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Russia 2001: Pursuing A Critical Mass Of Reforms

Executive Summary

Three common perceptions of Russian affairs in mainstream reporting are: 1) President Putin is establishing a centralized-authoritarian regime and economic reforms are not seriously on the agenda, 2) economic growth has faded fast, and even turned into contraction, and 3), real exchange rate appreciation is the main culprit behind the evaporation of economic growth. We believe all three perceptions to be largely erroneous and missing the point.

This study outlines how Russia's macroeconomic situation is mainly under control and why economic growth will continue this year, albeit at a slower pace. The main focus is on economic policies to lay the foundation for sustainable economic growth. We retain a constructive approach to Russian assets, founded on the progress towards a critical mass of structural reforms, positive evolution of fiscal and debt policy and debt management, and the next steps in the credit rating upgrade momentum.

Economic growth to continue, albeit at a lower pace

While moderating from 2000, real GDP growth of 3-4% is achievable for 2001. Growth dynamics continue to change, towards domestic demand and investment growth. The slow-down in economic growth can not credibly be said to be *caused* by real appreciation –exchange rate dynamics is a natural reflection of Russia's balance-of-payments and the transformation process itself, and systematic attempts to resist this will worsen rather than improve the situation. The issue lies elsewhere – primarily in corporate restructuring and the absence of deep financial markets.

Critical mass of structural reforms to be pursued, busy reform road map ahead

Russian economic policy is focused on pursuing structural and institutional policies, targeting the emergence of sustainable economic growth. For this purpose, a *core* set of near-term reform challenges is now formulated and pursued. The road map ahead is very busy, and the government will be pressed to neither overextend nor fall into a trap of reform fatigue. President Putin's annual Federal Assembly address should be seen as the start of a rejuvenated reform push.

Positive fiscal and debt policy developments

Prospects for fiscal policy and debt management reforms carry promises of market-supportive moves toward more transparency, efficiency and forward-looking macroeconomic policies.

Russia

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Pursuing A Critical Mass Of Reforms

Market recommendation

Domestic debt: neutral

External bonds: overweight

Rating: B3/B-

We remain ***overweight*** on Russian external bonds and ***neutral*** on domestic instruments. The continuation of our constructive approach to Russian assets is founded on the progress towards a critical mass of structural reforms, positive evolution of fiscal and debt policy and debt management, and the next steps in the credit rating upgrade momentum. The main risk remains reform fatigue and/or lack of willingness from the Kremlin to sponsor the pursuit of a core set of reforms, but the indications from President Putin's strongly pro-reformist programmatic annual address was positive. We judge chances as strong the Russian government by mid-year/the third quarter will be able to show achievements in terms of at least four major issues: the business reforms and further tax reforms, a new Land Code, legal reforms and initiation of UES restructuring. The so-called business de-regulatory reforms are particularly important – they represent the basis for the current rejuvenated push for economic reforms (after last summer's tax reforms). The pursuit of these measures through the required three Duma readings will be another important indicator of the authorities' ability to concentrate political capital to further prioritized issues.

Economic developments: growth and inflation in focus, first quarter 2001 fiscal indicators encouraging

Economic growth and inflation in focus.

In terms of macroeconomic developments, two main issues are currently in focus — the path of economic growth and inflation. On the former, some participants in the domestic Russian debate have maintained growth dynamics have not only weakened, but also turned into stagnation and decline. In addition, some have maintained rouble real appreciation is the key danger for the Russian economy, and implying economic policy should prefer a weaker rouble. In our analysis and treatment of the available data, we find the economic contraction claim unconvincing, the real appreciation story erroneous and especially the policy conclusion detrimental.

Real GDP growth in 2001: 3-4% is achievable.

Our analysis, and other Russian economic research, indicates that if the level of GDP in 2001 stays flat from the December 2000 levels, GDP growth would still be some 2%-2.5%[1]. As we have noted, a realistic range of growth estimates for Russia in 2001 would be between 2%-2.5% and 3.5%-4%. We maintain our 2001 forecast of 3-4%. Against the context of a global growth slow-down, we do not regard such moderation from near 8% growth in 2000 as dramatically worrying, and we do not share the general perception of real appreciation as the main culprit in the growth slow-down. Instead, we would highlight the importance of the economic policy and reform process, especially through confidence, credibility and sentiment channels. In the sections below, we outline these issues in more detail.

[1] See, e.g, various reports from EEG, Ministerstvo finansov Rossiiskoy Federatsii, "Obzor ekonomicheskikh pokazatelyey".

First quarter industrial production points to slow-down, but still continuing growth. Other indicators point to overall GDP growth.

In January 2001, Goskomstat reported year-on-year industrial production growth at 5.3% (adjusted for the number of working days, the growth was 2%), while the month-on-month decline was 5.4%, which is not unusual for January, a month of many holidays. In February, industrial production was up a mere 0.8% year-on-year, but adjusted for working days, the increase was 4.9%. For the two first months of the year, compared to the corresponding period 2000, industrial production expanded by a modest 3.1%. According to preliminary data, in the first quarter of 2001, industrial production expanded by 3.3% YOY, following March industrial production growth of 3.6% YOY and 10.3% MOM. While overall industrial production growth has slowed down during the last part of 2000 and going into 2001, the structure of production dynamics is encouraging. Light industry was up 8.1% in the January-February period year-on-year, machine-building 5.2% (one sub-category here is television sets, the production of which was up 43.3%), while energy increased only 2.1% over the corresponding period.

Other indicators also support continued overall GDP growth, but investments and real incomes are issues to watch carefully over next quarters.

Other indicators also support the continuation of economic growth, and point especially to overall GDP growth being stronger than industrial production growth[2]. In the January-February period, investments grew by 7.6%, retail trade by 8% and real incomes by 5.7%. In the first quarter 2001 year-on-year, investment growth was 6.6%, retail trade increased by 8.2% and real incomes by 3.2%. Goskomstat's index of so-called base sector output of goods and services, capturing some 65% of GDP, was up by 3.5% in the January-February period, and 3.6% in the first quarter year-on-year. In addition, given January and February export and import figures, it is likely that net exports will be up by close to 10% in the first quarter year-on-year[3]. In line with this, the Ministry for Economic Development and Trade has recently forecasted real GDP growth will reach 4.2% for the first six months of this year. However, the slow-down in investment growth needs to be watched carefully, as does the development of real incomes. Further slow-down in investments over the next quarter would be a worrying indicator, pertaining to the expectations and level of confidence in the rate of improvement of the investment climate. Real income dynamics need to be followed closely as well, with the higher-than-budgeted inflation eroding the outcome for the first quarter. However, it should be noted that retail trade remains almost as strong as in 2000. Finally, regional fiscal data present an indirect indication of growth dynamics. Despite last year's centre-regional fiscal reforms, including e.g. a re-distribution of VAT revenues towards the federal centre, regional fiscal performance has continued to improve in the early months of this year. The loss of VAT revenues has been compensated for by a notable growth in regional profit tax collection and income tax collection. Total profit tax collection of the consolidated budgets of Russia's regions rose to 2.1% of GDP in the January-February 2001 period, compared to 1.7% of GDP in the corresponding period 2000. The income tax collection rose to 2.5% of GDP from 1.7% of GDP[4].

[2] Similar results are also found in Belousov, A & Ivanter, A, "Konets stagnatsii", *Expert*, March 26, 2001. Andrei Belousov is head of the Centre For Macroeconomic Analysis and Short-term Forecasting at the Russian Academy of Sciences, and part of the working group behind Russia's long-term economic strategy and medium-term economic action plan.

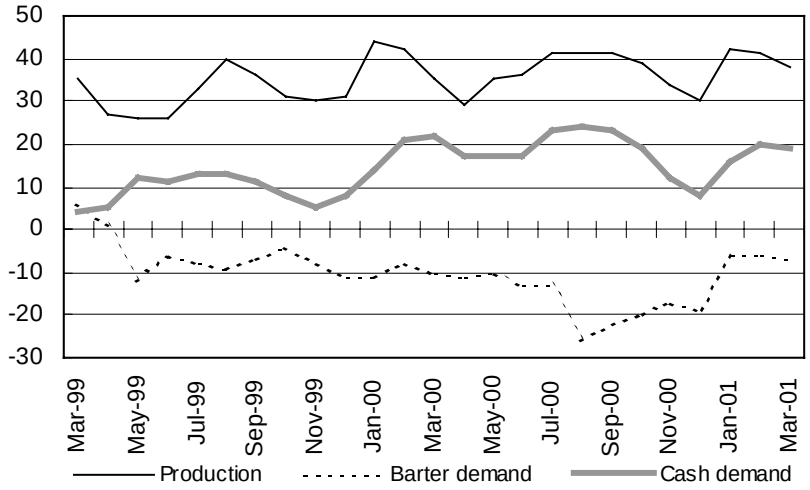
[3] See also the note on growth decomposition in 2000 by Frenkel, A et al, "Faktory rosta izmenilis", *Vedomosti*, April 18, 2001.

[4] See EEG-Ministerstvo finansov, "Obzor ekonomicheskikh pokazatelyey", April 12, 2001.

The importance of enterprise and consumer surveys — optimism preserved.

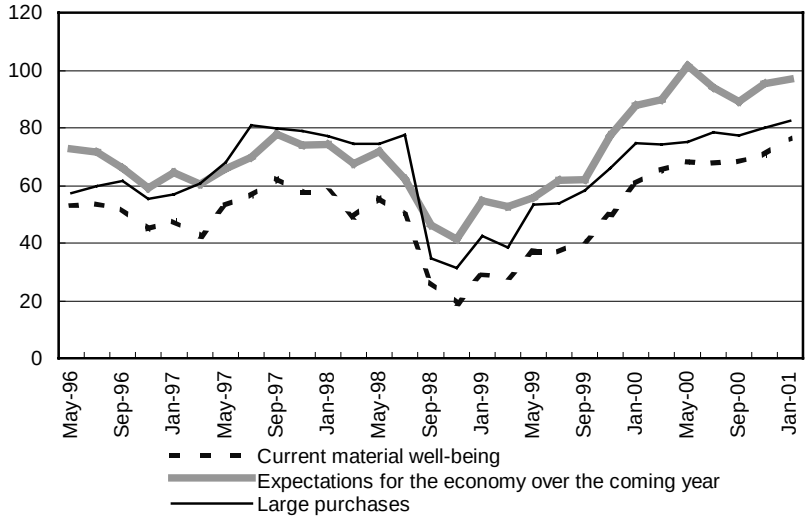
We would also stress the interesting picture arising from enterprise surveys, lending further support to a picture of growth picking up in February-March this year, and continuing later in the year. It is clear that after something of a lull towards the end of last year, enterprise expectations have improved again notably. This could be a leading indicator for a pick-up in growth later in the year[5]. As the graphs below indicate, production *expectations* in January-March have staged a notable recovery since December and remain at high levels, as have *expectations* of cash demand. Consumer surveys also testify to preserved optimism. As the second graph below indicates, in January 2001, consumer sentiment in terms of current material well being, expectations for the year ahead and the propensity to make large purchases all rose to new highs.

Figure 1. Russia — Enterprise Surveys, April 1999-February 2001



Source: IET. The data points measure the difference between increase and decrease expectations over the coming months.

Figure 2. Russia — Consumer Surveys, May 1996-Jan 2001 (VTSIOM Survey Indices)



Sources: VTSIOM, Tsentr Razvitia.

[5] This analysis is also supported by the findings of the leading indicators index created by Tsentr Razvitia. See Tsentr Razvitia, "Svodny operezhayushy indeks", January 2001, and other issues of this series.

Russian economic growth and the real exchange rate – the importance of focusing on reforms in the context of real appreciation.

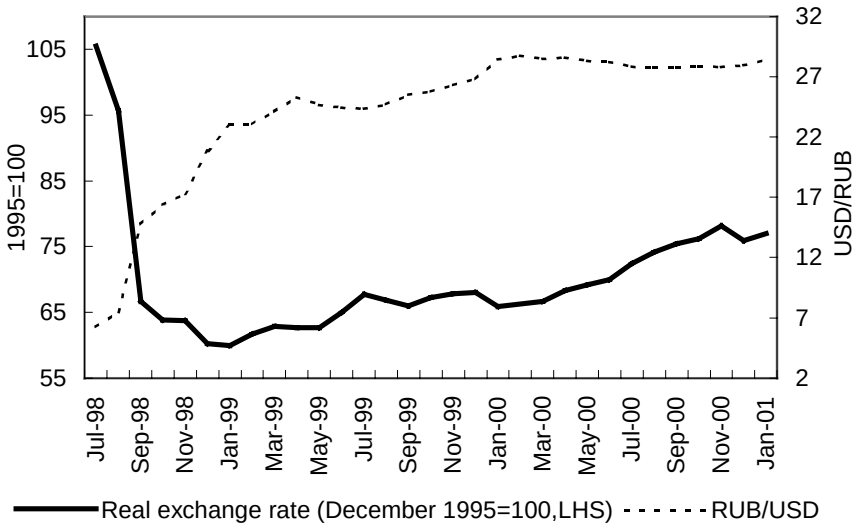
Thus, while there was undeniably a slowdown in the second half of 2000, mainly due to CIS import growth and PPI movements, signs of a growing Russian economy are still present, albeit at a lower pace. In terms of quarter-on-quarter GDP growth, the expansion moved from +5% in the first quarter of 2000 to +0.9% and +1.4% in the last two quarters of 2000 respectively. In the fourth quarter, the year-on-year GDP growth rate was 7.3%, and the annual real GDP growth came in at 7.6%. Subsequent data revisions are likely to raise these figures further. It is fashionable to attribute the slow-down in economic growth and even fears of contraction to rouble real appreciation, with the transmission mechanism being a loss of competitiveness and evaporation of such gains induced by the 1998 devaluation. It is often added the large current account surplus is a problem in this regard. We recognize there is a relevant discussion regarding the extent and speed of real appreciation and the interaction with structural reforms and corporate restructuring. However, the insistence on making real appreciation and the current account surplus the main culprit for the alleged evaporation of economic growth does not stand up to scrutiny and carries flawed policy conclusions. Rather, the focus should be on accepting real appreciation as a reflection of the transformation process, while focusing on pursuing financial system restructuring, acceleration of structural reforms and improvement of the investment climate[6]. Very little will be achieved through engineering a policy of a weaker rouble, and it could well end up making the situation worse.

The real exchange rate: the level is still low and the appreciation neither dramatic nor unusual.

Before we go into some of these issues in more detail, two facts about rouble exchange rate dynamics need to be underlined. ***First***, while the rouble certainly has appreciated in real terms, the gap between the market exchange rate and the PPP exchange rate remains large – larger than e.g. the corresponding difference in more advanced transition economies. In addition, the level of the real exchange rate remains well below that of the pre-1998 period. Even assuming a 10% real appreciation on average for the year ending in December 2001, the level of the (trade-weighted) real exchange rate would be still more than 20% below the level of 1997. ***Second***, the extent and speed of the real appreciation is not overly dramatic or unusual. In 2000, the trade-weighted real exchange appreciated by about 10.2%, and in the first quarter 2001 by 3.4% (or 3.1% if measured against the dollar), the stronger real appreciation in this year's first quarter mainly attributed to the higher-than-expected inflation.

[6] This approach is also supported by the leading Russian macroeconomist Evgeny Gavrilenkov, currently Deputy Head of the Bureau for Economic Analysis and Professor at Higher School of Economics in Moscow. See e.g. "Vozvrashenie v SSSR – Rossiya prodolzhaet finansirovat gosudarstva SNG", 2001, mimeo.

Figure 3. Russia — The Real (Trade Weighted) and Nominal Exchange Rate: 1998-2000



Source: Schroder Salomon Smith Barney, RECEP Moscow.

Why real appreciation is not a cause of the economic growth slow-down, and rather a reflection of the transformation process.

When considering the role of real exchange rate appreciation in the process of Russian economic growth and reforms, we would highlight a couple of aspects. ***First***, given the current macroeconomic situation and the structural reforms being pursued, the rouble *has to* appreciate, through basically two mechanisms - either a trend nominal appreciation or through the inflation differential in the context of a stable or moderately depreciating nominal exchange rate. The current account surplus remains very large, and despite still continuing capital flight, the net supply of dollars to the rouble market is substantial. In addition, relative price adjustments (see more below) will put pressure on the CPI for some time, as structural reforms are accelerated. Importantly, for reforming transition economies, real exchange rate appreciation is an inherent and vital indication and part of the process of catching up and restructuring, whether for natural resource-importing or natural resource-exporting countries[7]. In addition, real appreciation is also a common phenomenon following a maxi-devaluation and financial crisis, as that experienced in Russia in late 1998. ***Second***, the eroding-competitiveness-through-excess-rouble-real-appreciation claim is equally unconvincing as an explanation to the growth slow-down. Russia's industrial competitiveness is not given primarily through the exchange rate and it is not lost primarily through the exchange rate. Looking at the *individual* costs of the factors of production, Russia is on paper a highly competitive economy. This has not changed significantly despite the gradual real rouble appreciation over the last couple of years.

Corporate restructuring should be in focus.

However, Russia's competitiveness and productivity problems in practice come from the structural characteristics of the corporate sector, the real economy and the

[7] As two of the leading contributors to the literature on exchange rate dynamics in transition and reforming economies recently put it: "It is important to note, as a conclusion, that the Balassa-Samuelson effect is an equilibrium phenomenon, not an undesirable transitory effect that ought to be counteracted through policy actions…The real appreciation reflects the natural evolution of the economy which has to be translated into relative price changes." See Halpern, L & Wyplosz, C (2001), "Economic Transformation and Real Exchange Rates in the 2000s: The Balassa-Samuelson Connection", March 2001, mimeo. See also Halpern, L & Wyplosz, C (1998), "Equilibrium Exchange Rates in Transition Economies: Further Results", November 1998, mimeo.

institutional set-up. Examples here would be *over-employment*, *all kinds of market distortions*, *lack of a transparent legal framework*, *unsure property rights*, and so on[8]. The key point is this: if there is a problem with competitiveness, it is not because of the gradual rouble real appreciation, but because of slow or problematic corporate restructuring. In this context, engineering a weaker rouble – assuming this could be done against the current macroeconomic fundamentals – would basically be a sign authorities are unconvinced of the reforms and corporate restructuring (and other institutional reforms) underway. The benefits of such a policy are hard to see[9]. In addition, it should be pointed out that engineering a weaker rouble would all else equal lead to a *higher*, not lower, external surplus.

The role of accumulated and currently ongoing enterprise adaptation.

Instead of entirely ascribing Russian economic growth to factors such as the oil price and the exchange rate, or some combination thereof, one should not underestimate the importance of more generic factors such as accumulated enterprise adjustment. While indirect liquidity effects of improved external conditions have played an important role in 1999-2000, we would highlight the *combined* impact of external influences *and* the process of enterprise adaptation, corporate and consumer optimism, tighter budget constraints, and new international financial realities (less or no IMF funds, firmer "ownership" of the economic policy agenda). One of the leading and most insightful Russian economists and reformers, Professor Egor Gaidar, has repeatedly made the point that while external factors account for a certain part of, e.g., economic growth generated in 2000, the contribution from an inherent process of enterprise adaptation and restructuring, both accumulated over the years and that proceeding at the moment, is substantial[10].

The combination of external surpluses and thin financial markets – a legitimate concern.

If there is a problem with the exchange rate-growth connection, it lies not so much in real appreciation per se, but in the combination of large external surpluses and thin financial markets/unrestructured financial system. In this regard, one relevant policy discussion is, as noted above, the extent and speed of the real appreciation. Because of thin financial markets and low financial intermediation between the financial sector and the real economy, there are scant sterilization options for the Central Bank. Accumulation of reserves has in this environment been carried out to prevent a too rapid real appreciation, but it has created additional money supply, with the potential of becoming a more notable problem than hitherto. So far, the bulk of the excess domestic liquidity has been soaked up through fiscal surpluses and CBR deposits. The lack of banking sector restructuring is a real problem, and there have been little to be optimistic about over the last couple of years. Monetary authorities have not shown great interest in pursuing this issue. This, however, is not a problem of the real appreciation *per se*, and equally it can not be blamed on the existence of a large current account surplus.

[8] The most comprehensive studies in this regard are McKinsey, "Unlocking economic growth in Russia", October 1999, and the World Bank (B.Pinto, V.Drebentsov, A.Morozov), "Dismantling Russia's Non-Payments System: Creating Conditions For Growth", mimeo, 1999.

[9] See also the encompassing analysis by Dynnikova, O, "Makroekonomicheskie perspektivy ukrepleniya rublya I valyutnaya politika", EEG-Ministry of Finance, July 2000.

[10] For example, in the long interview in *Literaturnaya Gazeta*, April 4-10, 2001.

The link between the exchange rate, exporters and domestic liquidity.

Another aspect to credibly consider is the link between the exchange rate, the main exporters and domestic liquidity – and thus indirectly investment growth and monetization. Following the 1998 devaluation and the start of the oil price rise from the second quarter of 1999, Russian exporters were faced with a double windfall gain – higher export prices and lower domestic costs, as the latter is denominated in roubles. In the wake of this, the export sector started to meet domestic payments of various kinds (taxes, wages, pensions, and suppliers' payments) at higher and higher degrees of cash component. This provided a positive jolt to domestic liquidity, which trickled down through the Russian economy. This process is one part of the financing situation behind the near 18% jump in investment growth in 2000. In so far as the current account will gradually shrink from here, all else equal, this channel will become less important. But again, this is not real appreciation eroding competitiveness.

Our inflation forecast revised to 18% from 15% - but no major concern.

Given January-March CPI indicators, we have revised our 2001 CPI forecast to 18-20% from 15% (and the 2002 estimate to 15% from 12%). January CPI came in at 2.8%, compared with 1.6% in December 2000, 1.5% in November and 2.3% in January 2000. In February, CPI inflation declined to 2.3%, and in March moderated further to 1.9%, bringing first quarter inflation to 7.1%. We do not see the higher-than-budgeted inflation trend as a major problem, and had already anticipated budgeted inflation of 12% would be too low and that an outcome around 18-20 was more likely. The Russian government has recently acknowledged the budgeted inflation may have to be revised upwards[11]. This, however, will help rather than hurt the budget, as expenditures are fixed.

Relative price adjustments the main driver behind 2001 monthly inflation rates.

Embarking now on a series of major structural reforms, while also the CBR's sterilization options remain limited, relative price adjustments will exert pressure on Russian CPI for some time. The breakdown of the monthly CPI data for January-March emphasizes services price growth continues to be the dominating factor behind monthly inflation. In January, services were up 4.6% compared with 2.8% for the full CPI. In February, municipal service prices rose 7.3%, and in March services rose by 3.4%. For the full first quarter, services price growth was 12.9% (compared to 7.1% overall CPI). The services inflation is driven by readjustment of municipal and electricity tariffs, both sectors which will be engaged in major relative price adjustments for some time going forward as structural reforms are accelerated.

Fiscal developments – the 2001 budget amendments.

The main fiscal event during February-March was the adoption of amendments to the 2001 budget, in order to mobilize additional revenues to debt service (to make full Paris Club payments and to substitute budgeted but non-realised IFI funding). After some fairly tough discussions with the Duma, a compromise was found, and necessary amendments approved in three readings on February 22. In mid-March, the Federation Council without problem approved the same amendments in the one reading required there. The amendments concern mainly three aspects: allowing additional domestic borrowing of RUB 30 bn, allowing the use of some RUB 33 bn from 2000 fiscal funds to be used for debt service purposes, and establishing that the first RUB 41.2 bn of excess budget revenues is channeled to debt service with the subsequent RUB 124 bn split 50/50 between debt service and non-interest expenditures.

[11] The government may adjust the inflation expectation to 16%, from 12-14%.

The Russian government will have more than enough to meet full Paris Club payments and substitute budgeted but non-realized IFI funding.

According to Ministry of Finance estimates, the fiscal gap these amendments need to fill is RUB 182.95 bn. This figure is arrived at by the Ministry of Finance using conservative estimates with regards to non-IMF IFI and bilateral funding. However, in our analysis we believe the Russian government will have no problem meeting this gap as per the now adopted 2001 budget amendments. In the table below, we outline our base case scenario. The key parameter is the estimate of excess budget revenues. As was politically sound, the government estimated at first some RUB 108 bn in total 2001 excess budget revenues. However, we expect the real outcome to be closer to RUB 200 bn. The table below is constructed assuming 2001 excess budget revenues at RUB 200 bn.

Figure 4. Russia — Excess 2001 Budget Revenues – The Distribution To Debt Service (assuming RUB 200 bn excess revenues)

	RUB bn
The first RUB 41.2 bn of excess revenues to debt service	41.2
The subsequent RUB 124 bn is divided 50/50 between debt service and non-interest spending	62
Excess revenues above RUB 165.2 bn to debt service	34.8
Additional domestic borrowing	30
Funds transferred from year 2000, to be used for debt service	33
TOTAL	201

Source: As per the 2001 budget amendments. The Ministry of Finance, Schroder Salomon Smith Barney.

First quarter 2001 fiscal indicators encouraging – could tax reforms adopted last year already have some impact?

Early fiscal indicators for 2001 are encouraging, and indeed point to the potential for substantial excess revenues. In January, normally not an active month in terms of economic activity and fiscal performance due to many holidays, federal revenues were nevertheless some 4.1% above the monthly target, while expenditures were 13.6% below target. In February, federal budget revenues were 6% over target, with expenditures 12.6% below target. For March, preliminary data indicates federal fiscal revenue collection at 3.8% above target, with expenditures 13.6% below target[12].

Tax collection continues to improve.

Note in particular that tax collection (as collected by the Tax Ministry) was 6.8% above target in March, and corresponded to some 11.7% of GDP, up nearly two percentage points of GDP since January. For February corresponding figures for tax collection (a sub-category of total federal revenues) were 5.1% above target in February, and corresponded to 10.7% of GDP, compared to 9.8% of GDP in February 2000. In January 2001, the same Tax Ministry tax collection was some 10.1% of GDP, up from 9.8% of GDP in January 2000. The Ministry of Finance's preliminary first quarter fiscal date point to total first quarter tax collection at RUB 195.3 bn and total first quarter federal revenues at RUB 318.8 bn, or 17.7% of GDP. Given these figures, the government has now raised second quarter federal revenue targets by RUB 51.8 bn compared to the initial 2001 budget (putting total second quarter revenues at RUB 302.8 bn) Thus, already in these early months the trend in tax collection is positive. While still early days, one can not completely discount the possibility of some positive influence already from the tax reforms adopted last year and in effect from January 1, 2001 (e.g. the flat income tax rate of 13%)[13]. Indeed, the preliminary Ministry of

[12] The Ministry of Finance: "Predvaritelnaya otsenko ispolneniya obyemov finansirovaniya raskhodov, defitsita I postupleniya dokhodov federalnovo byudzheta", January, February, March 2001.

[13] Note also that the recently initiated auctions of quotas on water resources (e.g. fishing rights) are doing well, and revenues are notably above expectation. For the first six such auctions in February and March, the government netted some RUB 1.6 bn.

Finance fiscal data shows personal income tax collection jumped about 70% in the first quarter this year compared to the first quarter 2000.

Figure 5. Russia — Fiscal Revenue Performance – First Quarter 2001

	Actual performance, % of target
January federal budget revenue collection	104.1%
January tax collection	106.5%
February federal budget revenue collection	106%
February tax collection	105.1%
March federal budget revenue collection	103.8%
March tax collection	106.8%

Source: The Ministry of Finance, Schroder Salomon Smith Barney. Federal budget revenue collection includes tax and non-tax revenues. Tax collection refers to the bulk of taxes, as collected under the auspices of the Tax Ministry.

Figure 6. Russia — Macroeconomic Forecast, 1998-02F

	1998	1999	2000	2001F	2002F
Real GDP (US$bn)	–4.6	3.2	7.6	4.0	5.0
GDP (US$bn)	285	170	240	267	287
Per Capita Income (US$)	2108	1140	1620	1804	1939
Trade Balance (US$bn)	14.2	35	52	47	47
Current Account Balance (US$bn)	2.5	25	45	35	35
Inflation (Year-on-Year % Chg)	84.4	36.5	20	18	15
Current Account (% of GDP)	0.9	14.7	18.8	13.1	12.2
Official Reserves (Months of Import)	2.7	3.5	7.5	8.1	9.7
Fiscal Balance (As a % of GDP)	-4.8	-1.5	2.4	2.0	1.0
Total External Debt/GDP	57.6	94.2	61	55	51
Total External Debt/Exports G&S	187	191	137	140	147
Debt Service Ratio	28.0	11.9	9.8	10.0	10.5

F Schroder Salomon Smith Barney forecast.

Source: Schroder Salomon Smith Barney.

Currency, interest rates and the banking reforms

Maintain a neutral stance on local currency instruments.

Against the above inflation background, we would maintain our neutral stance on federal rouble instruments, where yields remain fairly low and kept within a relatively tight range. However, there are other rouble instruments which may be more interesting, such as St Petersburg rouble bonds and the still nascent but now growing rouble corporate bond market. Regarding the latter, issuance activity is fairly active, although from a low base. There are indications authorities are interested in boosting this market, with the Federal Securities Commission considering making the registration procedures more efficient, and the Duma considering to lower taxes applied to corporate bond issues.

We are not concerned about the rouble — the key dynamics remain the same.

After a stable January, the rouble weakened in February-April. We do not see this as a major shift in the exchange rate outlook. The fundamental fact about the Russian foreign exchange market is that the Central Bank controls it effectively and is able to bring the currency pretty much where it wants to, as well as to continue accumulating reserves. As per March 30, CBR reserves stood at USD 29.7 bn, and we expect reserves to end the year at about USD 35 bn. Following January-February inflationary trends, the CBR decided to depreciate the rouble to avoid a too sharp real appreciation. In the first quarter, CPI inflation reached 7.1%, and in the first 9 days of April, inflation was 0.6% (indicating a potential full April inflation of around 1.5-2%). As noted above, the trade weighted rouble real exchange rate appreciated by 3.4% in the

first quarter of 2001. Given April-May inflation outcomes, the CBR may decide to yet again guide the rouble lower. On our revised inflation outlook, we expect the rouble nevertheless to end the year around 31 roubles per dollar, corresponding to an 8%-10% real appreciation. Apart from these intra-month movements, it remains the case the Central Bank is in principle skeptical of a policy of a "weak rouble", and would prefer a stronger rouble.

The CBR — not in favor of a "weak rouble policy".

This has also been confirmed by CBR governor Geraschenko, emphasizing the Central Bank sees more risks with a policy of a "weak rouble" than benefits, and that the task of the CBR on the forex market would continue to be to avoid any sharp movements. At the same time, the CBR will not explicitly strive for a stronger rouble, and be ready to continue dollar buying to prevent a too sharp appreciation. In general, exchange rate policy is squeezed between the need to prevent a too rapid real appreciation and concerns over monetary consequences of reserve accumulation in the context of thin financial markets. Furthermore, the lobbies of exporters and domestic producers, preferring a softer rouble, are not unimportant, whereas the government, while also interested in keeping the extent of real appreciation manageable, benefits from a gradual real appreciation as it alleviates the external debt burden and as we have discussed above, a policy of explicitly engineering a weaker rouble would carry with it substantial risks.

Accelerating structural reforms in the context of gradual real appreciation is the best choices for Russia. This is also included in the draft macroeconomic assumptions for the 2002-2004 macroeconomic action plan.

Contrary to perhaps general perception, in our conversations with Russian officials we see Russia ultimately moving towards accepting the combination of rouble real appreciation and reform acceleration. While in the short term moving against selected vested interests calling for a "weak rouble policy", this policy should be the best one for the government and ultimately also for the real economy. The external debt burden will moderate, a certain push for enterprise restructuring will be present, reform acceleration will help ratings upgrade momentum, and the pay-off to structural reforms will come over the medium term. Indeed, in the macroeconomic assumptions underlying the government's draft 2002-2004 macroeconomic action plan, it is assumed the rouble will continue to follow a path of gradual real appreciation.

Financial system restructuring – finally in focus?

A focus over the coming weeks and months will be financial system reforms and restructuring, up until now the most disappointing policy field of economic reform. Encouragingly, signs are the government, perhaps pushing with them the more reluctant Central Bank, is now intent on visibly moving this process forward.

The "IMF package" of banking law amendments, and a deposit insurance law.

Specifically, the government, the Duma and the Kremlin appear now to more or less agree on the road map for the set of crucial amendments to three separate banking laws making up what is known as the "IMF package". This package is composed of amendments to the law on bank bankruptcy, to the law on banking activity and to the law on the Central Bank. The full adoption of these amendments has for some time constituted a key IMF prior action. On March 23, the Duma banking committee decided to recommend the parliament to approve the above amendments in a second reading, and on April 18 the amendments were approved by the Duma in the second reading. There are also other signs of a new focus on financial system reforms. In late February, the Duma approved in a second reading legislation which exempt Central Bank-issued bills from taxation, which is part of the process of enabling the resumption of Central Bank bill issuance, as liquidity-regulating instruments. We

expect this process to be concluded within the next months. Separately, the relevant agencies and ministries are expected to in April submit to the government a draft law on deposit insurance. This is preceded by ongoing discussions and work on banking sector restructuring under the auspices of the Ministry for Economic Development and Trade.

In April, the first auction of a bank restructured by ARKO, the state agency for bank restructuring.

The government and the Kremlin are also more clearly moving towards currency regime liberalization, specifically (but not exclusively) with regards to the rule on obligatory hard currency revenue sales. Representatives from both the government and the Kremlin have indicated that shortly they will move to lower the obligatory sales from the current 75% to around 50-40%, and then later even further, to 20-40% and with even the possibility of complete abolishment at a later stage. However, since the Central Bank leadership is far more cautious in this issue, we expect any liberalization of the currency regime to be more graduated and careful. Finally, ARKO, the state agency for bank restructuring, concluded in February the reform and restructuring work on the first bank under its control slated for a post-restructuring auction, the regional bank Chelyabkomzembank. On April 23, ARKO will hold the auction for this bank, selling 73.3%, in what will be the pilot project for post-restructuring bank auctions. ARKO plans to be able to sell another 2-3 restructured banks during 2001, and in total expects to over time sell 7 banks under its control.

Economic policy

Economic policy in focus.

Russia's economic policy debate is at the moment revolving around three issues***: the prioritized economic policy measures for the remainder of 2001***, ***the short-term economic action program for 2002-0 and the 2002 budget*** and ***the codification of the long-term economic strategy (to 2010) via a presidential decree***.

Priority of structural reform implementation confirmed — but risk of overextending.

On March 1, the Russian government reviewed the main macroeconomic outcomes of year 2000, but primarily focused on the challenges for the 2002-04 period, including measures for the remainder of 2001. This was an opportunity to emphasize the pursuit of structural reforms, a struggle the government has sought to revive over the last few months. Our basic assessment is this: Towards the end of 2000 and early 2001, something of standstill emerged, partly because the government was risking "overextending" itself — the list of structural reform priorities grew very long and perhaps a further round of prioritizing and sequencing the necessary political coalition-building was needed[14].

Russian economic reforms are progressing, and Putin is right to sponsor the pursuit of such reforms with his political capital.

The importance of prioritizing is a key point. A general perception is of Russian reforms as being glacial, piecemeal and/or unconvincing. There are even suggestion the Putin regime should *not* use its accumulated political capital to pursue reforms, and rather try to not "rock the boat". Whereas the former perception suffers from perhaps too unrealistic expectations, the second is particularly misleading. It is easy to pursue reforms when times are bad. It is when times are good the challenge is there. And it is precisely in good times the Russian establishment needs to show it is capable

[14] On the slow-down or lull in the pursuit of economic reforms after the first half-year or so of the Putin regime, see also the insightful discussion by Professor Egor Gaidar in *Literaturnaya Gazeta* (interview, April 4-10, 2001). See furthermore the outstanding treatise of the early part of Russian economic reforms by Egor Gaidar in *Dni porazhenii I pobed*. See also Professor Gaidar's address to an EBRD seminar, "Renewal of Russian Reforms", on January 26, 2001 (mimeo), as well as Egor Gaidar, *The Struggle For A Free Economy And Society In Russia*, the Sir Ronald Trotter Lecture, New Zealand, 2000.

of formulating priorities and move forward on these priorities. In our analysis, a potential problem has been not the speed of reforms (expectations here have been too unrealistic) but *the scale of declared ambitions and the list of reforms coupled with the limited administrative ability of the overburdening Russian ministerial bureaucracy.*

President Putin's annual Federal Assembly address on April 3 has re-focused the economic policy agenda.

Although *per se* a good sign in terms of ambitions, a too wide focus will possibly complicate achievement in a more narrow set of reforms of higher importance. During February, March and early April, the government and the Kremlin gradually showed a new willingness to revive the pursuit of crucial economic reforms. In particular, the strongly pro-reformist annual Federal Assembly speech given by President Putin on April 3, in which he urged an acceleration of structural economic reforms and boosted many of the ideas pursued by key reformers in the government, has injected new focus. Another example would be the overwhelming Duma approval on April 4 of the new profit tax in a first reading. Yet another would be President Putin's creation on April 9 of a special working group to by July present measures for a phased liberalization of the Gazprom share markets, as well as calling for greater transparency and efficiency in Gazprom. And yet another indication is the approval in a first reading by a large Duma majority on April 11 of the new version of the Arbitration-Process Code. This act is part of a substantial package of legal and judicial reforms, whose impact will also be felt in terms of improving the investment climate by making the legal system more transparent and efficient. This is positive, as the investor community will look carefully on the progress achieved this year in terms of judging the momentum and intent of the Putin regime in this area.

The core set of reforms: business reforms, a new Land Cod, legal reforms and initiation of UES restructuring

The need for careful coalition building in each of the key reform issues should not be underestimated. President Putin still enjoys strong popularity, but institutional and economic reforms do require the crafting of workable political-administrative coalitions and consensus[15]. Against this background, we welcome as positive sign indications the Russian government is moving towards outlining a core set of reforms which will be pushed to conclusion over the remainder of this year. This does not mean other reform priorities are discarded, but it does mean chances of success are enhanced across the near-term key priorities, as it will concentrate and could make more efficient use of the authorities' political capital. It might also serve to introduce perhaps a more realistic benchmark against which Russian progress is judged. We would like to call this identifying and achieving ***the critical mass of structural reform progress***. By implication, we would identify four main areas, which the Russian authorities are now crystallizing as main near-term challenges:

[15] President Putin himself also emphasized this in the major programmatic interview published in four Russian newspapers on March 22. See "Vladimir Putin: za god ya stal dobre", *Izvestia*, March 22, 2001.

The core set of near-term reform priorities

1. ***The business de-regulatory reforms and the second phase of the tax reforms***

While complex and intricate, these are reforms of huge importance[16]. They pertain to the nuts and bolts of doing business in Russia, whether for domestic or foreign investors. These reforms constitute the second major reform step after last summer's tax reform phase. As with most of the other reforms, these are drafted and directed under the auspices of German Gref's Ministry for Economic Development and Trade. The cost to the Russian economy of excessive licensing, bureaucratic barriers to business and similar practices is huge. For example, there are now some 500 activities, which require licensing on the federal level and another 600-700 (illegally) on a regional level. The main idea behind the third and crucial initiative is to cut the number of federally required licenses from around 500 to about 100. The Ministry for Economic Development and Trade estimates these practices cost the Russian economy some RUB200 billion per year, or around US$5 billion (more than the annual Paris Club debt service). Specifically, the first package of business reforms and de-bureaucratization measures is composed mainly of three items:

- On the protection of legal persons and individual entrepreneurs in the context of government controls
- On government registration of legal persons
- Amendments to the law on licensing

On March 2, in an extraordinary government meeting, the cabinet approved two of the above three legal projects in this field, marking a new phase in the pursuit of these reforms. On March 15, the government approved the third amendment. On March 19, the two first legal initiatives were submitted to the Duma, and on April 4 the third was submitted. A reasonable ambition should be to have the above approved in at least a couple of Duma readings by the Duma summer recess, around July 1. Later, going into 2002, a second package of business reforms will be prepared.

The bulk of the second phase of tax reforms is made up of a new profit tax. After quite some work and compromise consultations, the new profit tax law was submitted to the Duma on March 19. The explicit ambition of the government is to have the new profit tax approved in all Duma readings, in the one required Federation Council reading, and signed by President Putin by July 1. In an encouraging sign, an overwhelming Duma majority swiftly approved the new profit tax in a first reading on April 4. The other main part of this second phase of tax reforms is a new tax on natural resource extraction, as well as possible new regulations affecting transfer-pricing practices. As with the profit tax, the ambition is to have the new tax on natural resource extraction approved by the Duma summer recess around July 1.

2. ***The new Land Code and private ownership of land***

At a meeting of the State Council (Gossovet) on February 21, President Putin outlined the roadmap in this issue and re-emphasized the importance of now settling the question of private ownership of land. The government should be able to discuss a full draft version by April 19. By May 1, the government should have submitted the new Land Code to the Duma. The explicit ambition of the government is now to have a new Land Code approved in a first Duma reading by the summer recess, around July 1. The summer would then be spend preparing for a second and third reading during the autumn and winter session. Furthermore, by June the government was mandated to draft the separate law on the treatment of agricultural land. Such a law might be adopted by the Duma in 2002. The immediate economic impact of a new Land Code is less important than its political and symbolic content. However, it would play a role fairly soon as part of debt-for-equity-and-investments ideas, on Russia's Soviet-era debt.

3. ***Reforms of the legal and judicial system***

Another process which over time should have a major impact on the investment climate is a wide-ranging reform of the legal and court system, prepared under the auspices of Dmitri Kozak, one of Putin's deputy heads of the presidential administration. The idea is to make the legal system more professional and less prone to corruption. In line with this ambition, the Duma has already overwhelmingly approved a new version of the Arbitration-Process Code (on April 12). The main idea behind this change is to strengthen the independence of the arbitration courts, and to make the arbitration courts the sole venue for hearing economic cases, also those involving foreign companies. This would go a long way towards dealing with some of the problems, which have arisen over the years in such cases when heard in other courts, non-arbitration courts. Another part of this reform package is a new version of the Civil-Process Code, a first reading of which is expected late April/May, as well as a new law on the status of the courts. In December, the most controversial part of the judicial reform program might be up for a reading, the new Criminal-Process Code.

4. ***UES restructuring and reform***

The special working group formed to draft a UES restructuring program by April 15, and the relevant authorities involved, will present one version of a compromise restructuring program by April 22. From there, the Kremlin and President Putin will point out the next steps, and hopefully we could see the initiation of the restructuring process shortly.

[16] The importance of the business reforms as an indication of the government's political ability to concentrate its efforts on a prioritized task and push it through is treated in Vladimir Mau, "Deregulirovanie predprinimatelskoi deyatelnosti kak put postroeniya silnovo gosudarstvo", Itogi, January 15, and "Prostota protiv vorovstva", Itogi, March 27.

The importance of reforming the rules and regulations facing business and the need to fight bureaucracy.

Particularly the first category of reforms is key: the push for business reforms will require not insignificant political capital and determination on behalf of the government to pursue through the Duma. To guide them through the parliament will be a challenge, and an important indicator of the government's political stamina in terms of pursuing prioritized economic reforms, as we have noted. Nevertheless, German Gref, who will be the Minister ultimately in charge of steering them through Duma readings, will be strengthened by a couple of things. *First*, Putin's annual address to the Federal Assembly contained a notable re-affirmation of his support for these kinds of measures. *Second*, Duma forces are rallying to support Gref's measures, and a special intra-group Duma structure of 55 deputies has just been formed called "Delovaya Rossiya", or "Business Russia". The specific purpose of this new group is to support Gref in pushing for his business reforms. Also, given the failure of the recent Communist-initiated vote of no confidence in the government, the parliament was again reminded of the change in political balance - towards the centre and centre-right. The recent decision to further consolidate the Kremlin-supportive political centre, through a coordinating council between Unity, Fatherland, Russia's Regions and People's Deputies is part of this process.

Other reforms pursued as well: new Customs and Labor Codes, pension reforms, WTO membership, and corporate governance.

In addition to the above core set of reforms, the government is also in various stages preparing for a long list of other measures, such as a new Customs Code (to be submitted shortly to the Duma), a new Labor Code (a government-Duma working group is drafting a proposal, and Duma officials estimate a new Labor Code might be heard in a full Duma session by the summer recess), a re-worked system of fiscal federalism and centre-regional budget relations (to be submitted shortly to the government by the Ministry of Finance and discussed by the full cabinet on May 23) and pension reforms. Also, reforms of the natural monopoly the Railways Ministry is approaching. On March 19, a reform concept prepared partly by McKinsey was more or less approved by the Railways Ministry and Gref's Ministry for Economic Development and Trade, and discussed by the government in April. President Putin has also mandated an accelerated approach to WTO negotiations, seeking to faciliated Russia's inclusion already in 2002. Another vital area for the investment climate is work on introducing a Code of Corporate Governance, a process driven by the Federal Securities Commission under the leadership of Chairman Igor Kostikov. The expectation is this Code will be fully drafted this year. Importantly, this process has the government's support, as recently confirmed by Prime Minister Kasyanov.

Russia's long-term economic strategy to be codified via a presidential decree.

The Russian government's long-term economic program (up until 2010), augmented and amended from last year's version, was reviewed in a special briefing with Prime Minister Kasyanov on March 7, and generally approved on March 22. Signs are following another round of intra-governmental discussions, President Putin has agreed to codify the program in the form of a presidential decree. As before, the program places its key emphasis on improving the investment climate. There are four main observations to make regarding the amended and re-worked economic strategy:

1. The focus on ***targeting the emergence of sustainable economic growth*** via the pursuit of major and comprehensive institutional and structural economic reforms is maintained and re-emphasized.

2 ***Budget policy, exchange rate and debt policy takes center-stage in terms of macroeconomic policy***. Notably, there is a movement towards emphasizing the need to change, modernize and make more transparent the budget process as a way of dealing with the external debt problem.

3 ***An explicit policy of a weak rouble as surrogate economic policy is not embraced***, rather it is held up as a worst-case outcome. A gradual rouble real appreciation will be assumed.

4 ***A more notable attempt on the need to engage the Central Bank actively in financial system reforms***, such as reforms of the banking system, the currency regulatory regime and with regards to monetary policy.

Further economic policy measures for the remainder of 2001.

The Kasyanov government has also recently outlined some specific budget, debt policy and other measures to be taken during the remainder of 2001. The below measures are in addition to the 2002 budget preparation process and the recently ordered task of preparing a fiscal forward-looking plan for the period up to and including 2004 (see more on this below).

- The Ministry for Economic Development and Trade is mandated to coordinate a methodology for **a full evaluation of the economic situation and investment potential of Russia's regions**.
- The Ministry for Economic Development and Trade is also ordered in the second quarter to **conclude the work on normative legal acts with regards to entrepreneurial activity**.
- The Ministry for Economic Development and Trade is mandated to by the fourth quarter draft and submit to the government a **new federal law on regulating external trade activities**.
- The Ministry of Finance is ordered to present to the government in the fourth quarter a **report on the results of budget expenditure reforms and on the progress in tax reforms**.
- The Ministry of Finance is **mandated to take measures to regulate Soviet-era external debt, and to present a report to the government on the results by the fourth quarter.**
- Relevant ministries are mandated to by September 1 draft and present proposals on **how the effectiveness of companies with state involvement can be enhanced** (where the stake of the state is more than 50%).
- Relevant ministries are ordered to by July 1 draft and present proposals for how to deal with **the restructuring of enterprises with a state stake which are in a situation of bankruptcy**.

Credit ratings: the upgrade momentum continues

Russia is on a medium-term path of credit rating upgrades.

The table below summarizes Russia's ratings from the three main agencies. Following the collapse of ratings in the aftermath of 1998, Russia entered in 2000 a ratings rehabilitation momentum, which has continued in the first quarter of 2001. SSSB also believes this will continue over the next couple of years. We expect Moody's to this

year at least upgrade Russian Eurobonds to B2, once the level of comfort with the Paris Club situation solidifies. In S&P's latest move early March, they decided rather surprisingly to put Eurobonds, and all Minfins (4-8) except unexchanged Minfin 3 at the same level of rating, B-.

Compared to market evaluation and our assessment, Russia remains an underrated country.

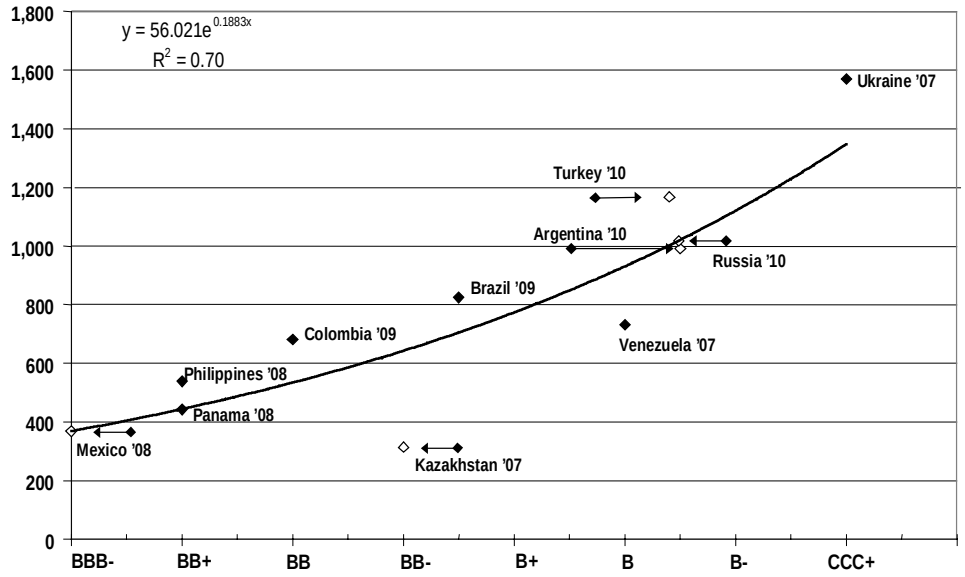
Currently, SSSB's "shadow rating" or value opinion, puts Russia as a mid B credit. In the graph below, the SSSB sovereign credit and ratings analysts have modeled the relationship between ratings and spreads for a number of emerging market countries[17]. The model has an R-square of 70%. As can be seen, Russia comes out as an underrated country given where we see the rating potential, with the market pricing Russia closer to a mid B than B-.

Figure 7. Russia's Credit Ratings, April 2001

	Moody's	S&P	Fitch
Foreign Currency Ratings			
Long-term ceiling for bonds (Moody's) / issuer credit ratings (S&P & Fitch)	B2	B-	B
Short-term ceiling for bonds (Moody's) / issuer credit ratings (S&P & Fitch)	NP	B-	B
Long-term ceiling for bank deposits (Moody's only)	B3	--	--
Short-term ceiling for bank deposits (Moody's only)	NP	--	--
Eurobonds	B3(ru)	B-	B
MinFin 6,7	B3	B-	CCC+
MinFin 4,5	Caa3	B-	CCC
Minfin 8)for Moody's, Minfin 8s are not rated)	N/R	B-	CCC
MinFin 3 (non-exchanged)	Ca	W/D	--
Local Currency Ratings			
Long-term bond ratings (OFZ's)	B3	B-	B-
Short-term bond ratings (GKO's)	NP	C	B

Note: (ru) indicates on review for possible upgrade. Source: Moody's Investors Service, S&P, Fitch.

Figure 8. Spread And Rating – Emerging Market Bonds



Source: Schroder Salomon Smith Barney

[17] This work on credit rating analysis and on rating and spread relationships is directed by Christopher Kelly, Sovereign Credit Research, SSSB.

Debt management reforms

Debt management reforms underway – positive for Russian assets.

Alongside an improving fiscal situation and a promising evolving debate on a more forward-looking fiscal policy (see below), debt management has over the last year increasingly been in focus. We drew attention to the process of reforming Russia's debt management system already last year, as an additional reason to be constructive towards Russian assets. Debt management reforms are now also a more active ingredient in an overall interest from the Russian side in retaining and developing a constructive dialogue with private international capital markets. Given the ratings upgrade process described above, Russian authorities are wary of upsetting a rehabilitation momentum which is under way, given the likelihood of a focus on new market access in 2002-03. The process of reforming Russian debt management into a more efficient and transparent operation is proceeding along four basic lines:

- Continuing the work on regularizing hitherto unsettled Soviet-era debt, both external and domestic debt categories. This includes the implementation of a core FTO bond exchange (possibly be implemented in the autumn 2001), further progress towards regularization of the IIB/IBEC issue (potentially in connection with the FTO bond exchange), and further moves to deal with various domestic debt categories from the late Soviet period, still unresolved.
- Concluding a full inventory review of financial assets and liabilities of the Russian Federation, conducted by the Ministry of Finance. This is expected by end-May/early-June. It is an important phase, as the clearer the picture regarding existing assets and liabilities are, it helps in formulating the most appropriate fiscal and debt management policies.
- Giving fiscal and debt policy an important role in the 2002-2004 macroeconomic action plan. This includes, as emphasized recently by President Putin, a shift to focus on measures to enable Russia servicing its debt in full even during the debt service peak, while still pursuing consultations with official bilateral creditors on a possible debt rescheduling, should that be necessary given economic conditions.
- Reforming the debt management system into a more efficient and transparent operation, preferably via unifying external and domestic debt management into one platform, as well as creating a national debt agency as the main analytical, strategic and tactical debt centre. The idea is clear – through a more efficient debt management system improve the structure of the debt liabilities and decrease the cost of debt service.

President Putin boosts the idea of debt management reforms and a unified debt management platform.

The Ministry of Finance external debt team has professionally pursued these ideas for some time now, and received recently a substantial political boost as President Putin outlined his support for debt management reforms[18]. More specifically, the plan to reform Russia's debt management system includes a move to establish Vneshekonombank as a commercial bank and to break out VEB's function as the government's external debt agent to a separate national debt agency (the ***DARF*** – the Debt Agency of the Russian Federation). These measures are targeted to be formally taken by December 31, 2001, and the whole process of fully setting it up could take

[18] See "Vystuplenie Prezidenta Rossiiskoi Federatsii V.V. Putina na rasshirennom zasedanii kollegii Ministerstva finansov", April 16, 2001.

another 12-24 months. It also includes setting up a special monitoring system of non-government liabilities, such as regional debt. The next steps are now to finalize the drafting of the necessary government resolutions and presidential decrees, which as noted, has been given extra impetus following Putin's official support recently. Vneshekonombank has submitted drafts to such resolutions and decrees, but some further consultations and negotiations with the Ministry of Finance might be needed in order to in detail iron out issues such as the exact jurisdiction of the debt agency, as well as the likelihood of a unified domestic and external debt platform. Regarding the latter, it is notable that President Putin has specifically stressed that "a unified system of government debt management" needs to be established.

Improving debt ratios – a sign of the rehabilitation process.

Improving debt ratios are also an indication of the process of rating rehabilitation. A look at some key debt ratios will also underline the potential for significant returns-to-scale to a more transparent and efficient Russian debt management approach. The table presents five important ratios, pertaining to both the evolution of the stock and to Russia's liquidity situation. Notably, the table shows Russia does not really have, and did not have, a major external debt problem *per se.* While debt/GDP ballooned in 1999, this was mainly an exchange rate effect. Rather, Russia's problem in the 1990s have been *liquidity and poor economic policy* – reserves were mostly stagnant despite non-trivial external surpluses, a sign of substantial capital outflows. Whereas the economy's overall debt ratios did not appear overly worrisome before 1998, the federal government had major problems capturing parts of the resources generated (via reserves or tax collection e.g.).

Fiscal policy reforms and restructuring to make further progress on improving debt ratios.

Over the last couple of years, however, the direction is clear – tax discipline has improved significantly and capital flight (in a relative sense) has decreased, allowing for reserve accumulation (although reserves in months of imports are flattered by an import collapse in 1999) and improving ratios. The key ratio beyond the short-term is annual debt service to federal budget revenues (the last column). During the 1990s, apart from the 1998-99 crisis, roughly between one-fourth to one-third of federal revenues went to debt service. This is clearly unsustainable for a long period of time, especially for a transition economy seeking to implement a range of structural reforms. The main continuous improvement in this ratio, however, is likely to come from a gradual increase in collection through better incentives as introduced via the now pursued tax reforms, as well as significant restructuring and rationalization of the expenditure side[19]. We forecast that debt service could already by 2002 be down to about 23% of federal revenues.

[19] For a full analysis of the challenge of structural fiscal reforms (mainly in the form of expenditure side restructuring) see the excellent paper by Alexander Ustinov, "Vliyanie strukturnykh reform na byudzhet Rossiiskoy Federatsii v dolgosrochnoy perspektive", BEA-EEG-Ministry of Finance, 2000.

Figure 9. Russia's Debt Ratios 1996-2002 (external debt service)

	Reserves (mth imports)	Debt/GDP	Debt/Exports of G&S	Debt service ratio	Debt service/fed.revenues
1996	3	33.4	138.4	14.5	30
1997	3	34.2	149	16	30
1998	2.5	57.6	187	28	89
1999	3.8	94.2	191	11.9	41`
2000	7.5	61	137	9.8	28
2001	8.1	55	140	10	25
2002	9.7	51	147	10.5	23

Source: CBR, Ministry of Finance, SSSB. Average RUB/USD per period. SSSB estimates and forecasts for 2001-02.

The Paris Club uncertainty and the Minfin 4.

However, while we expect Russia to continue on a path of debt normalization, the Paris Club will remain a source of uncertainty. The Russian side cannot rule out the possibility that should it indeed get a Paris Club deal by 2002-03, the Paris Club would ask for comparability of treatment of the Minfin 4-5 (should the relevant consolidation windows so imply). Nevertheless, our judgement is the official sector would not reject considering broader options in such a situation, e.g. if new money by then is provided by private creditors via new market access, or an analysis of past restructurings. It also remains our impression that should the Russian side at some point seriously consider a bond restructuring of the Minfin 4-5, such a restructuring would be done in as market-constructive a way as possible.

Outlook: a forward-looking fiscal policy and the economic policy road map

Fiscal policy reforms and debt management reforms in focus.

The soon to be concluded 2002-2004 macroeconomic policy program and President Putin's annual Federal Assembly address given on April 3 have provided focal points for an evolving discussion on budget and debt policy. The core of this evolving discussion is that it will further strengthen incentives for reforms and constructive behavior towards international financial markets as well as strengthening the situation for private market bonds maturing in the 2002-04 period (e.g. the Minfin 4).

Macroeconomic and fiscal forward-looking policies.

A strategic direction in budget and debt policy is starting to emerge — to make the fiscal process more transparent and forward-looking, to adopt a program of debt management reform, and to prepare fiscal policy more rigorously for the eventuality of future external shocks and handling of the 2003 debt service peak. In other words, Russian economic policy makers are already actively and formally considering fiscal, macro and debt policies for the period up to and including 2004. This should be taken as a clearly encouraging sign. To continue the credit upgrade momentum and to secure private market access in terms of future refinancing – while being cautious in terms of adding to the existing stock of debt – is part of this development.

President Putin proposes a "reserve budget" as an insurance mechanism for external shocks and debt service payments.

President Putin's annual address on April 3 focused among other things on fiscal and budget policies. As such, this represented a continuation of a more general discussion among Russian economic policy makers. In his address, President Putin directly proposed to construct the next years' budgets out of two parts, one current and one for future needs, the latter as a policy of building up an insurance mechanism against external shocks and debt service peaks. The latter part of the budget would be built up using revenues generated by an advantageous economic conjuncture, both external and domestic. Specifically, Putin proposes a somewhat new mechanism of approving the annual budget. The Duma is proposed to have the right to either approve or reject

the first, current, budget, but not to change its parameters (i.e. not to infringe on what the government has deemed to be potential for excess budget revenues). Currently the Duma loses this right only after the first reading. Regarding the second part, the government would have more room for maneuver, in terms of introducing changes and amendments along the way[20].

Prime Minister Kasyanov has mandated the preparation of fiscal scenarios and financial planning up to and including 2004.

This Putin proposal should be taken as a political confirmation of ideas already raised in the Russian policy debate. Leading government members have already raised the issue of preparing the necessary amendments to the Budget Code in order to implement this proposal. In practical terms: while not ruling out diplomatic consultations on the possibility of a future Paris Club rescheduling deal covering the 2003 debt service peak, Russia is no longer to assume this for certain and instead include in its policies the eventuality that Russia will handle all the debt payments on its own. This approach was furthermore indirectly confirmed in the top-level Russian-German April summit in St.Petersburg, where German Chancellor Schroeder declared Germany was ready to support a Russian debt restructuring effort in 2003-2004, if the economic situation at this time have deteriorated so it would be necessary.

Prime Minister Kasyanov has mandated the preparation of fiscal scenarios and financial planning up to and including 2004.

It might the case that in line with the above, the 2002 and 2003 budgets are constructed on the basis of full Paris Club payments and will not include assumptions of external debt rescheduling or restructuring of payments originally due. Deputy Prime Minister/Minister of Finance Kudrin has already confirmed the 2002 budget (to be a balanced budget) will be drafted assuming full scheduled external debt payments. This has also been supported by leading Duma officials, with for example Alexander Shokhin, Chairman of the Duma Banking Committee, welcoming the move. According to Kudrin, the government will pursue three main avenues in other to be able to handle even the debt peak years on their own: fiscal policy (formally balanced budgets with the likelihood of overall surpluses in practice), selective work with IFIs (the World Bank, and later the IMF), and private market access for re-financing of maturing bonds. As noted above, it would be only if the economic situation has deteriorated substantially by 2003 that Russia would seek the understanding of e.g. Germany for an official sector debt rescheduling. In this context, Prime Minister Kasyanov has ordered the preparation during April-December of not only the 2002 budget and macroeconomic forecasts for 2002, but also mandating the Ministry of Finance and relevant ministries to outline a prospective financial plan up to and including 2004, as well as the necessary macroeconomic forecasts to accompany such a fiscal plan[21]. The government is preparing to discuss the main parameters of the 2002 budget in a cabinet session on May 24, and the Ministry of Finance is mandated to submit a full 2002 budget to the government by August 1.

Politics and economics.

There are two main reasons behind this gradual shift to a more forward-looking fiscal policy and changed debt policy emphasis, one economic-political, the other foreign policy. On the former, the government seeks a realistic “insurance policy” against reliance on external factors. Also, the government is keen to avoid this year’s

[20] Leading economic policy-relevant Duma officials have already expressed understanding and sympathy for this idea. The chairman of the Duma banking committee, Alexander Shokhin, has stated the Duma will most likely consider the 2002 budget along these new principles.

[21] *Postanovlenia pravitelstva*, April 3, 2001, nr.428.

example, when a Paris Club rescheduling was budgeted, but then did not appear, leading to time lost in Duma budget re-negotiations. Second, the Kremlin appears to be losing patience with every year having to go to the G7/Paris Club with requests for debt relief — requests which are, in the current international political environment, probably less politically acceptable not only for the leading G7 countries but also for the Kremlin administration.

The IMF situation, the G7 and the Paris Club

At the recent Palermo G7 Finance Minister meeting, the G7 expressed satisfaction and confidence with the Russian government's policy of paying in full on 2001 payments, and the package of budget amendments which has now been approved by the Duma. The Russian delegation stressed that while the situation in 2001 might be manageable, Russia could be forced to come back to the Paris Club for consultations in the future, referring to the 2003 debt service peak (see also the recent German comments on this issue, above). In bilateral talks, several G7 ministers expressed an understanding that this might be the case, should the economic situation worsen. The Russian side also continues to refer to the June 1999 G7 Cologne communiqué, where a G7 commitment to the pursuit of a comprehensive deal on Russia's Paris Club debt was affirmed (the exact words were: "In order to support Russia's efforts towards macroeconomic stability and sustainable growth, we encourage the Paris Club to continue to deal with the problem of the Russian debt arising from Soviet era obligations, aiming at comprehensive solutions at a later stage once Russia has established conditions that enable it to implement a more ambitious economic reform program").

The IMF issue.

Another issue is the IMF. During January-March, the Russian position regarding the IMF underwent some change, mainly as a response to unwillingness by the IMF to start consultations on a three-year program already now. Instead of starting discussions on such a medium-term program, Russia was basically offered a "two-stage" approach with the IMF: targeting first a one-year precautionary program, then later discussions on a two-year program (covering 2002-03, including the 2003 debt service peak). At the moment, a joint government-Central Bank letter of memorandum of economic policies (with policies and targets already agreed with the IMF missions) pertaining to such a one-year precautionary program is basically concluded, and awaiting publication. It will likely be published by the holding of the IMF/World Bank annual meetings end of April. However, the Russian government has declared that given the above, they see little reason for them to go through the full formal process for only a one-year precautionary agreement.

IMF informal monitoring and continued World Bank lending.

Thus, Russia will not submit the memorandum on economic policies to the IMF board for a *formal* review and vote, and rather the memorandum will be circulated informally at the IMF and form the basis for *a monitoring-type of relationship* over the next year. The Russian side motivates their understandable move with that it is anyway only talk about a one-year precautionary program (while Russia wanted consultations to begin on a medium-term program) and Russia is convinced they will handle the situation on their own during this period. The IMF has responded with understanding, and the Russian side has emphasized that the cooperation with the IMF will continue during this period, with regular (half-year or more frequent) mission visits to evaluate the progress under the soon-to-be-published memorandum of

economic policies. This cooperation will continue with an eye to at some later point decide on the possibility for initiating consultations on a medium-term, non-precautionary program, covering 2002-03. Separately, World Bank programs continue, and there is a possibility that the board of the World Bank could approve at the end of June three new Russian projects, totaling some USD 280 mn. Existing World Bank projects planned for disbursement in the financial year 2001 amounts to some USD 600 mn. At the same time, given the strong BOP situation, the fourth tranche of the structural adjustment loan is unlikely to be disbursed. Note that the Russian side has during April in any case started to deal with the main IMF prior action, that of amending banking sector legislation (three bank restructuring amendments)[22].

Russia's economic policy road map April-July.

Given all of the above, the Russian economic policy road map over coming months is summarized in the table below. The table concludes with the main ambition of the government in terms of achievements by July 1, the approximate start of the parliamentary summer recess. As can be seen, it is dominated by economic policy-relevant Duma legislation. The government's ability to pursue these measures through the required readings will be another important test. In a similar vein, the Kremlin's willingness to sponsor these reforms with President Putin's political capital will be a related test – an indication of the Kremlin's political stamina and the kind of political trade-offs they are ready to take as complex and not uncontroversial structural reforms are embarked upon. As already noted, a positive sign is the passing of the new profit tax in a first Duma reading on April 4, as well as the passing on April 11 of the new Arbitration-Process Code in the first reading and the approval in a second reading of the "IMF package" of amendments to banking sector reforms.

The perception of Russian affairs – to gradually change for the better?

The rejuvenated push for structural and economic reforms outlined in the study above takes place amidst lingering outside concerns over Russian affairs. Many of these concerns are legitimate and require careful consideration and discussion. The expose and discussion above on reforms pursued and results already achieved should go some way towards answering some of the issues. It is also important to stress these are still very early days for the Putin regime. It is barely one year since Vladimir Putin was elected on March 26, 2000, in a first round as Russia's new President. Considering the short time period, by any realistic benchmarks there has been a notable change in a positive direction with regards to economic policy and governance in comparison to most of the Yeltsin era, especially the post-1996 part. In the words of two of the leading experts on and participants in Russian economic reforms: "Previously, Russia had been idealized in the West, and even it's most obvious problems and contradictions had been overlooked. By the end of the 1990s, in contrast, its negative features were being grotesquely exaggerated and positive aspects were being completely ignored"[23]. With a critical mass of structural and economic reforms

[22] There are a few other minor prior actions as well. These have included specifying the requirements for hiring an international consultant to do a review of Sberbank, to more clearly outline the strategy for exiting the CBR from the offshore subsidiaries (this process is already under way), and to clear the final hurdles to allow the CBR to resume issuance of CBR bills as liquidity-regulating instruments.

[23] See Vladimir Mau and Irina Starodubrovskaya, *The Challenge Of Revolution*, Oxford University Press, 2001. Vladimir Mau, a leading participant in Russian reforms over the last decade, is currently Head of the Government's Working Centre For Economic Reform. Irina Starodubrovskaya is Deputy Director of the Foundation For Enterprise Restructuring and Financial Institutions. This major treatise into the process of revolution, both past ones and with a particular focus on Russia in the 1985-2000 period, is likely to become a new benchmark and focal point for the discussion into Russian affairs and the process of economic reforms. The conclusions and insights arising from Mau and Starodubrovskaya's work are of direct relevance for the current debate and understanding of the

pursued, chances are perceptions of Russia will undergo changes in a more positive direction.

Figure 10. Russia – Economic Policy Road Map Up To The Duma Summer Recess 2001: Selected Issues

During April	The 2010 **long-term economic strategy** is submitted to President Putin for possible codification through a presidential decree.
Week of April 16	Final compromise and consultation work on reaching a **UES restructuring pr**ogram, to be presented to President Putin.
April 16	Ministry of Finance collegium, including President Putin, to discuss the project of **a new debt management system**.
April 17	The 2nd meeting of the Presidential National Council For Pension Reforms, the main vehicle for formulating and drafting the Russian **pension reform** project.
April 18	Second Duma reading of the three legal amendments making up the so-called "IMF package" of **bank restructuring reforms,** to be also approved in a third reading May-June.
April 19	The government to discuss and approve the 2002-04 macroeconomic action plan, as well **as a new Land Code**.
April 22	The UES restructuring working group to present to President Putin a unified, compromise program for **UES restructuring**. The final political decision to proceed from here is expected on May 16.
April 25/26	Prime Minister Kasyanov to meet the Duma leaders and parties to discuss the process of **pursuing the government's prioritized legal initiatives** through the parliament, and to outline the main initiatives in May-June, and what initiatives are to be expected for the autumn session.
April 27	The Ministry for Economic Development and Trade to present to the government **the amended macroeconomic assumptions to be used as a basis for the 2002 budget, and for the 2002-2004 macroeconomic action plan**. The base case scenario used will be a conservative variant, taking into account less favorable external and domestic conditions.
During second half of April/early May	Changes to **the Civil-Process Code** in a first Duma reading, as well as a new law on the status of the courts in a first Duma reading.
During April, May and June	First and possibly second readings of the three legal initiatives making up the first package of so-called **business de-regulatory and de-bureaucratization reforms**.
During late April, May and June	Second and third Duma reading **of the new profit tax**, as well as three Duma readings of the new tax on natural resource extraction.
May 1	By May 1, **a new Land Code** to be submitted to the Duma.
May 8	The Ministry of Finance to submit **a first draft fiscal plan up to and including year 2004**, based on the macroeconomic assumptions part of the 2002-2004 economic action plan.
May 10	The government to have prepared drafts of the necessary legal initiatives needed in order to realize the **pension reform** project, as approved by the Presidential National Council For Pension Reforms in April.
May 16	Final **political decision on the UES restructuring** process expected to be taken.
May 17	The Ministry for Economic Development and Trade (and relevant ministries) to **submit the central macroeconomic forecasts for the 2002-04 perio**d, together **with the central parameters of the 2002 budget as well as the 2003-04 budgets**.
May 23	A new concept of **fiscal federalism and intra-budgetary relations** to be discussed by the government, as part of the ongoing expenditure and fiscal restructuring work.
May 24	The government to discuss the main parameters of **the 2002 budget**.
During May	Prime Minister Kasyanov to conclude a plan for **a government restructuring** and submits to the President for implementation. This restructuring concerns mainly the structure and efficiency of the government and ministries, and is not primarily about personnel changes.
End-May/early-June	The Ministry of Finance concludes **an inventory of the Russian Federation's financial assets and liabilities**, and submits the report to the government.
End-May	The **pension reform legal initiatives** to be submitted to the Duma.
By July 1	**Targets**: the new profit tax and the new tax on natural resource extraction approved in all three Duma readings, one Federation Council reading and signed by President Putin, the package of business de-regulatory reforms approved in two or three Duma readings, the new Land Code approved in one Duma reading.
By mid-July	Special presidential Gazprom working group to present measures for **a phased liberalization of Gazprom share markets**, leading to its eventual unification.

Source: The Russian government, the Ministry of Finance, the State Duma, SSSB.

future evolution of Russian reforms. To mention just a few key points, Mau and Starodubrovskaya outlines how the revolutionary phase of Russian developments in the 1990s have now transited to a post-revolutionary stage, where Russia will gradually embark along the path of more evolutionary changes. In this process, moves to strengthen a weakened state should be seen as a natural ingredient. Furthermore, historical analysis indicates that stable economic growth can only be reached as the process moves into this post-revolutionary stage. Having this said, it does not mean Russia's continued reform path will be smooth or simple, it means that the challenges and constraints will be different, and one of the key such challenges will be how Russia establishes itself in the context of the current globalized international economy.

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