0	-	
Interior debt of the RF Central Bank accepted from the former USSR	330	0.2	335	0.05	335	0.0	335	0.01
Difference in prices for the agricultural feedstock requiring redemption	61	0.04					-	
Deficit of republican Budget in 1991	63	0.04	63	0.01	63	0.0	63.027	0.00
Indebtedness of the RF Central Bank for the credit resources of the former Sberbank	128.8	0.08	90.6	0.01			-	
Indebtedness to the Pension Fund					1630	0.1	-	
Information: GDP{	162.3		630		1659.2		2256	

* Including the indebtedness for financing of the expenditures on formation of the mobilization reserve (Rbl. 1960 bn).

** Including the indebtedness for the centralized credits and charged interests of the agro-industrial complex organizations carrying out the "Northern import" (Rbl. 25 trln.).

Source: RF Ministry of finance.

Their experience confirms that, after solution of the initial problems of the macro-economic stabilization, the Government inevitably finds itself in a situation of the budgetary crisis being deprived of such well tested mechanism of solution of its problems as the inflational tax. Moreover, for Russia this quite natural situation was complicated by the two additional factors. The first one was the delayed stabilization resulting in the four-year period of high inflation, became one of important factors of degradation of the fiscal sphere; hence, the sharp decrease of the taxes collection. The second one was the electoral populism having shown itself in both the income and expenditure parts of the Budget and having become the additional factor of growth of the social and economic tension.

1.5. Economic Policy after Presidential Elections

The victory of B. Yeltsin having ensured the succession of the economic policy created the conditions for beginning of inflow of foreign investments and repatriation of the exported domestic capital. This should have incited the reduction of the demand for hard currency and, at the same time, the growth of its offer, thus leading to the new (after the middle of 1995) dedollarization of the Russian economy. Yet, the worsened health of the President led to additional political uncertainty hindering these processes. The crucial budgetary crisis was the other (background) factor of the post-elections evolution of the country.

Table 1.11.

Execution of the Russian consolidated Budget for 1996 (in % of the GDP)												
	1.02.96	1.03.96	1.04.96	1.05.96	1.06.96	1.07.96	1.08.96	1.09.96	1.10.96	1.11.96	1.12.96	1996
Incomes												
Tax on profit	3.03	3.48	3.90	4.45	4.38	4.34	4.24	4.31	4.16	4.07	4.05	4.28
Income tax	2.04	2.23	2.26	2.34	2.31	2.34	2.39	2.50	2.45	2.43	2.42	2.51
VAT, special tax, excise tax	6.69	6.53	6.76	6.79	6.72	6.86	7.25	7.72	7.84	7.96	8.20	9.24
Tax on foreign trade and foreign economy transactions	0.92	0.99	1.33	1.28	1.24	1.30	1.19	1.16	1.10	1.07	1.03	1.01
Other taxes, levies, and payments	1.84	2.03	2.15	2.62	3.04	3.07	3.16	3.52	3.52	3.56	3.72	3.92
Total taxes and payments	14.51	15.26	16.40	17.48	17.69	17.91	18.22	19.20	19.07	19.10	19.42	20.97
Non-tax inflows	1.65	2.31	2.47	1.83	2.43	2.92	2.78	2.60	2.46	2.39	2.20	2.58
Total incomes	16.60	18.09	19.85	20.34	21.20	21.91	22.12	22.99	22.69	22.63	22.81	24.76
Expenditures												
State administration	0.42	0.70	0.78	0.82	0.77	0.83	0.83	0.80	0.77	0.75	0.75	0.76
International activities	0.68	0.64	0.62	0.62	0.61	0.68	0.69	0.70	0.88	0.93	0.90	1.18
National defense and law enforcement	2.67	3.83	4.03	4.62	4.50	4.48	4.41	4.55	4.45	4.34	4.28	4.57
Fundamental research	0.05	0.25	0.30	0.33	0.30	0.29	0.29	0.29	0.30	0.30	0.29	0.31
Services to national economy	4.51	5.62	5.75	6.44	6.55	6.55	6.46	6.83	6.69	6.73	6.91	7.87
Social services	5.34	6.93	7.92	8.50	8.53	8.75	8.44	8.56	8.25	8.11	8.09	8.35
Servicing of State Debt	1.50	1.27	1.54	1.36	2.26	2.09	2.08	2.04	1.93	1.89	1.85	1.98
Other expenditures	1.13	1.49	2.03	2.01	2.15	2.50	2.76	2.87	2.75	2.65	2.68	2.79
Total expenditures	16.31	20.74	22.98	24.70	25.68	26.16	25.96	26.65	26.02	25.69	25.74	27.81
Loans minus repayments	2.35	0.93	0.46	0.51	0.40	0.38	0.76	1.14	0.96	0.90	0.85	1.12
Expenditures and loans minus repayments	18.66	21.67	23.43	25.21	26.09	26.54	26.72	27.79	26.98	26.59	26.59	28.93
Budget deficit	-2.06	-3.58	-3.58	-4.87	-4.89	-4.63	-4.60	-4.80	-4.29	-3.96	-3.78	-4.17
Total financing, incl.	2.06	3.58	3.58	4.87	4.89	4.63	4.60	4.80	4.29	3.96	3.78	4.18
interior financing	1.15	2.47	2.55	2.87	2.52	2.81	2.78	3.18	2.89	2.58	2.28	2.70
exterior financing	0.91	1.10	1.03	2.00	2.37	1.82	1.82	1.62	1.40	1.37	1.50	1.47
Information: GDP (Rbl. trln.)	166	322	508	691	876	1066	1260	1403	1609	1819	2031	2256

Fiscal and budgetary policies

After the elections, the tax inflows to the Budget grew somehow: by 3.5% in constant prices in July (see Table 1.9). In the same July, the inflows to the consolidated Budget grew by 6.8% in constant prices (see Table 1.11).

The further dynamic of the tax inflows in accumulated count shows their stabilization (at the level 8.2% to 8.4% of the GDP to the Federal Budget and 19.0% to 19.2% of the GDP to the consolidated Budget). As Table 1.7 shows, this process was due to a certain slowdown of the arrears growth.

Hence, no intense reversal occurred in the evolution of the financial crisis after the elections. This fact may have the two explanations which do not exclude each other. The first one is the remaining sound "anti-tax motivation" among the economic agents, arising from both the weakness of the Federal Government and the fear to lose competitive position in the event of observation of the fiscal discipline. The second one is the engagement of most subjects of the Federation in the regional elections campaign (mainly from September 1996 to

January 1997), which, like in the period of the Presidential elections, weakened the possibilities of a firm policy in relation to enterprises. It is not hard to see that the above causes of the aggravation of the Budget inflows crisis are of political character and are directly related to the elections.

On the background of the continuing tax crisis, the certain growth of expenditures of the Federal Budget to 15.0% of the GDP in July and to 15.5% of the GDP in August did not allow to reduce the Budget deficit to the level fixed by the Law on Budget for 1996. The deficits calculated using the Methodology of the RF Ministry of finance was 4.1% of the GDP for July and 4.2% of the GDP for August. According to our estimates, the additional accounting for the expenditures on the State loans servicing increases the secondary deficit of the Federal Budget to 6.1% of the GDP in July, and 6.5% of the GDP in August.

The data shown in Tables 1.9 and 1.11, allow for the conclusion on the similarity between the budgetary indexes of the consolidated and republican budgets. The only significant difference is that the smooth decrease of the local budgets deficits smoothens somehow the deficit growth of the Federal Budget.

The creation, in autumn, of the Temporary Extraordinary Commission on the fiscal and budgetary discipline (Presidential Decree of 11 October 1996) showed the understanding by the executive power administration of the fact that overcoming the budgetary crisis is associated not only with the imperfection of the legislative base and fiscal system, but, first of all, with the presence of the politically influential groups of interests, whose economic well-being depends on the tax evasion²⁴. Indirect confirmations of the emergency of the urgent administrative measures in the field of taxes collection were both the certain improvement of the taxes collection during the first period of the Commission's activity and the fierce resistance to these activities among certain economic and political circles.

At the end of the year, the gross tax incomes of the Federal Budget grew from 8.4% of the GDP in October to 8.7% of the GDP in November, and 9.7% of the GDP in December (taking into account the final circulation), i.e., up to 9.7% of the GDP accumulated. The incomes of the consolidated Budget grew from 19.1% of the GDP in October to 19.4% of the GDP in November and to 21% of the GDP in December 1996. If counted in constant prices, in December, 1.8-fold more taxes were collected to the Federal Budget than in November; the growth of the real taxes coming to the consolidated Budget made 1.6-fold. The most important source of growth of the tax incomes was the reduction of the volume of arrears, having made 46% of growth of the tax inflows in December, in current price. However, the Government was unable to maintain this trend. This was due, partly to the strongly grown political pressure on the executive power from the politically influential agents and regions, and partly due to the new illness of B. Yeltsin: the administration faced again the political incertitude.

A certain decrease of the Budget deficit in September and October should be noted (see Table 1.9). This was favored by the decrease of the State expenditures in the autumn months. A certain role in the limitation of the Budget expenditures was played by the Decree "On the Emergency Measures to Ensure the Regime of Savings during Execution of the Budget in the Second Half of 1996" of 18 August 1996. It suspended the effectiveness of all the decisions on increase of the expenditures part of the Budget, except, for example, the Decrees on payment of pensions (of 8 April and 25 January) and Act on provision of military people with living facilities. From the macroeconomic viewpoint, the Decree favored the support of the

²⁴ The main purposes of the Commission include: control of the timeliness and fullness of the taxes and other duties payment; development of the measures to ensure their collection in full amount; ensure the legal character and efficient activity of the fiscal and custom bodies, tax police included; and control over the timely and goal-oriented use of the Federal Budget and State out-budget funds assets.

financial stability. However, this document obviously contradicted the political ethics because it broke the promises of the executive power, including the electoral ones.

The comparison of reconstruction of the Budgets of 1995 and 1996 (see Tables 1.12 and 1.13) shows that in 1996, compared with 1995, an insignificant decrease of the inflows to the consolidated Budget occurred (1.7% of the GDP). The main reduction was in the tax inflows to the Federal Budget (1.4% of the GDP). Meanwhile, the level of contribution to the out-budget funds remained the same, though the indebtedness for the 1996 contributions into, e.g., Pension Fund increased 2.2-fold. On this background, in 1996, the expenditures and loans minus repayments from the consolidated Budget grew (by 2.7% of the GDP), mainly due to the growth of expenditures of the out-budget funds (by 1.3% of the GDP) and local budgets (by 0.8% of the GDP); the expenditures of the Federal Budget grew by 0.7% of the GDP (without non-controlled expenditure items). These processes resulted in the growth of the consolidated budget deficit (by 2.4% of the GDP).

In 1996, if compared with 1995, the secondary deficit of the Federal Budget grew substantially: in 1996 it was 7.2% of the GDP (with 5.6% of the GDP for the State debt servicing), while in 1995, it was 4.7% of the GDP (with 3.2% of the GDP for the State debt servicing). Hence, a certain growth of the primary deficit may be determined (from 1.5% to 1.6% of the GDP).

Table 1.12.

Reconstruction of State incomes and expenditures of the Russian Federation in 1995									
	Republican Budget		Local budgets		Out-budget funds*		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
I. TAX INFLOWS									
1. Incom taxes, profit taxes	44245	2.7	109020	6.6			153266	9.2	27.0
1.1. Income tax from natural persons	3250	0.2	33178	2.0			36428	2.2	6.4
1.2. Tax on profit of enterprises	40995	2.5	75842	4.6	2		116839	7.0	20.6
2. Contributions to social insurance funds					120291	7.2	120291	7.2	21.2
2.1. Employed persons					2542	0.2	2542	0.2	0.4
2.2. Employers					117749	7.1	117749	7.1	20.7
Pension fund					79671	4.8	79671	4.8	14.0
Social insurance fund					17569	1.1	17569	1.1	3.1
Employment fund					5629	0.3	5629	0.3	1.0
Fund for social support of population					127	0.0	127	0.0	0.0
FOMS					14752	0.9	14752	0.9	2.6
3. Taxes on labor remuneration fund			4345	0.3			4345	0.3	0.8
4. Taxes on property	1018	0.1	18940	1.1			19957.6	1.2	3.5
4.1. Tax on wealth			15790	1.0			15790	1.0	2.8
4.2. Tax on land	187	0.0	3079	0.2			3266	0.2	0.6
4.3. Tax on transactions with securities	831	0.1	71	0.0			902	0.1	0.2
5. Interior taxes on goods and services	99260	6.0	42393	2.6			141653	8.5	24.9
5.1. VAT	70704	4.3	24543	1.5			95247	5.7	16.8
5.2. Excise taxes	17682	1.1	6536	0.4			24218	1.5	4.3
5.3. License fee on production and sale of alcohol									
5.4. Payments for use of mineral and natural resources	1174	0.1	5583	0.3			6756	0.4	1.2
5.5. Contributions on reproduction of material and feedstock base	1683	0.1	604	0.0			2287	0.1	0.4
5.6. Special tax	7266	0.4	3618	0.2			10883	0.7	1.9
5.7. Other taxes on goods and services	753	0.0	1510	0.1			2262	0.1	0.4
6. Taxes on foreign trade	24155	1.5	29	0.0			24184	1.5	4.3
6.1. Import duty	8468	0.5	4	0.0			8473	0.5	1.5
6.2. Export duty	15685	0.9	24	0.0			15709	0.9	2.8
6.3. Other inflows from external economic activities	2	0.0					2	0.0	0.0
6.4. Inflows from the State monopoly on centralized export transactions									

Reconstruction of State incomes and expenditures of the Russian Federation in 1995

	Republican Budget		Local budgets		Out-budget funds*		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
7. Other taxes	1785	0.1	14283	0.9			16068	1.0	2.8
8. Goal-oriented budgetary funds	14128	0.9	4041	0.2			18169	1.1	3.2
9. Out-budget funds					14940	0.9	14940	0.9	2.6
9.1. Road funds					13139	0.8	13139	0.8	2.3
9.2. Other out-budget funds					1801	0.1	1801	0.1	0.3
TOTAL TAX INFLOWS	184591	11.1	193050	11.6	135231	8.2	512874	30.9	90.3
II. NON-TAX INFLOWS									
1. Profit of Central Bank	3475	0.2					3475	0.2	0.6
2. Switch rate									
3. Other non-tax inflows	35403	2.1	40903	2.5	6618	0.4	46991	2.8	8.3
incl. Transfers and subventions	90	0.0	29224	1.8	6618	0.4	0	0	
TOTAL NON-TAX INFLOWS	38878	2.3	40903	2.5	6618		50466	3.0	8.9
III. CAPITAL INCOMES									
1. Incomes from privatization	3408	0.2	1234	0.1			4642	0.3	0.8
TOTAL INCOMES	226877	13.7	235186	14.2	141849	0.4	567981	34.2	100.0
STATE EXPENDITURES AND LOANS MINUS REPAYMENT									
I. STATE EXPENDITURES	282066	17.0	235282	14.2	142903	8.6	624318	37.6	95.8
1. General purpose State expenditures (support of State administration), incl.	4490	0.3	7419	0.4			11909	0.7	1.8
2. Defense	47553	2.9					47553	2.9	7.3
3. Law enforcement bodies	19194	1.2	6388	0.4			25581	1.5	3.9
4. Science	4801	0.3					4801	0.3	0.7
5. Social and communal services	18649	1.1	108335	6.5	127428		254412	15.3	39.0
5.1. Education	8643	0.5	47818	2.9			56461	3.4	8.7
5.2. Culture and art	1123	0.1	5898	0.4			7021	0.4	1.1
5.3. Mass media	1644	0.1	746	0.0			2390	0.1	0.4
5.4. Public health and physical culture	3464	0.2	36946	2.2			40410	2.4	6.2
5.5. Social policy	3775	0.2	16927	1.0			20703	1.2	3.2
5.6. Social services at expense of out-budget funds					127428	7.7	127428	7.7	19.5
Pension fund					88709	5.3	88709	5.3	13.6
Social insurance fund					17458	1.1	17458	1.1	2.7
Employment fund					6400	0.4	6400	0.4	1.0
Fund for social support of population					128	0.0	128	0.0	0.0
FOMS					14733	0.9	14733	0.9	2.3
6. State services to nationals economy	36198	2.2	101773	6.1	15475	0.9	153446	9.2	23.5
- From out-budget funds					15475	0.9	15475	0.9	2.4
7. Other functions	151182	9.1	11367	0.7			126617	7.6	19.4
incl. to out-budget funds	6618	0.4					0	0	
7.1. Other expenditures	46632	2.8	11277	0.7			57908	3.5	8.9
7.2. Expenditures on external economic activity	21492	1.3					21492	1.3	3.3
7.3. Expenditures on servicing of internal debt	38236	2.3					38236	2.3	5.9
7.3.1. incl. servicing of GKO and OFZs	28960	1.7					28960	1.7	4.4
7.4. Expenditures on servicing of State external debt	15599	0.9					15599	0.9	2.4
7.5. Subventions to other levels of administration	29224	1.8	90	0.0			0	0	
II. LOANS MINUS REPAYMENTS	22463	1.4	5884	0.4			27590	1.7	4.2
1. Budgetary loans	12188	0.7	5884	0.4			17314	1.0	2.7
incl. to other levels of State administration	667	0.0	90	0.0			0	0	
2. State credits to foreign Governments	-2653	-0.2					-2653	-0.2	-0.4
3. Incomes not transferred by Central Bank	5038	0.3					5038	0.3	0.8
4. Foreign credit resources granted to enterprises	8175	0.5					8175	0.5	1.3
5. Credit on conversion needs	169	0.0					169	0.0	0.0
6. Credit on investment needs	132	0.0					132	0.0	0.0
7. State credits to CIS countries	-585	0.0					-585	0.0	-0.1
TOTAL EXPENDITURES AND LOANS MINUS REPAYMENTS	304529	18.4	241165	14.5	142903	8.6	651908	39.3	100.0
INCOMES AND GRANTS minus	-77653	-4.7	-5979	-0.4	-1054	-0.1	-83927	-5.1	

Reconstruction of State incomes and expenditures of the Russian Federation in 1995

	Republican Budget		Local budgets		Out-budget funds*		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
EXPENDITURES AND LOANS MINUS REPAYMENTS									
III. FINANCING									
1. Interior financing									
1.1. Credits of RF Central Bank on financing of Budget deficit (net)	-1145	-0.1							
1.2. Change of balances of Budget assets on Ruble accounts in banks	-2376	-0.1	71	0.0	1054	0.1			
1.3. Short-term State bonds (incl. OFZs)	53554	3.2							
- Mobilization of assets	28543	1.7							
- Repayment of main sum of indebtedness	-1037	-0.1							
1.4. Saving loan (net)	1965	0.1							
1.5. Golden certificates (net)	-1	0.0							
1.6. State treasury bills (net)	-1502	-0.1							
1.7. Treasury bonds (net)	2473	0.1							
1.8. Other State securities (net)	-586	0.0	1059	0.1					
1.9. Other interior loans (net)	-93	0.0	4894	0.3					
TOTAL INTERIOR FINANCING	52290	3.2	6024	0.4	1054	0.1			
2. Exterior financing									
2.1. Credits of international financing organizations (net)	29560	1.8							
2.2. Other foreign credits (net)	-6126	-0.4							
2.3. Change of balance of assets on foreign currencies accounts	1929	0.1	-45	0.0					
TOTAL EXTERIOR FINANCING	25363	1.5	-45	0.0					
TOTAL GENERAL FINANCING	77653	4.7	5979	0.4	1054	0.1			

Table 1.13.

Execution of Russian republican Budget in 1996

	Republican Budget		Local budgets		Out-budget funds		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
INCOMES	0								
1. Income taxes, profit taxes	37632	1.7	115732	5.1			153363	6.8	19.76
1.1. Tax on profit	32512	1.4	64145	2.8			96657	4.3	12.45
1.2. Income tax on natural persons	5120	0.2	51447	2.3			56567	2.5	7.29
1.3. Other taxes on profit or income	0	0.0	140	0.0			140	0.0	0.02
2. Taxes on labor remuneration fund	0	0.0	7708	0.3			7708	0.3	0.99
3. Taxes on goods and services	152137	6.7	56253	2.5			208390	9.2	26.85
3.1. VAT on goods and services produced in the territory of Russian Federation	83466	3.7	42081	1.9			125547	5.6	16.17
3.2. VAT on goods and services imported in the territory of Russian Federation	18311	0.8	0	0.0			18311	0.8	2.36
3.3. Excise taxes, incl. crude oil, incl. gas condensate	45258	2.0	8159	0.4			53417	2.4	6.88
3.4. Special tax for financial support of critical branches of national economy	13104	0.6	0	0.0			13104	0.6	1.69
3.5. Other taxes on goods and services	2765	0.1	2326	0.1			5091	0.2	0.66
4. Taxes on wealth	2337	0.1	3688	0.2			6024	0.3	0.78
4.1. Taxes on transactions with securities	299	0.0	36636	1.6			36935	1.6	4.76
4.2. Other taxes on wealth	299	0.0	12	0.0			311	0.0	0.04
5. Payments for use of natural resources	0		36624	1.6			36624	1.6	4.72
5.1. Payment for mineral resources	4340	0.2	16835	0.7			21175	0.9	2.73
5.2. Contributions for reproduction of materials and feedstock base	2016	0.1	8517	0.4			10534	0.5	1.36
5.3. Land taxes and land rent	1679	0.1	2268	0.1			3947	0.2	0.51
5.4. Other payments for use of natural resources	423	0.0	4840	0.2			5262	0.2	0.68
6. Taxes on foreign trade and external economic operations	222	0.0	1210	0.1			1432	0.1	0.18
6.1. Import duties	22846	1.0	1	0.0			22847	1.0	2.94
6.2. Other taxes on import	14839	0.7	0	0.0			14839	0.7	1.91
	0	0.0	1	0.0			1	0.0	0.00

Execution of Russian republican Budget in 1996

	Republican Budget		Local budgets		Out-budget funds		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
6.3. Export duties	8008	0.4	0	0.0			8008	0.4	1.03
7. Other taxes, levies and duties	1467	0.1	21107	0.9			22574	1.0	2.91
8. Contributions to social insurance funds	0				165540	7.3	165540	7.3	21.33
8.1. Employed	0				3903	0.2	3903	0.2	0.50
8.2. Employers	0				161636	7.2	161636	7.2	20.82
Pension fund	0				109297	4.8	109297	4.8	14.08
Social insurance fund	0				24557	1.1	24557	1.1	3.16
Employment fund	0				5517	0.2	5517	0.2	0.71
Fund of social support of population	0				73	0.0	73	0.0	0.01
FOMS and territorial FOMS	0				22193	1.0	22193	1.0	2.86
9. Other out-budget funds	0				19686	0.9	19686	0.9	2.54
TOTAL TAXES AND PAYMENTS	218722	9.7	254272	11.3	185226	8.2	658219	29.2	84.80
NON-TAX INCOMES	0							0.0	0.00
1. Incomes from State property or activities	5432	0.2	3589	0.2			9021	0.4	1.16
1.1. Transfer of profit of RF Central Bank	5000	0.2	0	0.0			5000	0.2	0.64
1.2. Other inflows from State property or activities	432	0.0	3589	0.2			4021	0.2	0.52
2. Incomes from sale of State property	825	0.0	1741	0.1			2566	0.1	0.33
3. Incomes from sale of State stocks	17675	0.8	0	0.0			17675	0.8	2.28
4. Incomes from sale of land or non-material assets	6	0.0	132	0.0			138	0.0	0.02
5. Inflows of capital transfers from non-State sources	0	0.0	0	0.0			0	0.0	0.00
6. Administrative payments	10	0.0	522	0.0			532	0.0	0.07
7. Penalties	180	0.0	555	0.0			735	0.0	0.09
8. Incomes from external economic activities	13972	0.6	16	0.0			13988	0.6	1.80
9. Other non-tax incomes	1153	0.1	8499	0.4			9653	0.4	1.24
10. Grants from other levels of power	28	0.0	46327	2.1	8160	0.4	x	x	
10.1. Subsidies	0	0.0	2085	0.1	8160	0.4	x	x	
10.2. Subventions	0	0.0	2651	0.1			x	x	
10.3. Money transferred at mutual settlements	28	0.0	18202	0.8			x	x	
10.4. Transfers	0	0.0	23389	1.0			x	x	
11. Other grants	0	0.0	259	0.0			259	0.0	0.03
12. Incomes from State enterprises and institutions	0	0.0	738	0.0			738	0.0	0.10
13. Incomes to fiscal bodies accounts	0								
14. Incomes from State out-budget funds	0		2487	0.1			x	x	
15. Other incomes from State out-budget funds	0				37893	1.7	37893	1.7	4.88
TOTAL NON-TAX INCOMES	39281	1.7	64866	2.9	46053	2.0	93199	4.1	12.01
INCOMES OF BUDGETARY FUNDS	22878	1.0	5076	0.2			27954	1.2	3.60
Contributions for formation of goal-oriented budgetary funds (-)	1855	0.1	1276	0.1			3131	0.1	0.40
TOTAL INCOMES	279026	12.4	322938	14.3	231279	10.3	776241	34.4	100.00
EXPENDITURES	0								
1. State administration	5355	0.2	11868	0.5			17222	0.8	0.02
2. International activities	26680	1.2					26680	1.2	0.03
3. National defense	63891	2.8					63891	2.8	0.07
4. Law enforcement and security	28541	1.3	10638	0.5			39180	1.7	0.04
5. Fundamental research and support of scientific and technical progress	6632	0.3	416	0.0	800	0.0	7848	0.3	0.01
6. State services to national economy, incl.:	41424	1.8	136028	6.0	20006	0.9	197459	8.8	0.21
6.1. Industry, power, and construction	26246	1.2	12650	0.6			38896	1.7	0.04
6.2. Rural economy and fishing	8486	0.4	16721	0.7			25207	1.1	0.03
6.3. Protection of environment and natural resources, hydrometeorology, mapping, and geodesy	1998	0.1	914	0.0			2912	0.1	0.00
6.4. Transport, roads, telecommunications, and informatics	703	0.0	16300	0.7			17002	0.8	0.02
6.5. Market infrastructure development	0		269	0.0			269	0.0	0.00
6.6. Housing and utilities	0		88619	3.9			88619	3.9	0.09
6.7. Prevention and liquidation of emergency situations and consequences of calamities	3992	0.2	555	0.0			4547	0.2	0.00
6.8. From territorial road funds					20006	0.9	20006	0.9	0.02

Execution of Russian republican Budget in 1996

	Republican Budget		Local budgets		Out-budget funds		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
7. Social services	31341	1.4	160889	7.1	173808	7.7	366038	16.2	0.39
7.1. Education	11366	0.5	72385	3.2			83751	3.7	0.09
7.2. Culture and art	964	0.0	8584	0.4			9548	0.4	0.01
7.3. Mass media	1049	0.0	1106	0.0			2154	0.1	0.00
7.4. Public health and physical culture	4302	0.2	51949	2.3			56251	2.5	0.06
7.5. Social policy	13661	0.6	26865	1.2			40526	1.8	0.04
7.6. From out-budget funds	0				173808	7.7	173808	7.7	0.18
Pension fund	0				125039	5.5	125039	5.5	0.13
Social insurance funds	0				20099	0.9	20099	0.9	0.02
Employment fund	0				6753	0.3	6753	0.3	0.01
Fund for social support of population	0				71	0.0	71	0.0	0.00
FOMS and territorial FOMS	0				21846	1.0	21846	1.0	0.02
8. Servicing of State debt	126672	5.6					126672	5.6	0.13
8.1. Servicing of internal debt	105667	4.7							
incl. servicing of GKO, OFZs, treasury bonds	92496	4.1							
8.2. Servicing of external debt	21005	0.9							
9. Replenishment of State stocks and reserves	8999	0.4					8999	0.4	
10. Expenditures of State goal-oriented budgetary funds	16473	0.7	4423	0.2			20897	0.9	
11. Other expenditures	64388	2.9	15012	0.7	29159	1.3	51557	2.3	
11.1. Financial aid to other levels of power	46327	2.1	28	0.0	2487	0.1	̊	̊	
- Subsidies transferred by budget of RF subjects for ZATO	0						̊	̊	
- Subsidies transferred to ZATO	2085	0.1					̊	̊	
- Subventions	2651	0.1			2487	0.1	̊	̊	
- Transfers for leveling of incomes	15239	0.7					̊	̊	
- Transfers at expense of VAT	8150	0.4					̊	̊	
- Assets transferred by mutual settlements	18202	0.8	28	0.0			̊	̊	
11.2. Other expenditures not related to other subsections	9901	0.4	14984	0.7			24884	1.1	
11.3. Subsidies to out-budget funds	8160	0.4					̊	̊	
11.4. Other expenditures of out-budget funds	0				26672	1.2	26672	1.2	
TOTAL EXPENDITURES	420396	18.6	339275	15.0	223774	9.9	926442	41.1	
CREDITING MINUS REPAYMENT	21746	1.0	3538	0.2			20113	0.9	
1. Budgetary loans	13697	0.6	3538	0.2			12065	0.5	
Loans to budgets	10424	0.5	112	0.0			̊	̊	
Repayment of loans by budgets	5278	0.2	88	0.0			̊	̊	
Clearing of loans by budgets	0						̊	̊	
Budgetary loans to ministries, departments, enterprises, and organizations	11066	0.5	8247	0.4			19313	0.9	
Repayment of loans by ministries, departments, enterprises, and organizations	2515	0.1	4733	0.2			7248	0.3	
2. State credits to CIS countries	-3281	-0.1					-3281	-0.1	
Granted	66	0.0					66	0.0	
Repaid	3347	0.1					3347	0.1	
3. State credits to foreign Governments	-5584	-0.2					-5584	-0.2	
Granted	776	0.0					776	0.0	
Repaid	6360	0.3					6360	0.3	
4. Foreign crediting resources granted to enterprises and organizations	13650	0.6					13650	0.6	
Granted	13781	0.6					13781	0.6	
Repaid	132	0.0					132	0.0	
5. Credits on conversion needs	-126	0.0					-126	0.0	
Granted	9	0.0					9	0.0	
Repaid	135	0.0					135	0.0	
6. Credits on investment needs	123	0.0					123	0.0	
Granted	211	0.0					211	0.0	
Repaid	88	0.0					88	0.0	
7. Incomes not transferred by Central Bank	2161	0.1					2161	0.1	
8. Not transferred contributions from budgets of RF subject in goal-oriented budgetary funds	1106	0.0					1106	0.0	
TOTAL EXPENDITURES AND LOANS MINUS REPAYMENTS	442142	19.6	342813	15.2	223774	9.9	946556	42.0	

Execution of Russian republican Budget in 1996

	Republican Budget		Local budgets		Out-budget funds		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
EXCESS OF INCOMES OVER EXPENDITURES AND LOANS MINUS REPAYMENTS	-163116	-7.2	-19875	-0.9	7505	0.3	-170315	-7.5	
GENERAL FINANCING	0								
1. Interior financing	0								
1.1. Credits of RF Central Bank to finance the Budget deficit	-175	0.0							
- Received	0								
- Repayment of principal of loan	175	0.0							
1.2. Change of balance of assets on Ruble accounts in banks	4708	0.2	635	0.0	-7505	-0.3			
Balance as of beginning of period	8452	0.4	5254	0.2					
Balance as of end of period	3744	0.2	4619	0.2					
1.3. State short-term bonds	101121	4.5							
- Mobilization of assets	284698	12.6							
- Repayment of principal of loan	183577	8.1							
1.4. Federal Loan bonds - variable coupon income	25839	1.1							
- Mobilization of assets	34480	1.5							
- Repayment of principal of loan	8641	0.4							
1.5. Federal Loan bonds - constant coupon income	3800	0.2							
- Mobilization of assets	3800	0.2							
- Repayment of principal of loan	0	0.0							
1.6. Saving loan	7328	0.3							
- Mobilization of assets	10328	0.5							
- Repayment of principal of loan	3000	0.1							
1.7. Golden certificates	0	0.0							
- Mobilization of assets	0	0.0							
- Repayment of principal of loan	0	0.0							
1.8. State treasury bills	0	0.0							
- Mobilization of assets	0	0.0							
- Repayment of principal of loan	0	0.0							
1.9. Treasury bonds	-6264	-0.3							
- Mobilization of assets	0	0.0							
- Repayment of principal of loan	6264	0.3							
1.10. Other State securities	-615	0.0	3564	0.2					
- Mobilization of assets	-27	0.0	13885	0.6					
- Repayment of principal of loan	588	0.0	10321	0.5					
1.11. Credit received from State out-budget funds	0	0.0	513	0.0					
- Mobilization of assets	0	0.0	832	0.0					
- Repayment of principal of loan	0	0.0	319	0.0					
1.12. Budgetary loans received from superior budget	0	0.0	5155	0.2					
- Received	0	0.0	10433	0.5					
- Clearing	0	0.0	0	0.0					
- Repayment	0	0.0	5278	0.2					
1.13. Other interior borrowings	-5882	-0.3	10031	0.4					
- Mobilization of assets	11185	0.5	17935	0.8					
- Repayment of principal of loan	17067	0.8	7905	0.4					
TOTAL INTERIOR FINANCING	129860	5.8	19898	0.9	-7505	-0.3			
2. Exterior financing	0								
2.1. Credits from international financial organizations	22473	1.0							
Received:	25076	1.1							
- tied	3446	0.2							
- untied	21631	1.0							
Switch rate on credits:	136	0.0							
- tied	136	0.0							
- untied	0	0.0							
Repayment of principal of loan for credits:	2740	0.1							
- tied	0	0.0							
- untied	0	0.0							

Execution of Russian republican Budget in 1996									
	Republican Budget		Local budgets		Out-budget funds		Consolidated Budget		
	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	Rbl. bn	% of GDP	% of budget
2.2. Credits from foreign Governments, foreign commercial banks and firms to Russian Federation	10783	0.5							
- Mobilization (use) of assets	17179	0.8							
- Repayment of principal of loan	6396	0.3							
2.3. Credits by Vneshtorgbank	0	0.0							
- Mobilization of assets	0	0.0							
- Repayment of principal of loan	0	0.0							
1.2. Change of balance of assets on foreign currencies accounts in banks	0		-23	0.0					
Balance as of beginning of period	0		73	0.0					
Balance as of end of period	0		97	0.0					
2.5. Other exterior financing	0								
- Credits received	0								
- Switch rate	0								
- Repayment of principal of loan	0								
TOTAL EXTERIOR FINANCING	33256	1.5	-23	0.0					
TOTAL GENERAL FINANCING	163116	7.2	19875	0.9	-7505	-0.3			

Monetary situation

Inflation and policy of the RF Central Bank. In August 1996, the consumer prices index reduced by 0.2% (deflation). This is due to not only the strict monetary policy, but also the seasonal prices fluctuation. In September-October 1996, the tendency of the inflation rate decrease was superseded by the inverse one. In September 1996, the consumer prices index grew by 0.3% (or 3.7% in the annual calculation); in October to December 1996, the average monthly inflation was 1.5%.

The dynamic of the monetary sets in January to August 1996 shows the excess of the actual values over the limitations set by the monetary program of the RF Government and Central Bank for 1996, coordinated with IMF. Thus, as of 1 August, the money base was Rbl. 131.1 trln. at the limit Rbl. 127.9 trln., i.e., the excess was 2.5% (see Table 1.16). The acceleration of the prices growth rate in September to October 1996 shows that the growth of demand for money could not compensate the excessive emissional activity in the pre-elections period.

In October, for the second time in 1996, Russia did not receive from the IMF the due tranche of the EFF credit. The rigid position of the IMF management resulted from the aggravation of the taxes collection situation of August-October 1996. The financing under the EFF program was recommenced only in January 1997

Nevertheless, simultaneously with the delay of the October tranche, the leading agencies Standard & Poor Corp., Moody's Investor Services, and IBCA declared the assignment to Russia the international crediting ratings BB (for Governmental loans) and Ba2 (for corporate loans). Russia took the 15th place in the rating of the borrowing countries, i.e., higher than the Governmental experts and foreign investors had expected.

Fig. 1.9.

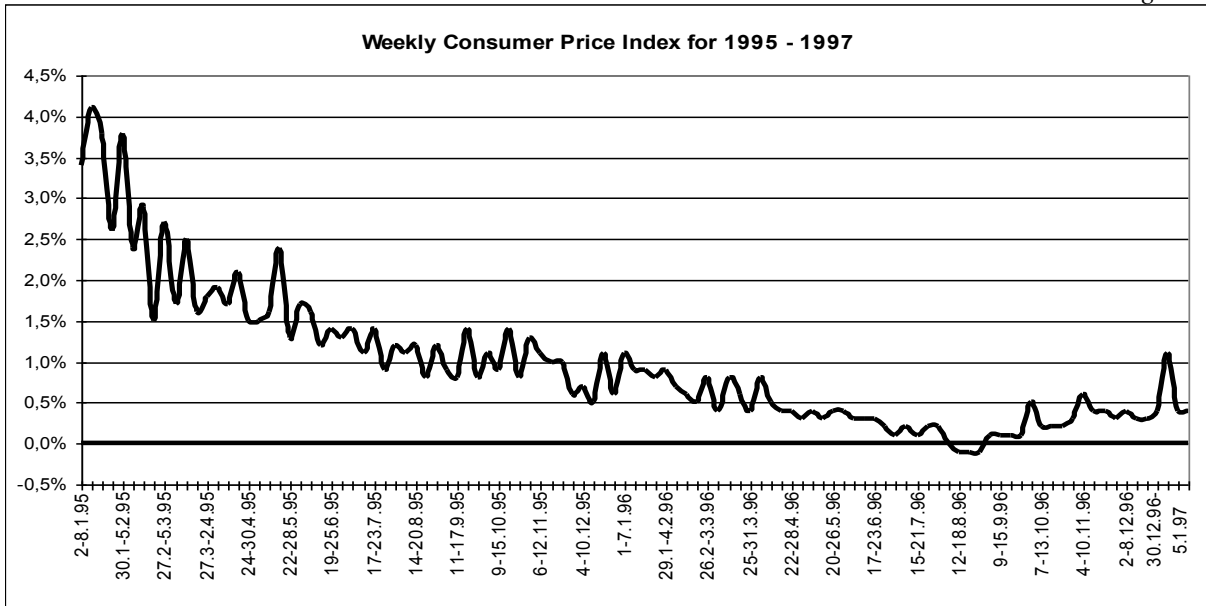
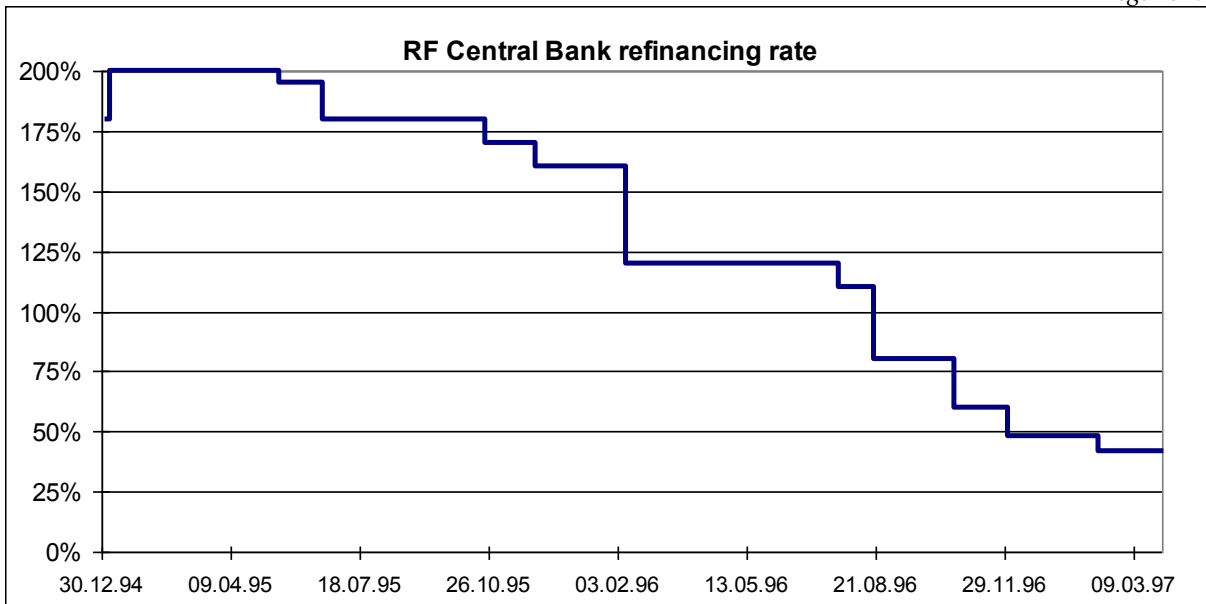


Fig. 1.10.



The significant decrease of the profitabilities in the financial markets allowed to the Central Bank to reduce, on 21 October, the refinancing rate (see Fig. 1.10). The new value was fixed at the level 60% annual which agreed with the actual 40% annual rate. At that time, the mean weighted profitability of the GKO's equaled 68%.

In October, the refinancing system saw its further development. It was decided to divide the GKO's-OFZ's market dealers into the starting ones and the rest. The starting dealers were to assume the obligation to purchase at the initial auctions at least 1% of the current issue; for this they were authorized to use the liquidity windows, i.e., take from the RF Central Bank unsecured overnight credits and be entitled to execute the repurchase transactions²⁵.

From November 1996, the new normatives of the mandatory reserves for commercial banks took force. Thus, for the Ruble on demand accounts with less than 30 days maturity, the rates were reduced from 18% to 16% for the up to 30 days maturity; and from 14% to 13% for

²⁵ In such event, a starting dealer is entitled to sell its securities to the Central Bank with their further redemption, while the Central Bank fixes the repurchase in the annual percent and the limits for such transactions.

the up to 90 days maturity. For the hard currency accounts, the norm was increased from 2.5% to 5%.

In December 1996, the above mechanism served for a significant growth of the refinancing (up to Rbl. 3.5 trln., which exceeds 60% of the average monthly increase of the M2 in 1996).

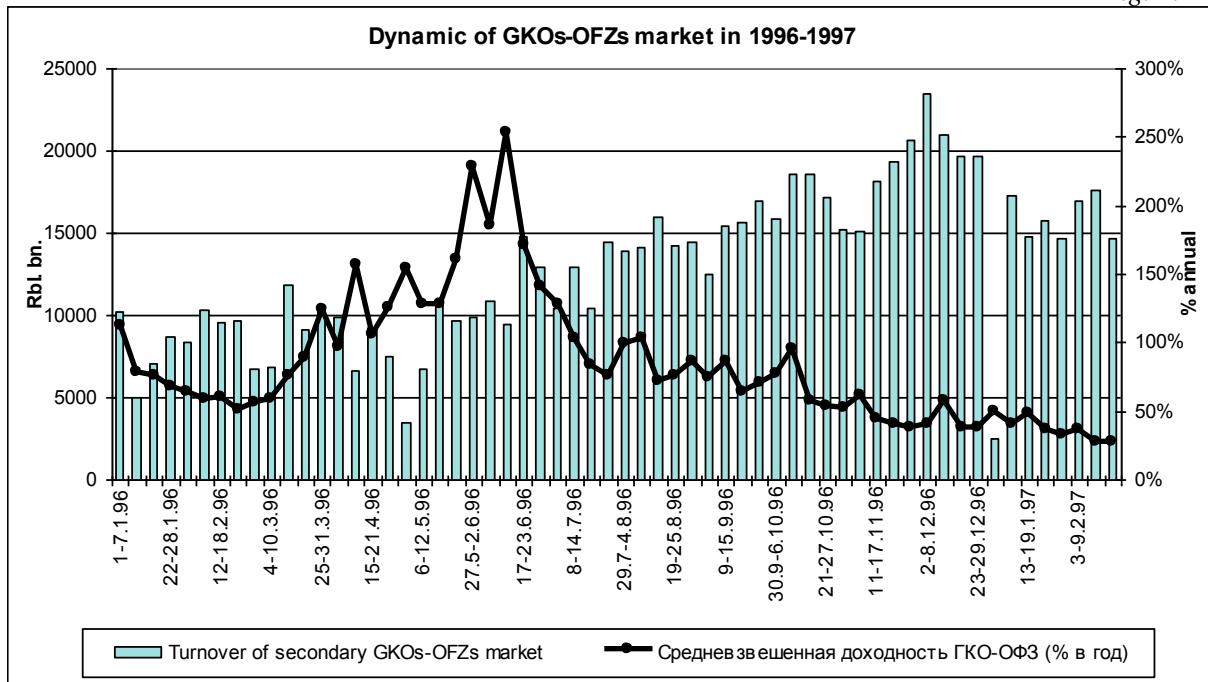
The second half of 1996 showed the tendency to a certain absolute reduction of the available monetary mass and the simultaneous growth of the monetary mass M2. Thus, in the first four months of the second half of 1996, the ready cash (M0) reduced by 10.2%, the monetary base reduced by 4.2% against the growth of the monetary mass M2 by 4.4% (see Table 1.16). This reflects the growth of the monetary multiplier from 2.07 as of the end of July up to 2.25 as of the end of October. Firstly, the reduction of the monetary base was due to the currency policy of the Central Bank having to make currency interventions at the exchange market and withdraw Rubles from circulation. Secondly, from 11 July, the reserve requirements for the deposits in commercial banks reduced by 2 percentage points. Thirdly, under the political uncertainty due to the elections and the following illness of the RF President, the demand of the population for the hard currency grew. This resulted in the reduction of the ready money in hands of the population, and, hence, the growth of the credit multiplier M2.

State securities market situation. The dynamic of the interest rate in the GKO-OFZs market in the second half-year was determined rather by the fundamental factors than by the short-term effects of liquidity and political risks. This showed itself in the fact that, in contrast to 1995 and first half of 1996, the volumes of the bonds placed by the Ministry of finance influenced less and less the cost of servicing of the internal borrowings. This situation can be explained by the inflow of foreign investments to this market. The growth of the acceptance of non-residents in this market allowed to the Ministry of finance to eliminate the effects of the liquidity limitation in the financial markets and smoothed the fluctuations of the interest rates conserving the high enough rates of growth of the circulating State securities (see Table 1.5. and Fig. 1.4).

In September and October, the general level of profitability reduced from the weekly 1.5%-1.6% (78%-83% annual) at the beginning of September to the weekly 1.1%-1.2% (57%-62% annual) in the last third of October (see Fig. 1.11). A series of leaps of profitability observed in the market during this period, was due, in a great extent, by the circulation of the rumors on the state of health of the RF President.

In October, the mean weighted profitability to maturity was 58% annual, with the continuing growth of the volumes for placement. The volumes of the secondary market also continued growing: from the weekly Rbl. 12 to 15 trln. as of the beginning of September to the Rbl. 16 to 19 trln. as of the end of October. In November, the market of the State securities continued showing the tendency to the prices growth for all the series. The mean weighted profitability to maturity fell from the 80% to 90% annual as of the beginning of October to the 45% to 55% in the second half of the same month. The lowered level of the political uncertainty due to the success of the surgical operation of B. Yeltsin led, in November, to the further decrease of the bonds profitability. In October and November, the turnover of the secondary market stayed stable, at the level Rbl. 16 to 19 trln. weekly.

Fig. 1.11.



In November, the RF Ministry of finance increased the monthly quota for the non-residents from US\$ 1.5 bn to US\$ 2.0 bn. The substantial demand from foreign investors favored the further decrease of profitability of the State bonds to the 40% annual to the last third of October.

An important event from the viewpoint of the State Budget deficit financing and formation of the milestones for the domestic money market was the placement, on 15 November 1996, of the last tranche of the Eurobonds, for the sum US\$ 1 bn. The maturity of these securities is 5 years, the coupon rate is 9.25% annual. The conditions of placement for Russia turned out more profitable than expected²⁶.

At the end of November, the GKO-OFZs market showed, together with the growth of quotations a significant growth of turnover (see Fig. 1.11, Table 1.5). In December 1996, the State securities market showed the further stable prices growth. E.g., in November 1996, the mean weighted profitability of the GKO-OFZs to maturity was about 45% to 50% annual; to the last decade of December it reduced to the 38% annual. The total reduction of profitability in the State securities market permitted the Central Bank to reduce, from 5 December, the guaranteed level of hard currency profitability for non-residents to 13%.

Currency policy

After the elections, the Central Bank reduced, abruptly enough, its behavior in the currency market. The volumes of the US Dollar interventions reduced, while the US\$ exchange rate growth rate increased, in August, to 3% (see Fig. 1.12).

The average monthly exchange rate growth rate made 1.45% in the second half-year. This change of the policy was due, mainly, to the significant reduction, during the electoral period, of the hard currency reserves: they reduced, in the first half-year, by US\$ 3.6 bn. After the elections, the political necessity to maintain the low exchange rate growth rates became less imperative. Hence, the Central Bank softened the exchange rate policy, having reduced the US Dollar interventions and accepted the increase of the exchange growth rates. The dynamic of the official US\$ exchange rate in 1996 is shown at Fig. 1.13.

²⁶ In accordance with the Standard & Poors Corp. rating (BB-), the borrowing price for the Russian securities was estimated by 1.5 to 2.5 percentage points higher.

Fig. 1.12.

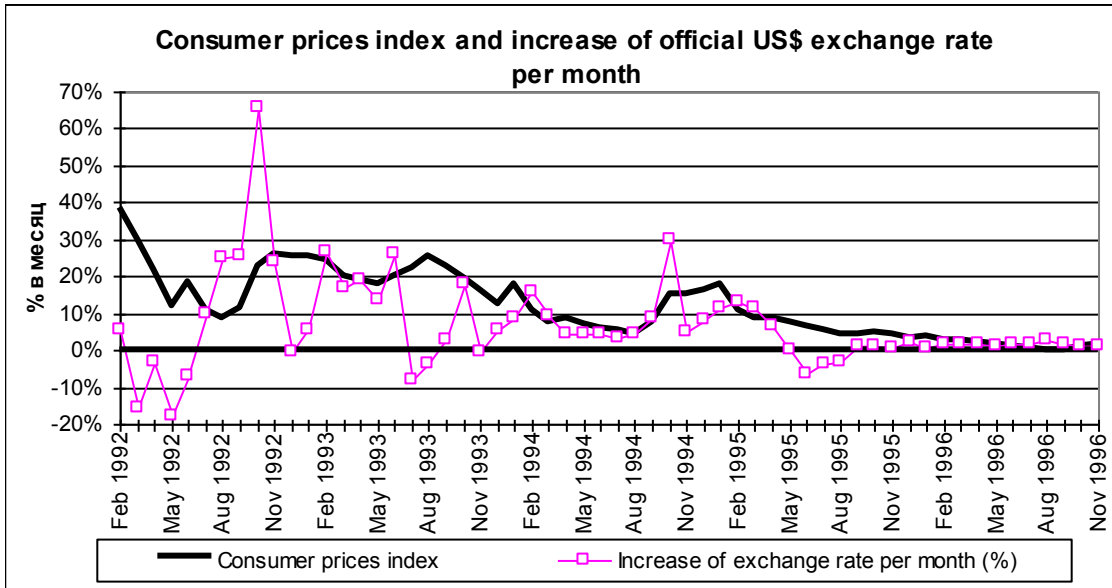
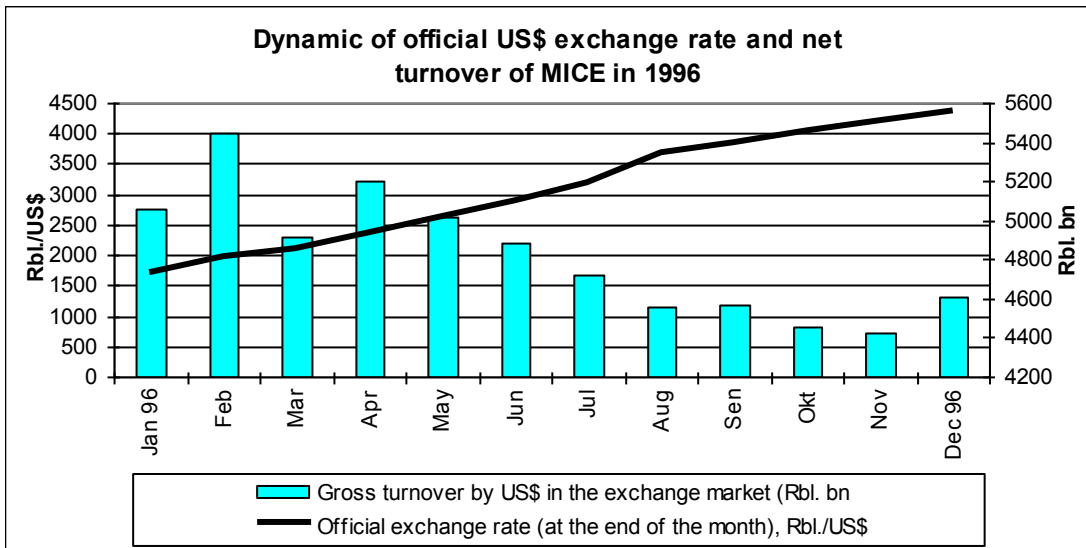
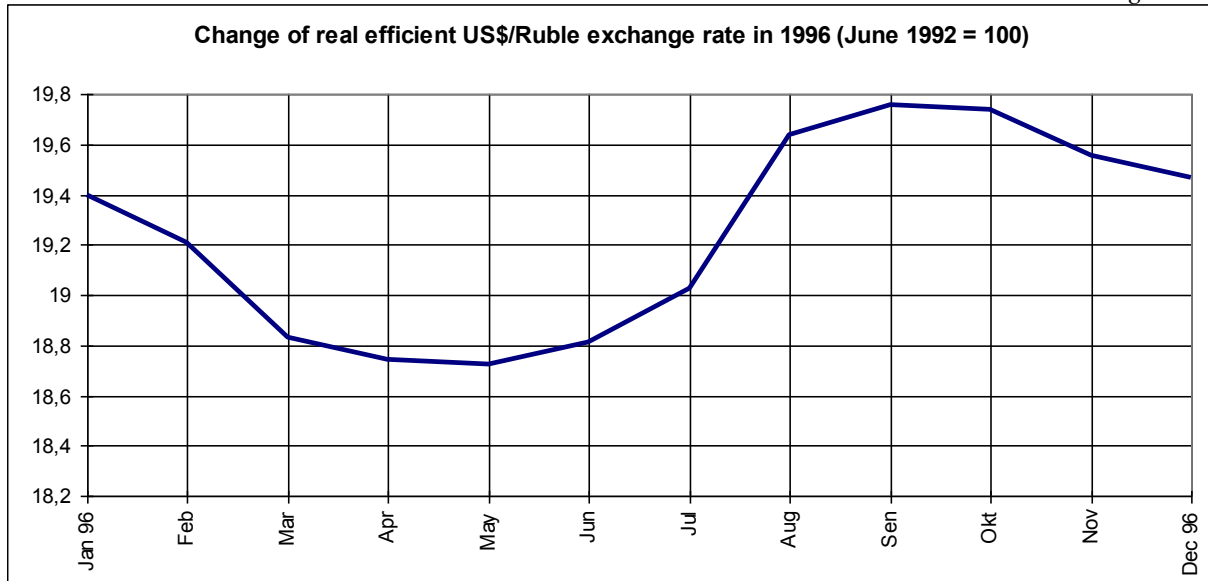


Fig. 1.13.



The wish to slow down the growth of the real Ruble exchange rate could be the additional factor of acceleration of the US\$ exchange rate growth rate. Nevertheless, due to the lower inflation, the growth of the real Ruble exchange rate sharply slowed down already in the first half-year, having made only 5.4% (27.9% for the same period of 1995). Due to the introduction by the RF Central Bank, in July 1996, of the inclined currency exchange corridor, the RF Central Bank came, in the second half-year, to the policy of the smooth nominal devaluation of the Ruble. In 1996, the growth of the nominal rate was 19.8%. As a result, to the end of 1996, the real exchange rate returned, practically, to the level of the end of 1995. As Fig. 1.14 shows, there were three periods during the year. The first one (January to May) is characterized by the trend, continuing from 1995, to the growth of the real exchange rate. To the middle of May 1996, the Ruble rose, in comparison with December 1995, by 3.5%. Due to the introduction of the inclined currency exchange corridor, the RF Central Bank came, in the second half-year, to the policy of the smooth real devaluation of the Ruble. Hence, from May to September 1996, the real exchange rate reduced by 5.4%. In September, this trend was replaced by the opposite one, and the third period began.

Fig. 1.14.



To the end of 1996, the real Ruble exchange rate practically returned to the level of December 1995. In this connection, it is important to emphasize that the growth of the real course resulted from the use of the stabilization mechanism of the nominal anchor in 1995, when the relatively high prices growth rates continued by inertia. In 1996, this effect stopped acting due to suppression of the inflation.

In autumn 1996, the decrease of the net international reserves of the Central Bank continued (see Table 1.16). This process was determined by the continuing redollarization of the economy due to the remaining political uncertainty. Besides, the statistical data reflected the operations of the Central Bank relative to the redemption of the Ruble sums of the redeemed GKO's. To the end of the year, the net international reserves grew somehow: to the end of November they made US\$ 2.51 bn (against the minimal value US\$ 1.34 bn at the end of October).

The policy of the Central Bank, aimed at reduction of profitability in the financial and money markets gave a certain predictability to the dynamic of the exchange rates, having, thus, reduced the attractiveness of the currency exchange market for the banks. The reduction, in September to October, of the arbitrage spread between the official and market rates confirms the stabilization of this sector of the market.

Hence, the stabilization of the political expectations to the end of 1996 improved the trust of the economic agents in the obligations of the monetary powers. In particular, the stability of the RF Central Bank policy of the currency exchange rate remained effective, despite the abrupt reduction of the hard currency reserves in September and October. In such situation, it is expedient to continue the policy, of the second half of 1996, of the controlled exchange rate coordinated with the inflation rate.

The high possibility to forecast the dynamic of the exchange rate in the second half of 1996 improved the possibilities for arbitrage operations in the currency market. With the relative mobility of the capital, the reduction of the risk favored, for the one hand, the growth of investments in the Ruble assets. For the other hand, in such conditions, the dynamic of the exchange rate needs to be coordinated with the value of the differential of the interest rates on the Ruble and US Dollar assets. Hence, to the end of the year, the dynamic of the main parameters in the financial markets was determined, mainly, by the interests parity. In the other words, the increase of the US Dollar exchange rate was approximately equal to the differential of the interest rates on Rubles and hard currencies taking into account a small premium for risk.

For 1997, the Central Bank intends to pursue the policy of the inclined currency corridor. For the end of the year, its upper limit is fixed at Rbl. 6,350/US\$ 1 and the lower limit is fixed at RBL. 5,750/US\$ 1. As before, the width of the corridor is Rbl. 600, while the possible growth of the exchange rate does not exceed 14.2%. However, the Central Bank will not fix the daily upper and lower limits, thus being capable to regulate the exchange rates changes during the year with more flexibility.

In the event of favorable development, in 1997, the dedollarization process will create the problems similar to these surged in the first half of 1995 and resulted in the breaches of the limits of the monetary mass growth. The support of the lower limit of the inclined corridor fixed by the Central Bank can lead to additional Rubles emission. We believe, that the protection of the lower limit is not absolutely necessary from the point of view of support of trust in the anti-inflation policy. However, the most probably, the Central Bank will have to support the US Dollar because of the pressure from the manufacturers-exporters and IMF. This seems expedient from the viewpoint of the economic growth stimulation, as well.

1.6. Phenomenon of Deferred Growth

Today's Russian conceptions of economic growth

The issues of the search for the adequate economic growth model have formed the central point of the economic policy discussions in the post-elections Russia. Strictly speaking, they became priorities a bit earlier, already in the end of 1995. During the Duma electoral campaign, the three main approaches to the solution of the growth problems delineated themselves quite clearly: the Governmental (based on the macroeconomic stabilization); the left (inflationist, supposing the production stimulation on the basis of the artificial extension of the aggregate demand); and the nationalist (protectionism and support by the monopolist structures existing in the economy) ones. Moreover, in the today's Russia, the two latter models are closely interrelated, from both politically and in essence²⁷.

The important feature of the Governmental conception is the understanding of the link between the problem of growth and the purposes of the deep structural reform of the Russian economy; the two other models suppose, first of all, the restoration of the pre-reform structure of the national economy. This contradiction is essential: it means not only the preferences for branches of industry resulting from this or that models of growth. The conception of restoration means the accent on the unemployment problem, its priority over the economic efficiency. The above is always characteristic for the left and nationalist parties positions. Hereby, the issue of the economic growth (not of the macroeconomic stabilization) became the crystallizer for the formation of the positions of the main social policy forces, and, hence, the significative political parties of Russia.

Notwithstanding the fierce polemics of the past years as for the role of the macroeconomic stabilization between the opposition and the Government, the mastering of the inflation became the main reason for the intensified attention of politicians to the growth problems. The connection between the beginning of the economic upsurge and reduction of the inflation below 50% annual has been well studied in the economic literature of the last years²⁸. This empirical fact formed the basis of the economic policy of the Russian Government during all the years of the radical economic reform. At the same time, this strategy was the object of severe criticism of the main opposition parties trying to prove the impossibility to support a

²⁷ For more detail see: IET Review "Russian Economy in 1995. Trends and Outlooks".

²⁸ E.g.: Fisher S., R.Sahay, C.A.Vegh. Stabilisation and growth in Transition Economies: The Earlier Experience. IMF Working Paper. 1996. N 31. P. 11-15.

low inflation during a long enough period (this was the position of G. Yavlinski) or insisting on the radical measures of “restoration of the national economy” rejecting the anti-inflation monetary policy (CPRF’s position).

Thus, the political struggle around the strategy and tactics of the economic policy shifted to another plan. The attention became centered at the issue whether the relatively low inflation is a necessary condition for the beginning of the growth. Or, more exactly, whether, under the conditions of the actually finished macroeconomic stabilization, it is possible to stimulate the economic activity by a certain softening of the monetary policy.

From the methodology viewpoint, the discussion of the late 1991 - early 1992 resurged. The political decision on liberalization was accompanied by serious doubts whether the reaction of the Russian economy to such measure would be adequate, whether this measure has some hidden mechanisms (flaws) due to which the liberalization would not result in victory over the lack of goods and strengthening of the economic agents’ interest in the Ruble. Similar questions surged in 1996, but, this time, because of the correlation between the inflation and the economic growth.

However, there exists a series of peculiarities. If the prices liberalization is not only necessary but sufficient condition for liquidation of the goods shortage, the only suppression of the inflation may be insufficient for the start of the economic growth. The economy may conserve the specific mechanisms blocking the growth; this has been shown by the experience of certain Latin American and African countries. Moreover, the issue of the growth start in Russia is, as of today, not only economic, but also political, similarly to the role of the anti-inflation policy when solving the stabilization problems, when the inflation level actually reflected the balance of forces between the main groups of the social economic interests²⁹.

Political prerequisites of growth

The absence itself of the growth officially registered during 1996 is not inconsistent with the macroeconomic regularities revealed by economists based on the stabilization experience of other countries, first of all, post-communist. Thus, a statistically revealed stable regularity for the latter is the beginning of the growth eighteen months to two years after the year in which inflation gets below 50% (i.e., the last year for Russia). Just this logic, the cautious monetary policy accounting for the expected start of the growth, forms the basis for the post-elections activities of the Government. This was reflected in the draft Federal Budget for 1997, which will be discussed below.

However, when estimating the efficiency of such logic, at least two issues of principle need to be taken into account. Firstly, whether the one or two-year time lag natural from the macroeconomics viewpoint is acceptable politically, i.e., whether the social and political situation in the country is stable enough to go through the extremely painful situation of depression without shocks. Secondly, how successfully are forming the other (besides inflation) prerequisites required to restart the growth. The answers to these two questions determine the solution of the key problem of today: whether the beginning of the economic growth in Russia will be deferred.

The problem of stability of the social and political situation cannot be subject of a strict analysis. Though, the most crucial points here are obvious enough: the low level of the budget financing of the social sphere, armed forces, and other recipients of budget assets; the budget non-payments and indebtedness for labor remuneration; the growing differentiation of incomes; etc. These factors may become decisive for the evolution of events the next year.

²⁹ For more detail see IET Reviews “Russian Economy. Trends and Outlooks” for 1993-1994.

More definite can be the judgment on the economic growth factors; here both the macroeconomic and purely political ones are essential. First of all this is the issue of the political stability as prerequisite for the growth of the investment activities for both domestic and foreign investors. B. Yeltsin's victory at elections and successful surgery created the basic prerequisites for the political stability in Russia. This has already seen its confirmation in the attribution to Russia of the high enough (for the beginning) rating of investing reliability and in the successful placement of the first series of eurobonds in November 1996. Another positive factor is that the constitutional and legal mechanisms allowed to go through the period of the forced political passivity of the President without any serious shocks.

The political stability obtained in the second half-year turned out even better than expected: this is confirmed by both the post-elections tactics of the CPRF and the activities of the trade unions. The opposition went the way of its organizational formation at the simultaneous gradual integration in the power structures. For G. Ziuganov, an important result of the Presidential elections was the understanding of the fact that even the combined left-nationalist electorate was insufficient to win the elections; hence the change of his tactics. For the one hand, the leaders of the CPRF began vigorously looking for popularity among the non-socialist groups (intellectuals, business people), for which the democratic decency needs to be demonstrated.

As for the administration of the Government, it demonstrated the readiness to cooperate with the left opposition. For the one hand, it was pushed to this by the distribution of forces in the State Duma where the support from the CPRF fraction is vital, especially in the situation when the "Yabloko" fraction, though of democratic image, rejects vigorously any cooperation with the executive power. For the other hand, it is the expected reinforcement of the left fractions in the Council of Federation after the autumn regional elections. The introduction of A. Tuleyev in the Cabinet of Ministers, though not ensuring for the Government the support of the Parliament majority (due to the special constitutional conditions of Russia), improved the interaction between the Prime Minister and the leaders of the left majority.

After the elections, the readiness of the trade unions leaders (FNPR) to cooperate with the Government and President outlined itself quite clearly. This was distinctly seen during the autumn (November) rallies and strikes, led by the FNPR and held within the peaceful, legal limits. The FNPR had a success (though not complete) in neutralizing the actions of the left extremists among workers.

Thus, the political evolution after the elections showed the stability and relative reliability of the constitutional-legal regime of the post-communist Russia as a prerequisite for the beginning of the investment activity. The issue of the institutional reforms, whose gist is to ensure the immutability of the property rights, is more complicated.

Of course, B. Yeltsin's victory at the elections eliminated the main threat to the economic stability, conditioned by the negative attitude of most candidates to the privatization and the intention of the CPRF to review its results and follow the way of nationalization on large scale. However, the laws regulating the property rights are today poorly developed, and neither the Duma, nor the Government do not show readiness to the quick promulgation of the relevant acts³⁰.

There are serious problems with the set of macroeconomics parameters influencing directly the outlooks of economic growth. First of all, the beginning of the growth depends upon the situation of the Federal Budget. The remaining level of the Budget deficit requires huge interior borrowings which affects negatively the perspectives of the investment activities of

³⁰ Moreover, the Governmental draft law on foreign investments, submitted to the Duma last autumn, contained a long list of fields where the foreign capital would not be accepted.

economic agents. However, this thesis cannot be perceived unequivocally, reducing all the tasks to the reduction of the Budget deficit by measure of victory over the inflation and passage to the growth phase. The experience of the post-communist countries shows that, *ceteris paribu*, the solution of the stabilization problems is accompanied by the a certain growth of the budget deficit³¹, at least during the first two or three years following the stabilization. In the other words, the question is just the time gap separating the reduction of the annual inflation to the level below 50% from the beginning of the economic growth itself³². The governments usually utilize the growth of the budget deficit in such situation as an additional tool for the structural reforms.

In Russia, the situation is different. For the one hand, after the elections, the crisis of the State incomes was not overcome. As shown above, the tax inflows, somehow grown in summer, wend down again in autumn, despite a certain resurgence of the production activity and growth of inflation. For the other hand, the crisis of the expenditure side of the Budget continued aggravating. The problem of the constant reduction of the expenditures in real terms following the evolution of the taxation crisis deserves a more detailed discussion in connection with the approbation of the Russian federal Budget for 1997.

Budgetary policy of 1997 and economic growth

The analysis of the dynamic of the State expenditures (including out-budget funds) in shares of the GDP for 1992-96 shows their almost 2-fold reduction (see Table 1.14). The greatest reductions were observed in the expenditures on defense, national economy³³, science, loans minus repayments. The share of the expenditures of the consolidated Budget on the State administration, law enforcement, and social purposes stayed practically the same. At the first sight, such conclusion contradicts the concepts that, under the non-fulfillment of the budget plans for incomes, the sequestering of the expenditures performed under pressure of various lobbies leads, as a rule, to the greatest reduction of the social expenditures, not supported by clearly defined pressure groups.

However, it is important to take into consideration the different degrees of rigidity of individual groups of expenditures. Thus, the volume of the price subsidies is determined by their sums per unit of goods and the production or sale volumes of such goods. The grant of subsidies for the exchange rate to the importers, whose volume depends also upon the real exchange rate is similar. The agriculture subsidies and the subsidies to the unprofitable enterprises depend upon the production volumes. When the economy is shrinking, such expenditures can be reduced relatively easily (though the process itself of the GDP reduction may lead to additional expenditures relative to the growth of unemployment, etc.). The State investments can be reduced relatively easily to a certain level (the problems begin when the amount of the relevant expenditures stops ensuring the normal functioning of the infrastructure and the requirements of the environmental and nuclear safety, etc.). Similarly, the defense expenditures can be reduced by reducing the production and purchase of arms, reduction of the armed forces, etc. The expenditures on the State administration, especially in what concerns the sectors management depend significantly upon the size of the economy.

On the contrary, the social expenditures are less dependent on the scale of the economic activity or such State activities as support of tenability, law enforcement, or national security.

³¹ See: Fisher S., R.Sahay, C.A.Vegh. Stabilisation and growth in Transition Economies: The Earlier Experience. IMF Working Paper. 1996. N 31. P. 10b.

³² Of course, the countries having the relevant legislative limitations are exceptions. E.g., Estonia, whose Constitution prohibits promulgating a budget with deficit.

³³ The growth of the share of expenditures on the national economy in 1992, and its sharp reduction in 1993 are explained, as noted before, in many aspects, by the growth of the real exchange rate of the Ruble and reduction of the accompanying estimate of the expenditures covered by external credits.

Even more, when the economic activity and the above activities reduce, the State has to expand the social expenditures (unemployment allowances, construction of living facilities for dismissed servicemen, expenditures on retraining of the dismissed employed people, etc.).

The dimensions of different kinds of social expenditures depends on the particularities of the economic policy of the State. Thus, the subsidies to the municipal facilities, being of the social character, but entered in the section of the national economy expenditures, may be replaced by the direct transfers to the needy layers of the population. The same is true for the subsidizing of certain kinds of food, medicaments, etc.

Thus, the share of the social expenditures in the GDP is the index sufficient to compare situations in different countries or in a same country in different periods of time at a stable dynamic of the GDP. The latter is not true for Russia: in 1996, the GDP reduced by 38%, compared with 1991. Similar processes were observed in practically all the post-socialist countries. Based on such significant reduction of the per capita GDP, the analysis of the budget expenditures is necessary to get the idea on the real situation in the field of State finance. Table 1.14 shows that, during the period from 1991 to 1996, the real State expenditures reduced 2.7-fold. At the same time, the social expenditures reduced 1.6-fold. The per capita expenditures reduction was similar.

When estimating the real social expenditures of the consolidated Budget, the continuing process of transfer of the social infrastructure of enterprises to the municipal balances and the necessity to increase the budget expenditures should be taken into account³⁴. The absence of the relevant growth means that the drop of the real social expenditures has been greater than Table 1.14 shows, which does not include the quasi-state social expenditures of enterprises.

Such reduction, necessary from the viewpoint of the financial stabilization, and support of the short-term budget equilibrium, apparently exceeds the limits supporting a stable long-term equilibrium. The reduction of the government intervention in the economy is the necessary and inevitable process for all the post-socialist countries. The reduction of the State expenditures, and, hence, the relieved tax pressure on the economy, allows to ensure the conditions for the growth of the private savings and investments which are of high efficiency. In Russia, beginning from the second half of 1993, this process of deetatization went on the background of the growing crisis trends in the fiscal sphere, uncontrolled reduction of the tax incomes to the budgetary sphere. The Taxation crisis conditioned the fact that such violent cutback of the State expenditures was required to ensure the financial stabilization. The same cause, the crisis of the tax incomes, expressed in the badly predictable reduction of the State incomes, led to the formation of the irrational structure of expenditures. In the situation of non-fulfillment of the budgetary plans for incomes, typical for the post-reform period, the expenditures are sequestered under the pressure of different lobbying groups (agro-industrial complex, armament industry complex, banking, mining and feedstock sectors, etc.). Hence, this process is uncontrollable and leads inevitably to the greatest reduction of the social expenditures, not supported by clearly defined pressure groups.

As a result, the structure of the State expenditures, formed to today, is definitely irrational, and unable to support either the conditions for growth or the sufficient social and political stability. At the today's level of incomes, the social expenditures could have been much higher, as the Budget has reserves for reduction in practically all other items of expenditures. Much more than necessary to support the economic and social stability is being spent on the defense, national economy, State administration, etc. However, the short term, these expenditures cannot be compressed, and the Budget has no sufficient reserves for their

³⁴ The social expenditures of enterprises include the cost of support of the living facilities and utilities which, after transfer of the living facilities to municipal bodies, are to be entered in the item of expenditures on national economy, and on support of the education, public health, and culture institutions, entered in the social expenditures section.

reduction and correction of their structure. The medium-term rationalization of the budget expenditures requires their interim growth.

Thus, the necessity of a significant reduction of the defense expenditures in medium term is quite apparent. Yet, this process is possible only under condition of a defense reform and a significant reduction of the armed forces which, in their turn, require the temporary growth of the State expenditures.

Table 1.14.

Expenditures of Russian consolidated Budget in 1991-96												
	Expenditures of consolidated Budget (% of GDP)						Real expenditures of consolidated Budget (Rbl. bn)					
	1991*	1992	1993	1994	1995	1996	1991	1992	1993	1994	1995	1996
State expenditures and loans minus repayments	69.3	65.1	48.6	47.5	39.3	42.0	901	724	493	421	335	336
1. Expenditures on State power and administration	0.6	0.6	0.9	1.1	0.7	0.8	8	7	9	10	6	6
2. Defense	6.3	4.7	4.4	4.4	2.9	2.8	82	53	45	39	24	23
3. Law enforcement	1.5	1.4	1.6	1.8	1.5	1.7	20	15	16	16	13	14
4. Science	0.6	0.6	0.6	0.5	0.3	0.3	8	7	6	4	2	3
5. Social and communal services, incl.	16	13.8	18.0	18.0	15.3	16.2	208	153	183	159	131	130
Education	0	3.8	4.3	4.4	3.4	3.7		42	43	39	29	30
Culture and mass media	0	0.6	0.6	0.7	0.6	0.5		7	7	7	5	4
Public health and physical culture	0	2.6	3.3	3.1	2.4	2.5		29	34	28	21	20
Social security	0	6.8	9.7	9.7	8.9	9.5		76	99	86	76	76
6. State services to national economy**	18.3	20.9	12.7	10.9	9.2	8.8	238	232	129	97	79	70
7. Other functions, incl.	9.3	9.4	8.0	7.1	7.6	9.7	121	104	81	63	65	78
Other expenditures	0	5.8	3.3	3.3	2.9	3.6		64	33	29	25	29
Expenditures on external economic activity	0	2.3	3.8	0.8	1.3	1.2		26	39	7	11	9
Expenditures on servicing of internal State debt	0	0.7	0.6	2.6	2.3	4.7		7	6	23	20	37
Expenditures on servicing of external State debt	0	0.7	0.3	0.5	0.9	0.9		7	3	4	8	7
8. Loans minus repayments***	16.7	13.8	2.3	3.6	1.7	0.9	217	153	24	32	14	7

* Expenditures of the Russian Budget and USSR Budget in the Russian territory

** The estimate subsidies to the importers in the 1991 prices were Rbl. 119 bn (10.5% of GDP) in 1992 and Rbl. 12 bn (1.1% of GDP) in 1993

*** The CIS countries, in the 1991 prices, made Rbl. 94 bn (8,7% of GDP) in 1992, and Rbl. 3 bn (0,3% of GDP) in 1993 Without reform, the conservation of the today's level of financing will bring to aggravation of the qualitative situation of the Armed Forces. The process for the law enforcement bodies is similar.

Further reduction is required for the expenditures on the national economy, including such articles, as the State support of the basic sectors of industry, the reproduction of the mineral and feedstock base, the conversion of the defense industry, and the construction. In these cases, to reduce the expenditures, their structure needs to be changed, accompanied with the reduction of subsidies, and increase of the expenditures on sanitation and shutdown of inoperative production sites.

Table 1.15.

Draft Federal Budget for 1997				
Items	Federal Budget			
	Law for 1996 (% of GDP, Rbl. 2100 trln.)	Execution in 1996 (% of GDP)	Execution in 1996, % of Law	Law for 1997 (% of GDP, Rbl. 2727 trln.)
Incomes				
Tax incomes, of them:	13.0	9.7	80	13.74
Profit tax	2.7	1.4	56	2.81
Income tax	0.2	0.2	107	-
Value-added tax	6.1	4.5	79	6.3
Excise taxes	2.0	2.0	107	2.78
Special tax	0.6	0.1	18	0
Payments for use of natural resources (royalty)	0.3	0.2	72	0.42
Tax on purchase of foreign notes	-	-	-	0.08

Draft Federal Budget for 1997				
Items	Federal Budget			
	Law for 1996 (% of GDP, Rbl. 2100 trln.)	Execution in 1996 (% of GDP)	Execution in 1996, % of Law	Law for 1997 (% of GDP, Rbl. 2727 trln.)
License fee for production and sale of alcohol	0.1		-	0.13.
Tax on transactions with securities	0.1	0.0	0	0.73
Taxes on foreign trade and external economic operations	1.4	1.0	77	0.80
Other taxes, levies, and duties	0.2	0.3	161	0.25
Non-tax incomes	1.9	1.9	107	0.93
Goal-oriented budgetary funds	0.6	0.9	161	1.25
Total incomes of Federal Budget	15.7	12.5	86	15.93
Expenditures				
State administration	0.4	0.2	54	0.43
International activity	1.3	1.2	99	0.38
National defense	3.8	2.8	79	3.83
Law enforcement and security	1.9	1.3	74	1.82
Fundamental research and support of scientific and technical progress	0.5	0.3	64	0.56
National economy	2.8	1.8	69	2.98
Education	0.7	0.5	77	0.68
Culture, art, and mass media	0.2	0.09	48	0.23
Public health and physical culture	0.4	0.2	54	0.42
Social policy	0.6	0.4	72	0.66
Redemption and servicing of State debt*	2.6	2.0**	83	2.87**
Replenishment of State stocks	0.5	0.4	86	0.39
Other expenditures, incl.:	3.3	3.7	120	2.68
Financial aid to other power levels	2.7	2.1	84	2.33
Expenditures of goal-oriented budgetary funds	0.7	0.7	107	1.51
Total expenditures	19.6	14.8	81	19.43
Budget surplus	-3.9	-3.3	91	-3.50
Interior financing	2.4	1.8	81	1.82
Exterior financing	1.5	1.5	107	1.68

* w/o expenditures on servicing of GKOs-OFZs

** w/o redemption of State debt

Source: Ministry of finance. Calculations: authors. It is necessary to cut abruptly the expenditures on the State administration; however, this has to be supported by the relevant measures requiring time and financial expenses.

The analysis of the newly promulgated by the State Duma Law “On Federal Budget for 1997”, shows that the Government takes no real moves in the directions we propose (see Table 1.15). The expenditures side of the Budget plans to increase the expenditures for all the items, except the international activities: the latter will make 0.38% of the GDP which is 0.8% of the GDP less than in 1996. It is planned to increase the expenditures: on the State administration almost 2-fold: up to 0,43% of GDP, compared with the 0,2% of GDP in 1996; on the national defense: by 1% of the GDP (without any plans of the armed forces reform); by 1,2% of GDP on the national economy; and by 0.8% of the GDP on the social services. The total expenditures of the Budget are to grow by almost 5% of the GDP; this will predetermine the Budget deficit of almost 3,5% of the GDP. More than half of such deficit will be financed from the interior sources and increase the internal State debt to 22% of the GDP, compared with the 16.2% of the GDP as of 1 January 1997.

For the most optimistic scenarios of the future process (suppose the real term arrears do not grow), the Budget incomes will amount to about 11,4 % of the GDP, i.e., by 4,5 % of the GDP less than the Law fixes; hence, the expenditures will be executed as the incomes come, and assets are mobilized to finance the deficit amounting to 3,1% of the GDP, i.e., they will not exceed the 14,5% of the GDP (see below). Meanwhile, the structure of the incomes, which is, in accordance with the Law, similar to the actual structure of 1996, will become even more similar to the latter as the Law is implemented. This is due to the fact that the balance of the political forces supporting the relevant expenditure items remains the same.

As of today, certain authors state that the high level of the State incomes and expenditures is the main obstacle in the way of the economic growth in Russia.³⁵

We believe, such approach is based on the overestimate of the level of the State intervention in the Russian economy and the unilateral comprehension of the mechanisms of the State interventionism and displacement of the private investments by the State ones. It should be taken into account that the levels of the State incomes and expenditures cannot be unambiguously considered a factor whose high value affects negatively the economic development. The economic literature³⁶ has already shown that the parameters of the economic growth are closely linked to the levels of incomes, rates of population growth, availability of the school education, and shares of capital investments in the GDP. The empirical analysis of the budget deficit, inflation, real currency exchange rate³⁷ shows a significant negative connection between these parameters and the economic growth, revealing, by the way, the causal dependence of the growth upon the above macroeconomic factors. At the same time, the State expenditures show a contradictory effect on the economic growth³⁸: e.g., the expenditures on the education, medical services, creation of infrastructure accelerate the growth. However, the tax withholdings, supporting the relevant expenditures, decelerate the economic development. Hence, taking into account the dependence between the incomes and expenditures of a State upon its economic development level, one can say that, the growth, between certain limits, of the social, educational, and infrastructure expenditures favor the economic growth.

During the socialist stage of its history, Russia was characterized by the extremely high State expenditures, if compared with those of the market economy countries of an approximately same level of economy. The huge social expenditures, that led, in the sixties-seventies, to the budget crisis, supported, in the socialism times, the high educational level of the population, the high multi-discipline scientific school, the efficient public health system, and the well-developed social infrastructure. All these are important factors creating the potential for the future growth in Russia or supporting the necessary level of the social and political stability in the society. Hence, it would have been extremely irrational to lose, in an historically short period of time, these comparative advantages because of the spontaneous reduction of the social sphere financing.

Hence, the way out of the budgetary crisis and the support of the budgetary equilibrium in the medium and long terms are possible only by stabilization and certain growth of the Budget incomes. The growth of the consolidated Budget incomes by 3% to 5% of the GDP will allow to avoid the degradation of the social sphere. We believe, that this purpose can be achieved

³⁵ See, e.g., Illarionov A. Theory of "monetary deficit" as reflection of the payment crisis in the economics // *Issues of Economics*, 1996, # 12, P. 40-60. Dmitriev M. Report: Budgetary Policy of Russia under Financial Stabilization" Moscow: Carnegie Center, 1996, P. 64.

³⁶ See Kuznets S. *Modern Economic Growth*. New Haven, 1966, 391p.; Kuznets S. *Total Output and Production Structure*. Cambridge, 1971.; Chenery H., Syrquin M. *Patterns of Development, 1950-1970*, London, 1975; Chenery H., Syrquin M. *Patterns of Development, 1950-1983*, Washington, 1988.; Mankiw N, Romer D, Weil D, *A Contribution to The Empirics of Economic Growth*, *Quarterly Journal of Economics* 107, 1992.

³⁷ See: Fischer S. The Role of Macroeconomic Factors in Growth // *Journal of Monetary Economics*, Vol. 32, 1993, pp. 485-512.

³⁸ See: Easterly. W., Rebelo S. Fiscal Policy and Economic Growth // *Journal of Monetary Economics*. Vol. 32 (1993). P. 417-58.; Barro R. Economic Growth in Cross Section of Countries // *Quarterly Journal of Economics*. Vol. 106 (1991) pp. 40-43.; Knight M., Loayza H., Villanueva D. Testing the Neoclassical Theory of Economic Growth // *IMF Staff Papers*. Vol. 40 (N 3) (September 1993) p. 512-541; Aschauer D. Is Public Expenditure Productive? // *Journal of Monetary Economics*. Vol. 23 (March 1989) 177-200pp., Masden K. Links between Taxes and Economic Growth: Some Empirical Evidence // *World Bank Working Papers* 605 (Washington. 1983); Cshin P. Government Spending, Taxes and Economic Growth // *IMF Staff Papers*. Vol. 32 N 2 (July 1995). pp. 237-269; Chenery H., Robinson S., Syrquin M. *Industrialization and Growth*. New York. 1986, 221p.; Summers R., Heston A. The Penn World Table (Mark 5): An Expanded Set of International Comparisons, 1950-1988 // *The quarterly Journal of Economics* 1991, pp.327-367.; Lin S. Government Spendings and Economic Growth // *Applied Economics*. Vol. 26 (1994). P. 83-94;

not by reinforcing the aggregate tax load, but by reducing the privileges and struggling against the illegal evasion from taxes.

And, last but not least, is the problem the improvement of efficiency of the Budget expenditures, including social. The question is, first of all of improving the distribution of the social expenditures. As of today, the granted and subsidized State services in the spheres of public health, education, municipal utilities are used not only by the persons really needing the State support, but also the well-off ones, capable to finance themselves all the relevant costs.

1.7. Variants of economic policy

In the second half-year, together with the complication of the monetary situation, the political pressure on the executive power with the aim to soften the monetary policy, including by inflation, grew, as well. First of all, this pressure comes from the economic agents, for which the period of stabilization without growth is really painful and which see the real lack of assets for production expansion. Secondly, it comes from the Council of Federation, which, after the newly elected Heads of Administrations had come there, became a body less dependent on the Federal Government. The new recombination of the political forces makes the position of the executive power much more complicated than in the situation, characteristic till the last times, of the conflict between the Government and the State Duma.

As a result, in the today's Russia, the problem of the budgetary policy acquires the two critical peculiarities, differing it from most post-communist countries at the relevant stage of economic reforms. Firstly, the budgetary policy and the budget deficit in Russia are not purely (or even mainly) economic phenomena being, first of all, political ones. Secondly, the budgetary policy has not become the mechanism offering to the Government the additional possibilities for the necessary structural reforms. On the contrary, to reduce the budget deficit, very painful and requiring additional resources structural shifts in the economy (and, especially its public sector) are needed.

The way out of this situation demands, first of all, the political solutions. On these depends, finally, the answer to the question, whether the economic growth of Russia will be deferred as the macroeconomic stabilization was before. Here the two variants are possible.

The first one supposes the growth stimulation by a definitive surmounting of the taxation crisis, and, hence, the related dependence of the Budget upon the interior borrowings. The institutional and social reforms have to go in parallel with it. The first ones are to form the efficient property rights. The second ones are to improve the flexibility and efficiency of the budgetary policy at the federal and regional levels.

The second variant is base don the hypothesis of the radical incapacity of the private business to accumulate capital and invest it in production. Hence, the State is put in the center of the investment activities. Here, the State is considered the main tool of accumulation of the capital and investments using for this the direct control over the main macroeconomic parameters³⁹, including the control over the prices for the main goods and services. I.e., the Government would concentrate in its hands the resources and redistribute them in accordance with the national economy interests. In fact, in such event, the attention of the State would become focused on the redistribution functions, mainly as for the export-oriented sectors of the national mechanical engineering.

³⁹ From this viewpoint, for example, the request to "increase the amount of money in the national economy up to the level of the developed states" formulated by certain communist deputies during the budget discussion in the State Duma in November 1996 was characteristic.

The latter is crucial. The gap between the export sectors of the national economy and the sectors oriented to the import substitution is, today, the key structure, and, at the same time, the social problem of the Russian reforms evolution. The gap between the interests of these two sectors forms, today, the basis for the fundamental differences between the leading political forces concerning the outlooks of the Russian economic policy. And, vice versa, the absence of such gap is a sine qua non as for the basic elements of the social and economic policy, characteristic for practically all the post-communist states of the Central and Eastern Europe.

The crisis in the relations between them showed itself obviously already at the beginning of the last year; it took its final shape in the contest between the two main runners for Presidency⁴⁰. However, the fact itself of B. Yeltsin's victory did not mean the automatic choice of a definite model, because the situation of the objective conflict of interests between these two sectors. As to today, this conflict became a priority in comparison with the former antagonism between the inflational and anti-inflational models of development and the supporting groups of interests.

Moreover, it seems that the struggle around this issue will aggravate due to the expected engagement in it of the leading Russian financial structures. As the Russian banks engage, more and more, in the real sector, purchasing blocks of shares of privatized enterprises, the system of their economic and political interests begins to be more and more determined by the interests of expansion of these or that production sectors. Last year, the first signs appeared of such difference among the Russian banks; hence, one may suppose that in the nearest future will be one of the most important when forming the Government course.

The choice of this or that economic model will inevitably require the consolidation of the political power, and, first of all, formation of a more integrated Government. In the other words, the solution of the economic growth beginning problems is, connected with the transition, at least for a certain period, from the conception of a coalition Government to that of the Government of supporters of a same idea; here we can see certain analogies with the period of the end of 1991 - beginning of 1992. Though the political program of such team cannot be clearly defined today, because the choice between the , yet.

The move in this direction has, already, begun. The liberal economists and the democracy-oriented politicians supporting them are regrouping their forces. For the same purposes, the left opposition is activating its relations with the today's Ministers of similar opinions. At the end of 1996, the both sides had approximately equal political chances to put the policy consolidation under control. Though the choice has not been made, yet, this choice will determine the main frameworks of the economic evolution, beginning from 1997, and, hence, the related political struggle.

* * *

In conclusion, here are some quantitative estimates of the forthcoming economic processes; these are based on the assumption of absence of brusque changes of the economic policy aimed either to dash or to hamper the economic transformations.

Forecast of budget situation. The 1997 Budget estimate assumed the GDP of Rbl. 2727 trln. with the real growth by 1% from the 1996 value and the annual inflation rate 0.8%⁴¹.

Our calculations were base don the average monthly inflation rate 1.23% and the real GDP at the 1996 level (see below). Based on this, the value of the nominal annual GDP was to be

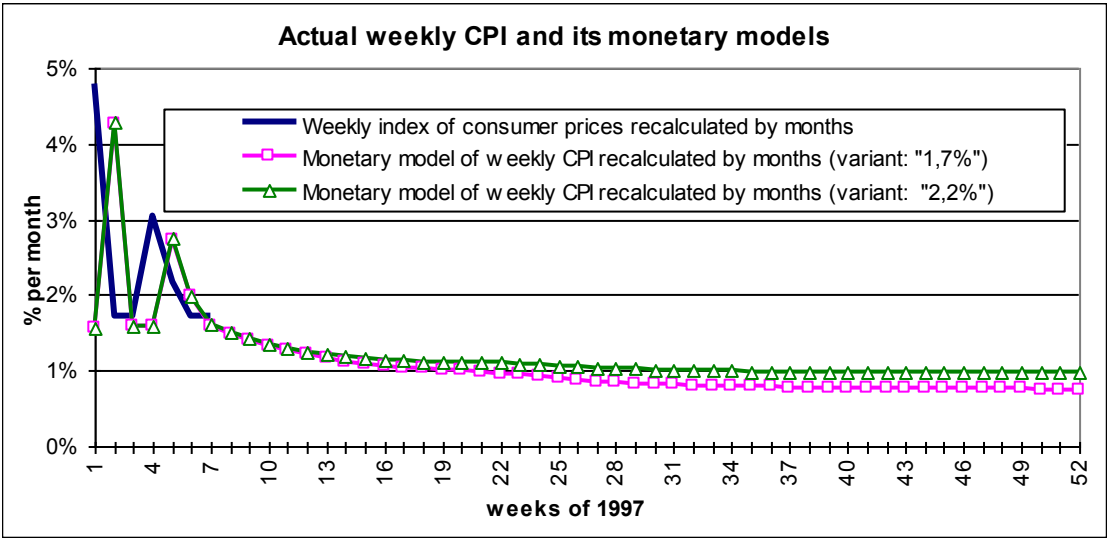
⁴⁰ See IET Review "Russian Economy in First Half of 1996. Trends and Outlooks"

⁴¹ According to IMF, the GDP was to amount to Rbl. 3425 trln. at the real GDP growth by 4% and the annual inflation rate 12%.

Rbl. 2622 trln. This index was calculated based on the assumption of the dynamic of the real 1997 GDP at the 1996 level. The monthly values of the 1997 GDP were calculated taking into account the nominal 1996 GDP and the accumulated prices index for the relevant period of 1996. The actual consumer prices index of 1996 and the prognosis of the relevant index of 1997 formed the deflator.

While estimating the share of the tax incomes in the GDP we were based on the 1997 amendments to the laws on the profit tax, income tax, excise taxes, and some other amendments, whose effectiveness, as we believe is the most probable (tax on purchase of foreign notes, ban of certain profit tax and VAT privileges). We have not accounted for the possible growth of the tax incomes due to the measures preventing from the illegal tax evasion. In the former event, as we believe, the tax incomes will amount to about 9.9% of the GDP, i.e., lower than the 12% of the GDP planned by the Ministry of finance⁴². The total incomes of the Federal Budget will amount to 10.9 % of the GDP, assumed the arrears grow, in real terms, at the same rate as in 1996 (its annual increase, including penalties made Rbl. 21.6 trln.).

Fig. 1.15.



At such prerequisites, during the budget execution, the necessity arises to sequester the expenditures by more than 34% (supposing the expenditures on the State debt servicing are fully financed). The event the Government follows a rigid course, to contest the non-payment of the taxes, the incomes of the Federal Budget may amount to 11.4% of the GDP; hence the sequestering of the expenditures at the level of about 30% of the GDP.

Inflation forecast. In November 1996, the main theses of the monetary and currency policies of the RF Central Bank for 1997 were published. In particular, they plan the growth of the monetary mass within the 35% limit, at the annual inflation not exceeding 16%. Thus, in its forecasts, the Central Bank plans to increase the demand for money by about 33 percentage points.

To forecast the 1997 inflation, the monetary autoregression model of the inflation processes was used⁴³. Based on this model, the two variants of the consumer prices growth are

⁴² Taking into account the tax payments collected in January 1997, amounting to 5.8% of the GDP, our forecast seems optimistic.

⁴³ In general, the dependence looks as follows:

$$p_t = a_1 p_{t-1} + a_2 m_{t-1,t-24}$$
 where p_t is the consumer prices growth index for the week t recalculated by months, p_{t-1} is the prices index growth for the previous week, $m_{t-1,t-24}$ is the average geometrical of the distributed by weeks monthly growth rates of the monetary mass

considered (see Fig. 1.16). They are determined by the two values of the variable exogeneous for the model, i.e., the average monthly rate of the M2 monetary mass increase. In the milestones of the monetary policy, declared by the RF Central Bank for 1997, the growth rates of M2 are set at the levels 1.7% to 2.2% monthly.

The simulation of the values of the weekly CPI begins from the middle of February. Further on, the support is the theoretical value of the prices growth for the antecedent week. In accordance with the model, the annual inflation in 1997 will be 13.95% for variant 1 (average 1.09% monthly) and 15.87% for variant 2 (average 1.23% monthly).

Profitability forecast for the State securities market. The profitability forecast for the GKO-OFZs for the first half of 1997 was made on the basis of the regression dependence between the profitability, inflation level, and the real issuing of the State securities for the coming period⁴⁴.

The following initial prerequisites were assumed for the estimate. The inflation level was assumed in accordance with the second variant of the above forecast (16% annual, i.e., 1.2% monthly), the level of the future real issuing was set up based on the average actual excess of the placement volume over the redemption in autumn 1996 (7.6%) and the evaluation of the State debt as of 1 January 1997 as Rbl. 240 trln. The dynamic of redemption is shown at Fig. 1.16 The obtained evaluation of the average monthly real increase of the interior debt in 1997 is about 1%. As the numerical analysis shows, if the above prerequisites are realized, the profitability level of the GKO-OFZs market will fall to 32% annual by the effective interest rate, which corresponds to 28% to 29% annual according to the estimate of the Ministry of finance.

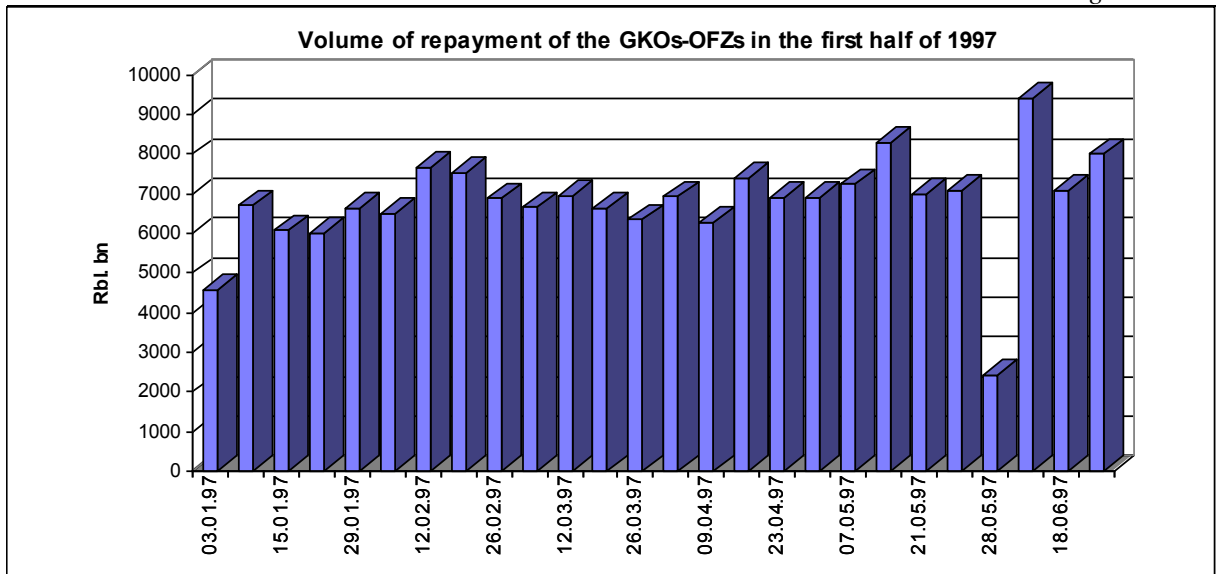
M2, a_1 , a_2 are the regression factors. The free term was excluded from the equation because this is consistent with the theoretical notions on the character of the dependence under study and because of its statistical insignificance (after the exclusion of the free term of the regression equation, the value R^2 changed insignificantly). The evaluations of the regression parameters, obtained accounting for the auto-correlation elimination in the remainders are: $a_1 = 0.873$ and $a_2 = 0.255$. The period of influence of growth of M2, equal to 24 weeks, was obtained as a result of selection from the dependencies yielding the greatest closeness indexes (R^2) for different terms (from 1 to 55 weeks). The normalized multiple determination factor $R^2 = 0.70$. The value of the t-statistics for the parameter a_1 equals 16.39, for a_2 it equals 1.86, which indicates their statistical significance at the level 93%.

⁴⁴ The estimate of the regression dependence between the aggregated profitabilities, the leading, smoothened by the nonlocalized median rates of inflation, and the rates of real issuing of the GKO yields the following results:

$$r_t = \underset{(9.15)}{1.89} + \underset{(4.94)}{0.25} x_{t,t+8} + \underset{(4.74)}{0.45} \pi_{t,t+8}$$

where r_t is the nominal aggregated net profitability of the GKO (%) in monthly terms during the week t , $x_{t,t+8}$ is the average rate of the real issuing of the GKO (%) in monthly terms within the eight following weeks, $\pi_{t,t+8}$ is the monthly rate of the consumer prices growth index (%) for the same period of time. Between the parentheses are the values of the t-statistics for the relevant parameters of the model; the multiple regression factor R^2 equals 0.43 (the regression was constructed by the 90-week observations for 1995-96).

Fig. 1.16.



Section 2

Real Sector of Economy

2.1 Main Trends in Real Sector of Economy

General characteristic. The economic conjuncture of 1996 was greatly influenced by the extremely acute situation with the Budget use, the high rates of growth of the domestic government borrowing, the deterioration of the real sector financial situation, decline of financial discipline at all the levels of economy. The negative effect of all these factors expressed themselves during the Presidential electoral campaign and the Government formation.

During 1996, the conjuncture of the financial markets, and, first of all, the dynamics of the interest rates stayed in a certain dependence upon the political factors. To the middle of June, the interest rates in the government stocks market and for interbank credits reached their maximal values. In the second half of the year, a significant reduction was observed.

The reduced profitability of the investments in the government stocks and the relatively low rates in the interbank market activated the growth of the demand for the foreign currency. Due to this, in October, the Central Bank increased 2-fold the mandatory norms of the foreign currency liabilities, while the reserve requirements to the Ruble liabilities were somehow eased. As a result, in 1996, the nominal MICE exchange rate of US Dollar to Ruble grew by 19.7%. The purchasing power of the US Dollar in the Russian market, taking into account the domestic inflation, lessened by about 1.6% against 41% in 1995.

During the whole year, the export volume was steadily growing, the net external balance remained positive. In 1996, the external turnover between Russia and FSU and foreign states (without non-organized trade) made US\$ 147.4 bn, or by 4% more than in 1995; the export grew by 8.1%, the import reduced by 2%. The export grew due to both the growth of the supplies of the main export goods, and the significant growth of the mineral feedstock export prices.

In 1996, the inflation index was 121.8%. In average by month, the consumer prices grew by 1.7% against 7.2% in 1995. In 1996, the industrial producers prices growth rate made 125.6% in whole, against 275% in 1995. During the whole year, the prices dynamics was the most influenced by the augmentation of the control of the prices for the products of the natural monopolies from the public authorities and the limiting monetary and currency policy of the Russian Central Bank.

In 1996, the monetary mass growth rates reduced almost 3-fold, compared with the previous year, but, in contrast with the first years of the reform, they exceeded the prices growth; this confirms the steady enough process of inflation reduction. At the same time, the adaptation of most economic agents to the reducing inflation rates and “appreciating” money without real responsibility of enterprises for financial liabilities, as well, as the poor development of the crediting system were the factors that aggravated the payments crisis.

The measures aimed to suppress the inflation by limiting the monetary mass without the relevant control over the situation with the settlements in the economy favored the deepening of the negative phenomena in the settlements system. In 1996, especially in the first half of the year, the various “money substitutes” (bills of exchange, tax exemptions, commodities credits) and barter transitions reached significant magnitudes in the turnover system; hence, the additional cutback of the taxation base and reduction of the real inflows to the Budget.

Table 2.1

**Dynamics of main macroeconomic indexes,
% of previous year**

	1993	1994	1995	1996
Gross domestic product	88	87	96	94
Industry	88	79	97	95
extracting industry	85	89	98	95
processing and manufacturing industry	84	74	95	91
Rural economy	96	88	92	93
Investments	88	76	90	82
Traffic of transport entities	75	86	99	95
Sales turnover	102	100.1	93	96
Paid services	70	62	83	
External trade turnover			121	104
Export	104	111	120	108
Import	89	114	113	98
Real	110	116	87	100
Unemployed, officially registered	114	126	158	126
Prices indexes:*)				
<i>consumer prices</i>	940	320	231.3	121.8
food	900	310	223.4	117.7
non-food	740	270	216.3	117.8
paid services to population	2410	620	333.2	148.4
<i>industrial prices</i>				
end products	990	510	275.0	125.6
purchased resources	-	305	314	126.1
capital investments	1160	53	270	139.3
transport of cargoes	1850	760	320	122
official exchange rate of US Dollar	300	285	131	119.7

In 1996, the fierce trouble in the labor market could be avoided. As of the end of the year, the number of the officially registered unemployed was 2.5 mn. persons (3.4% of the total number of employed in the national economy) against 2.3 mn (3.2%) at the end of 1995. Herewith, the number of unemployed grew, in 1996, at a lower rate than in the preceding three years.

The uncompleted system market transformations, the absence of dynamism and integrity reform, the weak structural, fiscal, and budgetary policies, and the unbalanced policy of governmental borrowings did not favor the animation of the economy and the cessation of the investments decline.

Table 2.2

**Dynamics of main structural components of GDP production,
% of previous year**

	1995	1996
GDP	95.8	94.4
Goods	95.1	91.5
Services	96.4	97.1
market	95.3	96.2
non-market	99.5	99.7
Net taxes	96.1	95.7

Production of GDP. In 1996, the GDP was Rbl. 2,256 trln; in the real terms it reduced by 6%, compared with 1995. The structure of the GDP production conserves the trend to the growth of the share of services at a steady decline of the goods production.

In comparison with 1995, the year 1996 showed the recession in the main sectors of the national economy: industry, construction, transport, and rural economy.

The volume of industrial production decreased by 5.5%, compared with the previous year. In 1996, in contrast with 1995, the production recession was observed in practically all the industries, except gas production. This is due to the continuing contraction of the effective demand for the products of the branches oriented, mainly, to the Russian market. The production recession made 4.7% in the extractive industry and 9.1% in the processing and manufacturing industries. The dynamics of the industrial production is negatively affected by the remaining trend to the growth of the recession at the enterprises of the defense industry under conversion to 30% in 1996 against 23% in 1995, as well as the progressive reduction of the consumer goods production.

The production of the rural economy reduced by 7%, in compared with 1995. The trend, revealed in 1995, when the agricultural production characterized by a deeper recession than the GDP and industry, continued. The financial situation of the rural economy worsened brutally, as well. If, in 1995, the sector had 57% of unprofitable entities of all forms of property, in 1996, the relevant number was 75%.

The dynamics of the value added in 1996 was especially significantly influenced by the important decay of the investment activity parameters: the construction production decreased by 11%, compared with the preceding year. The share of construction in the value added reduced from 8.6% in 1994 to 6.2% in 1996.

The accrual of the gap between the economic potential of the real sector of economy and the level of production of goods formed under the influence of the demand and crediting limitations is accompanied by the reduction of the production potential load and employed, and, hence, growth of the additional production costs.

Formation of GDP by incomes. The deterioration of the financial situations of enterprises, the growth of non-payment's in the economy and the delays in payment of wages had a negative effect on the incomes formation. In 1996, the significant accrual between the indexes determined on the accrued basis and the estimates of the real money flows in the economy grew significantly.

Table 2.3

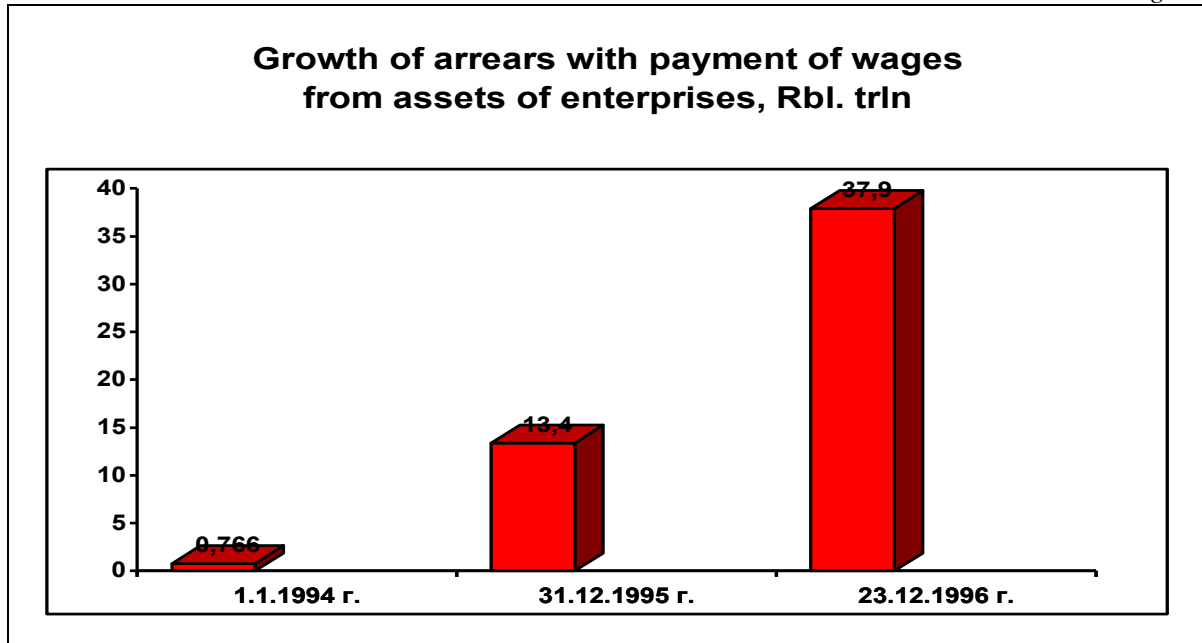
Structure of GDP by incomes, % of GDP

	1994	1995	1996
Gross domestic product	100	100	100
Labor payment for employees (accrued)	39.9	33.0	37.2
<i>Labor payment for employees (paid)</i>	39.0	31.3	35.6
Taxes on production and import (accrued)	13.5	14.2	15.8
<i>Taxes on production and import (inflows to Budget)</i>	13.2	12.9	13.6
Subsidies (minus)	4.4	4.5	4.5
Gross profit (gross mixed income)	51.0	57.3	51.5
Consumption of fixed capital	20.2	25.0	24.6
Net mixed income	30.8	32.3	26.9
<i>Information:</i>			
<i>Profit by national economy</i>	17.7	18.4	15.7

Source: Russian Ministry for economy

The share of the labor payment of the salaried employees (accrued) reduced from 39.9% in 1994 to 33% in 1995 grew, in 1996, up to 37.2%, according to the estimates. This is explained, first, by that the further decrease of the production volume at the enterprises of the real sector is not accompanied, as before, by the adequate staff reduction. Besides, in 1996, in contrast with the preceding year, the growth of the accrued average monthly labor payment in the economy sectors outstripped considerably the growth of the consumer prices.

Fig. 2.1



Thus, if, in October 1996, the consumer prices index was 127.2% relative of October 1995, the growth rate of the accrued wages and welfare benefits per employee for the same period was 135.5% for the economy in whole, with the existing differentiation for certain branches and sectors.

The relation between the dynamics of the accrued wages and inflation at deterioration of the financial situations of enterprises brought to the accelerated accrual of the wages arrears. In January to October 1996, the paid wages in industry were only 72% of the accrued ones. As a result, the accrual of the wages arrears exceeded more than two-fold the one for the preceding year.

Thus, the real reduction of the labor payment share (actually received) in the GDP is greater: from 39% in 1994 to 35.6% in 1996.

The share of the taxes on production and import in the GDP (accrued) grew, during 1994-96 from 13.5% to 15.8%, which shows a certain growth of the indirect taxation on the producers. Due to the annual reevaluation of the fixed assets, the taxes on property grew: the share of these taxes in the GDP grew during the two years by 1 p.p. During the same period, the share of the excise taxes grew by 1.6 p.p.

In 1996, the gross mixed income of the economy was 51.5% of the GDP, just as in 1994; but its components moved in different directions. The share of consumption of the fixed capital grew from 20.2% in 1994 to 24.6% in 1996, due to the reassessment of the fixed assets.

For the first time from the beginning of the reforms, the nominal aggregate mass of profit in industry, transport, and construction began reducing (in January-November 1996, it was 45% compared with the same period of the preceding year). This was conditioned by the continuing production recession, reduction of the inflation share of profit, growth of the

depreciation share due to the reassessment of the fixed assets from 1 January 1996, and the asynchronous dynamics of prices of the final and intermediate products. In 1996, the profit exceeded the level of the preceding year in the gas transport and power at a visible reduction of profit in all the other branches.

The specific weight of the profits of the branches of economy reduced from 17.7% of the GDP in 1994 to 15.7% of the GDP in 1996, reflects the deterioration of the enterprises' financial situations due to the sharp reduction of the profitability. In the first half of 1996, the profitability of commercial products in industry was 10.2% against 26.2% for the same period of the preceding year; in whole during the year, the profitability decreased from 19.7% to 13.8%.

The higher share of profit in the GDP in 1995 (18.4%) compared with 1996 accounts for the fact that, under the conditions of the favorable foreign economic conjuncture, the group of industries manufacturing the intermediate products (metallurgical, chemical and petrochemical, and cellulose-paper industries), in the first half of 1996, increased the prices on their products much faster than the prices of their input material resources grew. The profitability in these industries grew bluntly: up to 30% to 40%. This could go on only till the prices in Russia reached the world level; this happened, in most cases, to the end of 1995.

The comparison of the prime cost and commercial product volume growth rate for the last year brings to the conclusion on the anticipating growth of the prices of the consumed material resources compared with the end product prices in most branches. This shows that the effective demand of the consumers has reached its limit level.

Table 2.4

Structure of use of GDP, %

	1995	1996
	report	estimate *)
Gross domestic product	100	100
Expenses on end consumption	69.6	70.9
private households	47.6	47.7
State administration	18.7	19.5
individual services	10.0	10.8
collective services	8.7	8.7
non-commercial organizations servicing private households	3.3	3.7
Gross accumulation	26.2	24.5
gross accumulation of fixed capital	20.6	19.5
change of stocks of material circulating assets	5.6	5.0
Net export (minus import)	4.2	4.6

*) Estimate by Russian Ministry for economy

Source: Russian Goscomstat

Use of gross domestic product. The main factor influencing the dynamic and structure of the use of the gross domestic product in 1996, was the further reduction of the domestic demand. The reduction of the effective demand in the domestic market was initiated by the insufficiency of financial assets in all the sectors of the economy. The total final consumption of the material goods and services in 1996 was 96% of the level of 1995.

In 1996, after the reduction, in 1995, by 13%, the real disposable incomes of the population stayed on the level of the past year; with this, the growth by 5% of the real accrued wages per employee was observed, against the reduction by 28% in 1995.

Fig. 2.2

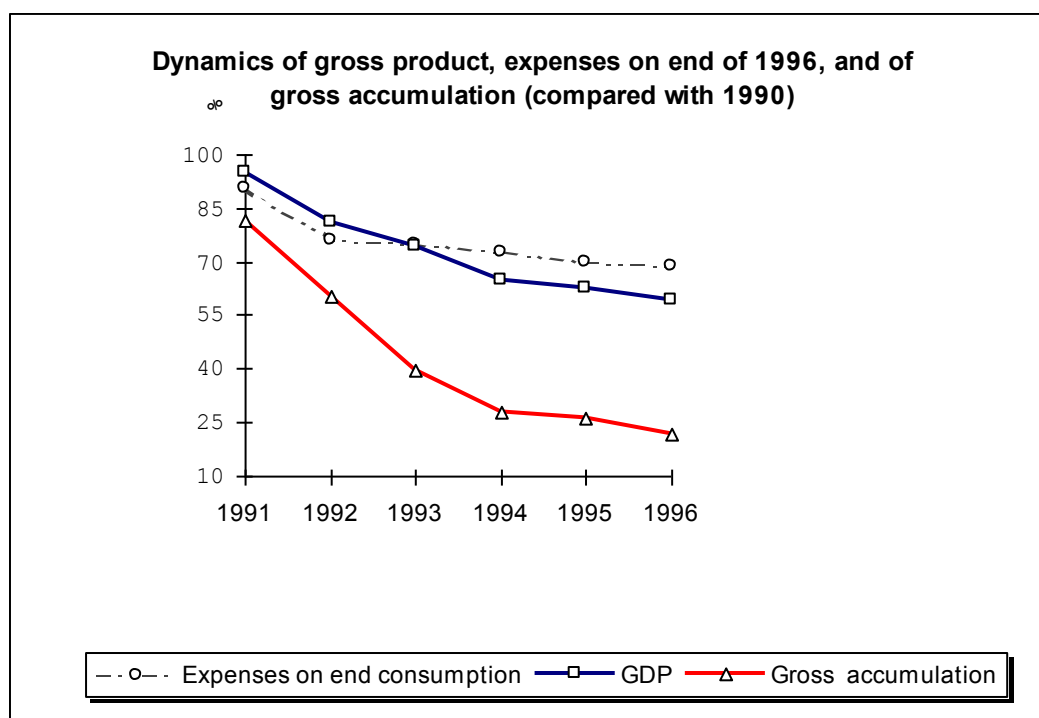
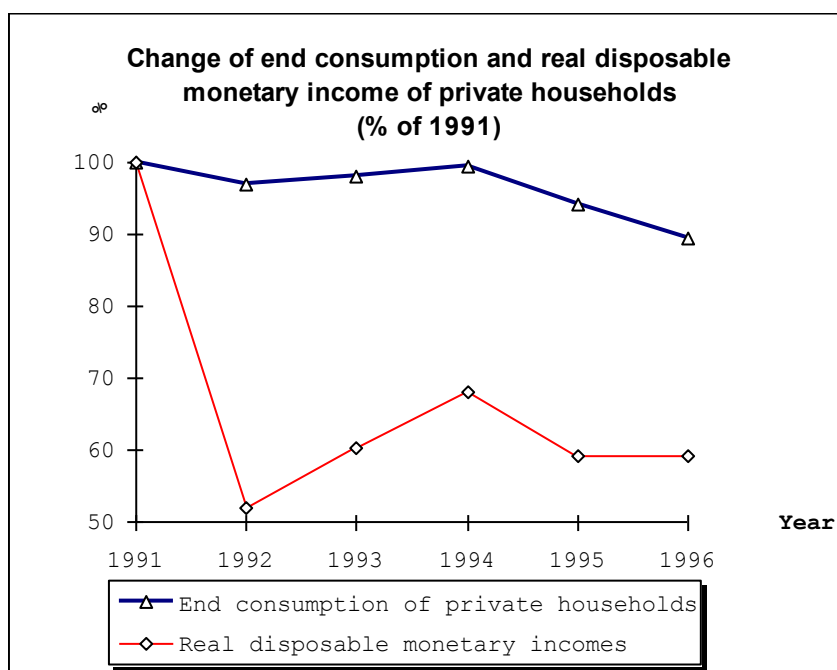


Fig. 2.3



In 1996, the actual end consumption of the private households, taking into account the cost free services, stayed at the level of the preceding year. The expenses of the private households on the end consumption of goods reduced by 4%. The structure of the expenses on the goods saw no substantial changes: the share of the food stayed at the level of 1995, i.e., 48%. The real decrease of the expenses on the final consumption of the paid for services to the population reduced by 18% in 1995 compared with 1994 to 7% in 1996 compared with 1995.

In 1996, the gross savings continued reducing both due to the reduction of the investments in the fixed capital and to the changes of the tangible circulating assets. The investments

recession of 1996 exceeded considerably that of the preceding year, and, just as in the past years, the rates of recession of the industry and GDP.

In 1996, the gross accumulation of the fixed capital reduced by 185 against 11% in 1995; moreover, the reduction of the fixed capital accumulation was similar in both the productive and non-productive spheres.

Beginning from 1993, the net accumulation of the fixed capital has been negative, especially in the production sphere; hence, the further reduction of the investments will lead to the lowering of the reproduction capacities.

The economic situation of 1996 may be defined as the new stage of the system crisis affiliated with the transformation of the production model in the direction of improvement of the interior balance by dismantling the non-utilized and losing capacities, as well as reduction of employment and inter-industries flow of the investment and labor resources.

2.2 Industry

Dynamics of industrial production

The industrial dynamics in 1996 was characterized by the remaining trend to the general production recession. The total industrial production reduced by 5.5% compared with the previous year. The least reduction was observed for the intermediate products: 4.3%. The production of the capital goods reduced by 14.5%; the production of the consumer goods reduced by 6.6%. The data on the production dynamics in the main branches of industry are shown in Tables 2.5 and 2.6 and at Figures 2.4 and 2.5.

The general causes of the industrial recession in Russia are the structural features of the Russian economy, and, first of all, the vast inefficient sector and hypertrophied development of the armament industry. The following main factors of the recession, having directly conditioned the reduction of the industrial production during the reforms and active in 1996, as well, are to be emphasized:

- the rapprochement between the levels of the domestic and world prices, resulting in the dismantling of the inefficient capacities and growth of the share of the imported product to cover the effective demand in the domestic market;
- the tightening of the financial and crediting policy having resulted in reduction of the financial support of the non-competitive capacities, abrupt reduction of the governmental investments and arms manufacture;
- the investment crisis having conditioned the investment production drop;
- the reduction of the effective demand of the population which has, together with the expansion of the import, conditioned the reduction of the consumer goods manufacture; and
- drop of the effective demand for the Russian industrial products in the CIS countries, as a result of the economic recessions in them and harmonization of the mutual trade prices with those of the world market.

Fig. 2.4

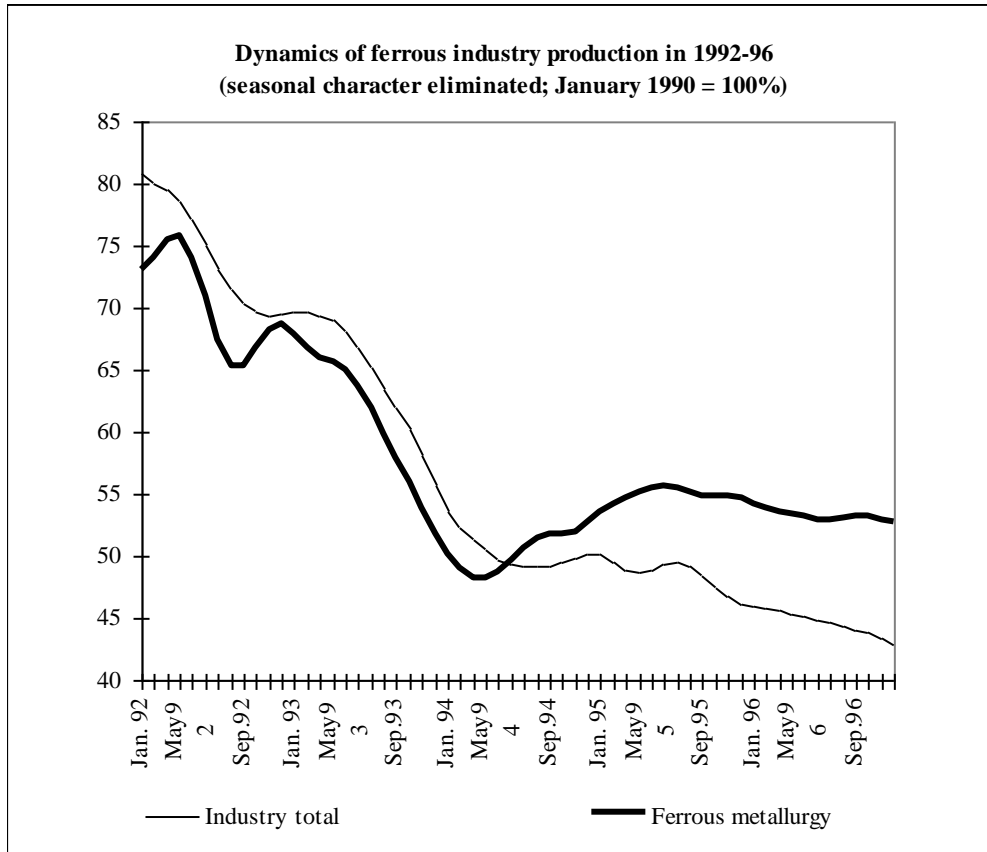


Fig. 2.5

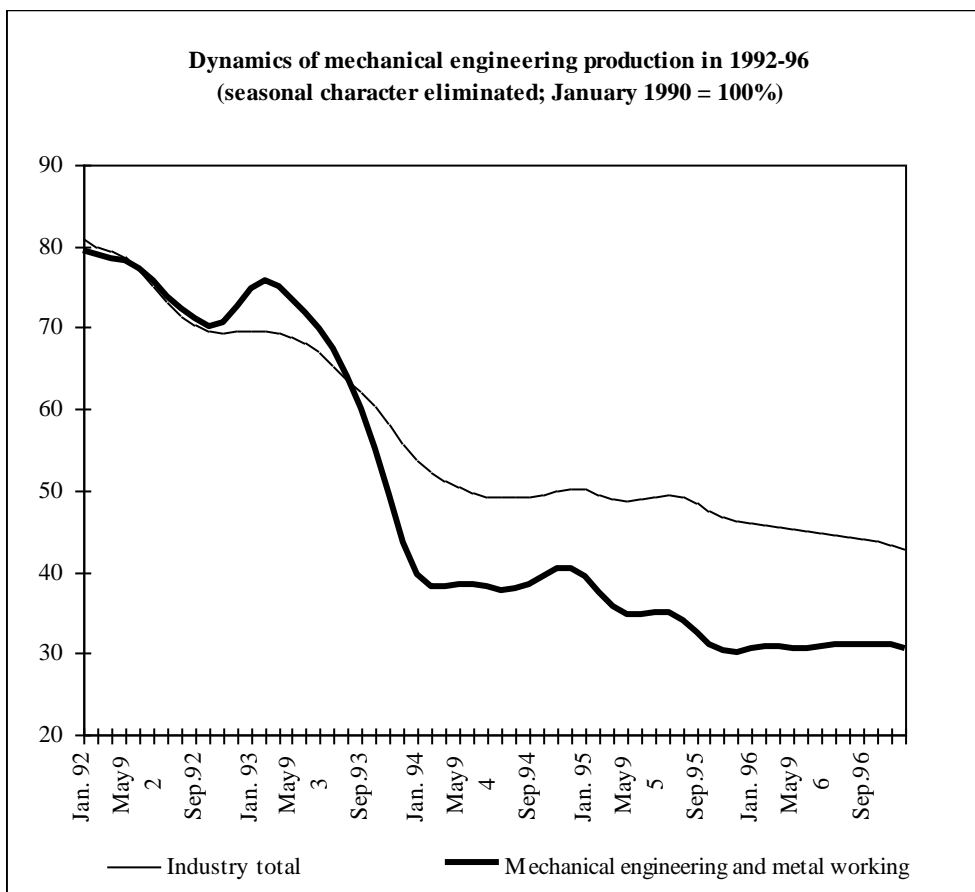


Fig. 2.6

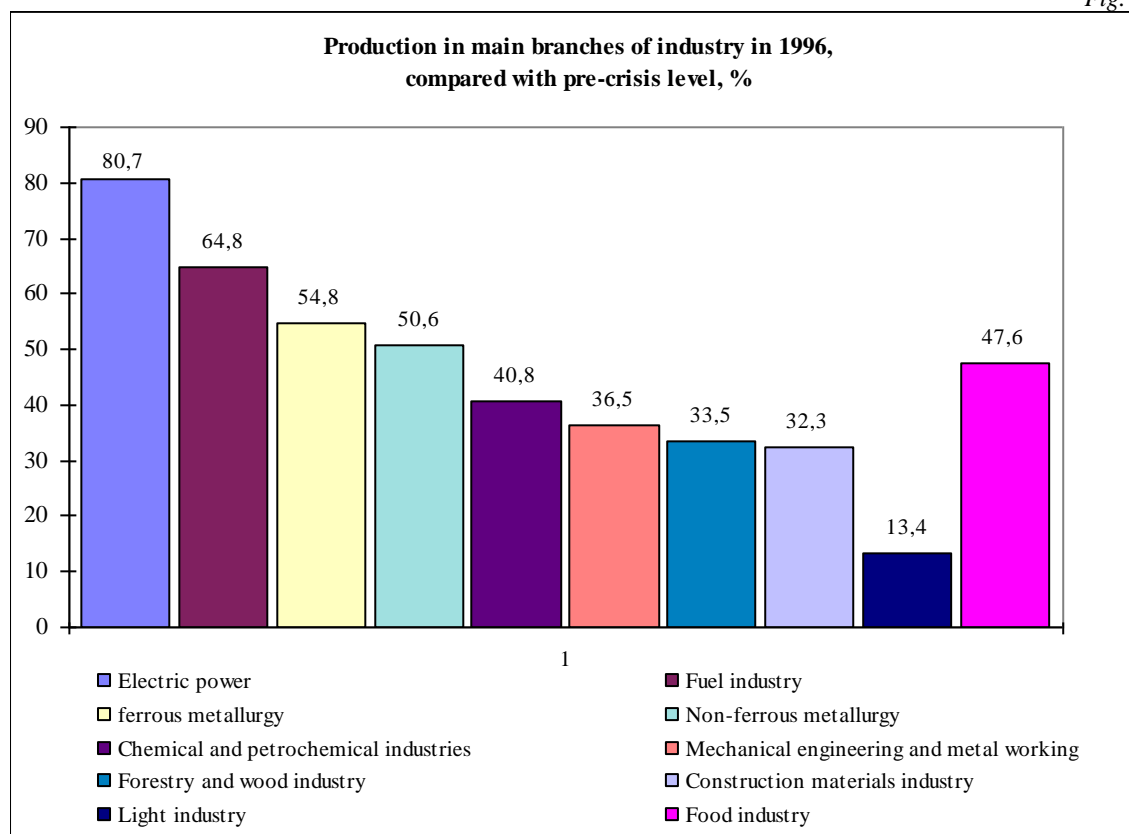


Table 2.5

**Dynamics of physical industrial production volume in 1990-96
(% of preceding year)**

	1990	1991	1992	1993	1994	1995	1996
Industry, total	99.9	92.0	82.0	85.9	79.1	96.7	94.5
Electric power	102.0	100.3	95.3	95.3	91.2	96.8	98.4
Fuel industry	96.7	94.0	93.0	88.4	89.8	99.2	97.3
Ferrous metallurgy	98.1	92.6	83.6	83.4	82.7	109.6	95.5
Non-ferrous metallurgy	97.6	91.3	74.6	85.9	91.1	102.8	94.6
Chemical and petrochemical industries	97.8	93.7	78.3	78.5	75.5	107.6	89.0
Mechanical engineering and metal working	101.1	90.0	85.1	84.4	69.2	90.9	88.9
Forestry, wood processing, and cellulose-paper industries	98.8	91.0	85.4	81.3	69.5	99.3	77.7
Construction materials industry	99.1	97.6	79.6	84.0	72.7	92.0	74.7
Light industry	99.9	91.0	70.0	77.0	54.0	69.8	72.4
Food industry	100.4	90.5	83.6	91.0	82.5	91.8	90.8

Source: Russian Goscomstat

The production recession has affected all the branches of industry; at the same time, the degrees of the recession differ by industries. The highest production levels remain in the fuel and power complex. In the electric power production, the production level of 1996 was 80.7% of that of 1989; the relevant figure for the fuel production is 64.8% (see Fig. 2.6). This can be explained, first of all, by the relatively high domestic demand for the electric power. This is conditioned by the following factors:

- first of all, the levels of power consumption reached in the non-production sphere (it consumes up to one fourth of all the electric power) remain the same;
- second, the production drop in the high power consumption industries (metallurgy) compared with the lower power consumption industries (mechanical engineering, light industry) was minor;
- third, the efficiency of use of the power resources dropped due to the reduced load on the production capacities and suspensions of production;
- fourth, the technology restructuring of the production is extremely slow due to the abrupt reduction of the production investments; and
- fifth, all these are linked with the existence of the twilight economy; the power production for its needs is accounted for by the official statistics, while its products and services are not.

The conservation of the relatively high production levels in the fuel industry is also explained by the relatively high export capacities of the oil and gas producing sectors. In 1996, the volumes of export were 41.7% of the production for the oil industry and 32.7% for the gas industry.

Table 2.6

Dynamics of physical volume of industrial production in 1996
(% of January 1990, seasonal character eliminated)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Industry, total	46.0	45.8	45.6	45.4	45.1	44.9	44.6	44.4	44.1	43.8	43.4	42.9
Fuel and power complex	68.3	68.6	68.7	68.4	68.0	67.5	67.1	66.9	66.7	66.3	65.4	64.2
Ferrous metallurgy	54.2	53.8	53.6	53.4	53.2	52.9	52.9	53.1	53.3	53.2	52.9	52.7
Non-ferrous metallurgy	82.9	82.9	83.0	82.9	82.7	82.4	82.2	82.4	83.0	83.9	84.7	85.5
Mechanical engineering	30.5	30.7	30.7	30.5	30.5	30.8	31.0	31.0	31.1	31.1	31.0	30.5
Chemical and petrochemical industries	42.1	41.0	40.3	40.3	40.5	40.9	41.3	41.6	41.9	42.0	42.2	43.1
Forestry, wood working, and cellulose-paper industries	36.2	35.1	33.9	32.4	30.8	29.9	30.1	31.0	32.0	32.1	30.9	28.0
Construction materials industry	32.4	31.5	30.8	30.2	29.6	28.9	28.4	27.8	27.2	26.4	25.8	25.7
Light industry	13.6	13.3	13.3	13.3	13.1	13.0	12.9	12.7	12.4	12.0	11.6	11.5
Food industry	40.9	40.7	40.6	40.7	40.8	40.5	39.3	37.7	36.2	35.3	35.0	35.0

Source: Center for economic conjuncture under the RF Government

Due to the relative stabilization of the domestic demand for power and a certain growth of the power resources export, the production drop rates in the fuel and power complex were the least, compared with the other branches. The aggregate production of the complex reduced by 2.1% compared with the preceding year. At the same time, the electric power production reduced by 1.6%, the oil extraction reduced by 2%, and the coal mining reduced by 6%. For the first time during the years of reforms, the natural gas extraction grew (by 1%) which is, as we believe, the indicator of the gas extraction industry transition from the production drop stage resulted from the drop of the domestic power consumption and reduction of the effective demand of the CIS countries, to the growth stage.

As we believe, during the last two years, the indexes of development of the crude oil extracting have shown an obvious trend towards stabilization. This allows to suppose the formation, on a lower than the pre-crisis level, of a new, relatively stable balance between the crude oil offer, for the one hand, and the domestic and foreign demand for it, for the other hand. The formation of such balance allows to count on the keeping, in the nearest years, of the trend towards stabilization in the oil extraction. Moreover, one should expect that the possible additional reduction of the domestic demand for crude oil will be cby the expansion of its export. As of today, the stable production growth is observed only for the group of joint ventures. In 1996, joint ventures expanded the crude oil extraction by 16%, while their specific share in the total crude oil extraction in Russia reached 5.2%.

The reduction of the domestic demand and the lowering of the export efficiency for the metallurgy and chemical industry conditioned the renewal of the recession in these sectors. Compared with 1995, the reductions were the following: 8% for the iron ore mining; 5% for the steel production; 7% for the pipes manufacture; 35% for the aluminum rolling; 5% for the mineral fertilizers production; 22 for the synthetic resins and plastics production; and 38% for the chemical fibers and threads production. At the same time, the production growth was observed for certain items: 3% for the aluminum production; 7% for the copper production; 5% for the zinc production; and 18% for the tires manufacture. The ferrous metallurgy has conserved the trend towards the growth of the specific share of the state-of-the-art technologies: the shares of the converter and electrical steel in the total melting volume grew from 60% in 1995 to 64% in 1996; the share of the continuous casting grew from 37% to 41%. In 1995 to 1996, in the non-ferrous metallurgy, the specific share of the products produced by tolling from the give-and-take feedstock reduced from 44% to 43% for aluminum and grew from 45% to 51% for zinc and from 4.3% to 5% for copper.

The external demand is becoming a more and more significant factor influencing the dynamics of the feedstock production. For certain products, it determines, in the decisive extent, the current volumes and dynamics of production. E.g., the specific share of the production for foreign markets in the total production volume reached, in 1996, 60% for the ferrous metallurgy and 70% to 80% for aluminum, copper, mineral fertilizers, and cellulose.

The sharp drop of the investment activity in the economy, due, in a great extent, to the influence of the Presidential elections, conditioned the significant reduction of the investment mechanical engineering production. In whole, the rates of reduction of the production means production grew from 9.8% in 1995 to 14.5% in 1996. The most significant was the reduction in the machine-tools manufacture (by 33%, compared with 1995) and in the tractors and agricultural machinery manufacture (by 41%). The situation in the automobile industry stayed stable enough: the general level stayed the same as in 1995, while the manufacture of passenger cars grew by 4%. The significant growth of manufacture of personal computers from imported components should be noted, as well (2.8-fold, compared with the preceding year).

The greatest production drop among the main industries, both compared with the pre-crisis level and with the preceding year's level, was observed for the light industry. The trend to the further production drop remained in the food industry, as well. The manufacture of the long use commodities also reduced sharply (e.g., the manufacture of the tape recorders, VCRs, and TVs reduced by 67% to 71%). Under the stabilization of the effective demand of the population, this is, obviously, explained by the growing import (growth of the imported products share in the structure of the domestic market effective demand satisfaction), conditioned by the low competitiveness of the domestic goods. This is confirmed by the results of the studies by the statistic bodies in the administrative centers of the Russian Federation subjects. To the end of 1996, the specific shares of the imported goods offered for

sale in the total amount of the goods studied were the following: 36% for sausages; 39% for butter; 38% for cheeses and vegetable oils; 62% to 65% for overcoats; 71% for men's shirts; 79% for men's shoes; 84% for ladies' shoes; 94% for color TVs; 99% for VCRs. In whole, the specific share of the imported products in the commodities resources of the retail trade made 52% in 1996.

The analysis of the industry recession structure by sectors, based on the 1992 prices, shows that the greatest share in the total reduction of production in Russia is due to the mechanical engineering and light industry (see Fig. 2.7). The reduction in these branches directly conditioned almost 40% of the recession. Besides, the reduction of the effective demand from these industries conditioned a significant share of recession in the metallurgy and chemical industry, and, hence, the fuel and power complex. This allows to consider the mechanical engineering and light industry as the main generators of the industry recession in Russia. Moreover, if the recession in the light industry is due, most of all, to its low efficiency, the recession in the mechanical engineering accumulated the effects of all the main factors of the recession, first of all, the low efficiency, investment crisis, and demilitarization. A great role in the production drop, especially in the mechanical engineering, chemical, and food industries was played by the drop of efficiency and production decrease in the rural economy which led to the sharp drop of demand for the agricultural equipment and mineral fertilizers and shortening of the feedstock base of the food industry.

Structural shifts

The differences in the production dynamics by main sectors of industry conditioned the significant changes in the industrial production structure (see Table 2.7, Fig. 2.8). As the data reflecting, together with the changes of the physical production volumes, the dynamic of the prices for the products of these sectors, show, the last years are characterized by the sharp growth of the fuel and power complex share in the industry structure; the fuel and power complex is becoming not only the basis of the export potential, but the basis of the Russian economy in whole. Taking into account the stable demand for the power resources in the foreign markets and the remaining gap between the domestic and world prices for the main power resources, the further growth of the specific share of the fuel and power complex in the industry structure is possible.

The specific share of the metallurgical complex grew, as well, compared with the pre-reform level. At the same time, the shares of the mechanical engineering and light industry decreased pointedly. The above trends are also seen when analyzing the structure of the industrial production in comparable prices. Thus, the specific share of the fuel and power complex (in the 1995 prices) grew from 20.4% in 1990 to 30.9% in 1996; during the same period, the specific shares of the mechanical engineering and light industry reduced from 22.6% to 17.5% and from 7% to 2%, respectively (see Table 2.8, Fig. 2.9).

Together with the change of the production structure, the structures of the capital investments and labor resources are changing quite significantly. The analysis of the capital investments statistics shows the important growth of the fuel and power complex and metallurgical complex in the investments in industry. At the same time, the important reduction of the investments in all the other industries is observed. Thus, the share of the fuel and power complex in the structure of capital investments in industry (in the current prices) grew from 39.1% in 1990 to 62.4% in 1996. At the same time, the specific shares of the capital investments reduced from 23.1% to 8.3% for the mechanical engineering and from 3.3% to 0.6% in the light industry (see Table 2.9, Fig. 2.10).

Fig. 2.7.

Contributions of main industries in total recession of industrial production in 1991-96, %

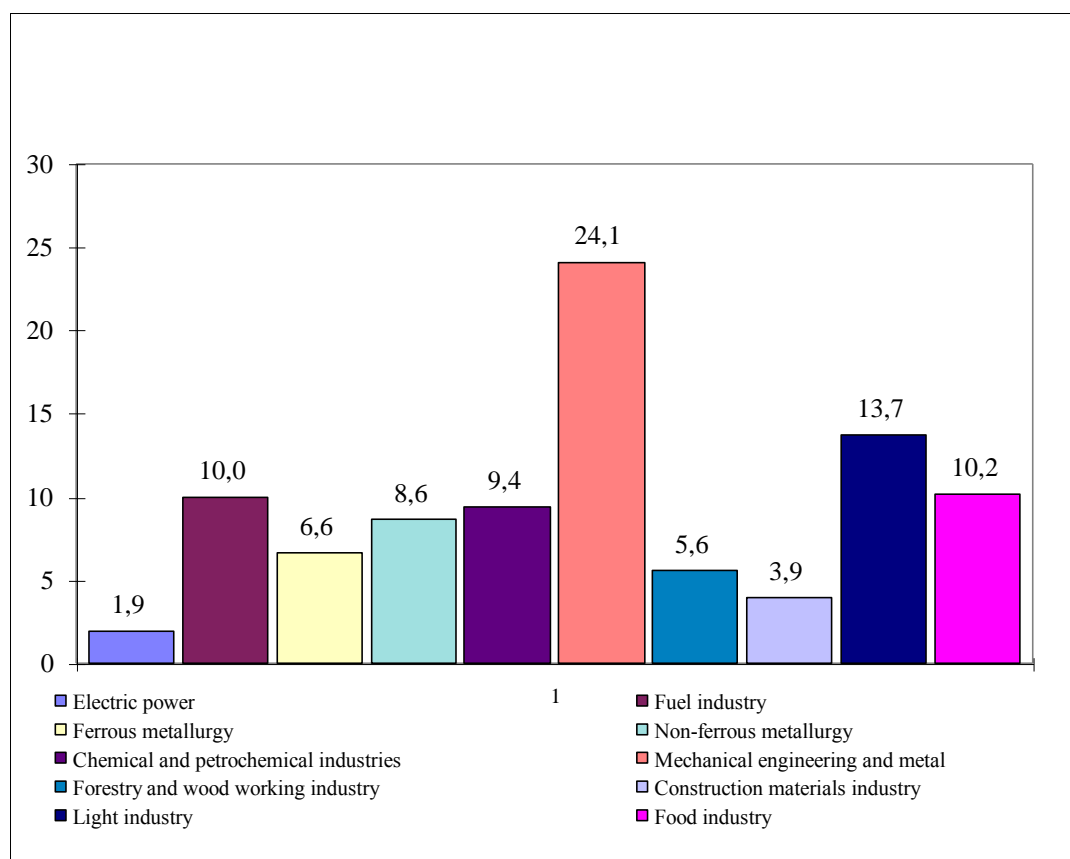


Table 2.7.

Structure of industrial production in current prices, %

	1990	1991	1992	1993	1994	1995	1996
Industry, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Fuel and power complex	12.2	11.9	25.3	26.7	29.4	31.0	35.8
Metallurgical complex	12.0	11.7	17.8	17.1	16.6	17.1	15.5
Chemical and wood complex	12.9	13.2	13.5	11.4	11.7	13.1	10.9
Mechanical engineering complex	30.8	25.7	20.5	20.3	19.1	17.7	18.1
Light industry	12.1	16.5	7.1	5.2	3.1	2.4	1.9
Food industry	11.7	13.3	9.8	12.4	11.9	11.3	10.7

Source: calculated acc. to Russian Goscomstat

Table 2.8

Structure of industrial production in comparable prices*, %

	1990	1991	1992	1993	1994	1995	1996
Industry, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Fuel and power complex	20.4	21.2	23.4	24.8	28.5	29.1	30.9
Metallurgical complex	14.4	14.2	13.3	13.1	14.3	15.9	16.4
Chemical and wood complex	14.1	14.1	13.9	12.9	11.8	12.8	11.7
Mechanical engineering complex	22.6	21.9	22.4	22.0	19.3	18.1	17.5
Light industry	7.0	6.8	5.6	5.0	3.4	2.5	2.0
Food industry	12.0	11.7	11.4	12.1	12.7	12.1	11.9

* 1995 prices

Source: Russian Goscomstat; calculations by authors.

Table 2.9

**Structure of capital investments in industry from all sources of financing
(current prices), %**

	1990	1991	1992	1993	1994	1995	1996
Industry, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Fuel and power complex	39.1	39.7	52.8	55.7	57.6	61.7	62.4
Metallurgical complex	8.2	9.1	11.1	10.7	11.0	12.3	10.4
Chemical and wood complex	9.3	10.1	9.3	6.9	5.0	7.2	7.2
Mechanical engineering complex	23.1	20.0	11.9	12.2	11.7	8.3	8.3
Light industry	3.3	3.4	2.5	1.7	1.2	0.7	0.6
Food industry	8.1	9.1	6.4	8.1	7.8	6.1	7.4

Source: calculated acc. to the data of Russian Goscomstat

Table 2.10

Structure of industrial production personnel, %

	1990	1991	1992	1993	1994	1995
Industry, total	100.0	100.0	100.0	100.0	100.0	100.0
Fuel and power complex	6.4	6.8	7.4	8.2	9.0	9.7
Metallurgical complex	6.0	6.5	6.7	7.1	7.2	8.0
Chemical and wood complex	13.9	14.1	14.8	14.6	14.6	14.7
Mechanical engineering complex	38.2	37.6	35.7	34.2	31.7	30.2
Light industry	10.9	10.7	9.2	9.0	9.2	8.5
Food industry	7.4	7.6	7.8	8.2	8.9	9.4

Source: Russian Goscomstat.

The data on the employment structure also show the growth of the specific share of the fuel and power complex and metallurgy in the whole number of the industrial and production personnel; meanwhile, both the relative and absolute numbers of the persons employed in the mechanical engineering and light industry are dropping (see Table 2.10, Fig. 2.11). With the general reduction of the number of the industrial and production personnel, the absolute number of employed grew only in the fuel and power complex. The number of employed in the mechanical engineering and light industry decreased abruptly.

Hence, the analysis of the structural changes shows the significant growth of the shares of the fuel and power complex and mechanical engineering in the industry structure. We believe that this result reflects not only the objectively conditioned conservation of the relatively high levels of production in the electric power sector and the drop of the investment purpose production, but also the difference between the levels of competitiveness of different industries. According to the results of the studies, the branches of the fuel and power complex (except the coal extraction) and metallurgy are the most competitive in the Russian economy from the viewpoint of the international division of labor (according to the calculations, these industries stay of high profitability even after transition to the world prices, i.e., under the conditions of the open market economy). As for other industries (and rural economy) the production stays either unprofitable or of low efficiency with the world level prices for the products they produce and consume. As a result, the rapprochement between the domestic and world prices, at the existing technology structure of the Russian economy, will, inevitably, lead to the drop of production in the low competitiveness sectors, and, hence, dismantling of production. At the same time, the competitive industries maintain the high levels of production, investments, and employment; this leads to the growth of their specific shares in the industry structure.

Fig. 2.8

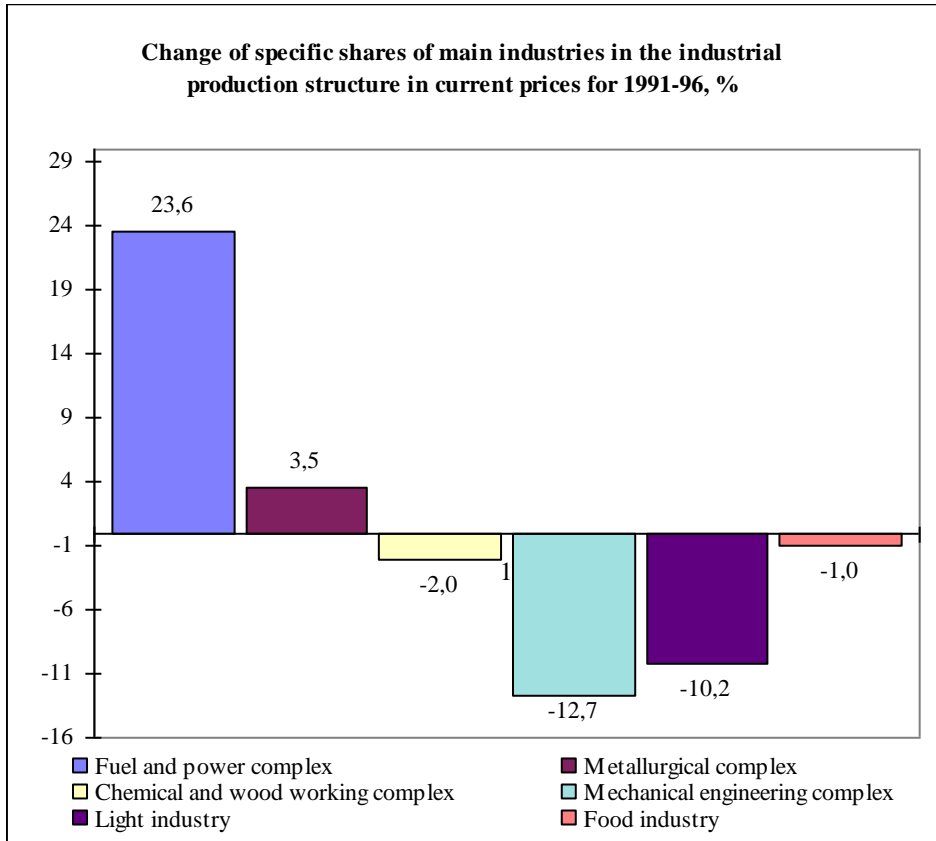


Fig. 2.9

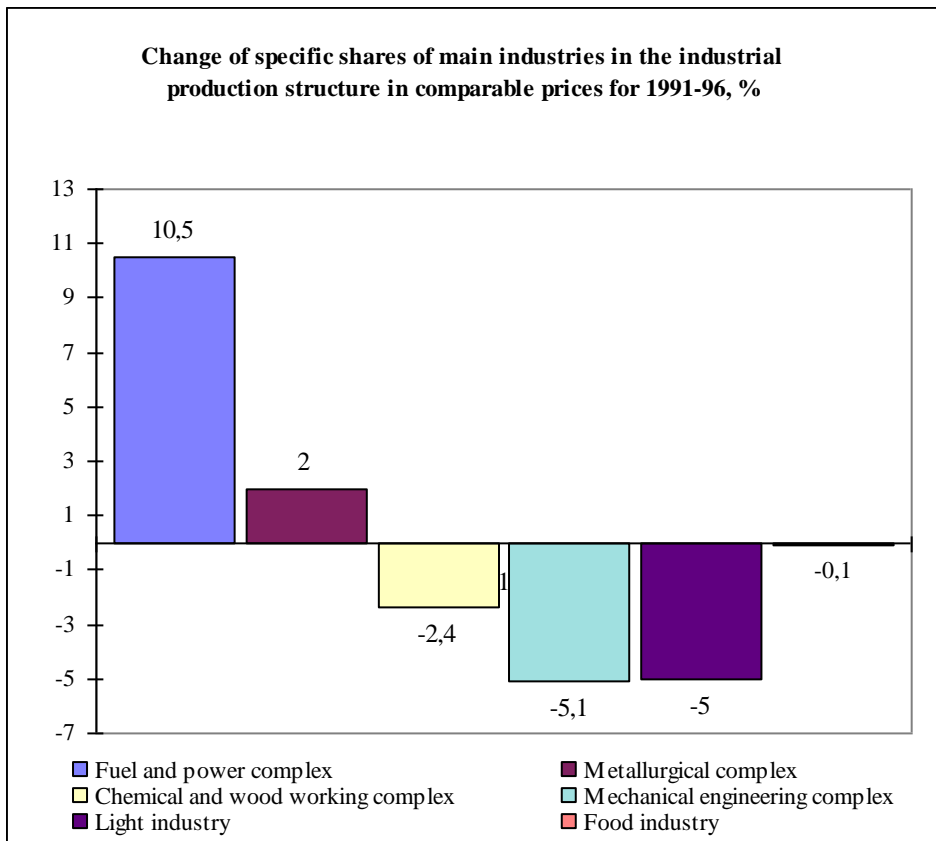


Fig. 2.10

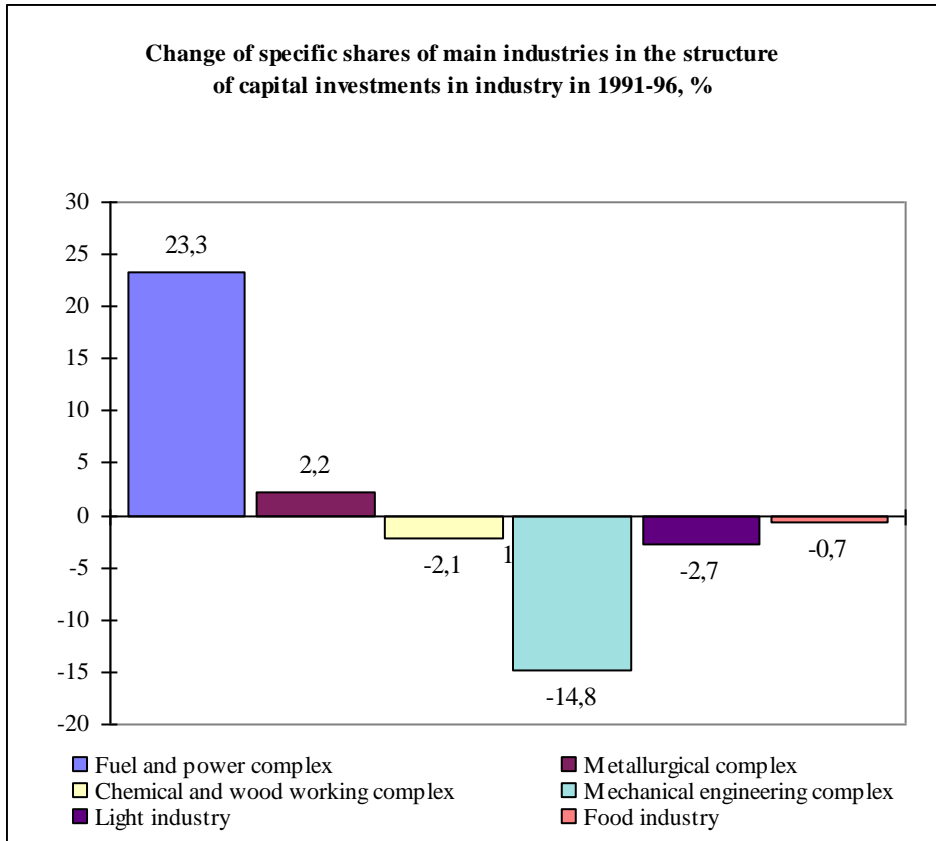
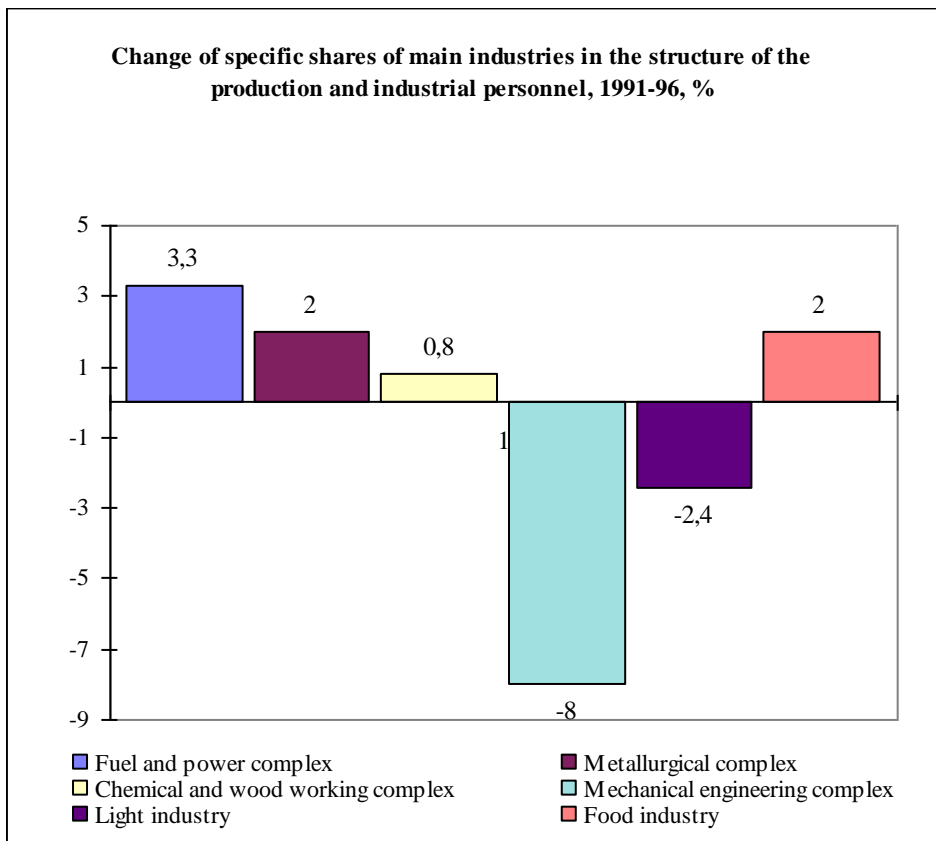


Fig. 2.11



Hence, in 1996, just as in the preceding years, the industry dynamics was determined by the set of the economic factors, first of all, the process of dismantling of the inefficient sectors of industry and rural economy; all these have determined the reduction of the aggregate domestic demand, and, hence, production in the competitive industries.

At the same time, the latest years have shown the trend towards the gradual stabilization of the industrial production and redistribution of the production, investments, and labor resources for the benefit of the most competitive sectors. Taking into account the positive general economy processes at the macroeconomic level, this allows to anticipate the close culmination of the crisis restructuration period of the Russian economy and formation of the prerequisites for the steady production stabilization and restoration of the industry growth.

2.3. Agro-Industrial Complex

General characteristic

The year 1996 has not become the year of the crucial changes in the rural economy. The conservation of the main characteristics of the agrarian policy conditioned the conservation of the former trends in production. For the other hand, the wave of the electoral promises and privileges stayed, firstly, within the limits of the already stable strategy of the agro-industrial complex (AIC), and, secondly, did not result in the implementation due to the budgetary limitations. As a result, the year 1996 can be characterized as a stagnation year for the agro-industrial complex.

The production recession continued for the whole complex: 7% for the rural economy production (8% in 1995); 9% for the food industry (9%); 41% in the tractor and agricultural machines building (36%); 5% for the mineral fertilizers production (this production has been growing during all the post-reform years, and the growth made 17% in 1995); and 21% for the plants protection agents.

The production in the rural sector itself depends, in a great extent, upon the weather due to the use of the more and more extensive methods. The low gross crops of the last year are conditioned, first of all, the low by the low yield resulting, in its turn, from the unfavorable weather in the main agriculture regions and the low level of use of the fertilizers and plants protection agents.

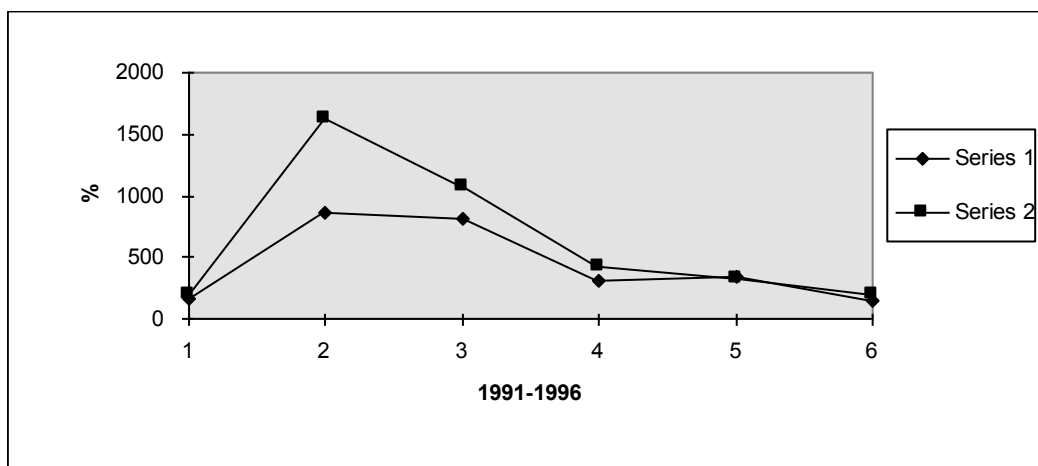
The recession in the food industry at the relatively stable consumption of the basic food is due to the growth of production in the private part-time farms and the relevant self-support of the population with certain agricultural products, the direct sale at markets (without use of the processing industry), and the growth of the consumption of the imported food in the largest cities.

The branches of the first sphere of the AIC bump into the low effective demand in the rural economy and absence of the relevant financial structure.

In 1996, the direct federal transfers to the rural economy were among the lowest for the last 5 years: Rbl. 8.6 trln. or 0.4% of the GDP; at the same time, the implementation of the 1996 approved Budget for this parameter was 59%. Meanwhile, for the industry, power, and construction the relevant figure was only 53%. Nonetheless, no changes in the rural economy support occurred: this is one of the main reasons of the low level utilization of the budgetary investments in this sector.

In practice, the exchange conditions for the rural economy have not changed from 1995 to 1996. The changes of the annual prices for the rural products and the production means for the rural economy were almost parallel (see Fig. 2.12).

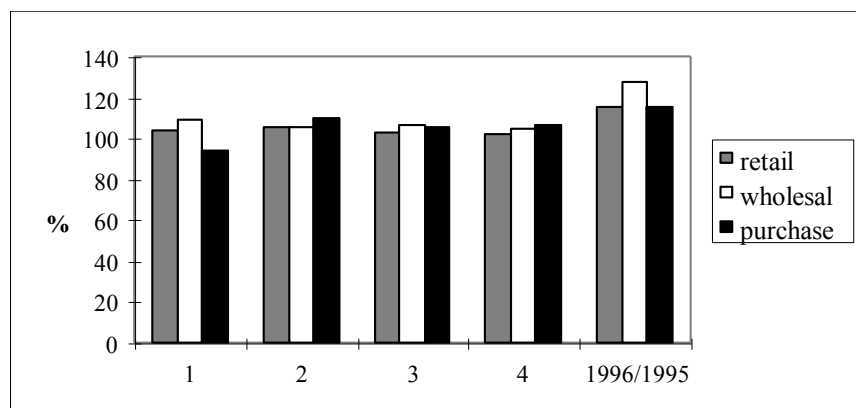
Annual indexes of prices for rural products (series 1) and production means for rural economy (series 2)



Source: Russian Goscomstat

The rates of change of the rural products purchase prices, of the processing industry purchase prices, and of the retail trade prices are of almost the same level (see Figures 2.13 and 2.14), thought with seasonal fluctuations. Thus, just as in 1994, the policy of underestimation of the purchase prices for milk within the “large milk” period led to the lack of the milk feedstock in the 4th quarter-year, and, hence, the outdistancing growth of the purchase prices (see Fig. 2.14). the growth of the milk purchase prices can be supposed for the first quarter of 1997 (judging by the conjuncture poll, two thirds of the respondents expect such growth; this confirms the relatively high degree of familiarization of the producers with this market¹. As for the other products, the dynamic is similar, which confirms our conclusion made in the previous reviews of IET² as for the achievement of the equilibrium level by the relative prices in the AIC. No deterioration of the pricing parity for the rural economy seems possible without the governmental or regional interventions in the market pricing.

Quarter-year and annual indexes of the retail, wholesale, and purchase prices for meat in 1996



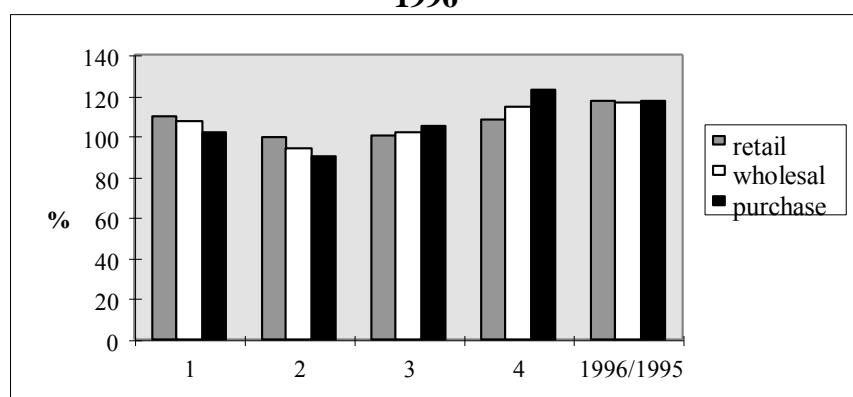
Source: Social Economy Situation of Russia. 1996. Goscomstat, 1997.

¹ As for the results of the poll, see Appendix III hereto.

² See IET reviews “Russian Economy. Trends and Outlooks”, issues 14 and 15.

Fig. 2.14

Quarter-year and annual indexes of retail, wholesale, and purchase prices for milk in 1996



Source: Social Economic Situation in Russia in 1996. Moscow: Goscomstat, 1997. P. 113-114; 131.

Main trends and shifts in plants growing and animals breeding

Plants growing. In 1995, the growth of the plants growing and productivity was observed for all the main crops except grain; as for the year 1996, it was the contrary. In 1996, a very important drop was observed in the production and yield of sunflower (by 33% and 30%, respectively), sugar-beet (16% and 14%), and flax (14% at the same yield). The crop and yield of the potatoes and vegetables reduced, though not so importantly. The growth was observed only in the grain production, though it may seem very relative, taking into account the low productivity of 1995 (see Table 2.11).

Table 2.11.

Gross harvest and productivity of main crops in 1996

	1996	1996 as % of:		
		1995	1991-1994	1986-1990
Gross crop, mn mt				
Grain (weight after processing)	69.3	109.3	73.6	66.4
Sugar-beet	16.1	84.3	72.2	48.5
Sunflower	2.8	66.7	100.0	90.3
Potatoes	38.5	96.5	106.9	107.2
Vegetables	10.7	94.7	107.0	95.5
Long stemmed flax (fiber), thousand mt	59.0	85.9	80.8	47.6
Yield, hundred mt per hectare				
Grain (weight after processing)	12.9	111.2	82.7	81.1
Sugar-beet	152	86.4	91.0	67.6
Sunflower	7.1	69.6	71.7	55.9
Potatoes	113	96.6	105.6	104.6
Vegetables	137	96.5	100.0	89.0
Long stemmed flax (fiber)	3.9	100.0	134.5	156.0

Source: Development of Agro-industrial Complex and Farming in RF, issue 2, Goscomstat, 1993, p. 85-88; Social Economic Situation in Russia in 1995, p. 36; Social Economic Situation in Russia in 1996, p. 50.

The drop of production of the main crops in 1996 was conditioned, first of all, by the decrease of the yield, because the reduction of the sown areas was insignificant, within the limits of 1% to 5%. Besides the shrinkage of the sown areas, the already traditional “technology” causes of the production drop stayed effective: the reduction of use of the fertilizers, plants protection agents, and agricultural machinery. This was completed by the

unfavorable weather of 1996: the dry may and June in the main producing regions at the early stage of the plants vegetation, plus the rainy period before cropping.

The *grain* harvest in 1996 increased by 5.9 mn mt, though it turned out much lower than the forecast one (about 70 mn mt), and one of the lowest from the 70's. Here, the possible significant underestimate by the official statistics of the real volumes of the gross grain crop should be noted (in 1995, such underestimate was 10%).

As for the grain segment, the shift towards the growth of production of the food grain and reduction of production of the fodder grain was observed for the second year (see Table 2.12). The share of the food grain group (wheat, rye, millet, buckwheat, rice) in the total crop of grain increased from 56% in 1991-92 to 61% in 1996. This shift reflects the important structural changes of the past years: first, the recession in the animals breeding had resulted in the relevant reduction of the fodder grain consumption; second, the reduction of the need for the fodder grain was a result of the increase, in the consumption structure, of the share of the imported meat and meat products (the poultry, being the largest grain consuming product, import grew especially high. Thus, the import of the chicken legs from the USA grew from 45,000 mt in 1992 to 850,000 mt in 1996).

Table 2.12.

Change of grain production structure in Russia

	1995 mn mt	1996 mn mt	Structure of grain production, %		
			1991-1992	1995	1996
Grain, weight after processing	63.4	69.3	100.0	100.0	100.0
wheat	30.1	34.9	42.7	47.5	50.4
rye	4.1	5.9	10.5	6.5	8.5
barley	15.8	15.9	27.4	24.9	22.9
oats	8.6	8.3	11.7	13.5	12.0
corn for grain	1.7	1.1	2.0	2.7	1.6
millet	0.5	0.4	1.1	0.8	0.6
buckwheat	0.6	0.5	0.9	0.9	0.7
rice	0.5	0.4	0.7	0.7	0.6
leguminous plants	1.5	1.8	3.0	2.4	2.6
other	0.014	0.076	0.0	0.0	0.1

Source: Social Economic Situation in Russia in 1996. P. 51.

In 1996, the *sunflower* became the most unfavorable crop having shown the greatest reduction of the production and yield. Besides the reduction of the sown areas, the late beginning of harvesting influenced the reduction of the yield. Moreover, the dry summer in the Southern regions reduced the yield by 30%. The drop of the production seems also due to the already usual breaches of the agricultural technology: the especially favorable for the sunflower market situation of the last years resulted in the decrease of the rotation of this crop in the rotation and depletion of the soils; hence, the reduction of the yield. Despite the decrease of the sunflower harvest, its significant export is expected due to the high demand in the world market.

In 1996, the production of the *sugar-beet* was extremely low: during the last 15 years a lower crop was observed only in 1994 (13.4 mn mt). Compared with the average annual levels of 1986-90, in 1996, the crop of the sugar-beet reduced by more than a half. Such stable reduction of the feedstock base of the last years resulted in the decrease of the sugar production from the domestic feedstock (by 44% in 1996, compared with the average levels of 1986-90 and by 20% compared with 1995), the growth of the dependence of the sugar

production on the import of the raw sugar, and the growth of the import share in the end consumption of the sugar.

The surge of the flax production in 1995 was conditioned by the governmental program for flax; nevertheless, as it was not implemented (the flax producers did not receive the pay for their product), the flax production began dropping again in 1996.

Table 2.13.

Dynamics of livestock in rural economy

	As of 1 January, mn heads		Change by year, %	
	<u>1996</u>	<u>1997</u>	<u>1996</u>	<u>1997</u>
Cattle	<u>36.8</u>	<u>35.8</u>	<u>92</u>	<u>90</u>
<u>incl. cows</u>	<u>16.4</u>	<u>16.2</u>	<u>95</u>	<u>93</u>
Swine	<u>20.7</u>	<u>19.5</u>	<u>91</u>	<u>86</u>
Sheep and goats	<u>25.4</u>	<u>23.6</u>	<u>81</u>	<u>84</u>

Source: Social Economic Situation of Russia in 1996. P. 52.

Animal breeding. In 1996, the number of the animals in the rural economy continued reducing (see Table 2.13) in all the categories of economies. In contrast to 1995, when a certain slow down of the livestock reduction was observed for all the categories, in 1996, it accelerated for the cattle and, especially, for the swines (due to the extremely large reduction of the number of these animals in the rural economy). According to the conjuncture poll³ performed by the IET among the rural producers in October 1996, about 50% of the economies planned to reduce, in the first quarter of 1997, the cattle and swines livestock; 75% wanted to reduce the numbers of poultry.

In 1996, the production of the main rural produce was about two thirds of the average annual levels of 1986-90 (see Table 2.14). During the last year, the rates of decrease of the meat and eggs production slowed down somehow, but the drop in the milk production was greater than in 1995. The general recession in the animals breeding was due, mainly, to the crisis of this sector in the rural economy; the greatest effect was on the large swine and poultry breeding complexes, the entities depending upon the intensive fattening and reacting specially on the fodder shortage and price. The reduction of the animal production began in the private farms, as well, though before 1995 they had shown the production growth.

Structure of rural production. In 1996, the former shifts in the sectoral structure of the rural production remained, though their intensities reduced. The share of the enterprises in the rural economy decreased, with the increase of the private households share (see Table 2.15). In 1996, the latter produced already a little less than a half of the produce (against the 24% in 1992), while the share of the private farms stayed at the level 2% for the last three years.

From the viewpoint of contribution into production of individual products, a certain labor division between sectors may be seen. The enterprises remain leaders in the production of grain, sugar-beet, sunflower, i.e., the products which either return to the production (fodder grain) or go to the industrial processing (bread, combined fodder, sugar, vegetable oil, etc.) and require industrial technologies. The private households give the main share of the fresh produce: 9/10 of the potatoes and over 3/4 of the vegetables. The production of the meat and milk has almost by shifted to the individual sector, though the latter depends greatly upon the fodder produced by large-size entities. The eggs, being a more industrial produce, are produced, in a great extent, by large entities.

³ As for the results of the poll, see Appendix III hereto.

Table 2.14

Production of main animal produce in 1996

	1996 mn mt	1996, % of			1995 as % of 1994
		1995	1991-1994	1986-1990	
Meat (cattle and poultry at slaughter, weighted alive)	8.6	91.5	68.6	58.0	86.0
Milk	35.7	90.8	76.0	65.8	93.0
Eggs, bn	31.5	93.5	75.2	65.8	90.0

Source: Social Economic Situation of Russia in 1996. P. 53.

Table 2.15

Shares of different categories of economies in rural produce

	Rural enterprises				Private farms				Private households			
	1992	1994	1995	1996	1992	1994	1995	1996	1992	1994	1995	1996
Grain	97.4	94.2	94.4	95.0	2.1	5.1	4.7	5.0	0.5	0.7	0.9	0.0
Sugar-beet	97.8	95.8	96.0	96.0	2.0	3.5	4.0	3.0	0.2	0.7	0.0	1.0
Sunflower	93.0	88.2	86.0	87.0	5.8	10.2	12.0	11.0	1.2	1.6	2.0	2.0
Potatoes	21.2	11.0	9.2	9.1	0.8	0.9	0.9	0.9	78.0	88.1	89.9	90.0
Vegetables	44.5	32.0	25.7	21.9	0.8	1.0	1.3	1.1	54.7	67.0	73.0	77.0
Meat	64.0	55.7	50.5	47.2	0.7	1.4	1.7	1.8	35.3	42.9	47.8	51.0
Milk	68.1	60.0	56.7	53.2	0.5	1.3	1.5	1.8	31.4	38.7	41.7	45.0
Eggs	73.8	70.9	69.7	68.5	0.1	0.3	0.3	0.5	26.1	28.8	30.0	31.0

Source: Social Economic Situation of Russia in 1995. P. 78, 80. Social Economic Situation of Russia in 1996, P. 51-53

Markets of rural produce and food

During the last year, the markets of the agricultural produce and food showed the stabilization of the institutional trends which had begun several years before.

The governmental presence in the agricultural and food markets continues reducing. The specific share of the governmental purchases from the grain market is decreasing at the fastest rates; in the animals breeding the relevant share stays high, yet (see Table 2.16). It should be noted that the supplies of the animal produce to the governmental funds are determined by the formal index: supplies to the entities fixed by the governmental order for the relevant produce. These are, as a rule, the local privatized meat and milk processing enterprises. The statistics fixes the supplies to them as the supplies to the government. Hence, the relatively high figures of the governmental purchases of the rural produce do formally reflect this fact, but do not reflect the real participation of the State in the produce distribution. From 1996, the Nizhni Novgorod region banned all the governmental supplies of the rural produce; de facto, this means the ban of the government order.

Table 2.16.

Share of governmental purchase in the total sales volume, %

	1995	1996
Grain	35	33
Sugar-beet	21	3
Sunflower	19	3
Potatoes	14	8
Vegetables	47	31
Cattle and poultry, weighted alive	60	51
Milk and dairy products	80	71
Eggs	87	79

Source: Short-term Economic Indexes, Russian Federation, 1996. Moscow: Goscomstat. 1997. P. 55

On the background of the general reduction of purchase to the food funds, the share of the purchase to the federal food fund reduced the most significantly. This dynamics is especially well seen with the example of the grain market of the last four years.

The volume of purchase to the regional funds has shrunked, as well: if compared with 1993 (the first year of the regional funds) it reduced almost 2.5-fold; this shows the reduction of the influence of the local administrations on the producers in the situation of the limited local budgets.

The 1996 volumes of the grain purchase to the regional funds were close to those of 1995: 8.2 mn mt; this was due to both the supplies of the grain to the regional funds as repayments of the credits against goods granted to rural entities at the beginning of 1996 and the existence, in certain regions of the bans on and suspensions of the grain outflow, as well as other administrative prohibitions.

With the Russia-wide trend towards the reduction of the governmental purchases, some regions see the reinforcement of the government role in the redistribution of the rural economy produce (see Table 2.17).

Table 2.17.

Indexes of gross grain harvest and governmental purchases for certain regions of Russia, %

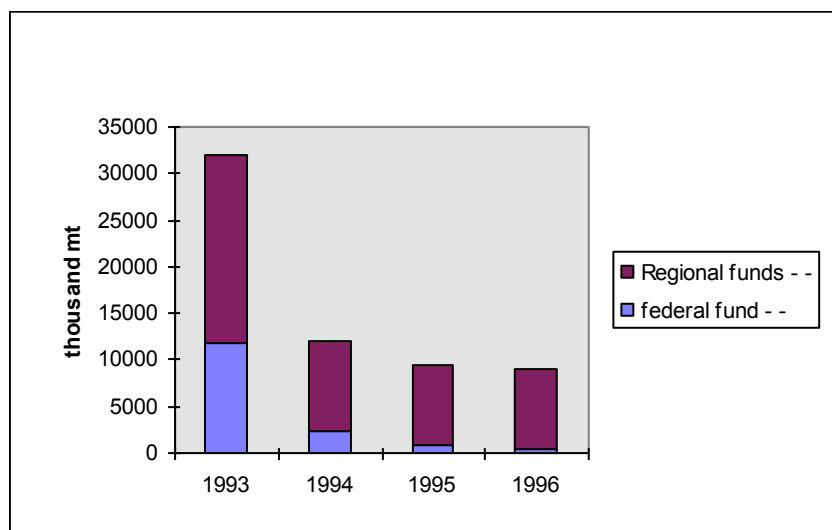
Federation subject	Gross harvest	Governmental purchases
Briansk region	80	112
Moscow region	122	145
Tula region	108	203
Yaroslavl region	113	139
Mordovia	158	415
Chuvashia	161	270
Lipetsk region	111	129
Tatarstan	157	213
Saratov region	191	390
Perm' region	96	144
Kemerovo region	64	231
Primorski region	115	188

Source: Social Economic Situation of Russia, P. 241-242, 259-260.

Just as during the preceding years, the State fixed the minimal guaranteed purchase prices for the main rural economy products. The level of these prices was fixed by the agreements between the three Ministries (rural economy and food; economy; and finance) based on the forecast inflation and the market conjuncture. The guaranteed prices are used only for the supplies to the governmental funds (mandatory for the federal fund and recommended for the regional funds); their mechanism does not suppose the governmental intervention in the markets. For almost all the time from their introduction, their level was lower than that of the formed market prices. Under such conditions, the local administrations are interested in the non-economic coercion of the producers to make supplies to the regional funds; further on, such produce is to be sold in the Russian market at the market prices.

Last autumn, due to the sharp and unforecast drop of the inflation, the guaranteed prices became higher than the market ones. At the same time, the decision was made, according to which, with the lack of money in the State Budget, the rural producers with the indebtednesses for the commodity credits were obliged to cover their debts by supplying their produce to the Armed Forces. For this, the natural volumes of supplies were calculated at the guaranteed prices; as a result, the Armed Forces had to purchase the produce for the actually overestimated prices.

Dynamics of purchase prices for food funds, thousand mt

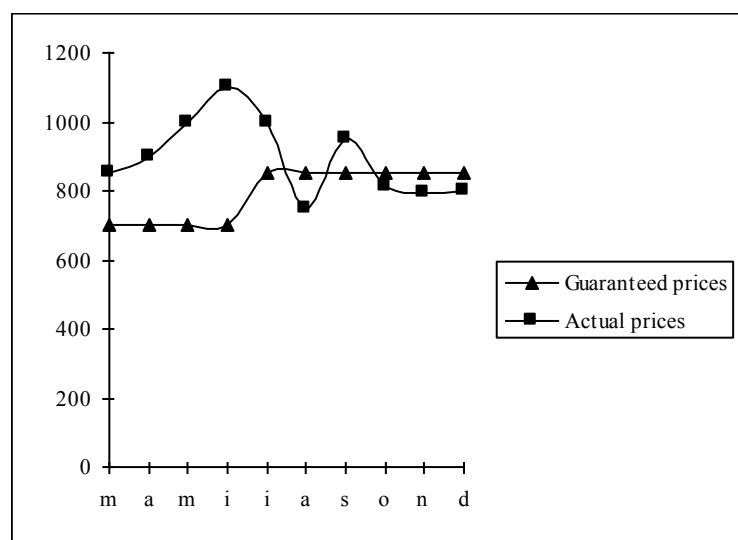


Source: current data of Goscomstat

Hence, the mechanism of the guaranteed minimal prices leads to the negative consequences both when they exceed the market ones and when they are lower than the market ones; however, in the latter event, it has no intervention effect on the market. The relations between the 1996 market and guaranteed prices for wheat are shown in Fig. 2.16.

Fig. 2.16

Minimal guaranteed and actual purchase prices for wheat, 1996, Rbl. thous/mt



Source: Protocol of Coordination for the guaranteed purchase prices for the rural produce purchased in the Federal Fund from 1 July 1996.

The end market of the food showed the further reduction of the governmental trade form: in 1996, the volume of the governmental trade was 9% against the 13% of 1995.

In 1996, the turnover of the food reduced by 2%. However, the sale of the meat, poultry, sausages, fish, eggs, and sugar grew. At the same time, the growth of the food sale outside the trading entities (i.e., municipal and small wholesale markets) should be noted; at the same time, the relevant sales by the trading entities are shrinking. E.g., in 1996, the share of the

small wholesale markets in the aggregate volume of purchases by population was 30% for the meat and poultry.

Financial situation of rural producers

The financial situation of the rural producers remains the gravest among all the sectors of the national economy. Despite the 1995 write-off of the debts, the credit indebtedness of the rural economy to banks continues growing. The credit indebtedness exceeds in a great extent the debit one. The labor payment in the rural economy is one of the lowest in all the sectors of the national economy; nevertheless, the arrears here exceed the mean level for the national economy (see Table 2.18).

Table 2.18

Main financial indexes in rural economy. January to November 1996.

	rural economy	industry	average for national economy
Excess of credit indebtedness over debit indebtedness, % to the debit indebtedness	258	49	38
Aggregate indebtedness for labor payment, % of the monthly accrued labor payment fund, as of 23 December	327	268	272
Arrears for bank credits and loans, % of the total indebtedness of the kind	27	17	19
Average monthly accrued wages, Rbl. thous.	350	904	786

Source: Social Economic Situation of Russia. P. 157.161. 164. 191-192.

In the structure of the outstanding credit indebtedness of the rural economy the share of the debt to the Budget is almost 2-fold lower than for the national economy in whole; this is due to the low level of the government-imposed tax on the rural producers. It is known that they do not pay the tax on profit from the rural economy activities and the activities relative to the processing of their own produce; the private farmers are exempt from the tax on land.

The conjuncture poll by the IET of the fourth quarter of 1996 showed that the most critical situation is that of the small and medium size economies, while the large size ones are better being from the finance viewpoint. The better financial stability of the grain and sugar-beet producers is also characteristic.

Despite the crucial financial situation of the rural economies, the incomes of the rural population are higher than these of the cities dwellers. The center for the economic conjuncture, the Kiel University, and the IET have performed two joint budget studies in three Russian regions. These were based on the budget panel by the Goscomstat adapted for the purposes of the study. In addition to the monetary incomes, the incomes from the part-time farms of the families were assessed. The latter were recalculated in the retail prices effective as of the moments of the studies in the relevant regions. The results are shown in Table 2.19.

The IET and the Agrarian Institute of the Russian Academy for Sciences jointly studied the sources of financing for 62 rural economy entities and 39 private farms in 9 districts of the Rostov, Pskov, and Orel regions. The analysis of the results has shown that the rural economy entities used, mainly their own assets for both the current financing and investments (practically absent). The bank loans were used only in the cases when the interest rates were partly covered by the local administrations (e.g., the Orel region)./ The governmental money against goods credit never exceeded 8% of the total financing volume. The governmental grants formed a negligible share in the total financing volume; moreover, the payments came with constant delays (in average, 80% of the subsidies came with the over 3-month delays). The commercial commodity credits (it is becoming more and more important) does not, yet, play any significant role in the entities financing. The studies by regions have shown a

somehow higher financial stability for the entities of the southern Russia; this seems quite logical. The conclusion may be made that the Rostov region has relied rather on its own resources, while the Orel region has tried to use the subsidized bank loans, and the Pskov region has used all the sources of financing, including the governmental grants and subsidies.

Table 2.19

Incomes of population*

	Orel	Pskov	Rostov	Average
<i>Per capita monthly income, Rbl. thous.</i>				
Regional center	<u>275</u>	<u>319</u>	<u>255</u>	<u>282</u>
City	<u>237</u>	<u>206</u>	<u>220</u>	<u>218</u>
Township	<u>230</u>	-	-	<u>230</u>
Rural locality	<u>360</u>	<u>262</u>	<u>340</u>	<u>319</u>
Average	<u>293</u>	<u>254</u>	<u>267</u>	<u>271</u>
<i>Family monthly income, Rbl. thous.</i>				
Regional center	<u>803</u>	<u>774</u>	<u>745</u>	<u>778</u>
City	<u>658</u>	<u>500</u>	<u>621</u>	<u>581</u>
Township	<u>819</u>	-	-	<u>819</u>
Rural locality	<u>1125</u>	<u>708</u>	<u>1017</u>	<u>941</u>
Average	<u>894</u>	<u>644</u>	<u>778</u>	<u>772</u>

* Incl. wages, income from part-time farms, land plots, gardens, etc.; social pays and benefits.
Source: Preliminary results of the IET, Kiel University and Center for economic conjuncture study

Food industry

In 1996, the yield of the main food products did not exceed the relevant volume of 1992 (see Table 2.20), except the oil extraction and sugar production where the reduction compared with 1992 was not so sharp; moreover, in 1996, a certain production growth was observed. The greatest recession in 1996 was seen for the grain processing sector; this is rather due to the poor supply of the feedstock resulting from the extremely low harvest of 1995.

Table 2.20.

Financing sources for the production activities of rural economy entities

Source	Share of entities using the source			Average sum, Rbl. mn			Share of source in total volume of crediting, %		
	Rostov	Pskov	Orel	Rostov	Pskov	Orel	Rostov	Pskov	Orel
Income from sale	<u>100</u>	<u>100</u>	<u>100</u>	<u>3686</u>	<u>2271</u>	<u>1794</u>	<u>90</u>	<u>82</u>	<u>88</u>
Governmental grants	<u>50</u>	<u>99</u>	n/a	200	<u>222</u>	n/a	<u>0.02</u>	<u>8</u>	n/a
Bank credits	<u>12</u>	<u>43</u>	<u>100</u>	<u>189</u>	<u>212</u>	<u>250</u>	<u>0.05</u>	<u>4.5</u>	<u>12</u>
Governmental commodity credit	<u>76</u>	<u>99</u>	n/a	<u>344</u>	<u>158</u>	n/a	<u>6</u>	<u>5.5</u>	n/a
Commercial commodity credit	<u>0.04</u>	<u>0.04</u>	n/a	<u>109</u>	<u>697</u>	n/a	...	...	...

Table 2.26

Production of main food industry produce, 1996, thous. mt

	1996	1996 as % of		1995 as % of 1994
		1992	1995	
Vegetable oil	755	82.3	108.9	87.1
Sugar	3285	83.7	104.4	116.0
Bread and baked goods	8154	51.2	82.2	85.0
Flour	8632	49.1	75.0	89.7
Groats	715	41.5	66.8	98.9
Sausages	1300	84.0	97.0	82.0
Meat*	1329	35.0	76.7	72.8
Unskimmed milk products**	4384	47.2	89.3	76.0
Butter	270	36.4	68.4	80.1
Strong alcohols, mn deciliters	68.5	45.5	56.5	98.2

* including subproducts of 1st category

** counted in milk

Source: Short-term Economic Indexes. Russian Federation.

The recession in the food industry, continuing since the 90's, resulted in an immense slack of the production capacities: in 1996 they were used for 12% to 22% in production of meat, unskimmed milk, and margarine, and by 32% to 45% in production of bread, baked goods, macaroni, and pastry.

The situation in the food industry was an inevitable result of the critical change of the governmental policy followed by the change of the consumer behavior, the feedstock crisis, the redistribution or loss of the traditional sale markets, the investment and technology crises. The domestic food industry approached the stage when the functioning on the basis of the old principles has become impossible; today, it is necessary to develop flexible market strategies, change radically the production nomenclature. These tasks are more complicated than just the technology upgrade because they need the changes of the economic practice stabilized in decades, the new thinking, and the new skills.

The last year also showed certain adaptation processes in the food industry. The investment activity in this sector grew. On the background of the general crisis of the processing industry and the disastrous situation of the local processors, the positions of the large-scale entities have been strengthening. The investments in the food production are growing in the regions of the relatively high purchase demand, i.e., large industrial centers. The lack of the assets for the large investments required to expand or upgrade the capacities results in mobilization of the foreign capital for investments. For the other hand, the potentially high capacity food market improves the interest of foreign companies in the direct investments in the food production complex.

The foreign investments in the food production have the following forms:

- establishment of entities with foreign capital in forms of joint ventures or purchase of shares of stock of the existing Russian entities. The examples are: the beginning of implementation of the "Nestlé Zhukovskoye Morozhenoye OOO" on the basis of the Zhukovski Refrigeration Factory; the purchase by Fazer (Finland) of 15% of shares of stock of the AO "Pekar", the largest producer of the oriental confectionery in the North-West region of Russia; or the purchase by Bahlzen (Germany) of 25% of shares of stock of the largest bakery of the Leningrad region;
- direct foreign investments, e.g., construction by Krüger (Germany) of a children's food factory; opening of the largest in Europe ice-cream factory by Baskin & Robbins; opening, in May 1996 of the chocolate factory in Stupino, Moscow region, by Mars Inc. (USA); or

opening by Wrigley's of a chewing gum factory. PepsiCo and Coca Cola declared their intentions to invest US\$ 550 mn and US\$ 250 mn, respectively; and

- crediting by foreign banks of the upgrade projects for food producers, e.g., the DM 2.5 mn credit from the BNP-Dresdner Bank for purchase of the upgrade equipment for the AOZT "Samson", the largest producer of sausages in the North-Western region of Russia; the German Wartburg Bank intends to open, at the beginning of 1997, the credit line for DM 60 mn to implement the project of construction in Russia of 10 vegetable oil factories.

The foreign capital is being invested in the entities with high value added, such as producers of ice-cream, children's food, pastry. The investments also cover the creation of the relevant distributors networks. At the same time, the processing sectors with low value added see the investments and property concentration mainly with participation of the national capital, e.g., such groups as Alfa, Menatep, etc. In certain regions they control the production and wholesale of such products as vegetable oil, sugar, macaroni, tea, etc.

Agrarian policy

In 1996, on the background of the electoral campaign, the RF President's decree "On the Guarantee of the Constitutional Rights of Citizens to Land"; actually, it completed the formation of the legal basis of the land reform conception and transformation of the rural economy entities which had begun in 1992. The transformations in the rural economy resulted in an ambiguous situation with the land property: lands are owned by the collectives of the former collective farms and State farms, while the users (often free of charge) are rural economy entities. From the legal viewpoint, their relationships had not been fixed as they should: the owners had received almost no guaranteed or contracted rental payments, while the land tax had been paid by the users. The use without contract had also been inconvenient for the users: any owner had been able to require, at any moment, to have its plot (share in property) to be returned. According to the above Presidential Decree, all the actual users of the land plots were to make, during the twelve months following, official contracts with the owners for rent or purchase.

To the beginning of 1997, about 70% of the contracts to be registered were legalized. Most owners of the land plots rent them to joint ventures. The cases of sales or investments in the shared capital are not numerous. The process of the land redistribution which began during such registration attracts attention: some owners prefer renting land not to their closes economies, but to neighbors, because the latter offer higher rental payments. The rental payments have, usually, the forms of supply, following the year results, of a share of produce (usually, grain, sunflower, or their processing products), services to the private households, etc.

In certain events, the managers of the agricultural entities refuse to rent land plots from some of their workers or retired persons. In the next year, this may become a social problem, especially acute in the marginal agriculture areas where the demand for land is minimal.

The problem of the AIC crediting was another grave problem of the 1996 agrarian policy. The new administration of the Ministry for agriculture and food began its activities by the conception of creation of the special governmental fund for the AIC support. This fund will be managed by the Ministry, while the settlements will go by the Agroprombank. The latter, being one of the largest banks in Russia, and possessing the second largest network of branches and subsidiaries, had the current liquidity loss of Rbl. 1 trln. to the middle of 1996. Besides, the bad debts of the borrowers exceeded this sum. The problem of sanation of the bank was combined, in the Ministerial conception, with the idea of centralization of all the resources allotted to the AIC. According to the Presidential Decree, it was supposed to nationalize the Agroprombank (the governmental share was 1.5% of the stocks, while the

other shares were distributed among thousands of rural producers) and authorize it to distribute the resources from the specially created Federal Fund for AIC financing.

The Ministry for economy was energetically against the nationalization of the unprofitable bank. As a result, the Agroprombank was authorized to issue additional shares of stock to be put to a public tender. As a result of the tender, the Agroprombank was integrated in the structure of the Stolichny Bank of Savings, and the new structure was named SBS-Agro. The first measures undertaken by the new management of the SBS-Agro allow to expect an improvement of the situation of this financial institution: the bank is oriented to accumulate assets of the rural population and to organize, for these purposes, crediting cooperatives; it considers necessary to finance, first of all, the processing and food industries, which are to become, in their turn, sources of the finance for the rural economy; moreover, it organizes a large-scale campaign of personnel training within its system, reorganizes the branch offices network for the on-site control of transactions, etc.

When considering the problems of the former Agroprombank, it is necessary to separate the problems of this financing institution as itself from the rural economy crediting problems. The Agroprombank credits covered only a half of the credits to the rural economy, and even less than 40% in such rural regions as the Northern Caucasus.

Despite the above reorganization of the Agroprombank, the Fund of soft loans to the agriculture is being created under the Presidential Decree "On the Measures for Stabilization of the Economic Situation and Expansion of Reforms in AIC". It is supposed to form it from the Rbl. 2.8 trln. of allocations from the Budget and the Rbl. 9 trln. of the return for the last year commodities credits. The Fund will credit at the 25% annual interest rate of refinancing of the Central Bank. The renewal of the soft loans may be dangerous for the AIC financing system in 1997, though it can be supposed that there will be no real replenishment of the Fund.

On the background of the electoral populism, the President signed certain Decrees aimed to show the support to the farmers, Cossacks, and part-time farms. The Decree was also signed trying to solve the long-lasting problems of the Consumers Union (Potrebsoyuz) having become monopolist in the rural retail trade. However, the documents not supported by real financing, became only declarations of intentions of the executive power.

The Decree "On Stabilization of the Economic Situation and Development of Reforms in AIC" of 16 April 1996 became a more significant advance in the electoral codification. The latter Decree, signed after the earlier traditional governmental decree on the rural economy, was of an obviously propagandist character. Nevertheless, the measures it envisioned were not extraordinary, they stayed within the limits of the general rural economy strategy and did not amend seriously the trends of the sector evolution. The most important measures envisioned by the above Decree were the prolongation of the rural producers debts for the commodities credit of 1995 to 1998 and the further delay of their debts for the centralized credits of 1992-94, not written off in 1995, to 2005. As it was unrealistic to expect the real redemption of these debts to the Budget, this write-off was the de jure acknowledgment of the already real fact of the economic life.

For example, for the commodities credit of 1996, of Rbl. 11.8 trln., the rural producers repaid, to the spring of 1997, only a little more than Rbl. 3 trln.; moreover, half of this sum was cleared as the Budget payments for the regions having suffered acts of God. It can be supposed that the practice of writing-off will continue for the commodities credit of 1996, as well.

At the same time, the Decree tried again to insist on the continuing governmental policy in privatization of the processing industry: the credits prolongations were also given to the processing enterprises, at the condition 51% of their shares of stock were owned by rural

producers. Nevertheless, this did not become a serious motivation for the processors as for the secondary issue recommended in 1995.

Foreign trade in agricultural produce and food

Main trends in food trade of 1996. According to the customs statistics, the share of the Russian food import in the whole import cost was 25.5% for the first 9 months of 1996; the relevant values for 1995 and 1994 were 27.3% and 28.4%, respectively. In the first 9 months of 1996, the share of the food export was 1.8%; the relevant values for 1995 and 1994 were 1.6% and 2.1%, respectively. Hence, in the cost structure of the import, the specific share of the agricultural feedstock and food was decreasing. At the same time, the rates of the food import growth were lower than for the whole import; moreover, in 1996, the volume of the food import even diminished, compared with 1995 (see Table 2.21).

The grain and vegetable oil, whose export conditions worsened, in 1996, compared with the preceding years, due to the recession of the domestic production, remained, yet, the most important in the export structure.

In 1996, no important shifts in the goods structure of the food import were observed. The growth of the end products import with the decrease of the feedstock import remained (see Table 2.23). The import of meat products, first of all, poultry meat, continued growing. The grain import grew due to the poor harvest of 1995. At the same time, the stable trend to the growth of the flour import combined with the 6 to 7-fold reduction of the pre-reform import of grain shows that today the growth of the end products import results from the low competitiveness of the domestic processing industry and its high costs.

Table 2.21

Balances of foreign trade in 1994-96 (1st to 3rd quarters), US\$ mn

	1994	1995	1996	1995 as % of 1994	1996 as % of 1995	1996 as % of 1994
Export (FOB)	45400	56051	59575	123.5	106.3	131.2
incl. rural produce and food	938	891	1097	95.0	123.1	117.0
Import (CIF)	27367	33044	34532	120.7	104.5	126.2
incl. rural produce and food	7773	9009	8789	115.9	97.6	113.1
Balance	18034	22711	25043	125.9	110.3	138.9
incl. rural produce and food	-6835	-8118	-7692	-	-	-

Source: RF Foreign Trade Customs Statistics. 1994, 1995, 1996.

Table 2.22

Dynamics of export of main kinds of food in 1994-96 (1st to 3rd quarters), thous. mt

	1994	1995	1996
Wheat and oil-yielding plants	242.1	135.9	130.1
Rye	63.6	338.8	4.5
Vegetable oil	72.6	94.5	23.3
Sunflower *)	632.9	463.4	N/A.

*) in twelve months

Source: RF Foreign Trade Customs Statistics. 1994, 1995, 1996.

Table 2.23.

Dynamics of import of main kinds of food in 1994-96 (1st to 3rd quarters), thous. mt

	1994	1995	1996	1995 as % of 1994	1996 as % of 1995
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Meat	452.2	518.1	562.0	114.6	108.5
Poultry	334.0	551.6	688.7	165.1	124.9
Milk and cream	59.1	62.3	34.1	105.4	54.7
Butter	128.6	192.0	74.8	149.3	39.0
Wheat, oil-yielding plants, barley, corn	3047.1	1431.4	3232.5	46.6	225.8
Flour	45.5	105.0	624.9	230.8	595.1
Sunflower oil	47.1	177.7	155.1	377.3	87.3
Cane sugar	921.4	953.9	1534.6	103.5	160.9
Beet sugar	20.7	34.7	16.7	167.6	48.1
White sugar	654.2	1204.2	1269.0	184.1	105.4
Citruses	405.0	328.5	135.4	81.1	41.2
Coffee	20.7	18.9	20.5	91.3	108.5

Source: RF Foreign Trade Customs Statistics. 1994, 1995, 1996.

At the same time, the high growth rates of the basic goods import are significantly decreasing; this may witness indirectly the relative saturation of the domestic food market. In the structure of the imported products, they are differentiated by assortment and cost parameters. The rates of the raw sugar import have grown due to the reduction, at the end of 1995, of the VAT on this product from 20% to 10%. The growth of the tropical produce import is slowing down due to the Ruble stabilization, though their per capita consumption is growing, e.g., from 90 kg in 1995 to 95 kg in 1996 for the citruses.

Changes in the system of governmental control over the foreign economic activities in 1996. The export conditions in the AIC are gradually becoming more liberal, showing less characteristics of the deficit economy. In particular, in April 1996, the registration of the export contracts and the mineral fertilizers export quotas were abolished. At the same time, certain attempts of protectionism measures were seen; they were aimed at limiting the food import.

In 1996, the import of the basic food grew combined with the stable decrease of the domestic production; these led to an extreme anxiety of both the local and Federal administrations. However, the administrative limiting measures had no real effect. The example is the well-known conflict of February 1996 with the chicken legs from the USA: this was an attempt to put obstacles on the way of import to protect the domestic producers by increasing the import duties from 25% to 35%. The formal reason was the inconsistency of the produce with the effective Russian standards. As a result, the claims to the quality of the US produce were satisfied, and the import duty on it was reduced to 30%.

There was also another new dash in the foreign trade control system, namely, the attempt to impose quotas on the import, in particular, of the alcohol (from January 1997); the main problem is the confirmation of the produce authenticity and the legality of its import (though this measure was abolished under the insistence of the WTO and never took force); it also related to the white sugar (the draft enactment as for the quotas on the import of this produce was submitted to the Government in November 1996). It is supposed to limit the import of the white sugar to the annual 1.5 mn mt, of which 1.15 mn mt is to be supplied from Ukraine.

As of today, the custom duties are used as a fiscal mean; hence, the frequent enough conjunctural changes. In such a way, the duties cannot serve stable milestones for the foreign economic activities subjects. Moreover, the Russian import duties are not, yet, as differentiated as in the developed countries, though certain progress is obvious. The maximal import tariff (since 1996) is 30% of the customs cost of goods, except for the delicacies, tobaccos, and alcohols. The minimal rate was increased to 5% (against 1%), in particular, for grain bread, juices, and citruses.

According to the State Customs Committee, a further increase of the customs duties seems impossible, because the Government has already used all the reserves for this due to the future

(though in far future) entrance of Russia in the WTO. In this connection, Russia has obliged to conserve the mean weighted rate of the import tariff fixed from July 1995 at the level 13% and at the condition of its gradual decrease by at least 20% to 1998 and by 30% to 2000. According to the customs tariff conception, the maximal rate must be reduced from the 30% of 1996 to the 20% in 1998 and to the 15% in 2000. Instead, the excise duties will be introduced.

Certain privileges for foreign companies have been envisioned, as well. E.g., the pastry and animal fodder imported by Mars will bear the duties 2-fold lower than the basic level, as the company has invested over US\$ 100 mn in the Russian economy.

Table 2.24

Dynamics of import rates for main kinds of food, %.

Goods	Before 15.03.94	From 15.03.94	From 1.07.95	From 15.05.96
Meat and food subproducts	N/A	8	15	15, but not less than 0.15 ECUs/kg
Chicken meat	N/A	20	25	30, but not less than 0.30 ECUs/kg*
Milk and dairy products	N/A	15	10-20	10-20
Grain bread	N/A	1	1	5
Oil-yielding grain and fruits	N/A	1	5-10	5-10
Butter	N/A	15	20	20, but not less than 0.3 ECUs/kg
Sunflower oil	N/A	N/A	15	15, but not less than 0.09 ECUs/kg
Juices, vegetable oil	N/A	N/A	N/A	5
White sugar	N/A	20	25	25, but not less than 0.07 ECUs/kg

*) from 15.04. 1996

During 1996, the Russian State Customs Committee granted to the subjects of the foreign economic activities, including in the agrarian sphere, “in the exceptional cases” the deferrals for the customs payments and other privileges, under the pressure of certain departments or groups. The deferrals (or spreads) for the customs payments were granted for three months and, frequently, repeated. In practice, they were indirect privileges after the ban by the Government, in 1995, of the direct foreign trade privileges. In certain events, large importers delayed their payments for twelve and more months. The regular bans by the Government of the customs privileges is rather of fiscal character than regulation of the foreign economic activities; it is one of the methods of procurement to the income side of the Federal Budget. As this tactical task has been completed, one may suppose that the privileges for the foreign economic activity subjects may occur again, in another form.

From 1 July 1996, the deferrals and spreads for the food VAT and excise taxes payments were banned. It should be noted that the manipulations with the VAT rates was an efficient enough method of the goods flows control. Thus, in 1995, due to the introduction, in April 1995, of the 20% VAT on the raw sugar and the 10% VAT on the white sugar, the import of the latter began growing. As a result, 1,798,000 mt of the white sugar and almost 1,000,000 mt of the raw sugar were imported to Russia. The mass import of the white sugar came, first of all, from Ukraine, due to the absence of the custom duties within the CIS and the preferential tariff treatment in Ukraine for the raw sugar import for the Ukrainian processing industry. The Ukrainian importers pay only for the custom expenses (0.15% of the contract cost); this was one the reasons why the 1994-95 transfer price for the sugar in the Ukrainian enterprises was by 15% to 20% lower than in the Russian ones. This conditioned the advantage of the Ukrainian sugar in the Russian import of 1995. In November 1995, the VAT rate for the raw sugar was reduced to 10%.

In the short term, a reduction of the goods turnover between Russia and Ukraine is possible, as Russia has taken some limiting measures in reaction to the ban by Ukraine of the

VAT on the goods exported to the CIS. In particular, from 1 September 1996, the goods imported to Russia from the customs territory of Ukraine will be imposed with the VAT in accordance with the order effective for third countries.

Share of import in per capita consumption. The trend to the growth of the import share in the average per capita consumption of the basic foods remained due to the drop of the domestic production (see Table 2.25).

Table 2.25

Share of net import on per capita consumption of the main foods, %.

Food	1986*	1987*	1988*	1989*	1990*	1991*	1992	1994	1995
Meat and derivatives	14.4	14.1	14.5	15.5	12.9	9.1	3.5	12.8	19.8
Sugar	39.7	47.9	41.8	37.8	30.9	79.8	83.3	48.8	75.3
Potatoes	5.7	5.3	5.0	5.3	3.8	4.3	N/A.	0.7	0.4

* import without FSU.

Source: Customs Statistics of Russian Federation Foreign Trade. RF Customs Committee. 1994, 1995. Russian Rural Economy. Russian Goscomstat. Moscow, 1995. Foreign Economic Links in 1991. CIS Committee for statistics. 1992.

At the first sight, one of the main trends of the reforms period was the growth of consumption of the imported food. As Table 2.30 shows, the share of the meat products in the average per capita consumption saw large fluctuations, though it always remained high. The low indexes of the crisis 1992 were results of the important supplies of these products within the humanitarian aid framework, not reflected in the official statistics of the period, and the mass slaughter of cattle by the producers in that period. However, it should be take into account that before the reforms most meat products came to Russia from the FSU (mainly, Ukraine), within the framework of the centralized inter-republic supplies.

The reduction of the potatoes import (Cuba, Poland) is representative enough: Russia has already reached the self-support for this produce. Already in 1993, the potatoes import reduced more than 5-fold, compared with 1992. As of today (1996) the import of the potatoes (0.02% of the gross production) is formed by the precocious potatoes, consumed in large cities.

During the pre-reform period, the food import was, in a great extent, inefficient, oriented to the feedstock import to support both the domestic rural economy, in particular, animals breeding, suffering the shortage of the fodder, and the processing industry. This fact sees its best elucidation in the comparative analysis of the grain and meat import. As it has been noted above, in the conditions of liberalization of the foreign trade, the low efficiency centralized import of the fodder grain was substituted by the import of the end produce, i.e., meat. Moreover, the growth of the animal produce import in 1994-96 results from the today's situation of the animals breeding in Russia with the high costs.

The domestic animals breeding is characterized by the extremely low conversion of fodder. The average consumptions of fodder in grain units per kilogram of gain in weight of the animals alive are the following: 10.625 kg for cattle; 6.5 kg for swine; and 3.99 kg for poultry (broilers). The largest share of the grain import was the fodder grain import (barley, corn, fodder wheat). In the import of wheat, the fodder wheat counted from 40% to 60% in certain years.

The domestic production of the meat imported today would have required to import about 12 mn mt of fodder grain in 1994 and 16 mn mt of fodder grain in 1996. Combined with the remaining grain import this would have resulted in the 15 and 17 mn mt, respectively. In the other words, the aggregate import of the meat, meat derivatives, and grain, counted in the today's grain equivalent, is lower than the Russian fodder grain import of the Soviets time.

During that period, the import of the grain was 19,800 mt in 1990; 20,200 mt in 1991; and 28,900 mt in 1992.

Evolution of foreign economic relations by regional groups of countries. After the substantial decrease of the food turnover between Russia and CIS which began in 1992, from 1994, its volumes have been increasing; in 1996, they grew 2-fold, compared with 1995⁴. The main goods range of the Russian food export and import for the CIS countries has not sustained radical changes. In the export to the CIS countries, a significant share (30% to 50%) belongs to the meat and its derivatives, food industry products, sugar, grain, etc.; the consumers are, mainly, the Central Asia and Armenia where their own production is insufficient. Besides, the Central Asia states see complications in the supplies of the potatoes; hence, they may become large enough sale markets for Russia which has already (see above) reached the self-support for this crop.

Russia remains the main importer from the CIS of many kinds of food, especially fruits and vegetables. The import of the vegetable oil, butter, meat, and other products remains important, as well.

In the food import of Russia the main volumes belong to Ukraine: almost half of the food in 1996, including almost 50% of the meat supplies. The links with the other CIS countries (Georgia, Armenia, Azerbaijan, Moldavia) are not so important; they import, mainly, fruits, vegetables, and wine; however, the volumes are much lesser than before the reforms. Russia exports to these countries the products of the processing industry (sugar, macaroni, canned food, etc.). The import from the Central Asia consists, mainly, of the fresh fruits and precocious vegetables, supplied, due to the short distances, mainly, to the Asian part of Russia. In the structure of the import from Kazakhstan, the leading positions belong to the grain and meat.

The prices for the products imported from the CIS are, as a rule, lower than the domestic ones; hence, their competitiveness against the similar Russian produce.

The customs statistics gives almost no data on the Russian export to the Eastern Europe (except ethyl alcohol). In general, Russia has the negative balance in the food trade with these countries. The food import from the Eastern Europe has decreased significantly. However, in 1995-96 its growth was observed, in particular, for the import of fruits and vegetables (especially from Hungary and Bulgaria), though the share of these countries in the Russian import of these produces is significantly lower than before the reforms; it amounts to 14% to 24% against the pre-reforms 80% to 90%.

The Russian supplies of food to the developed countries are oriented, mainly, to the traditional Russian exports, well known in the world market (caviar, alcohol, fish, sunflower seeds, rye). The cost of the import from the developed countries is growing, though not so fast as in the first years of the reforms.

Hence, the structural changes of the Russian food import of the period of reforms, i.e., replacement of the agricultural feedstock import by the processed products import are, today, economically valid; they directly result from the low efficiency of not only the rural economy, but also processing and food industries. At the same time, the today's situation of the rural economy does not show that it may adequately react on any limitation measures in the food trade field.

Table 2.26

Structure of Russian trade with main world countries in 1994-96

	Export	Import
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⁴ For the reasons of such important growth see also the "External Trade" section.

	1994	1995	1996	1994	1995	1996
Total	100	100	100	100	100	100
incl.						
OECD	<u>14.3</u>	24.9	4.4 <u>26.7</u>	15.1	21.6	2 4.9 <u>6.3</u>
EC	1.1	8.0	7.6	9.1	12.4	14.9
North America	10.6 <u>0.7</u>	2.1	1.1 <u>2.0</u>	3.8	6.6	9.6
Other, OECD	<u>12.3</u>	<u>13.5</u>	<u>13.8</u>	<u>0.9</u>	<u>0.8</u>	<u>0.9</u>
Central and Eastern Europe	<u>2.0</u>	<u>7.8</u>	<u>5.9</u>	<u>5.5</u>	<u>7.5</u>	<u>5.6</u>
Baltic states	<u>1.1</u>	<u>4.0</u>	<u>4.2</u>	<u>0.9</u>	<u>1.7</u>	<u>0.97</u>
Cuba	<u>0.1</u>	...	...	<u>3.6</u>	<u>2.1</u>	<u>4.6</u>
China	...	...	...	1.8	2.4	3.3
CIS	<u>5.1</u>	<u>6.1</u>	<u>10.0</u>	<u>6.4</u>	<u>8.6</u>	<u>17.5</u>
Other	<u>78.0</u>	<u>61.2</u>	<u>57.4</u>	<u>67.6</u>	<u>57.7</u>	<u>42.8</u>

*) insignificant

Source: RF Foreign Trade Customs Statistics, 1994, 1995, 1996.

2.4. Investment Processes in Real Sector of Economy

General characteristic. The investment sphere reacted on the unstable political situation and the aggravation of the budgetary crisis of 1996 by the sharp recession of the business activities. The total volume of the new investments in the fixed capital amounted to Rbl. 370 trln., or 16.4% of the GDP. In 1996, the production sector used Rbl. 220 trln. for the reconstruction and reequipment.

Table 2.27

Dynamics of new investments in fixed capital, % of the relevant quarter of preceding year

	1995	I quarter	II quarter	III quarter	IV quarter	1996 ä.
New investments in fixed capital	90	90	84	78	80	82
incl. by projects						
production purpose	89	86	83	77	81	82
non-production purpose	91	95	86	81	77	82
Dwelling houses put into service	105	103	101	76	77	84

Source: Russian Goscomstat

**Investments in fixed capital,
% of the relevant quarter of preceding year**

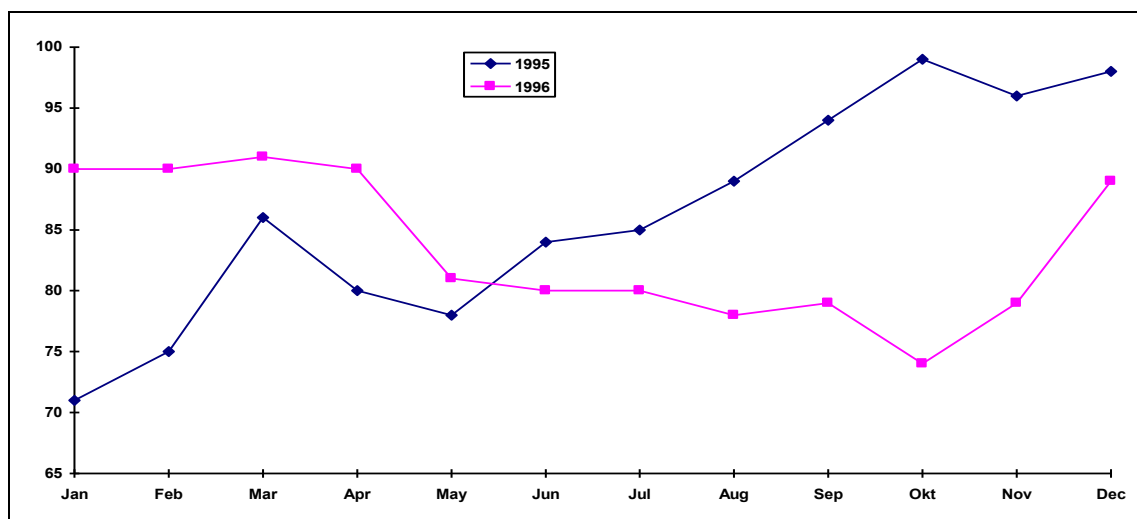


Table 2.28.

**Structure of investments in fixed capital by financing sources,
% of result**

	1994	1995	1996
Total	100	100	100
incl. from:			
Federal Budget	13.4	11.5	9.2
Federation subjects budgets	10.6	10.3	9.6
Own finances of enterprises and organizations	64.2	62.2	64.9
Individual developers	2.3	3.0	3.7
Budgetary fund for governmental support of priority sectors, centralized out-budget investment funds, and other sources	7.8	10.2	8.3
Foreign investments and joint ventures	1.7	2.8	4.3

Source: Russian Goscomstat

One of the particularities of 1996, was the reduction of the share of the investments in the social and civil construction from the 41.1% of 1995 to the 40.5% in 1996. The volume of investments in the civil sphere amounted to Rbl. 150 trln. for the twelve months.

The aggravation of the recession in the capital construction was initiated by the remaining trend to the accelerated growth of prices for the investment resources in 1996: the prices indexes of 1996, compared with December 1995, amounted to 137.6% for the capital construction, 134.4% for the construction materials, 141.4% for the construction and erection works, and 137.5% for the dwelling construction.

Financing of capital investments. About 80% of the investments in the fixed capital were financed by the out-budget money. The worsening of the payment and budget crises has limited the investment capacities of the real sector: the own assets of the enterprises amount to about 65% of the total volume of the investments in the fixed capital, remaining the major source of financing.

The re-estimation of the fixed assets of 1 January 1996 led to the growth of the depreciation fund of enterprises as source of capital investments; its share in the out-budget financing grew in 1996. However, due to the continuing recession of production and

aggravation of the financial situation in 1996, the share of profit of the real sector enterprises in the financing sources reduced. The decrease of the production profitability conditioned the reduction of the profit share in the investments financing sources from 20.9% in 1995 to 17% in 1996.

The reduction of the investment activity of enterprises was also conditioned by the displacement of a significant share of the investment resources to the financial market. The decrease of the profitability on the governmental securities (second half of 1996) was a factor which slowed down the shift of the resources from the real sector.

The borrowed assets for financing of the investments in the fixed capital could not be actively used due to the low solvency of enterprises, though the Central Bank decreased its refinancing rate from 160% in January 1996 to 48% in December 1996.

With the slowing down prices growth of the industrial end products, the real efficient interest rate decreased to 37% as of the end of December 1996; however, even this rate exceeds significantly the average production profitability in the real sector.

The extremely low solvency of the borrowers, the high risk on the long-term crediting transactions; the limitation of the deposits mobilized by commercial banks; the necessity to observe the liquidity norms; the high profitability of the transactions with governmental securities, especially in the first half of 1996; and the stricter reserve requirements for commercial banks from June 1996 were the factors slowing down the crediting of the long-term investments.

Table 2.29

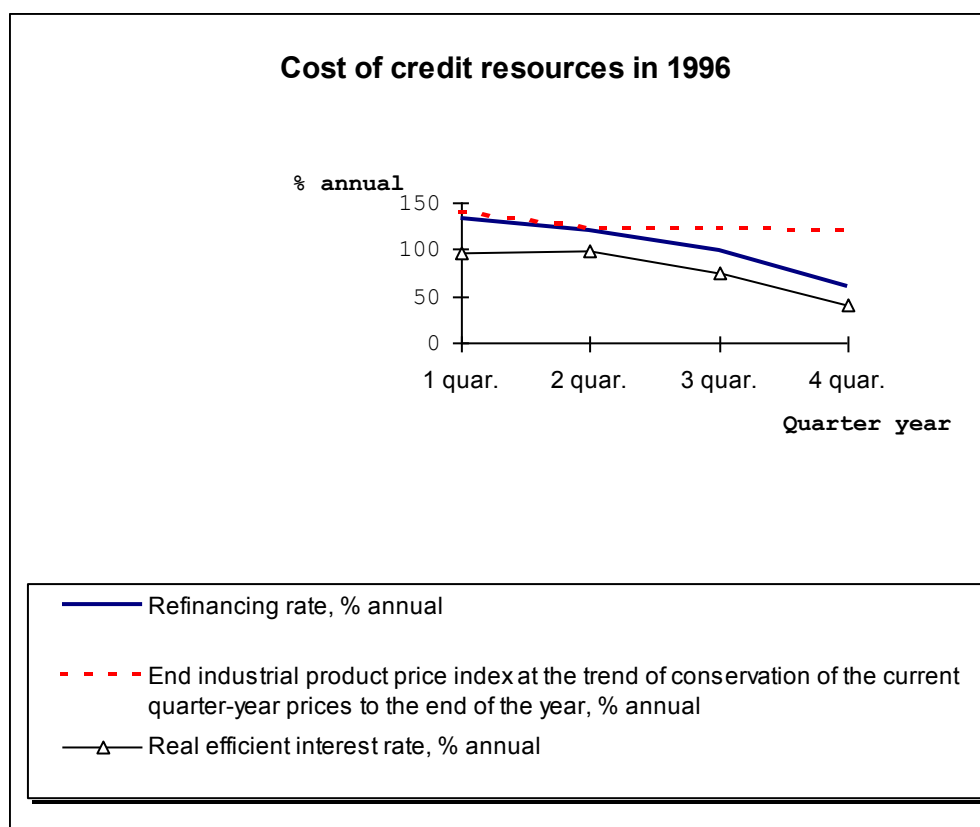
Dynamics of refinancing rate and share of long-term resources in economy

	1 9 9 5				1 9 9 6			
	1 qu.	2	3	4	1	2	3	4
RF Central Bank refinancing rate % annual	200	197	180	167	133	120	98	60
Industrial end product prices index (last month of the quarter-year to last month of preceding quarter-year)	157.2	132.6	120.5	109.6	108.7	105.2	105.1	104.5
Real efficient interest rate % annual *	35.6	66.9	96.9	125.4	96.0	97.9	75.9	41.6
Long-term credit investments in economy, as of the end of the period, % of total credit investments	13.4	12.6	12.0	10.9	5.1	7.7	9.2	9.9**

*) - estimates, average for period

***) - statistical data, as of the end of October 1996.

Fig. 2.18



The lowering of the mandatory reserves norm as for the assets in Rubles from November 1996 has not, either, led to the situation improvement, because the freed resources had to be allotted to the observation of the 2-fold grown norms of the hard currency reserves, thus limiting the possibilities of the long-term crediting in hard currencies.

The situation of the corporate securities market in 1996 can be characterized as the uncertain enough and of small influence on the real sector of the economy. Just as in the preceding years, the secondary market of the corporate securities was rather controlled by the large-size enterprises of the fuel and power complex, metallurgy, transport, and telecommunications, though the growth of the share of the issuers from other industries was observed. The share of the financial transactions with the corporate securities in the total volume of the stock market transactions remained low in 1996.

The negative influence on the market also came from the swift reduction of the governmental investments, not compensated by the private ones. The specific share of the governmental investments from the assets of the Federal Budget reduced from 2.95% in 1992 to 0.72% in 1996. The share of the really financed investment expenditures from the Budget under the Federal Investment Program amounted to about 4% of the total volume of the investments in Russia coming from all the financing sources. Most of the planned investment expenditures were financed from the Budget not in whole and untimely.

As for the results of 1996, Rbl. 16.4 trln. of the governmental investments were financed, or 49% of the year allotments; of them, about Rbl. 2.6 trln. or 16% were charged to redeem the credit indebtedness. The program of the defense industry conversion was financed for 16.3%, while the investments planned for the tender placement were financed for only 6.4% of the planned allotments for the year; moreover, their share in the expenditures on the governmental investments was less than 9%. Such situation destabilizes the capital investments market and reduces the trust of private persons in the Government.

Under the budgetary crisis aggravated in 1996, the Government had to sequester the unprotected items of the Budget, giving priority to the solution of the social problems. As a result, the 1996 investment program actually failed. Moreover, the Government continued increasing the domestic borrowing volumes and accumulated the financial resources which could have been invested in the real sector by the private capital.

The population invests the accumulated assets in the economy at a low level, either. With the high inclination to the accumulation of the financial incomes (about 23%) the population invests the money, mainly, in the hard currencies preferred to the Ruble investments and securities purchase.

Institutional structure. In the capitals market, the private economy sector is dominating; in 1996, its share amounted to 73% of the total volume of investments against the 68.5% of 1995. The unstable political situation, the remaining high profitability of the financial transactions and risks of the long-term investments in the real sector have determined the passive character of the investing activity of the private and joint stock capitals.

Substantial changes have occurred in the financing sources structure for the housing construction. As of today, the main sources are the out-budget assets combined with the various forms of governmental support for natural persons and legal entities, taking part in the housing construction financing. More and more foreign investments are mobilized in the housing construction; they are directed, mainly, to the construction of the dwelling homes for the families of the military people. As of the end of 1996, the share of the budgetary assets in the housing construction reduced to 12%, including a little more than 6% at the expense of the federal Budget.

In 1996, enterprises and organizations of all the forms of property put into operation the living homes of 34.3 mn m² of total surface, which is by 16% less than in 1995. The slowdown of the dwelling construction rates has been conditioned by the substantial difficulties with the housing program financing at the expense of the federal Budget. In 1996, about 11% of the individual living homes were built at the expense of the population.

Table 2.30

Structure of investments in fixed capital by forms of property, from all the financing sources, % of the result

	1994	1995	1996
Investments by enterprises and organizations of all forms of property	100	100	100
incl.:			
governmental	32.3	31.5	27.0
municipal	8.1	6.5	6.0
mixed	42.2	45.0	48.5
private	17.3	17.0	18.5

Source: Russian Goscomstat

Table 2.31

Dwelling homes put into operation for all forms of property

	Total, mn m ²		Growth rates, compared with preceding year, %		Structure, % of result	
	1995	1996	1995	1996	1995	1996
Dwelling homes, total	42.8	34.3	109.0	84.0	100	100
incl. by forms of property:						
governmental	9.8	5.9	98.0	76.0	22.9	17.2

incl.:						
Federal	7.4		94.9		17.4	
Federation subjects	2.4		109.0		5.5	
municipal	4.2	2.9	97.6	79.0	9.8	8.4
private	15.3	14.6	128.0	96.0	35.9	42.6
incl.:						
individual developers	9.9	10.0	140.0	111.0	23.2	29.1
mixed	13.4	10.8	103.1	79.0	31.2	31.4
incl.:						
dwelling construction cooperatives	1.7	1.3	88.0	74.0	4.0	3.7

Source: Russian Goscomstat

Table 2.32

Structure of investments in fixed capital by sectors of economy, % of result

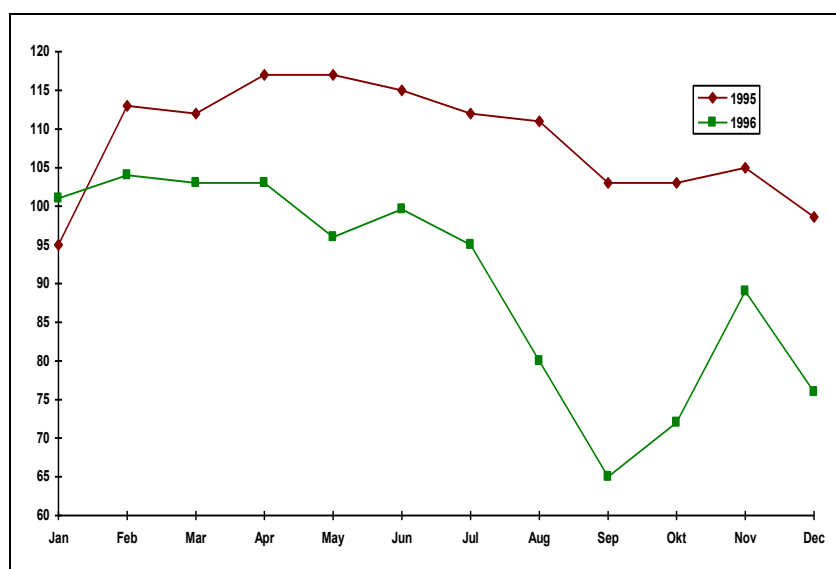
	1993	1994	1995	1996
Investments in fixed capital, total	100	100	100	100
incl.:				
industry and rural economy	44.9	37.3	36.8	39.4
production infrastructure	11.9	13.5	15.7	16.3
dwelling construction	23.1	23.7	26.0	26.8

Source: calculations by author based on the Russian Goscomstat data.

Structure of investments by sectors of economy. The trend of the important reduction of the investments in the rural economy (in 1996 they reduced by about 15%) remains effective. The volume of the investments in transport reduced more than in the preceding years. At the same time, the investments in the telecommunications, which, due to the short enough terms of repayment, remain attractive for both the domestic and foreign investors, grew by almost 20%. The investments in the expansion of the production and technology bases of the construction entities grew, as well.

Fig. 2.19

Dwelling houses put into operation by enterprises and organizations of all forms of property
(% of the relevant period of the preceding year)



The remaining unfavorable situation in the investments sphere resulted in the aggravation of the reproduction problems. The high rates of the investments insufficiency resulted in

formation, in the production sphere, of the immense mass of the worn and obsolete fixed assets. As of today, the average ages of the machinery and equipment have exceeded 12 years; most of the Russian industry fixed assets are obsolete and operated beyond the limits of the economic expediency. According to experts, as of today, the market really requires only 50% to 55% of the fixed assets; the remaining need to be replaced due to the wear and obsolescence.

The economic situation in the investments sphere can be defined as the new stage of the system crisis, relative to the transformation of the fixed capital reproduction model towards the improvement of the internal balance of the finances, materials, and equipment flows, as well as the employment reduction and inter-industry flows of the investments and labor, dismantling of the unloaded production capacities and unprofitable facilities.

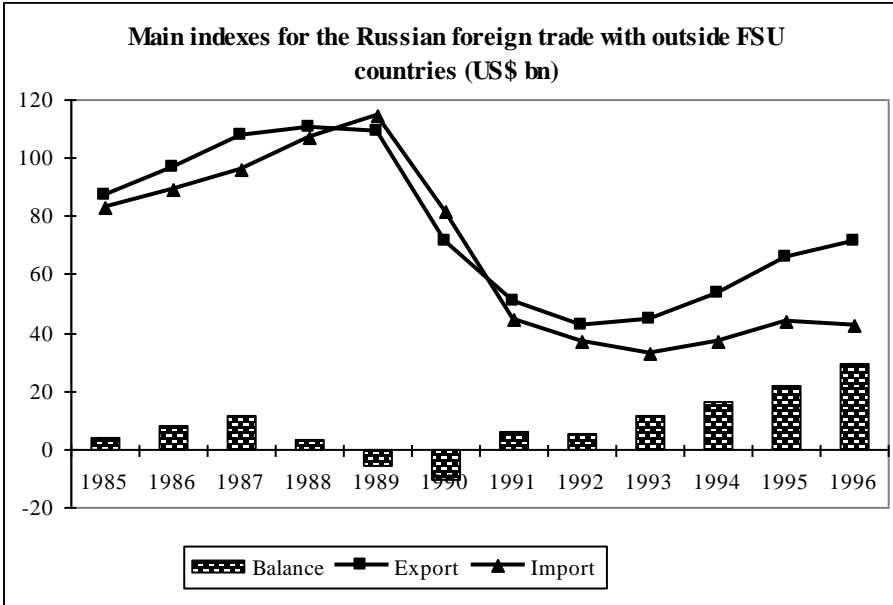
2.5. External Trade

The Russian external trade remains the only sector of the Russian economy showing a stable growth in the latest years. Having survived the deep crisis after the disintegration of the Comecon and USSR, the external trade turnover or Russia began growing. In 1996, it reached US\$ 148.1 bn, including the US\$ 113.7 bn for the FSU (the growth of the trade turnover for both the foreign countries and the FSU amounted to the annual 4%).

The evolution of the external economic activities is, as before, influenced by both the reached results and the newly appearing positive trends; however, the numerous problems in this field affect it, as well.

Among the factors stimulating the foreign economic activity are the already implemented measures stimulating the foreign trade, and the expanded participation of Russia in the multilateral cooperation organizations. The favorable conditions in the world feedstock markets also became the external factors favoring the expansion of the Russian export (see Table 2.33).

Fig. 2.20



Source: Russian Goscomstat

Table 2.33

Average world market prices (US\$/unit)

	1994	1995	1996
Crude oil, mt	112	120	150
Natural gas, thous m ³	70.6	80.4	80
Gasoline, mt	165	169	175
Diesel fuel, mt	152	154.8	182
Aluminum, mt	1910	1785	1510
Copper, mt	2951	2888	2552.9
Nickel, mt	8768	8512	7515.2

Source: center for Economy Conjunction

The foreign economic relations are slowed down by such factors as:

- low competitiveness of the domestic industrial products; it is impossible to improve it during the nearest years due to the critical financial situations of most entities of the processing industry and enterprises under conversion;
- insufficient investment activity in the domestic market;
- safeguard of the discriminatory measures against Russian exporters in foreign markets;
- growing production transport costs. The specific costs of the enterprises, taking into account the expenditures relative to the export, have already exceeded, for numerous goods, the export prices, including the rolled ferrous metals, steel pipes, primary aluminum, refined copper, nickel, and polyethylene by 15% to 32% for the foreign countries; for the FSU countries (taking into account the VAT) the relevant figures reach 32% to 70% for the primary aluminum, refined copper, nickel, polyethylene, and mineral fertilizers.

For certain goods, the wholesale prices have, already, exceeded the world market ones (world exchanges prices, world quotations), including the 15% to 40% for the reinforcement and hot rolled steel, refined copper, tin, zinc, and polyvinylchloride; the prices approached or equaled the ones for the cold rolled steel, polyethylene, and polystyrene.

the dynamics of the contractual export prices for the fuel and power goods and media was adequate when reflecting the world market prices. However, for numerous goods, the export contractual prices stay lower than the ones of the world market. E.g., the prices for the reinforcement steel, refined copper, coal, polyethylene, polystyrene, polyvinylchloride, the contractual prices are lower than the world market ones by 3% to 18%; this results in the important loss of profit and hard currency incomes (see Table 2.34).

Table 2.34

Average export prices for main RF goods export (without CIS) (US\$/unit)

	1992	1993	1994	1995	1996
Crude oil, mt	129.1	104.7	100.6	107.5	130.2
Gasoline, mt			129.3	149.1	156.4
Diesel fuel, mt			122.3	116.1	175.6
Fuel oil, mt			58.7	66.4	81.1
Natural gas, m ³	85.1	77.6	72.8	69.9	78
Coal, mt	41.3	32.4	33	33.6	40.3
Aluminum, mt			940.5	1502	1532
Nickel, mt			5233.8	7952.9	7655
Round timber, m ³	49.3	57.4	53.0	56.5	60.9
Sawn timber, m ³	131.0	111.1	108.1	100.7	118.5

Source: Russian Goscomstat

Table 2.35.

Share of export in production volume (%)

	1991	1992	1993	1994	1995	1996
Crude oil	38.6	36.2	32.8	37.4	39.1	40.9
Gasoline	10.3	9.3	7.9	6.9	8	19.6
Diesel fuel	27.4	21	23.8	29.1	38.6	45.1
Furnace fuel oil	16.5	16.3	16.8	18.5	23.3	22.0
Rolled ferrous metals	17.6	22.2	31.9	49	54	61
Aluminum	-	-	-	80.5	80.5	88
Copper	-	-	-	62.9	64.9	56.6
Nickel	-	-	-	78.3	79.9	79
Mineral fertilizers		51.6	54.1	65.2	72.5	74
Commercial wood			8.5	16.3	20	19
Sawn timber			18.4	19.8	21.4	24.2
Commercial cellulose	-	-	-	74.6	74.6	80
Paper and cardboard	-	-	-	44.1	47	49

Source: Russian Goscomstat

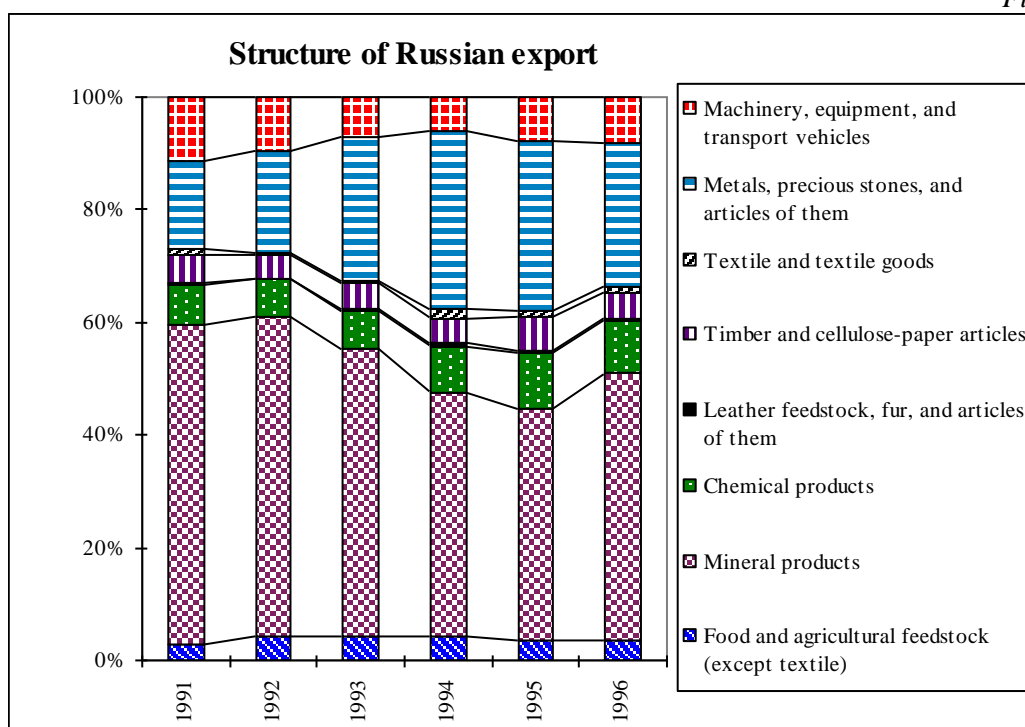
The insignificant fluctuations of the Ruble exchange rate of 1996 did not influence the situation with the export-import transactions.

In 1996, the reduction of share of the outside FSU countries in the total volume of the Russian foreign trade was characteristic; it reduced to 76.8% against the 77.3% of the 1995. This may be explained by not only the reinforcement of the links with the CIS, but, also, by the fact that a certain share of the goods turnover between Russian and the outside CIS countries transported in transit by the territories of the CIS was registered as the goods exchange between the CIS countries. E.g., according to the expert estimates based on the comparative statistics of the partner countries, Ukraine transported by transit the German production goods costing about DM 0.2 bn; the Ukrainian customs registered these goods as the Ukrainian export. It is also known that the main share of the imported automobiles comes to Russia by the so-called "Byelorussian corridor".

In 1996, the volume of the Russian export was US\$ 88.3 bn, which is by 9% higher than in 1995. The export outside FSU was US\$ 71.4 bn. Besides receiving the hard currency, the export, in the situation of reduced domestic demand, ensures the operation of Russian enterprises, and, hence, favors the preservation of jobs. Besides, the growth of the non-payments favors the redirection of supplies of many products to the foreign market. The share of export in production of practically all the competitive goods is growing (see Table 2.35).

The fuel and feedstock resources prevail, as before, in the export structure. Their share in the Russian export structure exceeds 70%, as in 1995. Such structure reflects the growing dependence of the feedstock sectors of industry upon the world market prices and brings elements of instability to the development of the Russian export based on the feedstock export: the share of the feedstock in the world trade has the trend to reduction, while the world prices undergo significant fluctuations.

The aggregate volume of export of the main *fuel and power resources* to outside the CIS was US\$ 32.6 bn in 1996, which is by 28% more than in 1995. This growth was due rather to the growth of the contractual prices than the growth of the physical volumes of export.



Source: Russian Goscomstat

In 1996, compared with 1995, the growth of the physical volumes and average export prices for the outside FSU countries made 9% and 21% for crude oil, 26% and 25% for petroleum products, and 5% and 11.6% for natural gas, respectively. The respective average shares of these goods in the total volume of the export outside FSU reached 18.2%, 9.8%, and 15% against 16.1%, 7%, and 14.8% in 1995.

In 1995, the Russian *metallurgy* increased the production due, mostly, to the export growth; its share in the ferrous metallurgy reached 60% of the production volume; for the non-ferrous metallurgy the relevant figure was 70%. In 1996, the unfavorable situation formed in the world markets for the non-ferrous metals export; the export cost was due to the growth of the volume at reducing prices.

In 1996, the physical volumes of export grew for the ferrous metals (by 10%), copper (by 12%), nickel (by 9%), and aluminum (by 16%). The share of the ferrous and non-ferrous metals in the total export outside the FSU was 18% against the 17% for the relevant period of 1995.

The non-ferrous metals export was, as before, of the feedstock character. The specific shares of the higher production readiness goods in the export of aluminum, copper, nickel, zinc, lead, and tin did not exceed 10% for any one of these metals.

The processing of the imported and domestic feedstock under the scheme of the exterior and interior tolling played an important role in safekeeping of the industrial potential and work places. In 1996, the shares of the metals supplied under the exterior and interior tolling in the total volumes of export were 79.3% for the primary aluminum, 83.8% for the zinc, 71.4% for the lead, and 64.3% for the tin.

Due to the limited domestic demand for the products of *chemistry and petrochemistry*, the export was of significance in 1996. The cost volume of the export of the chemical products was about US\$ 5.5 bn; this amounted to 6.3% in the aggregate Russian export. However, due to the reduction of the world prices for certain products, the situation with the chemical export worsened. The volume of sales in the foreign markets reduced by about 7%, compared with

1995. Over 40% of the chemical products export come from the mineral fertilizers and organic products (methanol).

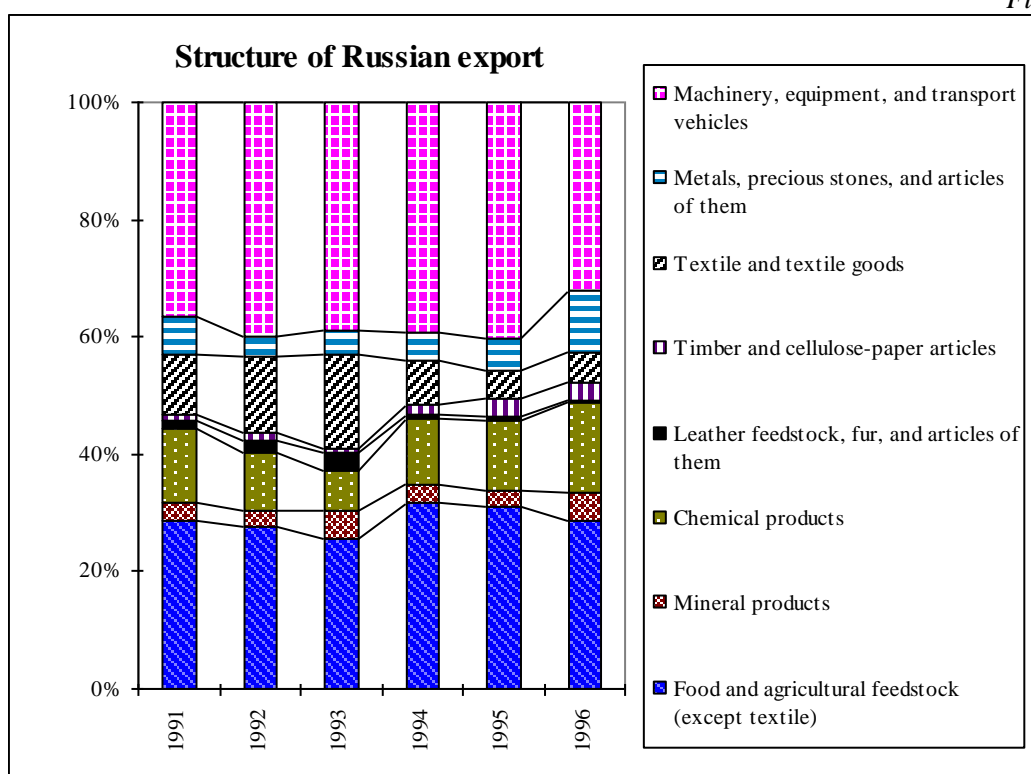
For all the kinds of the chemistry and petrochemistry products, the wholesale prices of producers approached or exceeded the foreign market prices.

The share of the competitive products of the *wood industry* complex sold in the foreign markets amounts to 50% of the aggregate production. However, in 1996, the cost of export of the forestry, wood working, and cellulose-paper industries reduced to US\$ 3.3 bn against the US\$ 4.3 bn in 1995; this was due to both the reduction of the physical volumes and the reduction of the export prices. Because of the foreign market conjuncture change, the sale volume of the round timber reduced by about 15%.

The share of the *machinery and equipment* remains traditionally low in the aggregate export. In 1996, it decreased to 9.4% against the 10.1% of 1995. The cost of this export increased, compared with 1995, by 1%, including by 5% for outside the FSU.

Certain enterprises support their production volumes only due to the export growth. The specific shares of the export supplies in the production volume reached 92% for the Voronezh Factory for heavy presses, about 45% for the “Leningrad Metallurgical Turbines Works”, and 50% for the “Vologda Bearings Factory”.

Fig. 2.22



Source: Russian Goscomstat

The analysis of the relationships between the prices for the main products and the relevant prices of the world markets shows that the today's economic conditions for sale in the exterior market are much worse than for the domestic one. E.g., in 1996, the respective prices for the domestic and foreign markets were as follows: US\$ 9,588 and US\$ 5,100 for the T-30 tractor, US\$ 7,488 and US\$ 3,500 for the T25A tractor (AO “Vladimir Tractors Factory”); US\$ 8,370 and US\$ 4,400 for the VAZ-2109 automobile (AO AvtoVAZ); and US\$ 9,059 and US\$ 6,627 for the universal screw cutting lathe (AO “Krasny Proletariy”).

The domestic market saturation with goods, the crisis in the payments sphere, the low investing activity, the lowered effective demand inside Russia, and the import control

measures had a suppressing effect on the growth of import. In 1996, the import cost was US\$ 59.8 bn (reduction by 2%, compared with 1995), including US\$ 42.3 bn from outside the FSU (decrease by 4%, compared with 1995).

The food, and machinery and equipment remain the main commodity groups in the import.

For the Russian importers, the market situation with a rank of the important products purchased from outside the FSU is quite favorable; this is confirmed by the serious enough decrease of the purchase prices. E.g., in November and December 1996, compared with 1995, the import prices lowered by 22.1% for the poultry, by 9% for the fresh frozen meat, by 18.3% for the citrus, by 62% for the coffee, and by 34% for the caoutchouc.

The share of the machinery and equipment in the aggregate import reduced from 31.8% against the 33.7% of 1995, including the 37% against 39%, respectively, for the outside the FSU. In 1996, the cost of the mechanical engineering products import was by 8% lower than in 1995; this was due, first of all, to the reduction of the relevant import from outside the FSU (by 9%), resulting from the drop of the investing activities in Russia.

The excess of the domestic prices over the foreign suppliers' ones in 1996 resulted in the 40% growth of the ferrous metals products import from outside the FSU.

The import of the steel pipes remained at the 1995 level (360,000 mt from outside the FSU).

For numerous commodities, the share of import in the aggregate volume of their sale grew, because the imported goods are more profitable. As of today, average prices for the imported goods are by 7% to 34% lower than the average prices of the domestic producers and manufacturers for the rolled ferrous metals, steel pipes, polyethylene, passenger cars tires, beef, butter, sunflower oil, and sugar.

The import of the food and non-food consumer goods predetermines the high saturation of the domestic market with them, on the background of the production decrease in the AIC, light, and textile industries.

Table 2.36.

Structure of retail turnover

	1995	1996
Own resources	46	48
Import (including unorganized)	54	52
incl. from CIS	14	15

Source: Russian Goscomstat

At the stable domestic consumer demand (the real disposable incomes of the population formed in 1995), reduction of the domestic production and import of the consumer goods by the officially registered channels, the import by the unorganized (shuttle) channels grew. According to the Bank of Russia, in 1996, the cost of such products was about US\$ 14.3 bn or 24% of the aggregate import volume. Such goods accounted for 26% for the outside the FSU countries, and 19% for the CIS countries. However, in the second half of 1996, the volume of the unregistered import decreased by 13%, compared with the first half. This was due to the seasonal factors in the trade in long lasting goods and animal products with the CIS countries and the reduction of the number of the unorganized resident "shuttles", having left the market due to the reduction of the norms of the duty-free transport of goods over border by natural persons.

The excess of the export growth over the import growth conditioned the significant increase of the positive foreign trade balance: in 1996, it grew, compared with 1995, by 41% and reached US\$ 28.5 bn.

In 1996, the trade and economic links between Russia and the USA saw a certain dynamism in their evolution. As for 1996, the estimated increase of the commodities turnover between Russia and the USA was 5% to 7%; the specific share in the aggregate commodities turnover of Russia was 5.9%.

Among the Western Europe countries, the leader in the trade with Russia is Germany with the 8.9% of the aggregate foreign trade turnover. The relevant figures are 3.9% for Italy, 3.4% for the UK, and 3.3% for the Netherlands. For the Central and Eastern countries, Poland should be noted, whose 1996 commodities turnover with Russia amounted to US\$ 4.2 to 4.5 bn, which makes it one of the largest trade partners of Russia. China is also an important trade partner with its 4.4% of the foreign trade turnover of Russia.

The reduction, during the last two years, of the demand for both the investment and consumer goods is one of the main factors on which the dynamism of the evolution of the foreign economy links with the outside the FSU countries is based. Under such conditions, numerous enterprises and even branches of industry almost came to bankruptcy: the activation of the foreign exchange was an important mean of survival for them.

Appendix I. Payment Balance of Russia

Table 2.37.

Payment balance of Russia for nine months of 1996 (US\$ mn)

	Consolidated	Including	
		outside CIS	CIS
Current transactions account	10243	11090	-847
Goods and services	13778	14724	-946
Export of goods and services	70529	55712	14817
Import of goods and services	-56752	-40989	-15763
<i>Goods</i>	<i>17474</i>	<i>18079</i>	<i>-605</i>
Export of goods (FOB)	63310	49753	13557
Import of goods (FOB)	-45836	-31674	-14162
<i>Services</i>	<i>-3697</i>	<i>-3356</i>	<i>-341</i>
Export of services	7219	5959	1260
Import of services	-10916	-9315	-1601
Incomes from investments and labor payment	-3400	-3467	67
Received	3747	3378	369
Paid	-7146	-6844	-302
<i>Labor payment</i>	<i>-501</i>	<i>-211</i>	<i>-290</i>
Received	81	81	0
Paid	-582	-292	-290
<i>Incomes from investments</i>	<i>-2899</i>	<i>-3256</i>	<i>357</i>
Received	3665	3296	369
Paid	-6564	-6552	-12
Current transfers	-135	-167	32
Received	247	210	37
Paid	-382	-377	-5
Account of transactions with capital and financial instruments	-3046	-2545	-501
Account of transactions with capital	-715	-413	-302
<i>Capital transfers</i>	<i>-715</i>	<i>-413</i>	<i>-302</i>
Received	1439	353	1086
Paid	-2155	-767	-1388
Financial accounts	-2330	-2131	-199
<i>Direct investments</i>	<i>1167</i>	<i>1166</i>	<i>1</i>
abroad	-263	-245	-18
in Russia	1430	1411	19
<i>Portfolio investments</i>	<i>2333</i>	<i>2264</i>	<i>69</i>
Assets	57	-23	80

	Consolidated	Including	
		outside CIS	CIS
Liabilities	2276	2287	-11
<i>Other investments</i>	-7224	-6955	-269
Assets	-19973	-18632	-1341
Foreign currencies in cash	-7664	-7664	0
Current accounts and deposits	468	532	-64
Trade credits and advances	-8070	-7693	-377
Credits and loans granted	7862	7078	784
outstanding debts	-8279	-7591	-688
Change of indebtedness for not timely received export hard currency and Ruble income	-1842	-1124	-718
Change of indebtedness for not timely redeemed import advances	-2300	-2300	...
Other assets	-148	130	-278
Liabilities	12749	11677	1072
National currency in cash	330	0	330
Current accounts and deposits	862	652	210
Trade credits and advances	...	...	...
Mobilized credits and loans	8221	8221	0
Outstanding debt	1963	1877	86
Other liabilities	1373	927	446
<i>Reserve assets</i>	2787	2787	0
<i>Amendments to reserve assets</i>	-1394	-1394	0
Amendment for settlements with CIS/outside CIS countries	-	-1477	1477
Net errors and omissions	-7198	-7069	-129
Aggregate balance	0	0	0

The payment balance of Russia stayed stable, reflecting the tendencies formed in the foreign economic sphere evolution.

The dynamics of the export-import transactions and the excess of the export over import of goods favored the preservation of the positive balance for the current transactions account; it amounted to US\$ 10.2 bn against the US\$ 8.6 bn in January to September 1995.

The negative balance of the services was US\$ 3.7 bn, having shown a 2-fold drop. The export of services reduced by 1%; the import reduced by 24%. The services to the foreigners, relative to the tourist, private, and business trips grew by 11%, due to the growth of the non-residents inflow. In the third quarter of 1996, the federal Borderguards registered a marked growth of the Chinese "shuttles" inflow to Russia.

As for the services import, 56% were paid for the stay of Russian citizens abroad. However, the number of the Russian citizens exiting Russia was almost 2-fold lower than for the relevant period of 1995, mainly due to the reduction of the trips to the CIS countries recorded by the Federal Borderguards. As a result, the reduction of the services import for the "Trips" item was 29%. The construction services import reduced by 20% due to the completion of most of the construction of the military settlements financed by Germany.

The negative balance of the incomes from investments and labor payment was US\$ 3.4 bn; the labor payment for the non-residents exceeded the relevant incomes of the Russian citizens abroad by US\$ 0.5 bn, while the payments of Russia for the use of the mobilized foreign investments exceeded the payments from abroad by US\$ 2.9 bn.

The labor payment of the non-residents, both officially registered, and temporarily employed in the Russian economy was US\$ 0.6 bn for January to September 1996. However, lots of the CIS residents are employed by the informal sector of the Russian economy. According to the experts of the Governmental Migration Service, it exceeds more than 2-fold

the number of the officially mobilized employees. However, as of today, it seems impossible to estimate the incomes received by this category of employees.

The diagram of the investment incomes for the considered period envisioned the reception by Russia of US\$ 3.7 bn, while the diagram of payments showed the level of US\$ 6.6 bn. The main monies went to the servicing of the both received and granted governmental credits.

As for the current transfers, the negative balance of US\$ 0.1 bn formed due to the reduction by 60% of the humanitarian aid from abroad. Within the period under consideration it amounted to US\$ 173 mn. The volume of the humanitarian and technical aid formally registered by the Russian State Customs Committee was much greater. However, the fact should be noted that, in order to avoid the custom duties, the tobaccos and alcohols were imported in Russia as humanitarian aid. In April to September 1996, the supplies of such goods amounted to 50% of the aid granted.

The second item for the account of transactions with capital is formed by the “transfers relative to the migration of the population”, reflecting the aggregate cost estimate of the flows of the property, financial assets and liabilities accompanying the migration to and out of Russia. The migrations between Russian and the CIS countries was the most important. The number of the persons having come to Russia in the first nine months of 1996 exceeds 2-fold the number of the persons having left Russia, while the cost estimate of the resources exported from Russia by the migrants (over US\$ 2.1 bn) exceeds the relevant cost estimate for the assets received by Russia (US\$ 1.1 bn).

In whole, the negative balance for the account of transactions with capital amounts to US\$ 0.7 bn; this means the relevant reduction of the Russian national wealth.

The direct investments in the Russian economy amounted to US\$ 1.4 bn, which is by 30% more than for the relevant period of the preceding year. The registered volume of the direct investments in the Russian economy formed at the level of the first nine months of 1995, i.e., about US\$ 300 mn.

The significant growth of the foreign liabilities for the portfolio investments took place. The capital inflow to the governmental management sector was determinant; this is due to the participation of the non-residents in the Russian securities market, first of all, the GKO and OFZs.

In whole, during the nine months, the net inflow of the foreign investments in the GKO and OFZs amounted to US\$ 1.7 bn.

It should be noted that the non-residents were indirectly presented by the Russian crediting entities in the GKO and OFZs market on a larger scale. This is confirmed, in particular, by the sharp growth of the foreign money mobilized by the commercial banks and investment funds; this is hard to explain from the viewpoint of the dynamics and situations of their international ratings. The calculations show that such indirect participation of the non-residents in the governmental securities market of January to September 1996 grew by US\$ 3.7 bn. It seems possible that the investments inflow by the above channels means the repatriation of the former exported Russian capital to be legalized, in particular, for participation in the market privatization. The estimated aggregate inflow of the foreign capital to the GKO and OFZs market for the considered period and all the possible forms (using both the official and unofficial investment schemes) amounts to US\$ 5.4 bn.

The capital export in form of the portfolio investments is executed, mainly, by commercial banks.

The increase of the foreign currency in the non-banking sector confirming the renewal of the economy dollarization process was US\$ 7.7 bn in January to September 1996. The growth of the demand for the cash hard currency was determined by the reduction of the interest rates on the Ruble instruments, the rapprochement of the profitability of the Ruble investments to

the one of the investments in the cash US Dollar, and the remaining problem of the mutual non-payments stimulating the use of the cash hard currency in the non-registered channels of the money circulation.

During the first nine months of 1996, the foreign assets in the Russian commercial banks reduced by US\$ 0.2 bn, while the liabilities increased by US\$ 2.6 bn; this led to the reduction of the net foreign assets by US\$ 2.9 bn. The decrease of the foreign assets is due, in a great extent, to the “withdrawal” by the Russian banks of the monies from the current and deposit accounts abroad, in order to satisfy domestic currency markets.

The greatest increase of the foreign liabilities of the commercial banks was due to the growth of the assets placed by the non-residents on the current and deposit accounts in Russian banks. Hence, the volume of the loans and credits, mobilized by the Russian banks from abroad, was continuously growing.

The negative balance for the item “Trade credits and advances” amounted to US\$ 8.1 bn; this meant the growth of the assets of the foreign non-residents.

The positive balance for the item “Granted loans and credits” amounted to US\$ 7.9 bn; this means the relaxation of the requirements to the non-residents.

The balance for the mobilized loans and credits was positive and amounted to US\$ 8.2 bn (for the first nine months of 1995, it amounted to US\$ 2.5 bn). This means the growth of the Russian liabilities towards the non-residents.

As of 1 October 1996, the international gold and hard currency reserves of Russia amounted to US\$ 15.1 bn; during the first nine months of 1996, they reduced by US\$ 2.1 bn. However, during the period under consideration, the stocks of the monetary gold increased by US\$ 0.9 bn, while the hard currency reserves decreased by almost US\$ 3 bn.

The above reduction was seen on the background of the growing demand of the residents for the cash hard currency and the massive escape of the non-residents from the GKO-OFZs market accompanied with conversion of the received assets in Rubles to hard currencies with their further repatriation.

Despite the unfavorable monetary situation, the financial control bodies managed to conserve the Russian monetary and hard currency reserves at an acceptable level.

Section 3. The Social Sphere

3.1. The Standard of Living

Money incomes. In 1996, the RF State Committee for Statistics (Goskomstat) estimated the households' total money incomes at 1375 trillion rubles. For the first time since 1992, the year 1996 displayed a stable trend toward a higher share of wages in the overall volume of incomes. As compared to 1995, the share of social transfers remained practically stable; there was a slight decline in the share of incomes from property and business, as well as the other types of income (Table 3.1).

Throughout 1996, real disposable incomes roughly corresponded to the 1995 level; there were two leaps, in June (a 7-percent rise from May) and (a more expected one) in December (a 20-percent rise from November). It should be noted that the December monthly growth of real incomes was practically double the monthly rise of real calculated wages. Thus, in December as compared to the previous months, there occurred a significant increase in the share of income from property and business, which indicates a break in the trend toward the change in the structure of incomes observed throughout most of 1996.

The RF Goskomstat thus distributed the households by average per capita incomes in 1996:

Table 3.1

Structure of the households' money incomes (percent)

Year	1992	1993	1994	1995	1996
Money incomes, total	100	100	100	100	100
Wages	69.9	60.5	46.6	40.7	43.4
Social transfers	14.0	15.1	15.4	12.4	12.8
Incomes from property, business, others	16.1	24.4	38.0	46.9	43.8

Source: RF Goskomstat.

Table 3.2.

**Distribution of the households by average per capita monthly income
(percent of total)**

Total number of households	100
Up to 400,000 rubles	25.3
400,100 - 600,000 rubles.	22.4
600,100 -800,000 rubles.	16.9
800,100 -1,000,000 rubles	11.5
1,000,100 -1,200,000 rubles	7.6
1,200,100 -1,600,000 rubles	8.4
1,600,100 - 2,000,000 rubles	3.9
over 2,000,000 rubles	4.0

Source: RF Goskomstat.

The year 1996 witnessed consolidation of the trend that first manifested itself in 1995: a halt in the redistribution of incomes in favor of the higher-income groups; the wealth gap remained almost unchanged and even narrowed somewhat. The value of the summary index describing the inequality in income distribution, the Gini coefficient, was practically the same throughout the year, showing a slow downward trend, from 0.38 to 0.37 (final value for 1996, 0.375). The distribution of the overall volume of money incomes among the population groups is shown in Table 3.3.

Table 3.3.

**Distribution of the households' incomes
in 1994 - 1996 (percent)**

	1994	1995	1996
Money incomes, total	100	100	100
by 20-percent population groups:			
first (lowest incomes)	5.3	5.5	6.5
second	10.2	10.2	10.9
third	15.2	15.0	15.5
fourth	23.0	22.4	22.4
fifth	46.3	46.9	44.7
Gini coefficient	0.409	0.381	0.375
Ratio between incomes of the wealthiest and the poorest 10 percent	15.1	13.5	13.0

Source: RF Goskomstat.

In 1996, there was a 1-percent increase in the share of incomes of the poorest 20 percent, and the position of the second and third groups, low- and medium earners, slightly improved. The share of the incomes received by the wealthiest 20 percent fell by 2 percent, and the incomes of the top 10 percent dropped by 3 percent.

On the whole, the data reported by Goskomstat are somewhat controversial and make it impossible to derive any definite conclusions regarding any at all significant changes in income distribution. Noteworthy is the broadening wealth gap between the top and the second-wealthy 10 percent: in 1995, it was approximately 100 percent, while in 1997 their incomes differed 3.17 times. In this situation, the inequality in income distribution should have increased as well. On the other hand, in 1996, the second 10-percent group received only 10.7 percent of the incomes, as against 15.9 percent in 1995. However, the second 20-percent group got 22.4 percent. In other words, there are discrepancies in Goskomstat's data (in purely statistical terms, it is impossible to record such a correlation between the incomes of the "wealthier" 10-percent group and the next 20-percent group). According to Goskomstat, there is also a widening gap in the incomes of the first and second 10-percent groups: it grew from 1.4 times in 1995 to 1.5 times in 1996.

In 1996, the inter-regional income gap remained extremely broad. In Moscow and in Russia generally, the gap between average per capita incomes widened from 3.1 times in March 1995 to 3.4 times in September 1996. While in the first half of 1995 the average per capita income received in Moscow was lower than in Magadan Oblast, in late 1996 Moscow incomes were double those in Magadan. The gap between the incomes in Moscow and elsewhere in Russia largely accounts for the high final indicators describing the differentiation of Russia's households by income level. In this context, the somewhat milder income inequality can be explained only by a stable reduction of inter-regional differentiation indicators. However, Moscow is a notable exception to the rule in this case, too: according to the Moscow City Committee for Statistics, over the past two years the Gini coefficient was at the 0.55 - 0.60 level. In other words, as far as the income gap is concerned, Moscow found itself ahead of Brazil. The Moscow phenomenon can be explained, in part, by the data collecting technique itself: due to super-high concentration of financial and banking establishments and trade outlets, part of the incomes of the other regions' residents obtained through the "mediation" of Moscow companies gets included into the Muscovites' incomes.

The subsistence minimum (established on the basis of methods developed by the Labor Ministry) was, as of the end of 1996, 379,000 rubles per person. For the first time, a decrease of the subsistence minimum was noted throughout the year: in December, it proved somewhat lower than in June for all population groups. In our view, this proves yet again that the Labor

Ministry's technique for estimating the subsistence minimum used by statistical organizations is based on an excessively rigid link between minimum and basic food prices. Indeed, a seasonal drop of vegetable prices alone hardly warrants a conclusion that the minimum consumer basket has become cheaper (in September, the subsistence minimum in Russia proved 5 - 6 percent lower than in June). If the old structure of expenses in the basic basket used to estimate the subsistence minimum, that is, orientation toward the structure of spending typical of low-income households at the turn of the 1990s, is retained, monitoring this indicator calculated on the basis of the Labor Ministry's technique would become a formal statistical exercise.

In 1996, average per capita monthly incomes of 22 percent of the households were below minimum (in 1995, this group encompassed 24.7 percent). Throughout 1996, the share of the poor steadily decreased, from 24 percent in the first to 19 percent in the fourth quarter.

In 1996, an improvement was registered of the correlation between the average level of money incomes and the subsistence minimum, from 201 percent in 1995 to 211 percent in 1996.

In December 1996, the average monthly wage rose to reach 944,000 rubles; in 1996 generally, the nominal average wage was approximately 800,000 rubles, rising 1.6 times from 1995. The average calculated wage in real terms (with account of the consumer price index) rose 5 percent in 1996, and its ratio to the subsistence minimum (for the able-bodied population) increased from 1.68 to 2.2 times. The wage debt rose to over 26 trillion rubles (about 4 percent of the overall volume of calculated wages); with account of this circumstance, real wages showed practically no change in 1996. The monthly dynamics of the average calculated wage throughout the national economy is presented in Table 3.4.

Table 3.4.

Monthly dynamics of average calculated wages (thous. rubles)

January	654.8
February	684.4
March	745.0
April	746.5
May	779.3
June	837.2
July	842.8
August	831.0
September	848.1
October	843.3
November	835.0
December	944.0

Source: RF Goskomstat.

In the context of overall stabilization of real wages, the wages in various industries slowly evened out: the average wages in health care, physical training, and social security in relation to Russian's average indicator (statistics for January - November 1996) were 75 percent as against 71 percent the year before; in education, this indicator rose from 63 to 68 percent, and in scientific research and its servicing, from 75 to 81 percent. The gap between the average wages in the leading industries and in the economy as a whole became somewhat narrower: while in 1995 the average wage in oil production was 2.88 times higher than average, in 1996 this figure was 2.78 times. In the gas industry, this indicator went down from 3.98 to 3.83 times. Only in the light industry, in 1996 the average wage repeatedly dropped below the subsistence minimum (for the able-bodied population). In the economy as a whole, the

average wage roughly corresponded to the subsistence minimum for a family of two persons of employable age.

The average calculated monthly pension was, in the end of 1996, 320,700 rubles, exceeding the subsistence minimum by 7 percent in the first quarter of the year, and by 20 percent in the fourth. Thus, for the first time since 1994, the relative level of calculated pension showed a rise (while in early 1994 the average pension was 40 percent higher than a pensioner's subsistence minimum, by year end the gap was only 10 percent). At the same time, due to the Pension Fund's large debt to pensioners, in the second half of 1996 the average actually paid pension was only 5 - 10 percent higher than the subsistence minimum. According to Goskomstat, real calculated pensions rose approximately by 9 percent as compared to 1993, but with account of the pension debt, actual growth did not exceed 4 - 5 percent. The ratio of the average pension to the average wage did not change much throughout 1996, fluctuating within the 0.37 - 0.38 range (with the exception of December, when due to a sharp leap of the wages the value of this indicator dropped to 0.33).

Analysis of the dynamics of deductions to the Pension Fund in 1996 shows that the debt formed because enterprises failed to make mandatory payments to the Fund (which was shortchanged of about 30 percent of the money due it). It must be recognized that reducing the pensions of the job-holding pensioners and even raising retirement age would be far less effective than ensuring that the enterprises pay the mandatory 28 percent of total calculated wages to the Pension Fund. Should this be achieved, it would become possible to raise the average pension to over 400,000 rubles, which is 30 percent more than the calculated pension in 1996.

Money expenses. In 1996, the share of the households' expenses on the purchase of goods and services remained stable and did not change from 1995, constituting 70 percent of the money incomes. Changes occurred in the structure of individual savings (the reference is both to bank deposits and securities and to the so-called "unorganized" savings - foreign currency and the money kept under mattresses).

Table 3.5.

Structure of households' savings in 1993-1996 (percent)

	1993	1994	1995	1996
Savings, total	100	100	100	100
Growth of savings kept as bank deposits and securities	26.7	22.7	21.9	17.8
"Unorganized" savings	73.3	77.3	78.1	82.2
including:				
purchase of foreign currency	33.9	61.6	62.7	76.7
growth of money held under mattresses	39.4	15.7	15.4	5.5

Source: RF Goskomstat.

"Unorganized" savings were made mainly through the acquisition of foreign currency; while in 1993 the share of the cash kept under mattresses in the overall structure of savings was 55 percent, in 1996 it was under 7 percent. In the last quarter of 1996, the share of the means spent on the purchase of foreign currency (cash) closely approached 22 percent of the households' money incomes. Due to the reduction of interest rates by the Savings Bank and commercial banks, in 1996 the growth of the savings kept as deposits and securities slowed down quite dramatically. As the gap between interest rates offered by the Savings Bank and by commercial banks began to close, the balance on the Savings Bank deposits began to increase faster than that on commercial bank deposits, over 50 and just 25 percent respectively. As a result by year end the Savings Bank accumulated 74 percent of all individual deposits as against 68 percent at the beginning of the year. At the same time, fear of

a monetary reform and political instability made many people give up the idea of keeping rubles at home: in the third quarter, the volume of money saved in this way dropped; throughout the year, its growth was only just over 1 percent of all money incomes.

The structure of the households' money expenses (especially the share spent on purchasing foreign currency) changed substantially in the course of 1996 under the impact of political factors, such as the elections and Yeltsin's health. Fig. 3.1 contains statistics illustrating the share of foreign currency purchase in the overall volume of the households' incomes in May - December 1995 and 1996.

It is easy to see that in the second half of 1995, the share of foreign currency purchase varied within the 13 - 16-percent range, while in the second half of 1996 this range was 18 - 22 percent, and the value of this indicator was steadily rising.

The political factor also made itself felt in that in the second half of 1996, there was a sharp reduction in the inflow of households' savings to commercial banks: in June and July, the balance of money on commercial bank deposits even decreased (Table 3.6).

In 1996, retail trade turnover in comparable prices fell by about 4 percent as compared to previous year. Since 1993, there has been a rise in the share of foodstuffs in the overall volume of turnover, with this share reaching 48 percent in 1996. The share of consumer goods, mixed, and food markets in overall turnover increased from 28 percent in 1995 to 29 percent in 1996. The findings of surveys of households show that in 1996, per capita consumption of the more valuable meat and dairy products somewhat declined; at the same time, supply of the basic types of consumer durables continued to improve.

Fig. 3.1

Share of foreign currency purchase in the overall volume of the households' money incomes in May - December 1995 and May - December 1996

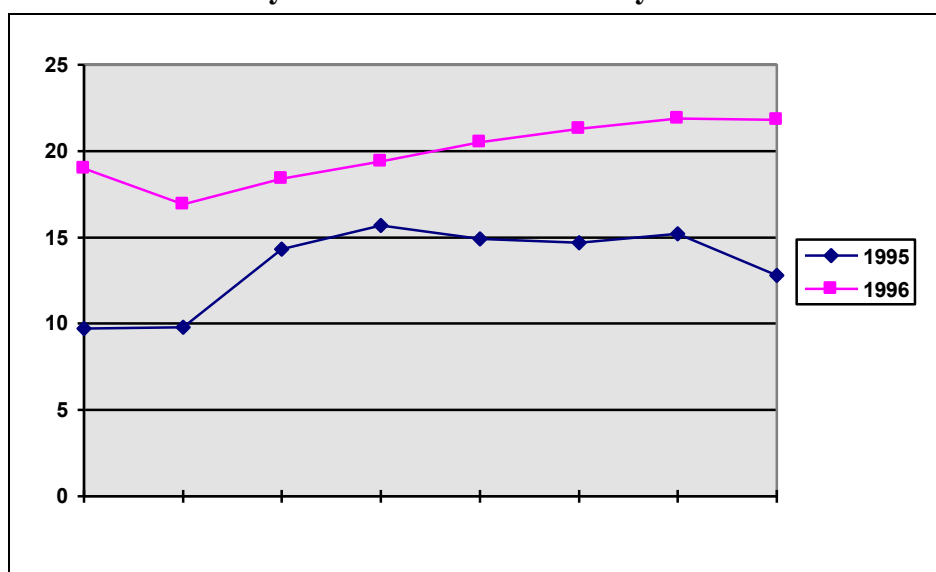


Table 3.6

Increase (+) and decrease (-) of the balance on deposits in the RF Savings Bank and in commercial banks in May - December 1996

	June	July	August	September	October	November	December
Growth of balance on bank deposits, trillion rubles	1.1	2.5	5.1	4.1	2.9	3.3	1.0
Growth of balance on RF Savings Bank deposits	1.9	3.0	4.2	3.3	2.6	3.1	0.9
Increase or decrease (-) of	-0.8	-0.5	0.9	0.8	0.3	0.2	0.1

balance on deposits in commercial banks							
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In 1996, the households' spending on paid services rose faster than overall trade turnover: this happened largely because service charges increased faster than the prices of consumer goods. Utilities and transportation tariffs, as well as the cost of stay in health homes and resorts rose more than 1.5 times; the share of the housing and utilities sector in the overall volume of services exceeded 20 percent (10 percent in 1993).

3.2. Social and Cultural Sphere

The main specific features of the status of the social and cultural sphere in 1996 were a substantial reduction of federal budget financing, formation of a stubborn wage debt, and an ensuing wave of strikes on the part of employees. The continuing degradation of state and municipal systems of health care, education, and cultural services brought them up to the situation when their further functioning has become impossible; it is inevitable that the bulk of their activities will have to be suspended.

Financing

In 1996, state budget spending on health care, education, culture, art, and the mass media constituted, in comparable terms, 65 percent of the 1991 allocations. Far from shrinking, within this time period the network of state and municipal health care, educational, and cultural establishments expanded because of the transfer of departmental social infrastructure facilities into municipal ownership. State funding is insufficient to provide for even the minimum needs of the state and municipal network so that it would be able to provide free health care and education. The chief problem facing the social and cultural sphere is, at present, the gap between the state's extensive obligations toward the citizens inherited from the Soviet past and the real volume of budget financing. This gap is not likely to close, which means that the social sphere is doomed to further degradation.

Table 3.7.

Public spending on the social and cultural sphere (in real terms, percent of 1991 outlays)

	1991	1992	1993	1994	1995	1996
Health care	100	80	108	99	72	76
out of:						
state budget	100	80	91	81	59	65
mandatory insurance fees of legal entities	-	-	17	18	13	16
Education*	100	79	79	76	56	66
Culture, art and the mass media *	100	91	81	87	63	61

* State budget expenses

Source: calculated on the basis of RF Goskomstat's statistics.

The 1996 federal budget envisaged a substantial increase of the share of allocations to the social sphere (health care, from 1.3 percent in 1995 to 1.7 percent in 1997; education, from 3.1 to 3.6 percent; culture, art, and the mass media, from 1.0 to 1.2 percent). But when the budget was implemented the rise did not take place. Just the opposite, the share of federal budget spending on health care fell to 1.2 percent, and on culture, art and the mass media - to 0.5 percent. The share of spending on education rose, but not very significantly, from 3.1 to 3.2 percent.

The problems arising from the reduction of federal budget revenues were solved by cutting down the financing of social programs. When budget revenues fell by 14 percent as compared to the planned values and expenditure declined 18 percent, budget implementation for educational expenses was 74.8 percent, and for health care spending - 57.6 percent. The scope

of reduction of the allocations for culture, art and the mass media was unprecedented: they constituted only 42 percent of the planned amount. The scope of reduction in the various fields was so unequal because of the difference in the share of spending falling to the protected sub-heads in the planned volume of financing, as well as by the unequal political weight of the various pressure groups.

Table 3.8.

Public spending on the social and cultural sphere
(percent of GDP)

	1991	1992	1993	1994	1995	1996
Health care	2.9	2.5	3.7	3.9	2.9	3.1
out of:						
state budget	2.9	2.5	3.1	3.2	2.4	2.5
mandatory insurance fees of legal entities	-	-	0.6	0.7	0.5	0.6
Education*	3.6	3.6	4.1	4.5	3.4	3.7
Culture, art and the mass media *	0.5	0.6	0.6	0.8	0.6	0.5

* State budget expenses

Source: calculated on the basis of RF Goskomstat's statistics.

In 1996, federal budget allocations to the social and cultural sphere constituted 69.2 percent of the 1995 level (in comparable terms). It was a characteristic feature of 1996 that the decrease of federal budget financing was more than made up for by an increase of such spending in the budgets of the RF subjects. Its share rose from 37.5 percent in 1995 to 39.9 percent, and its volume increased by 14.5 percent in comparable terms. As a result, consolidated budget allocations to the social and cultural sphere proved 111.5 percent of the 1995 level (in comparable terms). The ratio of federal budget allocations to those of the budgets of the RF subjects changed from 14:86 in 1995 to 12:88. The dynamics of state financing of the social and cultural sphere in 1991 - 1996 are presented in Tables 3.7 and 3.8.

Wage debt

In the past few years, the wages in the social and cultural sphere remained very low as compared to the other economic sectors. In 1996, calculated wages in this sphere rose noticeably faster than on average in the economy: 1.8 and 1.6 times respectively. As a result, the wage gap became somewhat narrower but remained significant. In health care, the average monthly wage in January - November 1996 was 65.4 percent in relation to the average wage in industry, 59.2 percent in culture, and 54.6 percent in art.

Another feature of 1996 was a substantial difference between the rate of growth of budget allocations to the social and cultural sphere, and the rates of the rise of calculated wages to its employees. In nominal terms, financing increased only 1.4 times. As a result, a wage debt appeared. Its slight reduction at the time of the presidential election campaign was unable to drastically change the situation, and by year end the budget's debt to the employees in health care, education and culture rose over three times from January (Table 3.9). Unlike production, where in December the debt was reduced by 0.6 percent as compared to November, in the social and cultural sphere the debt continued to grow (in education, by 10 percent; in health care, by 6 percent; in culture, by 5 percent).

Table 3.9

Budget's wage debt, billion rubles

	as of 20.01. 1996	as of 18.03. 1996	as of 10.06. 1996	as of 08.07 1996	as of 12.08. 1996	as of 23.09. 1996	as of 23.12. 1996	as of 27.01. 1997
Total	20804	4835	5654	447	4328	40235	47151	48602

Social sphere	2376	3742	4565	267	5801	243	8597	8712
including:								
education	1398	1064	1171	221	876	932	4467	4645
health care	823	2307	2924	2579	985	221	2567	2588
culture and art	155	213	269	92	51	68	482	492

Source: RF Goskomstat.

The strike movement

The sharpest reaction to wage delays was a large-scale strike movement launched by employees in the social and cultural sphere, which encompassed most Russia's regions. This is true, above all, of education, where throughout 1996 7,396 establishments held strikes, which involved 251,000 persons (Table 3.9). According to the estimates made by the trade union of public education workers of the Federation of Russia's Independent Trade Unions, in December 1996 taking part in a termless strike were about 90,000 public education workers in 27 RF regions, as a result of which over 500,000 children did not attend school.

Table 3.10.

Strike movement in sectors of the social sphere in 1996 (running total)

	Jan.	Febr.	March	April	May	June	Sept.	Octob.	Nov.	Dec.
	Number of organizations in which strikes took place:									
<i>Education</i>	2077	2594	2657	2691	2798	2881	3349	4260	5023	7396
<i>Health care</i>	22	22	23	23	23	21	82	117	159	229
	Number of strikers, thousands									
<i>Education</i>	44,4	89,6	94,1	97,7	104,	108,0	118,0	152,8	175,0	251,0
<i>Health care</i>	3,3	3,9	4,0	4,0	4,0	4,2	13,7	14,4	20,4	24,9

Source: RF Goskomstat.

Taxation policy changes

Since late 1995, it was the government's policy to cut down taxation privileges. As applied to the social and cultural sphere, this meant abolishing a number of privileges formerly extended to entrepreneurial activity in this field. Of interest is the selective approach used when implementing this policy. There is a clearly perceptible pattern: the better organized a groups sharing certain social interests was, the more privileges it managed to retain.

In 1993--1995, state and municipal libraries, museums, philharmonic societies, and theaters received profit tax exemption. Since January 1997, this exemption covered the profits derived from these establishments' basic activity; non-state-run ones were excluded from their number. Tax exemption also used to apply to the part of the profit directed by the companies belonging to charity funds and creative workers' unions into the latter's maintenance. In 1996, this privilege was abolished as regards the charity funds but retained for the creative workers' unions.

These steps further worsened the economic position of cultural and charitable establishments, for which revenues from business were essential for survival and continuation of their basic activity. This curtailment of taxation privileges was at odds with the evolution of the legislation on non-profit organizations. The 1995 federal laws "On Charitable Activities and Charities" and "On Non-Profit Organizations" created a legal framework ensuring that non-profit and charitable organizations would not be used as a facade for commercial companies dealing in tax evasion. Unfortunately, the financial bodies and the taxing authority find it easier to abolish taxation privileges than to organize control over the operation of non-profit companies envisaged by the law.

In late 1996, on the suggestion of the government, the State Duma once more revised the taxation law. Unlike the amendments introduced a year before, this revision was more

consistent and specific (the changes did not affect all the incomes from entrepreneurial activities of non-profit companies), and was less discriminatory. Exemption from value added tax for the goods and services produced and marketed by occupational therapy workshops at mental homes and clinics and by the invalids' public organizations no longer extends to the goods subject to excise duty, mineral raw materials, and minerals. The profit tax exemption enjoyed by religious associations and the invalids' public organizations, as well as the profit tax privileges granted to the companies set up within these associations and organizations, no longer extends to the profit derived from the production and marketing of the goods subject to excise duty, mineral raw materials, and minerals.

Health care: the fight for reform continues

The summer of 1996 produced a large number of concepts of health-care reform continuation. However, neither the government nor the Health Ministry defined their conceptual stand. The government's most notable steps in the field of health care in 1996 were the transformation of the Ministry of Health and the Medical Industry into the Health Ministry (August) and submittal to the Duma of a draft law on introducing amendments to the Law "On Medical Insurance of Citizens in the Russian Federation."

There was good reason to relieve the Health Ministry from administrative responsibility for the condition of the medical industry: it was a necessary step on the way to a health-care system meeting the standards of a market economy.

This, however, is not true of the government's stand on the medical insurance scheme. As in 1995, an attempt was made to revise the operating model of mandatory medical insurance (MMI). The prepared draft reflects, first and foremost, the interests of health-care system administrators. Under it, the elements of market regulation are to be replaced by state regulation. Non-state insurance companies were excluded from the range of MMI subjects. The territorial MMI funds, which are now independent agents, are from now on to report to the executive authority bodies. The draft law has lost the sections regulating voluntary medical insurance, whose legislative base is impaired as a result. In fact, the draft attempts to resurrect the state health-care system in a different form.

Some RF subjects treated the very fact that such a draft law was submitted as permission to revise the MMI model to suit the interests of medical administrators. Last December, on the government's initiative, in the Republic Marii El the republican MMI fund withdrew financing from the medical companies providing services under insurance schemes.

Should the draft law be passed, the health care system would lose the internal stimuli to maintain and improve the quality of the services, protect patient rights, raise efficiency, and make a better use of resources. The problems that appeared because the health care reform is inconsistent and fragmentary are to be solved by rejecting the principles of insurance medicine as the basis of health care organization in a market economy.

Immediately after the draft law had been submitted, the State Duma came up with an alternative one, which is designed to promote the interests of medical insurance companies and proposes to continue reforms on a large scale. However, it does not take adequate account of the difficulties that accompanied the introduction of MMI. The progress of the Duma debate of the draft law shows that the situation in health care is marked by a rough balance of forces among three "special-interest groups": medical administrators, MMI funds, and medical insurance companies. In this context, any revision of the legislation regulating medical insurance becomes a problem.

Education

In 1996, the state authority bodies did not change their attitude to the financing and state support of this sphere. Underfinancing, the emptiness of passed decisions and, in consequence, the rising social tensions in the educational workers' community - all these problems have become chronic.

In 1996, restructuring of the educational network continued. The overall number of general day secondary schools remained at the 1995 level, the number of "classical" schools rose by 9.6 percent, and the number of lyceums - by 11 percent. However, the share of schoolchildren attending them remains low, only 5.5 percent. The same is true of non-state general secondary schools, which are attended by just over 0.2 percent of schoolchildren (a rise of 2.4 percent from 1995).

The rising prestige of higher education manifests itself in the fact that the upward trend in college and university admittance continues since 1992 (in 1996, there was a 7-percent increase as compared to 1995). At the same time, the number of students accepted by state specialized secondary schools declined (99 percent of the 1995 level).

The highest growth dynamics has been demonstrated by non-state higher educational establishments, whose share was 30 percent of the overall number in Russia in 1996 as compared to 25 percent in 1995. Their purpose being to supply specialists in demand under market conditions, they trained 13,000 persons in 1996, or 71 percent more than in 1995. (To compare: the same indicator for the state higher educational establishments was 5 percent.)

The wish to stabilize their financial position promoted the expansion of the paid higher education system. In 1996, 321,100 students (11.6 percent) paid their own way in full (in 1993 - 3.7 percent, in 1994 - 4.6 percent, and in 1995 - 8.7 percent). Three and two percent of students respectively received an education at state higher educational establishments and vocational secondary schools on contract basis.

The advancement of the non-state sector in education, which is in fact the only manifestation of real institutional changes in this field, came up against serious obstacles when in 1996 a new edition of the Law "On Education" was passed. The following basic amendments eroded the status of the non-state educational system:

- equal rights when applying to a higher educational establishments were given only to the graduates of those non-state schools that had not only a license but state accreditation as well;
- the right of postponement of military service was extended only to the students of the higher educational establishments having state accreditation, and there are only a few in the non-state network;
- the following provisions were excluded from the text of the law: on the right of non-state higher educational establishments that have passed state accreditation to receive budget financing and on the granting of personal state educational loans. The state thus relinquished its obligation to budget-finance non-state higher education;
- privatization of all educational establishments was prohibited.

These amendments strengthened the political dependence of non-state education upon the power structures, complicated their financial positions obliging them to raise the fees, and curtailed legal and social protection of the students, thus making non-state education less attractive in their eyes.

Cultural policy

Quite a number of normative acts in support of culture was passed in 1996. In May, the government approved the Federal Targeted Program "Advancement and Protection of Culture and Art in the Russian Federation (1997 - 1999)". In July, the program was granted a

presidential status. This, however, failed to improve its funding. The 1997 budget allocated for this purpose only 67 percent of the money mentioned in the program.

Two days before the second round of the elections, the President signed a Decree “On Measures to Increase State Support of Culture and Art in the Russian Federation”; however, these measures are purely symbolic.

In August, the Federal Law “On State Support of the Cinema in the Russian Federation” was passed. It envisages big steps aimed at supporting Russian film-making, which is gripped by a crisis that is threatening its very existence. Over the past five years, the volume of output here went down nine times (in 1996, 2.5 times from the previous year; in 1992, there appeared 178 feature films, in 1993 - 137, in 1994 - 82, in 1995 - 51, and in 1996 - 20).

Among the more important steps designed to support film-making is the establishment of its minimum budget financing (0.2 percent) and a whole range of taxation privileges. This, however, is likely to remain a good intention. The rate of spending on film-making will not be observed, just as the rate of spending on culture generally (0.2 percent of the federal budget) established by the “Fundamental Legislation on Culture” passed in 1993 has never been observed. The 1997 budget allocates 0.63 percent (1.19 percent together with the spending on the mass media) to culture and art, including film-making. The provisions regarding taxation privileges do not operate directly and should be supported by a revision of the tax legislation; this has not yet happened and is unlikely to happen in the near term.

As regards the mass media, the share of budget financing replaced by other sources (income from advertising, founders’ donations) has been increasing. In comparable terms, budget spending on the mass media fell by 30 percent over the year. The volume of TV broadcasting directly funded by the state shrank further: in September, the eighth frequency channel, which had been used by the All-Russia State Television and Radio Company in the daytime and by the non-state Independent Television (ITV) in the evening and at night was given over to ITV.

At the same time, the power elite’s control over the mass media, especially television, did not relax and even became more efficient. This became obvious during the election campaign. The traditional state control mechanisms, which combine budget financing with influence within the framework of administrative right, metamorphosed into control mechanisms typical of a society split into clans.

Priority reform trends

It was declared in the course of the election campaign that the government would introduce a social reform program. There is no doubt that such a program is badly needed. Poverty on a large scale, the widening wealth gap, rising unemployment, worsening social disintegration, substantial reduction of public spending on the social sphere and thinly spreading this money over without revising the obligations assumed by the state, spontaneous metamorphosis of free services into paid ones - these and many other problems demand that the state not merely pay more attention to social policy but a thorough revision of this policy as well. This is what was expected from the document entitled “The Social Reform Program for 1996 - 2000”.

Last November, this program was approved by the RF Government. However, the directions of the state’s work in the social sphere sound rather like general pious wishes, which are not boosted in any way by the means at the disposal of the state. On the one hand, the program states quite realistically that in the middle term, a significant rise in the share of social spending in GDP should not be expected. On the other hand, it outlines steps that call for a big increase in the level of financing. The program makes no mention of the key problem of social policy in the next four years, an abyss between the volume of social guarantees inherited from the Soviet period and the level of budget financing of the social sphere.

The fact that the program is declarative and vague indicates that its adoption has little in common with real policy and is extremely unlikely to influence it.

So what reforms are in order? First, the economic situation in the social and cultural field (medicine, education, cultural establishments) should be brought back to normal.

It is necessary to *balance the financial flows and the state's obligations*. To deal with this task, either their funding should be increased by redistributing budget resources in their favor, or the state's obligations should be revised. The reference is to cutting down the amount of free or subsidized medical services and education and reducing the number of budget-financed cultural establishments. It appears justified to place some of the medical services and higher education on a paid basis, simultaneously introducing compensation payments for the low-income population groups.

There is need for a federal law "On State Minimal Social Standards" to estimate the rates of financing, which should then be included into the method of calculating the transfers from the federal budget to the regions.

Reducing the scope of free or subsidized services and revising the range of their recipients would be a radical and extremely unpopular measure. Viewed as a purely financial one and introduced separately, without revising the other state policy components could entail undesirable social and economic consequences on a large scale. If the financing rates established by the state are not observed, if there is no efficient control over the use of the allocated money, if there are no effective mechanisms protecting the citizens' rights (both those who will now pay for the services, and those who will continue to get them free of charge), this measure would only cause the old problems to be reproduced on a new and larger scale, increasing social discontent.

Neither is it feasible to simply curtail state involvement in the supply of social services and introduce quasi-market mechanisms that would automatically place this matter on a sensible foundation. The experience of reforms in the advanced market economies shows that market reforms in the social sphere can succeed only if the relevant state authority bodies fulfill their administrative obligations and if state discipline is tight enough. Otherwise the introduction of market elements weakens the mechanisms regulating the production of social services and damages both the state as a whole and the least protected population groups.

And the other way around, if a change in the terms of financing the social services takes place against the background of normal economic activities in the social and cultural sphere, if the least protected population groups do not lose but gain from an improvement in the quality of the services rendered to them specifically, if the president and the government prove that they are determined to combat the abuses, establish and ensure observance of strict rules in the rendering of social services, then this measure would be accepted by the public and would improve the situation in the social sphere.

To make sure that budget allocations are used sensibly, it is necessary:

- to introduce a budget code that would define the procedure of the executive and representative bodies' control over the use of federal budget means; to oblige the relevant federal agencies, regional administrative bodies, and extrabudgetary funds to make public detailed plans and accounts of how this money was spent;
- to revise the priorities and the structure of budget allocations to the social and cultural sphere; to revise the federal programs in the fields of education, health care, and culture;
- to complete the transition to the treasury system of execution of current federal budget expenditure regards the social transfers to prevent the regional administrations from using them not according to purpose;
- to introduce amendments into the "RF Fundamental Legislation on Health Care", the Law "On Education", and the "RF Fundamental Legislation on Culture" to secure openness of

the financial and economic activities of the budget-financed establishments working in the social and cultural sphere.

Inadequate coordination of the work of the various financial management bodies operating in health care prevents sensible use of the available money and material resources. There is urgent need for pilot projects to introduce organizational and legal mechanisms of interaction among the executive authority bodies at different levels, local government bodies, and mandatory medical insurance funds to deal with the problems of health care financing and management and ensure a sensible distribution of and control over all categories of means allocated by the state.

A heavy load on the budget is maintenance of the so-called “departmental” medicine. In the health care sub-head of the 1997 federal budget, the share of the Health Ministry constitutes only 66.5 percent; the share of the President’s Business Management Department is 10.4 percent; and the share of the other non-medical federal authority bodies is 23.1 percent. It is necessary to place the medical facilities belonging to other federal authority bodies into the Health Ministry’s management, take an inventory of their property, and begin financing some of them through medical insurance and provision of paid services.

It is important *to preserve the emerging medical insurance system by adjusting the reform under way now*. On the one hand, the state guarantees backing the financing of the MMI program should be built up and, on the other, control over the use of MMI means should be tightened.

Another task is to make sure that the introduction of mandatory medical insurance stops being so inconsistent and fragmentary: the budget must unfailingly transfer to the medical insurance funds the charges for the unemployed and remove double authority in the financing of medical services, which is typical of most regions. It is essential to realistically assess the regional differences in the pace of reforms, to institutionalize the permissible models of transition from budget to insurance-based medicine, and to set the terms and time-limits of the implementation of these models. It is time to draft and submit for consideration a new law on the introduction of amendments to the Law “On Medical Insurance of the Citizens in the Russian Federation”.

Simultaneously, there should be adopted a federal law “On the Mandatory Medical Insurance Funds” to replace the statutes “On the Federal Mandatory Medical Insurance Fund” and “On the Territorial Mandatory Medical Insurance Fund” approved by the RF Supreme Soviet in 1993. The new law should define more efficient mechanisms of control over the operation of the mandatory medical insurance funds, which should be open to public control. Specifically, it would be expedient to give their boards of directors a right to approve quarterly and even monthly plans of financial activities. Simultaneously, their liability for the results of the funds’ work should be clearly outlined. It would also help if the funds’ detailed reports were made public on a regular basis, and if it were clearly specified just what information they must include.

It is urgently necessary *to remove the institutional barriers in the way of non-state companies’ participation in the financing of social and cultural establishments*:

- to implement a series of pilot projects aimed at setting up new educational, medical and cultural establishment, whose co-founders would include government agencies, local self-government bodies and non-state companies, and to develop mechanisms of their financing and management;
- to abolish the rules and regulations prohibiting privatization of state and municipal educational establishments; a special law should define the permissible forms and the procedure of the transformation of state and municipal educational, medical and cultural establishments into non-profit organizations with a number of different co-founders.

Section 4. Institutional and Microeconomic Issues

4.1. Privatization in 1996: process dynamics and main problems

Expansion of the private sector and collapse of the government's privatization plans in 1995 - 1996

According to the Unified State Register of Enterprises and Organizations in All Forms of Ownership, in October 1996 the total number of registered economic agents (including subsidiaries and autonomous divisions) reached 2,425,000, with 1,125,000 joint-stock companies among them. In the first three quarters of 1996, their number rose by 7.8 percent (number of joint-stock companies and partnerships, by 125.8 percent). By form of ownership, the proportion of all enterprises and companies registered in Russia is as follows: 67 percent are private (including corporations with state participation); 10 percent are state-owned; 7.4 percent are municipal, and 4.9 percent are owned by public associations. The share of state and municipal companies is steadily declining. In 1996, the distribution of independent companies by industries was stable: trade and public catering - 29.7 percent, agriculture - 14.4 percent, industry - 13.3 percent, and construction - 11 percent.

According to the estimates of the RF State Property Committee and the RF Ministry of the Economy, the share of private sector in GDP was 38 percent in 1994 and 23 percent in 1996; of privatized enterprises (including corporations with state participation) - 37 and 39 percent, and of enterprises that had been set up as private - 25 and 38 percent respectively. The share of privatized enterprises increased so insignificantly because by the end of 1994, practically all major Russian enterprises had been transformed into joint-stock companies: this is why the share of the corporate sector in GDP could not change much in 1995 - 1996.

We see that, regardless of the political situation, the private sector is expanding quite steadily. In 1996 - 1996, **it grew largely thanks to the establishment of private companies and not because of privatization.**

As regards privatization, there is reason to talk about its metamorphosis into:

- (a) an essentially spontaneous process of "residual privatization" (parcels of shares of "rank-and-file" enterprises that were left over after the mass-scale model had been implemented);
- (b) the use of privatization (or, rather, quasi-privatization) instruments to find political allies among the local elites and major financial groups. This is typical not only of the situation before and during the June 1996 presidential elections, but also of the indefinite "state power situation" in late 1996 - early 1997;
- (c) noticeable "regionalization" of privatization, among other things, to promote political goals;
- (d) consolidation and further redistribution of property among the largest financial alliances and natural monopolies (a process that is closely linked with the three mentioned above).

The most important apparent feature of privatization in 1995 - 1996 was its use (or an attempt) to get "quick" money for the budget. It is clear that giving priority to this short-term tactical privatization goal, the state will miss profits in the long run. The genuine goals of privatization, investments into enterprises and restructuring, once again receded to the background. In view of the specific political and lobbyist background of privatization in 1995 - 1996, there should be no illusions about the way this task was accomplished.

In fact, privatization in 1996 was slow, at least as regards the number of newly privatized enterprises (Table 4.1). As in 1995 (loan-for-stock auctions held at the end of the year), only

in late 1996 the government stepped up its effort to use privatization (quasi-privatization) to deal with the mounting budget problems. In the first half of the year, the government could not afford to make any “risky” large deals for political reasons. In the second half, there were attempts (largely futile) to sell parcels of shares of large enterprises and companies at international auctions, issue Eurobonds, convertible bonds, etc. The obvious problem is that any international-level sale takes time; due to this, even potentially advantageous deals would be unable to help cope with the 1996 budget problems.

As is known, the 1996 budget was to receive **12.4 trillion rubles** from privatization. The RF State Property Committee believed that the realistic figure was approximately 8,5 trillion rubles. How much did the budget actually receive? In January - November 1996, aggregate factual privatization revenues amounted to 2.7 trillion rubles (the federal budget got 1.5 trillion rubles).

Table 4.1

Main indicators of privatization dynamics in the Russian Federation

Running total, from January 1, 1992	by 1.01 1993	by 1.01 1994	by 1.07 1994*	by 1.01 1995	by 1.01. 1996	by 1.01. 1997**
1. Number of state enterprises with independent balance sheet	204998	156635	138619	126846	90778	87018
2. Number of privatization applications	102330	125492	137501	143968	147795	150008
3. Number of applications denied	5390	9985	11488	12317	13295	13642
4. Number of applications at registration stage	46628	24992	19308	17491	13214	12327
5. Number of applications granted	46815	88577	103796	112625	118797	122044
6. Sale price of property (billion rubles)	57	752	1107	1867	2510	3230
7. Value of property sold on the applications granted (billion rubles)	193	653	958	1092	1618	2205
8. Number of state enterprises transformed into joint-stock companies with stock offered for sale	2376	14073	20298	24048	27040	28782
9. Number of leased enterprises (including lease-cum-subsequent sale)	22216 13868	20886 14978	20606 15658	16826 12806	14663 12198	14115 11844

*Official end of voucher privatization.

**Incomplete statistics, deals involving “residual” parcels of shares are not counted.

Source: RF State Property Committee database.

By the end of 1996, the Federal Budget received about **one trillion rubles** from the sale of parcels of shares (Table 4.2). It is indicative that for September 1996, the Russian Federal Property Fund (RFPF) planned 304 auctions and 21 commercial tenders, of which 91 and 1 took place. On the whole, in 1996, the RFPF held 35 cash and 17 specialized auctions (enterprises received 1.5 trillion rubles and \$553 million dollars, the proceeds from the sale reached 712 trillion rubles). Many parcels of shares were vainly offered for sale more than once (as required by the law and privatization plan). According to the RFPF, in the cases when deals were made, the sale price was usually more or less the same as the market price (if such a price had been set).

The only notable transaction of late 1996 was the sale of 8.5 percent of the shares of “Russia’s Integrated Power Grid” JSC at an auction.⁷⁸ The tentative cost of the transaction was about **1,87 trillion rubles**. Despite a large number of tenders, almost the entire parcel of shares was bought by one of Incombank’s subsidiaries, the Swiss Incomfinans Grupp AG. It is assumed that the formal buyer represented the interests of a consortium of banks and non-

⁷⁸ Originally, the plan was to sell convertible Eurobonds backed by 5.5 percent of the holding “Russia’s Integrated Power Grid” for approximately two trillion rubles. Right from the start, one of the main problems was the issuer’s “transparency”.

banking companies headed by the National Reserve Bank (Gazprom group). At present (early February), the real buyer is not known, but the possibilities are few: either “Russia’s Integrated Power Grid” JSC itself or Gazprom (to whom the former owes over 20 trillion rubles). In this connection, it would be logical to ask: who pays in this deal if the state holds the controlling parcel of shares in both these natural monopolies? In fact, the implication is that in both cases, the state (its budget) gets (state?) money for state-owned stock, which is bought from the state by a company owned mainly by the state; in other words, the state gets “privatization revenues” from itself. What is more, according to some sources, the National Reserve Bank received a loan to “pay” for this deal from the Central Bank of Russia, and that as part of the formal “proceeds” from it, the debts of “Russia’s Integrated Power Grid” to Gazprom will be canceled. This means that in this deal cannot really be counted as a source of budget revenues, even if formally some money changed hands.

Table 4.2

Privatization revenues in 1995 - 1996

Type of revenue	Actual revenues of the 1995 federal budget	Actual aggregate revenues of the budgets of all levels in 1995	Actual privatization revenues in January - November 1996			
			Total	Municipal property	Property of RF subjects	Federal property
1. Revenues from property sale, billion rubles	1105*	3596				
1.1. Shares of joint-stock companies	-	-	1284	65	143	1076
1.2. Not joint-stock companies	-	-	79	64	10	5
2. Dividends on shares, billion rubles	92,8	143,1	-	-	-	-
3. Lease of state property, billion rubles	116,7	1 470,0	443	436	4	3
4. Mortgaged stock, billion rubles	3573,7	3573,7	-	-	-	-
5. Payment of debt to the budget by joint-stock companies whose stock was pledged and sold at investment tenders, billion rubles	1543,5	1543,5	-	-	-	-
6. Bonds of LUKoil company, billion rubles	887,6	887,6	-	-	-	-
7. Sale of debtor companies, billion rubles	-	-	45	0,4	6	39
8. Real property sale	-	-	317	245	48	24
9. Land sale	-	-	106	17	56	33
10. Other	-	-	473	98	23	352
Total, billion rubles	7319,4	11214,1	2747	925	290	1532

*According to adjusted planned federal budget revenues for 1995 (Law of December 17, 1995), proceeds from the sale of property were to reach 4,785.4 billion rubles, with the total planned revenues being 4,991.8 billion rubles. Formally, this plan was met and even overfulfilled thanks to the loan-for-stock auctions, whose aggregate share (lines 4 and 5 of Table 4.2) constituted 70.8 percent in the federal budget privatization revenues.

Source: RF Goskomstat, State Property Committee, RPPF.

According to available information, one of the losers in the deal was CS First Boston investment bank, which has close contacts with ONEKSIMbank’s foreign partners. According to some estimates, CS First Boston already owns 10.36 percent of the company’s stock, and Credit Suisse controls about 20 percent (out of the 23 percent belonging to non-residents). CS First Boston intended to buy this parcel of shares for itself or its clients. It should be noted that CS First Boston simultaneously acted as the official consultant of the RF State Property Committee for this deal. Apparently, such notions as “conflict of interests” or “insider information” are unknown in the business practice of “authorized banks” and the RF State Property Committee’s “foreign consultants”.

Another planned deal, a tender for the sale of 25 percent of Svyazinvest Holding Company in December 1996 (to the amount of three - four trillion rubles) was canceled by the State Property Committee. The latter announced plans for the merger of the holding company (100 percent of the shares) and Rostelekom JSC (37.1 percent of the shares in federal ownership) in

a new company, which is to be privatized later. In any case, the transfer of Rostelekom's federal parcel of shares to the holding company is, most probably, a *fait accompli*.⁷⁹ Be that as it may, this not only signified the final failure of budget revenues from privatization in 1996 but also adversely affected the market of Rostelekom shares. It is not impossible that in the first half of 1997, the president will sign a decree regarding the fate of this "investment holding". It was assumed that not more than 49 percent of the stock would be sold to portfolio investors, with 25 percent (plus one share) to foreign ones. MOST-bank and Alfa-bank are named among the "noncash" and known claimants to the "Russian share".

In 1996, another method of replenishing the budget was tried: transfer of federal parcels of shares to the regions; the budget expected to receive **about one trillion rubles** (originally there were hopes for five or six trillion) as a result. This method is of special interest. The reference is, in fact, to the exchange of federal stock for the government's debt to regions. The basic decision was made as there appeared the RF President's Decree #292 of February 27, 1996, "On the Transfer to the Subjects of the Russian Federation of Shares of Joint-Stock Companies Formed in the Course of Privatization". The regional authorities were to receive a number of federal parcels of shares subject to sale to (primarily) individuals at regional and interregional auctions. The legal framework for this decree appeared only in May (RF Government Resolution #554 of May 8, 1996, "On Measures Aimed at Implementation..." of the relevant presidential decree).

Needless to say, repayment of debts as shares (as well as cancellation of some enterprises' debts as a result of loan-for-stock auctions) can hardly be counted as real budget revenues. Still, this scheme has obvious advantages: (1) the shift of responsibility for the standard sales (time-limits, volume, proceeds) to the regional administrations; (2) an opportunity to almost arbitrarily fix the "market price" of the transferred parcels; (3) political undercurrents of the "center - regions" relationship. By November 1996, parcels to the amount of approximately 200 billion rubles were handed over to Krasnoyarsk Krai and Novosibirsk and Sverdlovsk oblasts.

Implementation of this decree may be promoted by another presidential decree, #1368 of September 18, 1996, "On the Rates of Distribution of the Means Received as a Result of Privatization". It permits the RF subjects to keep 90 percent of the proceeds from the sale of federal shares received in payment of the government debt. As usual, there is a political aspect here: both the regions' loyalty before the elections of administration heads and financial support of the elections are ensured. In 1997, the regions are to receive shares of 200 joint-stock companies to the amount of 700 billion rubles.

Other sources are failing to perceptibly replenish the budget (it can count on **just 200 - 300 billion rubles**). Under the current system of privileges, many largest companies pocket the dividends on the state's shares.⁸⁰ The inventory of federally-owned real estate units (with the exception of those occupied by administrative bodies) is absolutely inadequate, which means that their designated use cannot be verified. It is impossible to receive an income from the management of federal property because an adequate legal framework is non-existent.

⁷⁹ Considering that Russian legislation is full of contradictions, there is always a chance to prove the legality and rightfulness of this type of transaction or, at least, to demonstrate opposite but apparently equally valid options. Nevertheless, some experts point out the following transgressions: the buyer of the parcel of shares was obliged to declare the buy-out of Rostelekom shares from all the other shareholders; joining the holding had to be approved by a shareholders' general meeting; there was no information about the State Anti-Monopoly Committee's permission to transfer the controlling parcel of shares.

⁸⁰ It should be noted that the budget-financial committee of the State Duma estimates that in 1997, 10 largest Russian companies alone can contribute five - six trillion rubles to the budget (provided all the privileges are abolished and the share of the state in the share capital does not change).

On the whole, 1996 did not witness any innovations in the legal basis of privatization. Several fundamental laws on privatization were debated at the level of first reading: a new draft of the law on privatization, the Law “On Appraisal Activities” (which can be regarded as part of the new law on privatization aimed at revaluation of the assets of large enterprises), and several draft laws on nationalization (as in 1995).

The new state privatization program submitted for consideration to the Duma back in late 1995 has not yet been approved. Its latest version was debated by the State Duma Committee on Privatization, Property and Economic Activities in April, and by the RF Government in July 1996. Unlike the previous ones, this draft contains the following innovations: the privileges granted to workers’ collectives are abolished; a new municipal property privatization procedure is proposed; the starting price is fixed on the basis of the latest (as of the date of submittal of privatization application) balance cost. From the viewpoint of the State Property Committee, the most important point is the abolition of privileges to the employees, mainly for fiscal considerations.

In December 1996, the State Duma approved at the first reading a new Law “On State Property Privatization and the General Principles of Municipal Property Privatization in the Russian Federation”, which reflects the parliament’s weak and harmless (for the government) attempts to establish control over property redistribution and “residual” privatization. Specifically, the scope of the law (as compared to the operating law passed in 1991) is extended to parcels of shares and real estate. There were compiled lists of objects (property) which may not be privatized, which temporarily stay in state ownership, which may not be privatized by non-residents, and which need special privatization permission. New privatization models (convertible bonds) are introduced, “social standards” are set to auctions and tenders, and the rights of local administrations are expanded. The appraisal is to rest on the market value of the object (property unit) in question.

Despite the failures of 1995 and 1996, the 1997 budget includes a line item of privatization revenues (six trillion rubles). The major sales to be accomplished in 1997 are:

- Svyazinvest (49 percent of the shares as two parcels through commercial tender);
- “Russia’s Unified Power Grid” JSC (1.5 - 2 percent of the shares, remainder of the parcels subject to privatization);
- Rosneft Oil Company (problems stemming from a conflict with Sidanko, no approved privatization plan);
- Transneft (24 percent of the stock through investment tender, although there is no privatization plan and problems exist);
- Slavneft Oil Company (19.68 percent of the stock [not more than 34 percent] through investment tender and specialized auction in Russia and Belarus simultaneously);
- LUKoil Company (15 percent of the stock through investment tender for foreign investors, and 4.97 percent through the sale of options);
- Norsioil Company (40 percent of the stock through investment tender);
- Rosgosstrakh (50 percent of the stock through specialized auction, although there is strong opposition owing to the low appraisal value placed of the stock);
- Yaroslavnefteprodukt (22 percent of the stock through specialized auction);
- Novorossiisk Steamship Company (5.34 percent of the stock through specialized auction);
- Arkhangelsk TsKB (20 percent of the stock through specialized auction);
- Novosibirsk Electrode Plant (24.5 percent of the stock through investment tender);
- Nizhegorodnefteorgsintez (15 percent of the stock through investment tender);
- Nizhegorodnefteprodukt (18.3 percent of the stock through investment tender and 23.4 percent through specialized auction);

- Novomoskovskbytkhim (20 percent of the stock through specialized auction, date set).

Of course, these parcels of shares may not be included in the final list of the property subject to sale. The experience of 1995 - 1996 shows that vigorous lobbying of very dissimilar interests is likely to continue up to year end, which means that many sales could take place only in the last months of 1997 and will hardly yield the sums they could (if preparations for them met world standards). All the funds taken together (RFPPF and regional funds) are planning to sell about 2,500 parcels of shares (yielding 0.5 trillion rubles to the budget), with 700 sales monitored by the RFPPF.

State and banking policy vs. the pledged parcels of shares of Russia's major joint-stock companies

The technical details of the privatization scheme known as "loan-for-stock" auctions are known well enough.⁸¹ The RF President's Decree #478 of May 11, 1995 directly instructed the government to draft a procedure for placing the shares of joint-stock companies in federal ownership in pledge, trust management by legal entities. The Decree "On the Procedure of Pledge of Shares in Federal Ownership in 1995" #889 of August 31, 1995 established the mandatory terms of the loan (winner - RF Finance Ministry), pledge (winner - RF State Property Committee) and commission (winner or third party - RFPPF) contracts, as well as auction rules.

The 12 auctions involving major Russian companies brought to the budget 5.1 trillion rubles, with 1.5 trillion as companies' canceled debts to the state. The most important actual winners were ONEKSIMbank and Bank Menatep. Regardless of the legal "shell", these auctions were, in my view, either disguised self-purchase of stock by companies or, in most cases, direct noncompetitive sale of parcels of shares to interested banks (financial-industrial groups).⁸²

Upon reaching the set deadline (September 1, 1996), the pledge-holder is entitled to sell his stock in a market. Originally, there were plans for extending the period of the contract of pledge up to 1997 and implementing various schemes for the buy-out of stock by the state (for Norilsk Nickel JSC, YuKOS, Surgutneftgaz, and Sibneft). Specifically, there was talk about forming a "pledge pyramid" for the buy-out of pledged stock with new loans, paying for certain stock with GKO's, "the Finance Ministry's free currency in commercial banks", etc.

Finally, in late September 1996, the government and the Security Council passed a joint decision which confirmed the right of banks to sell pledged stock after September 1, 1996. At the same time it was noted that the sales are to be monitored by the government and to take place at competitive open tenders. The stock of Norilsk Nickel and the North-Western Steamship Company may not be sold to foreign investors. For the petroleum companies, the aggregate foreign investment quota, 15 percent and under, was retained. It was also noted that the pledge-holders who did not sell the stock within the next three to six months were obliged to ensure "efficient management" of this stock. The government retained the right to have the owner's rights defended in court in case of "inefficient management".

Thus the right of choice went to the winner banks themselves. In this context, their strategy is determined by three factors: the objective of the deal (control or income), expiry of the commission agency contract period (three years), and restraints on stock management. Mixed strategy versions are possible, with the bank trying to optimize the balance of the following

⁸¹ For details, see: Radygin, A., "Residual Divestiture Following Mass Privatization: the Case of Russia", OECD Advisory Group on Privatization, Ninth Plenary Session, Berlin, 6 - 7 May 1996. Room Doc. AGP 9/6, pp. 1 - 22.

⁸² Several court trials took place over the outcome of the auctions; most of them were won by the winners and the RF State Property Committee. An intermediate decision invalidating the results of the Sibneft auction was passed.

factors: (a) control through trust management; (b) revenues; (c) acquisition of a full right of ownership over stock (this is important for removal of the existing restrictions on trust management); (d) minimization of financial outlays on the purchase of this right.⁸³ In practical terms, the following options are possible:

- (1) The least likely (but the simplest) one: open sale of stock in the market once the situation is favorable. Higher capitalization of most companies that could introduce this scheme may help repay the loan and derive a profit from the sale.
- (2) Currently the most common option: retaining the company management rights envisaged by the contract, since most winners' objective is to stay in control. Upon the expiry of the three-year period of the commission agency contract, it may be extended (with trust management extended automatically), or the bank' (its subsidiary's) right of ownership over the stock may be confirmed.
Some winners of loan-for-stock auctions pursue (probably as a provisional measure) a policy of consolidating the parcels of shares (owned by them) by offering relatively small parcels at tenders or selling them in the secondary market.
- (3) Cession of rights for stock to a third party with the government's consent. The reason is that operating legislation prohibits some pledge-holders to own stock of relevant enterprises. For instance, ONEKSIMbank and Norilsk Nickel are members of the Interros financial-industrial group. Norilsk Nickel is itself a shareholder of ONEKSIMbank, while "cross" ownership of stock (over 10 percent) within the framework of a financial-industrial group is prohibited. The Surgutneftegaz pension fund, which became a pledge-holder of 40 percent of the shares of "its own" holding company, Surgutneftegaz, has no right to own a large parcel of shares under the rules regulating the structure of assets of pension funds.
- (4) Sale of part of the parcel to repay the loan in a market "heated up" by the commissioner himself. The rest remains in trust management.
- (5) Sale of stock (with a slight excess over state obligation on the loan) and acquiring it into ownership through affiliated parties.

The latter scheme has already been used in the deals involving parcels of shares of YuKOS and Sidanko petroleum holding companies.

As a result of a loan-for-stock auction held in 1995, Menatep and its affiliated structures received 45 percent of YuKOS stock in pledge, and 33 percent was owned by it as a result of an investment tender. After the holding company's charter capital was watered (see below about supplementary issue) in 1996 the share of the state (i.e., the pledged parcel) was reduced to 33.3 percent, the aggregate share of three subsidiary companies of Bank Menatep was 38.57 percent, the share of "Russian Investors" Closed JSC (a new shareholder closely connected with Menatep) - 12.79 percent, the share of YuKOS-invest Ltd. - 7.05 percent, and of individuals - 8.29 percent. Thanks to the watering alone, Bank Menatep retained control over YuKOS through control (in one form or another) of 53 percent of the stock.

Nevertheless, the sale of the state parcel was required to obtain a qualified majority. This is the main reason why on December 20, the commissioner, Bank Menatep, and the RFPF offered the pledged state parcel of shares of YuKOS at a commercial tender with investment terms. It is quite obvious that the parcel was "bought" by Menatep's affiliated structure, Montblanc JSC, which "paid" \$160.1 million, the starting price being \$160 million (plus \$200 million as investments up to 1998). Montblanc's "rival" was the Moscow Food Combine controlled by Menatep through Rosprom. As a result, Menatep's control rose from 53 to 89 percent.

⁸³ See also: "Prospects of ? Auctions", *Rynki kapitalov*, 1996, no. 33, p. (2)-1-(2)-4; no. 34, (2)-1-(2)-3.

There is no such clarity about the deal involving the stock of Sidanko, an oil holding company, 51 percent of whose stock was pledged to MFK, an ONEKSIMbank group. The tender, which took place on January 10, 1997, was won by Interros-Oil, an affiliated company, which now owns 85 percent of the holding company's stock (counting the 34 percent bought in September 1996, including Chernogorneft). The winner paid \$129.8 million, the starting price being \$129 million. The problem is that there is no clarity about the property rights in the Purneftegaz subsidiary company (its transfer to Sidanko from Rosneft has been frozen, a court examination is in progress).

Offered for sale at a commercial tender was also the pledged parcel of shares (40.12 percent) of Surgutneftegaz Oil Company. The potential buyers include the pledge-holders itself, the Surgutneftegaz pension fund (with due account of the above-mentioned legal hitches); Neft-Invest Company (holding 40 percent of the stock bought at an investment tender), which is obviously "friendly" toward the holding company; ONEKSIMbank (which acted as guarantor for the pension fund's loan). In any case, this parcel is sure to stay with the group or affiliated companies.

It is indicative that not a single pledged parcel figures on the list of oil companies whose stock is being returned to federal ownership until December 31, 1998. Without question, in purely legal terms this would mean a conflict, with the state failing to repay the loan (not buying out the parcels of shares) and refusing to permit the pledge-holder to sell them.

We believe that another point is more important: what happens behind the facade of loan-for-share auctions, as well as some other major deals, is the final stage of property redistribution within some largest Russian companies. In some of them, agreement among the main centers of influence has already been reached, and redistribution of property, other things being equal, is unlikely. In others, the final establishment of control is taking time due to the continuing confrontation and active lobbying at several levels (government - banks - industries; in the top echelons; natural monopolies - largest banks, etc.).

Efficiency of privatized enterprise and management of the state parcels of shares

Despite the failure of state privatization policy in 1995 - 1996, the impetus given to the microlevel in the course of mass-scale and essentially noneconomic reform of ownership in 1992 - 1994 is yielding an increasingly beneficial mid-term effect. In this connection, of interest are the findings of the survey held by Leontieff Center in St. Petersburg (the author took part in devising its technique). They make it possible (always bearing in mind that the findings of any poll have a conditional character) to assert that privatized enterprises are more efficient than the rest of Russia's industry (Table 4.3). The following trends can be traced: (1) "deeply privatized" enterprises are more efficient than those with "mid-level privatization", and both categories are more efficient than state-owned ones; (2) the efficiency indicators for the enterprises privatized in 1993 are higher than for those privatized later.

The statistics presented in Table 4.3 are comparable to the findings of the surveys conducted by the Federal Commission on Insolvency (Bankruptcy) and its regional branches. The results of surveys of insolvent enterprises show that the situation is the worst where the share of federally owned stock is over 25 percent.

This clearly indicates that there is need for large-scale reform of the overall system of the management of property (shares, stock), which remains in state ownership. What is more, 1995 - 1996 witnessed a stable trend toward an increase in the number of parcels ("golden stock") in state ownership (Table 4.4).⁸⁴ A whole series of relevant decisions was passed on the basis of the RF President's decrees for individual industries (machine-building, nuclear

⁸⁴ In this case, the reference is not to the unsold parcels of shares that are managed by property funds pending a sale under the privatization plan.

power engineering, air transport). The government obviously realizes how important and pressing this problem is. However, so far the measures aimed at restructuring (to be more precise, quasi-restructuring) the management system were largely fragmentary.

In late 1995 - early 1996, 2,500 officials sat on the boards of directors of the joint-stock companies having stock in state ownership. Eighty percent of them were employees of federal ministries and administrative departments, and 20 percent - representatives of the local administrations and property funds. Their presence is purely formal. The experience of managing federal parcels of shares in 1993 - 1996 leaves no doubt that a government official is unable to efficiently manage the stock of five or ten joint-stock companies located in different regions and often belonging to different industries. Time and distance are not the only problems: as a rule, the necessary qualifications (knowledge how an enterprise operates) and legal material stimuli are absent. Here are two of the most typical patterns of the officials' behavior in joint-stock companies:

Table 4.3

Comparison of financial-economic integral efficiency indicators of state-owned and privatized industrial enterprise, by industry*

Industry	Integral efficiency indicator**		
	State-owned enterprises	Enterprises (JSCs) with a state share of over 25 percent	Enterprises (JSCs) with a state share of under 25 percent
1. Ferrous metallurgy	0.384	0.644	0.505
2. Nonferrous metallurgy	0.534	0.259	0.726
3. Chemical industry	0.309	0.533	0.895
4. Machine-building	0.128	0.696	0.922
5. Building materials	0.178	0.807	0.775
6. Light industry	0.292	0.461	0.681
7. Food industry	0.229	0.488	0.852
8. Medical industry	0.288	no data	0.727

*The actual sample, 2,438 enterprises, was based of the RF State Property Committee Register, and included: 575 state-owned enterprises, 596 privatized enterprises with a state share of over 25 percent, and 1276 enterprises with a state share of under 25 percent.

**The 1995 integrated efficiency indicator was computed on the basis of four economic efficiency indicators (labor productivity, profitability of produce, return on capital, rate of turnover of circulating capital) and four economic status indicators (autonomy coefficient, maneuverability, availability of own circulating capital, current liquidity). An integral indicator was computed for each group of enterprises and evaluated the given group for a broad range of characteristics. The integral indicator is, by its meaning, the level of characteristics (individual indicators) reached for the given group. The level of each individual indicator is rated from "0" to "1" for the compared groups of enterprises, with "0" being the lowest and "1" the highest value. The technique is described in detail in Annex 2 to the source quoted below.

Source: "Comparative Analysis of Economic Results of the Work of Russian Enterprises in Different Forms of Ownership", Moscow, St. Petersburg, International Center for Socio-Economic Studies (Leontieff Center), 1996.

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- (1) "indifferent behavior": the official shows no interest in the joint-stock company even though the state holds a controlling parcel of shares and the company has a large debt to the budget. Such a stand in fact leaves the company management free to do as they please;

(2) “interested behavior”: (a) the official deliberately ignores the company’s debts to the state while remaining on the board of directors and subsequently lands a cushy job with this company; (b) using the state parcel on behalf of the state to vote for secondary issue at a shareholders’ meeting, which causes the state share to decrease many times. According to some estimates, the state lost hundreds of billion rubles as a result of such behavior.

The parcels of shares remaining at the property funds and not sold for some reason may be auctioned (with a view to sale, “correct” voting among the fund, the management, and the other interested agents). Typically, the fund itself or the state’s representative in the joint-stock company do not have a clearly defined stand on management.

The RF President’s Decree #986 of October 7, 1995 “On the Procedure of Passing Management Decisions and Disposing of the Stock in Federal Ownership” established that the transfer of stock into management of individuals and legal entities or into pledge, or any other encumbrance, its introduction to charter capital can take place **only** on the basis of a presidential decree.

Table 4.4

Number of parcels of shares of privatized enterprises remaining in state ownership and sold under various schemes in 1995 - 1996

	by outset of sales (summer 1995)	by 1.01.1996	by 01.01. 1997
Overall number of registered joint-stock companies, including:	26000	28000	28500
a 100-percent share of the state	about 9000	over 12000	over 12000
51-percent parcel of shares	2300	698	750
“Gold share” is planned	1004*	1317	about 1350
Parcels of shares in federal ownership, no right of early sale**	2749	3659	over 3700
Other parcels of shares remaining in state ownership (at property funds and subject to sale)	over 13000	over 7500	over 6000
Sold (offered for sale) under all options	-	5522	1364 parcels (1683 tenders)***
Federal budget revenues from standard sales	-	1.1 trillion rubles (15% of aggregate revenues)	about 1 trillion rubles for 1996

*For 1992 - 1994.

**Joint-stock companies manufacturing products (goods, services) of strategic significance for national security (RF Government Resolution #949, September 18, 1995). The list was repeatedly expanded in 1996.

***The schedule for 1996 envisaged the sale of parcels of shares of 4,580 enterprises.

Source: RF State Property Committee.

In April 1996, the RF Government and the RF Central Bank held a closed meeting on ensuring efficient management of strategic enterprises, including the natural monopolies. The following tentative scheme was developed on the basis of the joint declaration and with account of IMF’s recommendations:

- appointed to an enterprise (company) as the official representative of the state is a representative of the government who has no labor relations with this enterprise (company) and who has a full right to manage the federal controlling parcel of shares;
- the representative of the government revises the board of directors, introducing to it “professional experts”, works to ensure “priority of state interests” and “profitability of capital investments and the payment of dividends”.

Of interest are the first steps aimed at implementing this scheme. The RF President’s Decree # 656 of April 16, 1996, “On the Measures to Stabilize the Economic Position and

Advance Reforms in the Agro-Industrial Complex”, transferred the powers of the RF State Property Committee in the management of parcels of shares to the relevant sectoral departments without, however, passing any concrete decisions on stock management.

As regards the defense complex, another federal commission was set up by the RF President’s Decree #541 of April 13, 1996, “On the Measures to Ensure Efficiency of State Control over Privatization of Enterprises and Organizations of the Defense Complex”. By all indications, this commission merely compiled a list of 480 defense enterprises not subject to privatization (RF Government Resolution #802 of July 12, 1996, “On the List of Enterprises and Organizations of the Defense Complex Whose Privatization Is Prohibited”).

To specify the general scheme described above, the government passed Resolution #625 of May 21, 1996, “On Securing Representation of State Interests in the Management Bodies of the Joint-Stock Companies (Economic Partnerships), Part of Whose Stock (Shares) Is in Federal Ownership”. This resolution approved a model contract on representation of state interests, as well as the procedure of its signing and registration. The RFPF was instructed to base its operation on this contract.

This contract was to have been approved back in 1994 in accordance with the RF President’s Decree #1200 of June 10, 1994, “On Some Measures to Ensure State Management of the Economy”. The decree established frame standards set to the contract between the government (federal body) and head of the federal state enterprise, as well as frame standards set to the representatives of state interests in a joint-stock company. These representatives were divided into two categories: state officials (appointed by decision of the RF President, RF Government, federal bodies, and the RFPF); other RF citizens (on an agreement for representation of state interests at joint-stock companies, on the one hand, and the RF State Property Committee and the RFPF or their territorial branches, on the other).

The two-year delay in the appearance of this important document, without which the Decree was practically idle, can be explained by the traditional confrontation between the RF State Property Committee and sectoral departments and regional administration heads. However, even the above-mentioned resolution controls only the latter category (“other RF citizens”). It is significant that the appointment of state representatives is a function of sectoral departments. A similar mechanism of the activities of state officials is still absent, as is regulation of the contracts for representation of state interests with legal entities.

In the case of the fuel and energy complex, this issue is regulated by the RF Government Resolution #777 of July 1, 1996, “On the Appointment of Representatives of the Russian Federation for Managing the Federally Owned Parcels of Shares of the Joint-Stock Companies Working in the Fuel and Energy Complex”. Such representatives are to be officials of the RF Fuel and Energy Ministry, who are obliged to vote at the shareholders’ meetings as instructed by this ministry. Specifically, such representatives were appointed to the “Unified Power Grid of Russia”, LUKoil, and Rosugol. The companies whose shares were pledged at the loan-for-stock auctions do not figure on the list.

Another important document having a bearing on the fuel and energy complex is the RF President’s Decree #1333 of September 9, 1996, “On Extending the Period of Federal Ownership of Shares of Joint-Stock Companies in the Fuel Industry and Power Engineering”. The first versions of this decree also referred to stock management, but the final version merely sets the date up to which the stock of strategically important companies remains in federal ownership, December 31, 1998. The President instructed the government to approve a list of such companies (Government Resolution #1415 of November 23, 1996, “On Extending the Period of Federal Ownership Over the Stock of Joint-Stock Companies Working in the Fuel Industry and Power Engineering”. The list included practically no companies whose shares had been pledged).

These documents are enough to get a clear idea of the **growing role of sectoral departments** in the management of state parcels of shares and gradual ousting of the RF State Property Committee from this field. And, considering that the revenues from privatization fell far short of the plan, the very existence of this organization loses all sense.

Also noteworthy are three documents pertaining to the **issue of shares and bonds by privatized enterprises**:

(1) RF President's Decree #1054 of July 20, 1996, "On Measures to Abolish the Joint-Stock Companies' Wage and Tax Debt", which permits the enterprises with **over 25 percent** of the stock in state ownership to issue shares to cover their debt to the budget. In other words, an alternative appeared: either the state share rises through a new issue (that is, stock is accepted in lieu of payment), or the state share is watered to the advantage of other shareholders ("strategic" ones under a closed scheme, and/or small "financial" ones in the case of public placing).

The first effort of this kind was the placing of an issue of YuKOS oil company to the amount of 499 billion rubles among the shareholders (preemptive right) and through open subscription (but only among "friendly" structures). By the time of issue, Bank Menatep and related structures owned 33 percent of the company's stock (as a result of an investment tender) and held another 45 percent as pledge. Charter capital rose by over 30 percent (2.3 billion rubles) to reach 8.9 billion rubles. The state parcel in this company decreased from 45 to 33 percent.

(2) RF President's Decree #1203 of August 17, 1996, "On the Issue of Bonds by Organizations with a View to Restructuring Their Debt to the Federal Budget" should help many enterprises to avoid having to sell their property to repay the debts (liquidation). In other words, in a number of cases **declaration of bankruptcy is just postponed**, and the state gets the enterprise's bonds. The latter are backed by the property of the enterprise or of third parties. The state has a right to either sell these bonds before the period of redemption is over, or upon the expiry of this period to receive a certain sum plus interest from the enterprise.

(3) RF President's Decree #1210 of August 18, 1996, "On Measures to Protect the Rights of Shareholders and the Interests of the State as Owner and Shareholder". According to the prevalent opinion, the purpose of this document is to protect the shareholders' rights in case of **reorganization (merger)** of the enterprise and to ensure the exchange of the stock of the reorganized enterprise for the stock of newly established companies. If a joint-stock company is reorganized, the stock may be placed only among the shareholders. All holders of the same type of shares have equal rights when the stock is placed. All closed joint-stock companies with a state parcel of under 75 percent are to be transformed into open companies before January 1, 1997. The decree also envisages some measures aimed at regulating the decision-making on the payment of dividends and the role of state representatives in the joint-stock company after the term of powers of the operating company management expires.

The big event took place only in late 1996: the president signed a Decree "On the Transfer into **Trust Management** of Federally Owned Stock of Joint-Stock Companies Set Up in the Process of Privatization" (#1660 of December 9, 1996).

As is known, the sectoral lobby in the government had long and successfully stopped this document, in the absence of which practically all decisions on transferring stock into state ownership lose all meaning. The "sectoral" draft "On Improving State Property Management" definitely handed over to the sectoral ministries all the rights over the state parcels of shares (including sale, appointing the manager, pledge, transfer into trust management, new issues of shares, issue of bonds to repay the debts to the budget, etc.). The RF State Property Committee's draft "On the Transfer into Trust Management of Parcels of Shares in Federal Ownership" envisaged a competition for the would-be managers (the winner contributes the

largest sum to the budget, which he gets back over the next three years through stock management).

The presidential decree defines the general terms of the transfer of parcels into trust management, namely, on the basis of the outcome of tenders for the right to sign a contract of trust management. Unlike the pledge scheme, the trust manager is not entitled to dispose of the stock entrusted to him, and the contract imposes restrictions on the trust manager's powers as regards the major issues of the functioning of the joint-stock company.

Identified as the priority objects were five joint-stock companies in the coal industry (on demand of the IMF). This is why a more detailed RF Government Resolution, #1485 of December 11, 1996, "On the Holding of Tenders for the Right to Sign Contracts of Trust Management of Federally-Owned Stocks of the Joint-Stock Companies Working in the Coal Industry (Coal Companies)" pertains, purely formally, to the coal industry alone. It is likely, however, that these rules will be extended to other industries. But one should not count on their early introduction. Experts say that the resolution on the tenders contains many drawbacks that may obstruct its application.

Key practical issues, openness and the criteria for identifying the winner, remain outside the framework of this document. Its second fault is guaranteed protection of the interests of the state and the enterprise against such provisional management (despite the stipulated demand that the winner back the assumed obligations with his own property). On the whole, however, this is a step forward. The less the state interferes into the economy and the more it does to shape conditions, rules and institutional structures ensuring economic independence, the better the chance that the economy will eventually become "manageable".

At the moment, however, the **prevalent trend is toward conserving or increasing the role of the state as a direct subject of property relations.** In view of the "election" situation, the 1995 - 1996 trends (or, rather, their interpretation) could present a distorted picture. The following obvious trends can be singled out:

- stable growth of federal parcels of shares not subject to sale;
- giving a legal status to the free transfer of federal parcels of shares into trust management by financial-industrial groups;
- orientation at trust schemes of state stock management (by itself, provided there is a truly efficient contract scheme and control, this the only alternative to inefficient sales);
- transfer of the right to appoint state representatives in joint-stock companies to the sectoral departments;
- growing "property" expansion of the natural monopolies;
- formation (in practice or at the level of approved proposals) of powerful holding companies at industry level (metallurgy, coal, machine-building, petrochemistry, etc.).

One has to agree that the merger of banking and industrial capital is an objective process. The various financial-industrial groups, "growth groups", financial and industrial holding companies set up from below (microlevel initiative) and vertically (that is, not exclusively for an, in the context of Russian practice) is a normal evolutionary way. The problem is that there are signs that banking and industrial capital becomes merged with the state in the latter's specifically "transitional" form. Due to this, the institutional-legal base, as well as the mechanisms of control over the practical implementations of the trends discussed above, must be above narrow parochial (private and/or state) interests and ambitions and must ensure their "filtration".

In practical terms, this can be done only through federal laws precluding any sublegal preferences and "special relations" with the state and stipulating rigid, public, competitive, and detailed mechanism of access, control and liability. An obviously necessary condition is

the presence of political will both to support this mechanism and defend it against the criminal element.

4.2. Institutional aspects of the evolution of the market of corporate securities and financial go-betweens

The current stage of the evolution of the market of corporate securities in Russia has the following characteristics:

- in 1994 - 1995, the legal framework determining the institutional aspects of the market's functioning was formed (a single regulating body, the Federal Commission for the Securities Market [FCSM] was set up);
- in 1996, the RF Laws "On Joint-Stock Companies" and "On the Securities Market" were adopted;
- 1994 - 1996 witnessed qualitative changes for the better in the infrastructure (150 licensed registrars, seven licensed depositories and steps to set up a central depository, gradual advancement of custodial services, establishment of the Russian trading system, formation of a system of self-regulating organizations of market participants);
- general favorable trends and significant reserves in market liquidity and capitalization, higher market stability;
- Russia is gradually winning international recognition and access to the world financial markets (Moody's, Standard & Poor's and IBCF credit ratings, publication of the IFC Global Russia index, issue of ADR/GDR by a number of companies, recognition of three Russian banks by America's SEC as "reliable foreign depositories", etc.).

Comparison of the statistics of several transitional economies reveals the following trend: the earlier a country began to introduce large-scale privatization schemes, **the more advanced its securities market is** (in the share of capitalization and volume of trade). This is true in the most general sense, regardless of the chosen privatization model. Considering the post-privatization structure of property, the following link emerges: the market (volume of trade) is more active in the countries where as a result of primary privatization the degree of property dispersal is higher. Among the transition economies with the most advanced securities markets the first place in the share of capitalization in GDP belongs to Czechia (Russia holds the fourth place), but that country is **only sixth** in the ratio of the volume of trade to capitalization (Russia is fifth).

Capitalization is a major indicator describing the scope of the market and the economy generally in a country. In 1994, the market value of stock in relation to nominal GDP was 76.2 percent in the United States, 68.3 percent in Japan, 27.4 percent in France, and 7.5 percent in Germany. In Russia, this indicator was 4 - 5 percent in 1994, 6 - 7 percent in 1996, and 7 - 8 percent in 1996.

According to various estimates, market capitalization of Russia's 20 largest enterprises was about \$8 - 10 billion in May 1995, \$11 -12 billion in March 1996, \$25 - 27 billion in November 1996, with account of Gazprom stock, \$35 - 37 billion by PTC quotations, over \$60 billion by ADS quotations), and over \$50 billion at the turn of 1996. The obvious leaders here are LUKoil, Gazprom, and "Russia's Unified Power Grid". Although on the whole there is a trend toward a lower share of the largest companies in overall capitalization, at present it is still very high: falling to 20 companies is two-thirds of capitalization of the market of stock of privatized enterprises. According to practically all experts, market capitalization as regards at least the blue chips will go up steadily due to:

- considerable understatement of the assets;
- alleviation of political risk;

- potential redistribution of means from the market of government securities (according to some estimates, an inflow of just 10 percent of the means to the market of corporate securities can secure a 100-percent growth of the latter's capitalization);
- increase in the contributions of global funds;
- lower risks associated with the market infrastructure;
- expansion of the network of collective investors.

Table 4.5

Development forecast for the market of corporate securities: quantitative characteristics

Characteristics (year end)	1995	1996	1998	2000
Securities turnover in the secondary market, billion \$	5	5,5	-	30-80
Summary capitalization of joint-stock companies operating in the market (minus banks), billion \$	10-12	35-50	-	70-110
Securities in active commercial turnover, billion \$	5	5,5	-	25-50
Net foreign portfolio investments, billion \$	1	2	5	10-11
Ratio of deals settled inside Russia (A) and outside it (B): A/B	1/3	1/3	-	10/1
Number of privatized enterprises - open joint-stock companies, thous.	25	28-30	-	30-32
Share of 200 major enterprises in industrial output, percent	70-75	-	-	70-75
Number of privatized enterprises where the "battle for control" is over, percent of the overall number of privatized enterprises	20	25-30	-	50

Source: FCSM, author's estimate.

On the whole, the place of the stock market as a mechanism mobilizing investment resources will expand as qualitative changes occur in the evolution of this market itself.

A specific issue is the impact of the emerging structure of stock ownership (as a result of mass privatization) upon the evolution of the Russian stock market. Let us identify the main characteristics of the current "intermediate" structure of stock ownership:

- long-standing parity between outside and inside investors;
- the managers combine the functions of shareholder and manager, outside (through their companies, funds, etc.) and inside (administration) shareholder;
- among the outside investors, parity is maintained between banks, on the one hand, and non-banking financial institutions and other legal entities, on the other;
- participation of company employees in share capital slowly decreases (on a mutually compensating basis), while the role of small outside investors grows.

Formation of such a model points, among other things, to prolonged reproduction of an environment conducive to conflict of interests and violation of shareholders' rights. This "intermediate" structure of the corporate control model directly affects the evolution of the stock market, aggravating its numerous problems:

- the relatively weak infrastructure is a brake on its development;
- protection of shareholders' right;
- insufficient openness of the market (as regards issues and deals);
- transition to international accounting systems is slow;
- the buy-out of land plots by privatized enterprises is extremely slow;
- over-the-counter market absolutely dominates;
- restrains on the growth of market liquidity;
- minimal progress in new issue of stock;
- low prices for the stock of most privatized enterprises (in the presence of a market) due to the competition of the government securities market and "spontaneous discharges" of parcels of government stock.

In my view, many of these problems are objective and relatively persistent. The main reason is that in many companies, the fight for control continues with all the ensuing consequences.

The development of the market should be promoted by lowering the yield on government securities, settling of the problem of currency operation when investing into securities, restructuring enterprises (management of state-owned parcels of shares, land plot privatization, etc.), revising taxation of investments into securities and other operations involving securities, advancing the network of financial institutions, and shaping an adequate national market model.

The world knows three most common types of financial institutions: the deposit, contract-savings, and investment types. Russia already has them in one form or another (Table 4.6). Some of them have already reached a certain degree of maturity. At the same time, as the past few years have shown, the different types of institutions develop separately and/or spontaneously, while reforms cannot be really successful without a single system of goals in the development of Russia's financial market.

Table 4.6

Structure of financial go-betweens and investment institutions in Russia

Investment institutions	end of 1993	1996
Banks	2019	over 2100
Investment institutions, total*	2159	about 3500
including:		
investment companies	307	-
financial brokers	943	-
investment consultants	898	-
closed and open investment funds (minus voucher funds)	11	-
Voucher investment funds	636	350
Pension funds, about	100	900-950
Insurance companies, about	1000	3000
Credit unions	-	130

*It is obvious that the number of investment institutions - registered legal entities - is somewhat lower due to combination of functions.
Source: FCSM.

Such targets are identified in the Concept of Development of the Securities Market in the Russian Federation approved by the RF President's Decree #1008 of July 1, 1996, "On Approving the Concept of Development of the Securities Market in the Russian Federation". Under the Concept, institutional reforms cannot be regarded as completed without the establishment of a competitive financial sector able to mobilize and supply investment resources for economic development.

Considering the scope of the tasks that need to be accomplished in the next ten years, it is clear that Russia can rely only on the budget system and the banking network to finance structural economic reform.

Banks have a significant role in corporate control, although the operating legal framework restricts their investment activities. Under the State Privatization Program, banks may not act as buyers, may not own over 10 percent of a joint-stock company's shares, and may not have over five percent of shares of joint-stock companies among their assets. This is why banks set up subsidiary companies to deal in investments and do business in the market of corporate securities.

The following reasons why banks invest in corporate securities are noteworthy:

- to establish control over a certain promising privatized enterprise or company;
- to buy shares to create "springboards" for expansion;

- the dominant motive is to buy up stock of privatized companies for major foreign and domestic investors (to benefit by the difference in the rates when reselling or get a commission);
- to redistribute in their own favor part of the yield from the sale of stock belonging to the state (the system of authorized banks);
- to create an “insurance fund” (knowing that the state will not let the industrial giants go bankrupt and is likely to grant subsidies or privileges that a shareholder may profit by);
- to own stock of the largest industrial joint-stock companies to create the image of a serious investor.

However, it is too early to refer to banks as a real strategic owner responsible for the company’s long-term development (the European model, under which the bank not only controls but finances the company in one form or another).

Hence two conclusions:

- first, the state must pursue a vigorous and purposeful policy vs. the development of the securities market, shape a model of market regulation that would be adequate to the Russian economic situation, national interests and tradition;
- second, it is an especially pressing concern for Russia to set up an efficient and large-scale network of collective investors as the key financial intermediary between the public and the enterprise (company).

Comparative analysis of the role and place of various institutional investors in the Russian financial and stock markets shows that in the volume of assets and investments, commercial banks are followed by insurance companies (value of insurance reserves in early 1996 - 7 - 8 trillion rubles). To compare: as of January 1, 1996, the aggregate value of the assets of all voucher investment funds was 2.2 trillion rubles (as of July 1, 1995 - 1.77 trillion); in early 1996, the aggregate assets of non-state pension funds were estimated at 1.5 - 1.7 trillion rubles.⁸⁵

The RF State Property Committee allotted the voucher investment funds (VIFs) a serious role in enterprise management in the post-privatization period. The main outcome of the work of the 650 VIFs set up in Russia was that over 16 percent (250 million) of Russia’s population became their shareholders; they accumulated 45 million, or 32 percent of the vouchers issued in the country. Using vouchers, the funds purchased over 10 percent of the assets of privatized enterprises offered for voucher auctions. The five largest funds have assets to the amount of 737 billion rubles, or 34 percent of aggregate assets.

VIFs operate mostly spontaneously and rely on speculative profit rather than participation in the management of corporations whose stock they buy. Only a small share of the major funds bought up large enough parcels of shares of production companies with a view to holding on to this property and exercising an owner’s rights not only by deriving an income but also by performing control and management functions. As a rule, such funds are members of financial-industrial groups. VIFs usually deal in brokerage: resell shares to enterprise managers or hand them over to the latter in trust, compile portfolios for foreign investors. So VIFs act as speculative portfolio investors. Their portfolios are marked by a high rate of renovation and, correspondingly, a higher share of liquid securities. At present, they are oriented mainly toward investment into government securities, which may reach 50 percent of their portfolios.

The VIFs ability to influence the management and economic behavior of privatized enterprises is doubtful. One of the reasons are the harsh restrictions on acquisition: they may

⁸⁵ Statistics supplied by the FCSM Group for Stock Market Monitoring. See also: Issues of Development of Collective Investors in Russia, FCSM, October 1996.

not buy more than 10 percent (since 1994, 25 percent) of the stock of one company or invest more than 5 percent of their assets into one issuer's securities. When voucher privatization was over and the emphasis shifted from accumulation to efficient management of the available assets, many VIFs found themselves in a crisis due to the need to find the money to pay dividends to the shareholders and cover the various current expenses, including administrative ones, in a situation when the stock of privatized enterprises in their portfolios was yielding a low income and had low liquidity. By May 1996, the number of really functioning VIFs went down to 350 (from July 1994) due both to a series of absorptions and mergers of VIFs and to reorganization.

Big hopes are pinned on Unit Investment Funds (UIFs). Their operation is regulated by the RF President's Decree #765 of July 26, 1995 "On Additional Measures to Raise the Efficiency of Investment Policy in the Russian Federation" and a whole package of regulations (over 20) adopted in 1995 - 1996. The law defines a unit investment fund as aggregate assets transferred by individuals and legal entities (investors) to a management company into trust management with a view to increasing these assets. A unit investment fund is not a legal entity. There are two types of unit fund, open and interval ones. The distinction between them lies in the structure of their assets and, correspondingly, the management company's obligations (time-limits) regarding repurchase of investment shares from their owners.

Hypothetically, UIFs should become an attractive option for investors because double taxation is avoided and there is tight government control over all aspects of their operation, from licensing and advertising to the structure of assets; special notions, "specialized depository" and "specialized registrar" have been introduced.

However, this collective investment option is still at a rudimentary stage in Russia (in practical terms). In April 1996, the FCSM issued the first licenses for trust management of unit investment funds. As of December, such licenses were held by 13 management companies. In November 1996, one of the first funds (open fund "Pioner Prevyi") began to sell shares. By March 1997, a number of funds completed the placement of shares. Although some funds are planning to specialize in corporate securities, at present the money is invested mainly into government securities.

Generally speaking, one should not pin too many hopes on this investment option. Collective investors themselves as active agents of the securities market emerged as the latter reached a certain degree of development and organization. Collective investors successfully consolidate the means of small investors, ensure professional management of the assets, and help diversify risks in a relatively advanced securities market.

