

**RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES**  
**February 2004**

**MONTHLY BULLETIN**

**Moscow**  
**2004**

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## **On the progress of reforms in February of 2004**

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February proved to be uneventful as concerns the progress of reforms, since it may be considered as a lull before the “storm” of reformist activities in April – exactly in this month it is planned to introduce the majority of legislative initiatives worked out by the “Shuvalov group” and the Center of strategic development of legislative initiatives.

At the same time, February witnessed a number of events, which were rather important for the further development of the Russia’s economy. First of all, it concerns the discussion of draft Forestry and Water Codes prepared by the joint working group of the Ministry of Economic Development and the RF Ministry of Natural Resources with participation of the Center of strategic development. The drafts envisage introduction of private ownership of forests and isolated water objects and introduce new structures of public management and new principles of economic relations in these spheres. The drafts are both radical in the good sense of the word, and have chances to be approved during the spring session of the Duma. At least, the discussion of these projects with participation of regions, which took place in the Ministry of Economic Development, as well as the discussion of the draft of the Water Code in the government demonstrated that there have been no irreconcilable or principal disagreements yet.

In the case these draft Codes are approved, there appears an opportunity to establish order in the sphere of utilization of natural resources, make forests and water real factors of economic development, and realize their potential competitive advantages.

In February, a certain attention was paid to the development of the financial infrastructure and the system of financial mediation. The State Duma of the Federal Assembly of the Russian Federation passed in the third reading the draft federal law envisaging that recovery of outstanding debts of professional market operators should not be applied to money funds of their clients in separate accounts.

In February of 2004, the President of the Russian Federation signed the federal law envisaging amendments to the law “On mortgage (pledge of real estate),” which would withdraw farm lands from the list of lands not subject to mortgage.

Certain progress was observed in the reform of the housing and public utilities sphere. The resolution of the Government of the Russian Federation adopted in February of 2004 approved the basic principles of price determination in the sphere of housing and public utilities, which set forth the key principles and methods of price determination as concerns services related to maintenance and repairs of housing, lease of residential housing and tariffs on communal services, as well as the rules governing regulation and application of such prices and tariffs.

In the sphere of management of the state owned property, in February of 2004 there was adopted the resolution of the Government of the Russian Federation “On creation, reorganization, and liquidation of federal state agencies,” which established that decisions on creation, reorganization, and liquidation of federal state agencies should be taken by the Government of the Russian Federation. In accordance with the resolution, the charters of federal state agencies should envisage the prohibition of transactions, which may result in alienation or encumbrance of property assigned to such an agency, the exclusive list of functions (types of activities) performed by the agency, etc.

The Government declared integration with CIS member countries as its priority in the sphere of foreign economic policy. In February of 2004, the President of the Russian Federation presented for ratification in the State Duma of the Federal Assembly of the Russian Federation the agreement on the formation of the common economic space signed in Yalta on September 19, 2003.

In February of 2004, the Government of the Russian Federation adopted the resolution approving the rules of transfer of pension savings for financing of the cumulative component of labor pensions from a non-state pension fund to another non-state pension fund, or from a non-state pension fund to the Pension Fund of the Russian Federation and determination of their value, as well as Model insurance rules of non-state pension funds engaged in mandatory pension insurance activities.

There was continued work on enhancement of effectiveness of expenditures of the federal budget, tightening of financial discipline, and creation of the environment for rehabilitation of state and municipal finances in subjects of the Russian Federation. The Government of the Russian Federation by its resolution adopted in February of 2004 approved the Rules of granting of budget loans for liquidation of temporary cash gaps from the federal budget to budgets of RF subjects.

*O. Fomichev*

## The State of the Federal Budget

In 2003, the revenues of the state budget (cash execution) made 19.4 per cent of GDP, while expenditures made 17.7 per cent of GDP (see Table 1). Therefore, the federal budget surplus made 1.7 per cent of GDP.

*Table 1*

### The monthly execution of the federal budget of the Russian Federation (in % of GDP<sup>1</sup>, cash execution).

	XI'02	XII'02	I'03	II'03	III'03	IV'03	V'03	VI'03	VII'03	VIII'03	IX'03	X'03	XI'03	XII'03
Revenues														
Profits tax	1.6%	1.6%	1.2%	1.1%	1.4%	1.5%	1.4%	1.4%	1.4%	1.3%	1.3%	1.3%	1.3%	1.3%
Income tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Unified social tax (UST)	3.1%	3.1%	2.4%	2.7%	2.8%	2.9%	2.9%	2.8%	2.8%	2.8%	2.7%	2.7%	2.6%	2.7%
Indirect taxes	8.9%	8.9%	11.2%	10.1%	9.9%	9.6%	9.6%	9.2%	9.1%	8.9%	8.7%	8.6%	8.5%	8.5%
VAT	6.9%	6.9%	8.5%	7.4%	7.2%	7.2%	7.2%	6.9%	6.9%	6.8%	6.7%	6.6%	6.6%	6.6%
Excises	1.9%	2.0%	2.7%	2.7%	2.6%	2.4%	2.3%	2.2%	2.2%	2.1%	1.9%	1.9%	1.9%	1.9%
Taxes on foreign trade and foreign economic transaction	2.9%	3.0%	3.4%	3.4%	3.4%	3.5%	3.5%	3.4%	3.4%	3.4%	3.3%	3.3%	3.4%	3.4%
Other taxes, fees and levies	2.1%	2.1%	0.5%	1.7%	2.0%	2.2%	2.1%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Total taxes and other payments **	18.5%	18.6%	18.8%	19.0%	19.4%	19.6%	19.4%	18.8%	18.7%	18.4%	17.9%	17.9%	17.9%	18.0%
Non-tax revenues	1.4%	1.4%	17.5%	8.5%	1.3%	1.2%	1.7%	1.6%	1.5%	1.5%	1.4%	1.4%	1.3%	1.3%
Total revenues	20.1%	20.1%	20.8%	20.6%	20.9%	21.0%	21.3%	20.6%	20.4%	20.0%	19.5%	19.4%	19.3%	19.4%
Expenditures														
State administration	0.4%	0.5%	0.3%	0.3%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.5%
National defense	2.5%	2.7%	1.5%	2.1%	2.6%	2.7%	2.7%	2.6%	2.6%	2.6%	2.5%	2.5%	2.5%	2.7%
International activity	0.3%	0.3%	-0.3%	0.0%	0.2%	0.2%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Judicial authorities	0.2%	0.2%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Legal protection and security	1.5%	1.7%	1.1%	1.4%	1.7%	1.7%	1.7%	1.8%	1.7%	1.7%	1.7%	1.7%	1.7%	1.9%
Fundamental research	0.3%	0.3%	0.1%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Services to national economy	1.3%	1.5%	0.2%	0.4%	0.5%	0.6%	0.7%	0.8%	0.8%	0.8%	0.9%	0.9%	0.9%	1.1%
Social services	5.6%	5.6%	1.5%	1.8%	2.0%	2.3%	2.2%	2.2%	2.2%	2.2%	2.1%	2.1%	2.1%	2.3%
Government debt servicing	2.0%	2.0%	1.7%	2.9%	3.0%	2.3%	2.1%	2.0%	1.8%	2.0%	2.0%	1.8%	1.7%	1.7%
Other expenditures	3.9%	3.8%	6.6%	7.1%	7.0%	7.0%	7.1%	7.1%	7.1%	7.0%	6.9%	6.8%	6.8%	6.9%
Total expenditures	18.0%	18.7%	12.7%	16.4%	17.7%	17.7%	17.7%	17.5%	17.4%	17.3%	17.1%	16.8%	16.7%	17.7%
Surplus (+) / deficit (-)	2.1%	1.4%	8.1%	4.2%	3.2%	3.3%	3.6%	3.0%	3.0%	2.7%	2.5%	2.6%	2.6%	1.7%
Internal financing	-0.2%	0.6%	-6.6%	-1.7%	-1.0%	-1.0%	-0.5%	0.3%	0.0%	0.3%	0.2%	-0.1%	-0.3%	0.5%
External financing	-1.9%	-2.0%	-1.4%	-2.5%	-2.2%	-2.3%	-3.1%	-3.3%	-3.0%	-2.9%	-2.7%	-2.5%	-2.3%	-2.2%
Overall financing	-2.1%	-1.4%	-8.1%	-4.2%	-3.2%	-3.3%	-3.6%	-3.0%	-3.0%	-2.7%	-2.5%	-2.6%	-2.6%	-1.7%

\* В % ВВП; \*\* ЕСН включен в налоговые доходы

As compared with the figures registered in 2002, the budget revenues decreased by 0.7 p. p. of GDP in 2003, while expenditures decreased by 1.0 p. p. and budget surplus respectively increased by 0.3 p. p. of GDP. At the same time, without SST the budgetary revenues decreased by 0.3 p. p. of GDP and made 16.7 per cent of GDP. VAT accounted for the major share of federal tax revenues – 36.7 per cent of the total tax revenues what is practically at the level observed in the respective period of 2002.

<sup>1</sup> Because of the estimated data on GDP, the indices may be subject to revision.

According to preliminary estimates, the cash execution of federal budget revenues made 20.9 per cent of GDP in January of 2004, what is by 0.1 p. p of GDP above the respective level observed in January of 2003. At the same time, the cash execution of expenditures made 11.1 per cent of GDP (12.7 per cent of GDP in 2003); therefore, in January of 2004, according to preliminary data, the surplus made 9.8 per cent of GDP.

According to the preliminary estimates of the Finance Ministry, in terms of fulfilled funding<sup>2</sup> the expenditures of the federal budget in January of 2004 made 15.6 per cent of GDP (see Table 2), while in January of 2003 this indicator was at 16.8 p. p. of GDP. In January of 2004, the amount of revenues of the federal budget increased by 0.1 per cent of GDP in comparison with the figures registered in January of 2003 and made 20.9 per cent of GDP. Therefore, the surplus of the federal budget in terms of fulfilled funding in January of 2004 increased by 1.3 p. p. in comparison with the figures registered in January of 2003 and made 5.3 per cent of GDP.

Table 2.

**The monthly execution of the federal budget of the Russian Federation  
(in % GDP, fulfilled funding).**

	I'03	II'03	III'03	IV'03	V'03	VI'03	VII'03	VIII'03	IX'03	X'03	XI'03	XII'03	I'04
Total expenditures	20.8%	20.6%	20.9%	21.0%	21.3%	20.6%	20.4%	20.0%	19.6%	19.5%	19.4%	19.4%	20.9%
State administration	0.5%	0.6%	0.6%	0.6%	0.6%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%	0.6%
National defense	2.5%	3.1%	3.3%	3.2%	3.1%	3.0%	2.9%	2.8%	2.7%	2.8%	2.9%	2.7%	2.7%
International activity	-0.2%	0.1%	0.2%	0.3%	0.3%	0.3%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%	-0.1%
Judicial authority	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Legal protection and security	1.9%	2.2%	2.3%	2.2%	2.2%	2.1%	2.0%	1.9%	1.9%	1.9%	1.9%	1.9%	2.1%
Fundamental research	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Services to national economy	0.6%	0.8%	0.9%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.1%	1.1%	0.5%
Social services	2.5%	2.7%	2.7%	2.9%	2.7%	2.6%	2.5%	2.4%	2.3%	2.3%	2.4%	2.3%	2.5%
Government debt servicing	1.7%	2.9%	3.0%	2.3%	2.1%	2.0%	1.8%	2.0%	2.0%	1.8%	1.7%	1.7%	1.1%
Other expenditures	6.8%	7.5%	7.3%	7.2%	7.4%	7.3%	7.2%	7.2%	7.0%	6.9%	6.9%	7.0%	5.8%
Total expenditures	16.8%	20.5%	20.9%	20.2%	19.9%	19.2%	18.8%	18.6%	18.3%	18.0%	18.1%	17.8%	15.6%
Surplus (+) / deficit (-)	4.0%	0.2%	0.0%	0.8%	1.4%	1.3%	1.6%	1.3%	1.3%	1.5%	1.3%	1.6%	5.3%

According to the estimates of the Revenue Ministry, in January of 2004 tax revenues of the federal budget made about Rb. 125.5 billion (without the single social tax). In real terms the revenues made 266.5 per cent of the level registered in January of 1999, while the respective indicator was at 230.0 per cent in 2003 and 218.7 per cent in 2002 (see Table 3).

It should be noted that in January of 2004 the revenues generated by the single social tax made Rb. 24.0 billion. Thus, in December of 2003 the RF Revenue Ministry transferred to the federal budget taxes and fees amounting to about Rb. 150 billion.

Table 3.

**Actual tax revenues to the federal budget, according to the data of the MTC  
(in % of the data for January of 1999)<sup>3</sup>.**

1999											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
100,0%	115,1%	122,0%	122,1%	104,5%	112,9%	127,0%	127,5%	124,3%	141,4%	160,8%	213,1%
2000											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
149,3%	160,5%	181,3%	205,8%	233,1%	186,9%	181,0%	186,4%	173,1%	181,1%	201,7%	254,1%

<sup>2</sup> The execution of the budget in terms of fulfilled (actual) financing is equal to the sum of the funds transferred to managers of budget funds, while the cash execution of the budget is equal to the sum of funds spent by managers of funds (i.e. without account of funds remained on their accounts).

<sup>3</sup> It was decided to choose January of 1999 as the benchmark in order to render the comparison more reliable. January of 1999 is not a remarkable date in terms of tax revenues.

2001											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
204,4%	198,4%	227,6%	267,5%	252,2%	233,3%	231,9%	235,6%	219,4%	237,5%	247,3%	360,6%
2002*											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
218,7%	187,1%	234,8%	277,8%	239,6%	218,0%	284,4%	246,5%	254,8%	299,7%	241,0%	250,2%
2003*											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
230,0%	229,2%	265,5%	280,4%	233,2%	240,0%	260,4%	242,6%	248,7%	265,6%	231,0%	247,9%
2004*											
I											
230,0%											

\* Without UST.

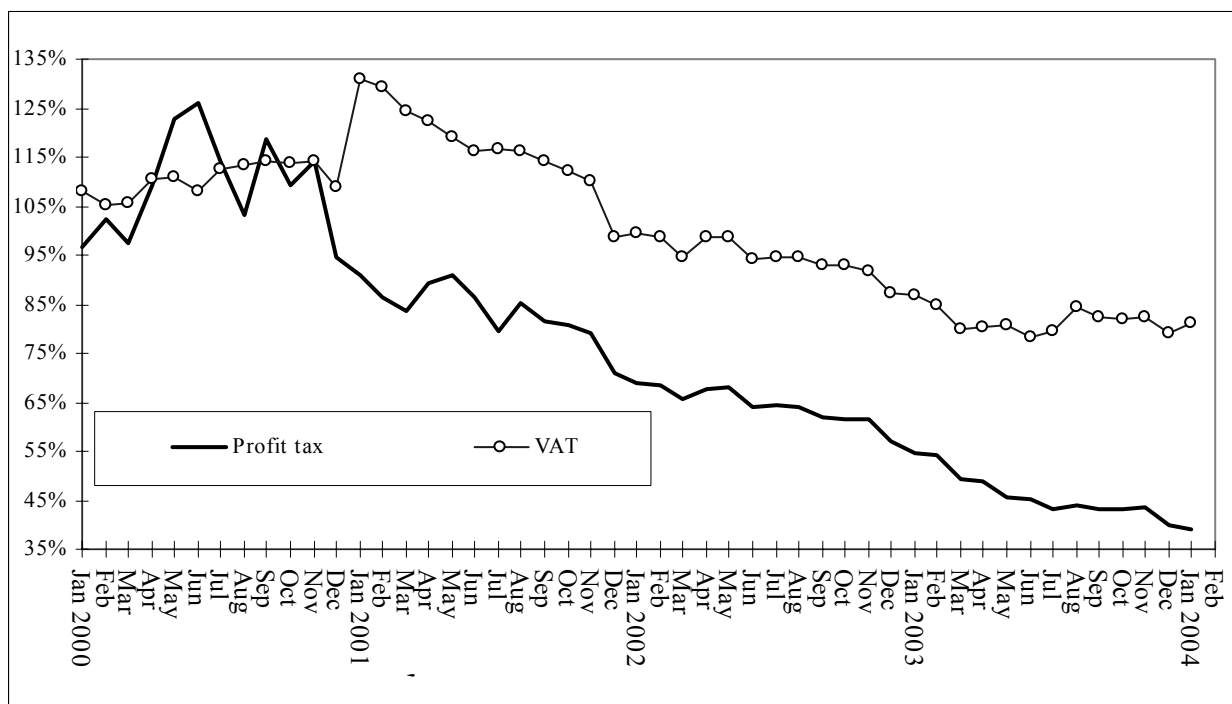


Figure 1. Rate of change in the real tax arrears to the federal budget (in % to June of 1999)

The dynamics of real arrears relating to major taxes since January of 2000 are presented in Fig. 1. The debts related to the payments due to the federal budget made for VAT Rb. 255.5 billion as on February 1, 2004, increasing by Rub. 11.9 billion in January of 2004, while the arrears of the profit tax increased only by Rub. 22 million and therefore remained at about the level of Rub. 26.4 billion. On the whole, a gradual decrease in the level of accumulated arrears observed since early 2001 to the second half of 2003 was replaced by the stabilization of the level of accumulated indebtedness as concerns both the profit tax, and VAT.

Table 4

**Execution of the RF consolidated budget (in % of GDP).**

1998												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	16,2%	17,4%	18,1%	19,3%	19,7%	19,8%	19,8%	19,4%	18,8%	18,5%	18,6%	19,6%
Revenues	18,8%	20,1%	21,2%	22,4%	23,0%	23,2%	23,2%	22,9%	22,3%	22,0%	22,0%	24,5%
Expenditures	25,3%	23,8%	27,0%	28,1%	28,6%	29,5%	29,4%	28,6%	27,4%	26,9%	27,1%	29,5%
Deficit	-6,5%	-3,7%	-5,8%	-5,7%	-5,7%	-6,3%	-6,2%	-5,7%	-5,2%	-5,0%	-5,0%	-5,1%

1999												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	16,8%	16,6%	18,1%	19,9%	20,1%	20,5%	20,8%	20,8%	20,3%	20,2%	20,9%	22,1%
Revenues	19,2%	18,9%	20,6%	22,7%	23,2%	23,9%	24,3%	24,5%	24,1%	24,0%	24,8%	26,3%
Expenditures	18,6%	20,3%	23,6%	25,6%	26,6%	27,3%	27,4%	27,4%	26,7%	26,3%	26,7%	29,2%
Deficit	0,6%	-1,5%	-3,1%	-3,0%	-3,4%	-3,4%	-3,1%	-2,9%	-2,7%	-2,3%	-1,9%	-2,9%
2000												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	20,8%	21,4%	22,6%	24,2%	25,5%	25,4%	24,9%	24,8%	24,1%	23,7%	24,0%	24,6%
Revenues	24,4%	24,8%	26,4%	28,2%	29,7%	29,7%	29,3%	29,2%	28,4%	28,0%	28,6%	30,0%
Expenditures	19,6%	21,1%	23,8%	24,8%	25,2%	25,5%	22,3%	25,1%	24,5%	24,2%	24,6%	27,0%
Deficit	4,7%	3,7%	2,6%	3,4%	4,5%	4,3%	7,0%	4,1%	3,9%	3,8%	4,0%	3,0%
2001												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	22,7%	23,6%	23,9%	25,4%	26,4%	26,0%	26,1%	25,9%	25,0%	24,8%	25,4%	27,1%
Revenues	25,9%	27,1%	27,4%	29,3%	30,5%	29,8%	29,9%	29,7%	28,3%	28,2%	28,8%	29,5%
Expenditures	16,8%	22,8%	23,7%	24,7%	25,1%	25,3%	25,5%	25,6%	24,9%	24,7%	25,0%	25,6%
Deficit / surplus	9,1%	4,2%	3,7%	4,7%	5,4%	4,4%	4,4%	4,1%	3,5%	3,5%	3,8%	3,9%
2002												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	28,7%	23,6%	24,3%	26,5%	26,6%	25,9%	26,4%	25,9%	25,2%	25,4%	25,4%	25,5%
Revenues	32,9%	31,3%	31,4%	33,6%	33,6%	32,7%	33,3%	32,5%	31,7%	32,0%	32,1%	32,1%
Expenditures	18,3%	23,7%	26,0%	28,4%	28,4%	28,8%	29,1%	28,9%	28,4%	29,3%	29,7%	31,1%
Deficit / surplus	14,6%	7,7%	5,4%	5,3%	5,2%	3,8%	4,2%	3,7%	3,3%	2,7%	2,4%	1,0%
2003												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	25,6%	24,4%	25,6%	27,4%	27,1%	26,0%	26,1%	25,7%	26,0%	25,0%	25,1%	25,2%
Revenues	32,0%	30,3%	31,5%	33,4%	33,6%	32,2%	32,2%	31,6%	31,9%	30,8%	30,7%	31,1%
Expenditures	20,7%	25,3%	27,7%	28,8%	28,8%	28,6%	28,7%	28,5%	28,2%	27,8%	27,9%	29,7%
Deficit / surplus	11,3%	5,0%	3,8%	4,5%	4,7%	3,5%	3,6%	3,1%	3,7%	2,0%	2,8%	1,4%

\* without USC

The revenues of the consolidated budget in 2003 made 31.1 per cent of GDP, including tax revenues (without SST) at 25.2 per cent of GDP (see Table 4). Expenditures of the consolidated budget decreased by 1.4 p. p. of GDP in comparison with the figures registered in 2002 and made 29.7 per cent of GDP. As on January 1, 2004, the surplus of the consolidated budget made 1.4 per cent of GDP, what is by 0.4 p. p. of GDP above the level observed in 2002.

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## **Military and related expenditures of the federal budget in 2004**

As concerns the federal budget for year 2004 (FB-04), the bulk of military expenditures in the RF concentrates in the section "National Defense," several subsections of "Law Enforcement and State Security" section, and a number of other subsections and targeted budget items. It is planned to earmark Rub. 411.5 billion (2.7 per cent of GDP, or 15.5 per cent of FB-04) for the "National Defense" section (Table 1). Expenditures in the section of "Law Enforcement and State Security" (Table 2) should make Rub. 310.6 billion (2 per cent of GDP, or 11.7 per cent of FB-04), however, a considerable part of these expenditures is not related to military outlays. The expenditures in this section, which may be defined as military outlays, since they are targeted to deter threats to the national and military security of the Russian Federation by military methods, would insignificantly exceed Rub. 100 billion.

As concerns the amount of expenditures, the major item of the "National Defense" section is the "Development and maintenance of RF Armed Forces," while the special item "Military Reform," recently introduced in the federal budget, mainly contains expenditures for the settlement of housing and other problems of servicemen dismissed from the RF military organization. It should be noted that these outlays

also diminish, what confirms the Defense Ministry statement about transition to the state of planned military development precluding large scale reductions of the strength of the military organization characteristic of the stages of reform.

The 11 per cent growth in money allowances of servicemen is in fact the compensatory bonus introduced in October of 2003 in order to adjust the pay for the last year inflation. Since the early 2004, a significant growth in money allowances (by Rub. 3 to 5 thousand and more) was registered only with respect to the persons serving on the contractual basis and in military units on permanent combat alert, who received the monthly pay rise, and those serving in the Chechen Republic, where there were increased daily allowances.

Table 1

**Direct military expenditures of the federal budget, the “National Defense” section**

No.	Sections and subsections	Code	Amount in FB-04 (Rub. mil.) / Same in prices of 2003	Difference between expenditures of FB-04 and FB-03 (Rub. mil.) and increment in expenditures (in %)	Share / change in share in comparison with FB-03 in %	
					In relation to FB-04	In relation to GDP
1	National defense	0400	<u>411 473</u> 367 386	<u>12 479</u> 3,40	<u>15,47</u> 0,77	<u>2,69</u> 0,01
1.1	Development and maintenance of RF Armed Forces	0401	<u>389 402</u> 347 680	<u>11 202</u> 3,22	<u>14,64</u> 0,71	<u>2,55</u> 0,01
1.2	Military program of the RF Ministry for Nuclear Energy	0402	<u>16 826</u> 15 024	<u>2 012</u> 13,39	<u>0,63</u> 0,09	<u>0,11</u> 0,01
1.3	Ensuring mobilization and extra-military preparedness	0403	<u>4 687</u> 4 185	<u>15</u> 0,36	<u>0,18</u> 0,00	<u>0,03</u> 0,00
1.4	Preparation of and participation in ensuring collective security and peace making activities	0404	<u>215</u> 192	<u>-703</u> -366,44	<u>0,01</u> -0,03	<u>0,00</u> -0,01
1.5	Ensuring the operation of national defense related industries	0407	<u>343</u> 306	<u>-47</u> -15,24	<u>0,01</u> 0,00	<u>0,00</u> 0,00

Table 2

**Direct and indirect military expenditures, other sections of the federal budget**

No.	Sections and subsections	Code	Amount in FB-04 (Rub. mil.) / Same in prices of 2003	Difference between expenditures of FB-04 and FB-03 (Rub. mil.) and increment in expenditures (in %)	Share / change in share in comparison with FB-03 in %	
					In relation to FB-04	In relation to GDP
2	Expenditures for the military organization included in item “Law Enforcement and State Security”					
	Total expenditures for law enforcement and state security, <i>including</i> :	0500	<u>310 577</u> 277 301	<u>27 502</u> 9,92	<u>11,68</u> 1,33	<u>2,03</u> 0,14
2.1	Troops of the RF Interior Ministry	0502	<u>21 531</u> 19 224	<u>1</u> 0,01	<u>0,81</u> 0,01	<u>0,14</u> 0,00
2.2	State security agencies	0505	<u>49 737</u> 44 408	<u>-3 768</u> -8,48	<u>1,87</u> -0,13	<u>0,33</u> -0,04
2.3	Border Service (agencies and troops)	0506	<u>29 993</u> 26 779	<u>580</u> 2,17	<u>1,13</u> 0,04	<u>0,20</u> 0,00
3	Military expenditures included in other sections of the Federal Budget					
3.1	Maintenance, military training, and logistics of MES	1302	<u>215</u> 192	<u>-703</u> -366,44	<u>0,01</u> -0,03	<u>0,00</u> -0,01



	forces (troops) (without fire service)					
3.2	Federal special construction service of the RF	0710	<u>1 089</u> 972	<u>-55</u> -5,69	<u>0,04</u> 0,00	<u>0,01</u> 0,00
3.3	Mobilization preparedness of the economy	2300	<u>1 100</u> 982	<u>482</u> 49,09	<u>0,04</u> 0,02	<u>0,01</u> 0,00
3.4	Civil defense	1303	<u>67</u> 60	<u>-7</u> -12,00	<u>0,00</u> 0,00	<u>0,00</u> 0,00
3.5	Military reform	2501	<u>7 246</u> 6 469	<u>-11 185</u> -172,89	<u>0,27</u> -0,46	<u>0,05</u> -0,09
3.6	Russian Defense Sports and Technical Organization (RDSTO)	0464	<u>18</u> 16	<u>-43</u> -266,55	<u>0,00</u> 0,00	<u>0,00</u> 0,00

However, taking into account the actual inflation rates (12 per cent in 2003), the growth in the total amount of military expenditures in comparison with the indicators of the federal budget as adjusted for inflation in the end of 2003 was less significant than the official figures published by the Defense Ministry: as concerns the “National Defense” section, it was not 1.16 times, but approximately 1.03 times (1.06 times in comparison with the amount shown in the first draft of the last year federal budget). At the same time, the expenditures included in the section “Law Enforcement and State Security” were increased in comparable prices by almost 10 per cent (for the data on the dynamics of expenditures over several years, see Table 3).

Table 3

#### Dynamics of expenditures for defense and security in 1999 through 2004

Sections of the Federal Budget	Years					
	1999	2000	2001	2002	2003	2004
Expenditures listed in the section “National Defense”	<u>93</u>	<u>140</u>	<u>214</u>	<u>281</u>	<u>354</u>	<u>411</u>
(in prices of the budget year / in prices of 1999), Rub. mil.	<u>702</u>	<u>852</u>	<u>688</u>	<u>970</u>	<u>907</u>	<u>473</u>
Increase in relation to the preceding year, %	—	25,1	28,5	15,2	10,1	3,4
<b>Increase in relation to 1999, %</b>	—	<b>25,1</b>	<b>60,7</b>	<b>85,2</b>	<b>103,8</b>	<b>110,7</b>
Expenditures listed in section “Law Enforcement and State Security (in prices of the budget year / in prices of 1999), Rub. mil.	<u>51</u>	<u>79</u>	<u>131</u>	<u>165</u>	<u>249</u>	<u>310</u>
Increase in relation to the preceding year, %	—	29,4	39,1	10,6	32,8	9,9
<b>Increase in relation to 1999, %</b>	—	<b>29,4</b>	<b>79,9</b>	<b>99,0</b>	<b>164,2</b>	<b>190,4</b>

On the face of it, as concerns the military and related expenditures of the RF federal budget for 2004, the priority is given to the components of the RF military organization intended to deter domestic military threats and terrorism. However, in fact (see Table 2), this growth occurred in items not related to the military organization. On the contrary, in the “military” subsections there was registered a decline, what, in the light of the current war against terrorism, should indicate that the priority is given to non-military methods.

The analysis of indirect military expenditures of the federal budget related to the current (see Table 2) and previous (see Table 4) military activities revealed that in 2004 they considerably decreased in comparable prices. Most probably, this development is a consequence of the marked government policy towards reduction of budget expenditures – it should be noted that in November of 2003, military pensions were already reduced by more than Rub. 5 billion. The same policy seems to account for the caps on food and clothing allowances of servicemen introduced in FB-04 (items 102 and 103).

On the whole, the aggregate indicators of military and related expenditures (see Table 5) confirm the trends towards growth indicated above. However, it should be noted that in spite of the fact that these amounts make significant shares of expenditures both in FB-04 (Rub. 2659 billion) and estimated GDP of 2004 (Rub. 15300 billion), the budget expenditures of the core agency of the RF military organization, the Defense Ministry (Rub. 471 billion) will make 77 per cent of the total direct and indirect military expenditures of the federal budget (90 per cent of the total direct military expenditures). No doubt that ideally this indicator should be close to 100 per cent, however, many obstacles should be overcome to reach this ideal.

Table 4

**Indirect military expenditures related to previous military activities**

No.	Sections and subsections	Code	Amount in FB-04 (Rub. mil.) / Same in prices of 2003	Difference between expenditures of FB-04 and FB-03 (Rub. mil.) and increment in expenditures (in %)	Share / change in share in comparison with FB-03 in %	
					In relation to FB-04	In relation to GDP
4.1	Military pensions	1804	<u>66 606</u> 59 470	<u>-3 129</u> -5,26	<u>2,50</u> -0,09	<u>0,44</u> -0,04
4.2	Utilization and liquidation of armaments, including the fulfillment of international obligations	2200	<u>10 365</u> 9 254	<u>-1 506</u> -16,27	<u>0,39</u> -0,06	<u>0,07</u> -0,01
4.3	Conversion of defense industries	0704	<u>190</u> 170	<u>-80</u> -47,37	<u>0,01</u> 0,00	<u>0,00</u> 0,00
4.4	Financing of the SHC program (in addition to the expenditures set forth in the section "Military reform")	0707	<u>6 806</u> 6 077	<u>551</u> 9,07	<u>0,26</u> 0,03	<u>0,04</u> 0,00

Table 5

**Aggregate indicators of military and related expenditures**

No.	Expenditures	Amount in FB-04 (Rub. mil.)	Share of expenditures in FB-04 in % (share / change in share in comparison with FB-03)	
			In relation to FB-04	In relation to GDP
1	Total direct military expenditures	521 364	<u>19,60</u> 0,73	<u>3,41</u> -0,03
2	Aggregate direct and indirect military expenditures related to the present and past military activity	612 576	<u>23,03</u> 0,15	<u>4,00</u> -0,17
3	Total expenditures for national defense, law enforcement, and state security	722 050	<u>27,15</u> 2,10	<u>4,72</u> 0,16
4	Amount of direct and indirect federal expenditures related to present and past military and law enforcement activity and state security	866 066	<u>32,57</u> 1,69	<u>5,66</u> 0,03

One of the major obstacles to the elaboration and administration of the federal budget with respect to military expenditures has been their secrecy, exceeding all reasonable limits.

In spite of the significant progress in the sphere of transparency of military expenditures discussed in the preceding IET monthly survey, the optimal decisions concerning this issue have not been worked out yet. The degree of transparency of RF military expenditures for domestic experts is much less than for foreign military researchers. Russia annually furnishes foreign organization with the data not only related to aggregate expenditures of the Defense Ministry, but also on the distribution of funds among three components of the Armed Forces, what is not reflected in the budget. Therefore, IET recommended to include the information on the RF military expenditures presented to international organizations in the list of open supplements to the federal budget, what has not been done yet.

The analysis of reports on the administration of the federal budget in 2003 revealed that the declassifying of estimated budgetary expenditures was not extended to the reporting on actual expenditures. For instance, the expenditures for the transformation of the recruitment system of the RF military organization were declassified in the budget of 2003. However, the open quarterly reports published by the Defense Ministry do not present these data. It is impossible to monitor the allocation and utilization of funds at the level of

targeted budget items and sections. The efforts to settle this problem face both organizational and technical difficulties. It seems that since budgeting and reporting are carried out by different departments of the Defense Ministry, it is a reason why it has failed to comply with one of the most important requirements set forth by the RF Budget Code: "Reporting for administration of the budget should be complied in accordance with the same structure and budget classification as was used for approval of the budget" (item 2, Article 272).

It should be also specifically noted the following: as concerns the purposes of detailed civil control over the RF military expenditures, the possibilities to obtain necessary information by further declassifying of the budget in the framework of the current budget classification have been exhausted. The matter is that a more thorough economic analysis is possible only by comparing financial indicators with actual indicators of military statistics (strength of personnel, quantity of armaments and military equipment, military objects, etc.). However, these data are absent even in the classified sections of the RF budget.

As concerns the practices of military budgeting in other countries, there financial and economic indicators are presented in their inseparable totality:

- expenditures for military personnel are supported with the information about its strength as broken down by key categories;
- expenditures for military procurement are substantiated by the information about planned purchases of concrete models of planes, tanks, missiles, etc.;
- expenditures for capital construction are substantiated by the information about airports, bases, residential housing, etc. being in the process of construction;

All this is planned and presented not separately, but in the budget and respective supplements.

As concerns the Russian planning practices, there are separately elaborated and approved, and, therefore, separately classified programs and plans. The state armament program, as well as the state defense procurement, which reached Rub. 341.2 billion in 2004, also are separate acts, which are implemented at the expense of budget funds but are not reflected in the budget. Even the data about the strength of the personnel of the RF military organization are still classified, although it is not the case in other countries' practices. Moreover, such information was published in order to substantiate budget expenditures in the early 1990s, but now it is classified. Therefore it would be feasible to improve the existing system of planning, programming, and budgeting on the whole. However, it is even more serious problem than the issue of declassifying of the federal budget in its present form.

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## **Modeling investment of pension savings on the market of subfederal and municipal bonds**

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In March of 2004, the Pension Fund of the Russian Federation should transfer the pension savings as at the end of 2002 in trust of management companies. Proceeding from the analysis of applications of insured persons, the amount of the said pension savings may be evaluated to make 5 per cent or slightly less of the total amount of insurance contributions in the cumulative component of the labor pension collected by the Pension Fund of the Russian Federation in 2002 and the net result of investment of these amounts. Other 95 per cent of funds should be managed by Vneshekonombank as the state management company. The most recent data published in mass media allow to evaluate the total amount transferred by the Pension Fund of the Russian Federation to make approximately Rub. 51 billion as in the beginning of 2004, therefore these 5 per cent will make, accordingly, about Rub. 2.5 billion<sup>4</sup>.

Below, there will be discussed the question of what influence the transferred funds may have on the market of bonds issued by RF subjects and municipal entities (further referred to as SFB) taking into account the investment restrictions set forth by the federal law "On investment of funds for financing of the cumulative part of the retirement pension in the Russian Federation" and the respective bylaws. According to the said law, only management companies chosen by the insured persons should have the right to invest pension savings in SFB, however, the quantitative limit of the share of such securities in the investment

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<sup>4</sup> In the beginning of 2004 this amount was estimated to make Rub. 50.5 billion, the amount transferred to management companies should make, according to the preliminary estimates, Rub. 2.3 billion, see: *Vedomosti* of February 19, 2004, and *Ekonomika i Vremya* (St. Petersburg) of February 23, 2004.

portfolios of management companies was not set. The respective restrictions were introduced by the RF Government resolution No. 379 of July 30, 2003.

According to the resolution, up to 40 per cent of pension savings may be invested in SFB.

An analysis of investment statements of management companies selected in the course of tenders does not permit to determine the future specifics of their portfolios. SFB was indicated as an object of investment by 52 companies out of 55, however, since some of them stated that these securities would make maximum 20 or 30 per cent of their investment portfolios, there will be made modeling calculations in accordance with two scenarios:

Scenario 1: the aggregate share of investment in SFB made by all management companies will be limited to 20 per cent of the total amount of funds transferred to them, what makes Rub. 0.5 billion;

Scenario 2: management companies will invest in SFB the maximal amount permitted in the first year (40 per cent of the total amount of transferred funds). Therefore, the maximal amount permitted for investment in SFB will make Rub. 1 billion.

According to the requirements set forth by Resolution 379, pension savings entrusted with management companies in SFB should be invested only in securities of those issuers, which are included in quotation listings. However, other requirements in fact limit the list of eligible issuers to the issuers included in the top listing.

SFB are primarily traded at two floors – MICEX and SPCEX. The A1 quotations of MICEX include bonds issued by 11 RF subjects (see Table 1) with the total amount of placement making Rub. 60 billion and municipal bonds of one issuer<sup>5</sup> (the amount of issue makes Rub. 0.7 billion). There dominate bonds issued by the Moscow Government. SPCEX A1 quotations include only the bonds issued by the Finance Committee of the St. Petersburg administration (a number of issues totaling to Rub. 17.06 billion).

Table 1

**Subfederal and municipal bonds included in A1 quotations  
at MICEX and SPCEX as on January 1, 2004**

No.	Issuer	Exchange	Issue, series	Amount of issue (Rub. billion)	Amount of trading in December of 2003 (Rub. million)
<b>Subfederal bonds</b>					
1	Moscow	MICEX	03, 24-33 issues	41	4904.1
2	Moscow oblast	MICEX	1 issue	1.9	256.7
			2 issue	1	64.4
			3 issue	4	244
3	St. Petersburg	SPCEX	OD-43	17.06	979.7
			FK2-FK6, FK-8, FK12-FK15, FK17, FK19-FK25, FK30-FK31, FK33-FK37		
4	Khanty Mansi AO	MICEX	1 issue	1	20.4
			5 issue	3	12.1
5	Finance Ministry of the Republic of	MICEX	4 issue	0.4	39.6
			5 issue	0.5	92.4

<sup>5</sup> Since only municipal bonds issued by one issuer (administration of the city of Ufa) answer the requirements, further municipal bonds are not reviewed as a separate type of assets and are integrated with SFB.

No.	Issuer	Exchange	Issue, series	Amount of issue (Rub. billion)	Amount of trading in December of 2003 (Rub. million)
	Komi		6 issue	0.7	47.8
	Yamal Nenets AO	MICEX	1 issue	1.8	0
7	Republic of Bashkortostan	MICEX	3 issue	0.5	20.3
8	Leningrad oblast	MICEX	1 issue	0.4	33.9
9	Republic of Sakha (Yakutia)	MICEX	10 issue	0.8	86.6
10	Novosibirsk oblast	MICEX	1 issue	1.5	159.6
11	Samara oblast	MICEX	1 tranche	1.185	6.9
12	Khabarovsk krai	MICEX	1 issue	0.3	6.6
	<b>Total</b>			77.05	6975.1
<b>Municipal bonds</b>					
1	Administration of the city of Ufa	MICEX	1 issue	0.3	12.1
			2 issue	0.4	80.5
	<b>Total</b>			0.7	92.6

In the case it is assumed that management companies will invest pension savings on the SFB market gradually, over three months, their share in the amount of trading could make, depending on the scenario, from 2.1 per cent to 2.6 per cent according to scenario 1 and 4.1 per cent to 5.3 per cent according to scenario 2 (see Table 2) proceeding from the actual amounts of trading observed in November and December of 2003 and in January of 2004.

Table 2

**Investment in SFB on the part of the companies selected via tenders  
as broken down by two scenarios**

Month	MICEX turnover, Rub. billion	SPCEX turnover, Rub. billion	Aggregate turnover, Rub. billion	Invested amount, Rub. billion		Investment of MC in % of the aggregate turnover	
				Scenario 1	Scenario 2	Scenario 1	Scenario 2
November 2003	4.88	1.59	6.47	0.17	0.34	2.6	5.3
December 2003	6.09	0.98	7.07	0.17	0.34	2.4	4.8
January 2004	7.42	0.83	8.24	0.17	0.34	2.1	4.1
Mean	6.13	1.13	7.26	0.17	0.34	2.3	4.7

MC - management companies selected via tenders.

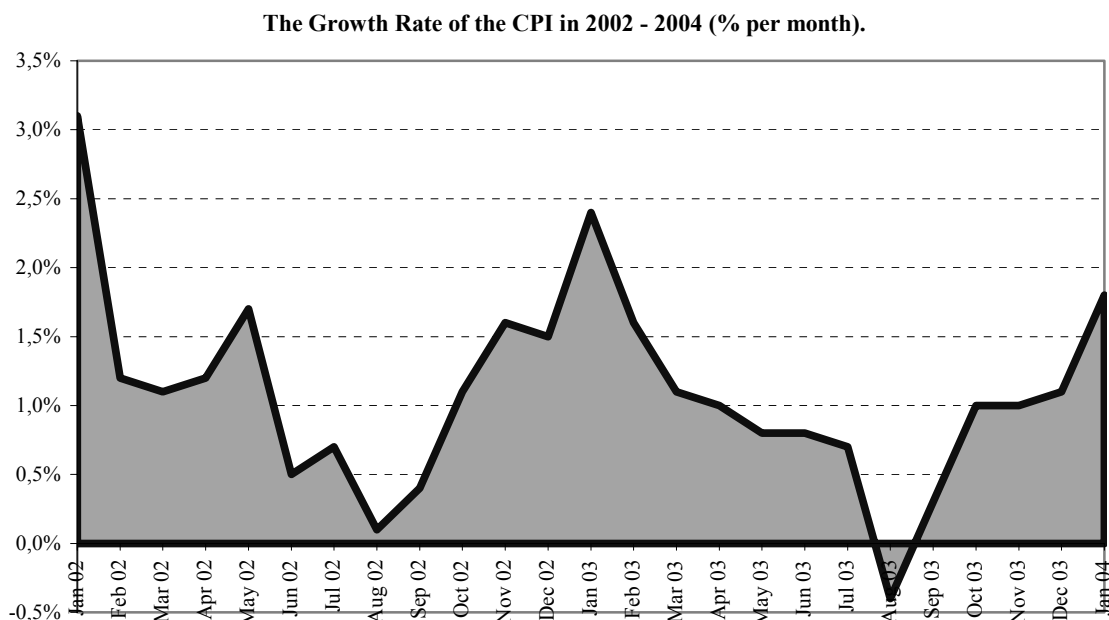
As it is indicated by the results of the modeling calculations, in the case management companies invest the transferred funds in SFB in the maximal possible amount in equal installments over three months, on the average their investment will make less than 5 per cent of the monthly amount of trading with SFB included in A1 quotations at MICEX and SPCEX under the conditions existing in the end of 2003 and the beginning of 2004. It is approximately three times less than in the case the funds were invested in corporate bonds according to a similar scenario and most probably will not cause significant price distortions in this segment. However, in the case the investment of funds is more “concentrated” in terms of time, for instance, if all management companies, which were granted the right to invest pension savings, prefer to invest the maximal permitted amounts over one month, the estimated average percentage may increase, accordingly, to 14 per cent and proceeding from the amounts of trading registered at the stock exchanges before the transfer of

funds, it may be expected that prices in this segment will rise because of the impact of new investors. However, much will depend on the combination of a number of other factors, including the additional placement policies of issuers. Thus, according to the data presented by the general agent for St. Petersburg public borrowing, ABK company, the amount of SFB actually placed by St. Petersburg makes only 58.6 per cent of the registered amount of the issue as concerns the issues included in A1 quotations at SPCEX and, therefore, the issuer can increase the supply of securities on the market at any moment. The turnover on the secondary SFB market are also rather volatile and may both increase and decrease by the moment management companies invest pension savings in this segment of the market.

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## Monetary Policy

In January of 2004, inflation observed on the consumer market made 1.8 per cent as compared with 2.4 per cent registered in January of 2003 (see *Figure 1*). The base consumer price index, which excludes short term volatile changes in prices caused by individual administrative, non-recurrent, and seasonal factors made 100.9 in January. It should be noted that both in January of 2002 and in January of 2004, base inflation rates were twice below the CPI values. In Moscow and St. Petersburg, prices grew by 2.4 per cent and 1.9 per cent respectively in January. It should be reminded that the governmental forecast of inflation rates in RF for 2004 was 8 to 10 per cent, while in 2003 inflation was registered at 12 per cent.



*Figure 1.*

The most significant growth in prices was observed in the group of food products (1.5 per cent), while prices of paid services increased at a more moderate rate (0.9 per cent), what was by 3.5 percentage points below the figure registered in January of 2003. Non-food goods went up in prices by merely 0.5 per cent in January of 2004.

In January of 2004, the rates of growth in the CPI were by 25 per cent below the value of this indicator registered in the respective period of the preceding year. In January of 2003, the rates of growth in the consumer price index were by 22 per cent below the respective growth rates observed in January of 2002. Therefore, according to the Goskomstat estimates, consumer prices have declined more actively since early 2004 as it was observed in 2003.

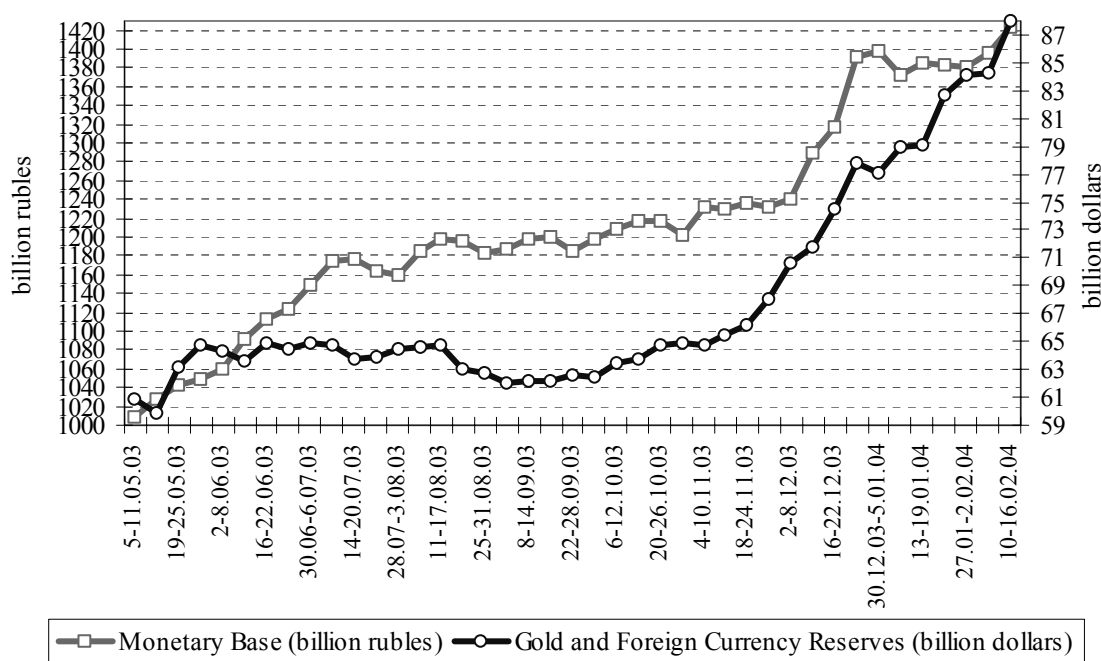
According to the authors' evaluations, in February the growth in consumer prices did not exceed 1.2 to 1.4 per cent.

In January of 2004, the amount of gold and foreign exchange reserves of the Bank of Russia increased by 9.2 per cent (see *Fig. 2*). In the first two weeks of February, the gold and foreign exchange reserves grew

further by 4.8 per cent, thus reaching the next historical maximum of US \$ 88 billion. It should be noted that in the beginning of February there was observed the maximal weekly rate of growth in gold and foreign exchange reserves over the whole time of monitoring: in the period from February 6 till February 13, they increased from US \$ 84.3 billion to US \$ 88 billion, or by US \$ 3.7 billion (+ 4.4 per cent). Such high rates of growth in gold and foreign exchange reserves of the Bank of Russia were primarily caused by massive Ruble interventions by the RF CB on the forex market aimed at the support of the US \$ exchange rate, what became necessary due to the fact that the forex market was flooded with considerable amounts of forex denominated export proceeds in the situation of high world prices of energy resources. Thus, early in February, the Bank of Russia had to purchase more than US \$ 3 billion on the forex market in one day, what is a highest value registered over the whole history of trade at the Russian forex exchange.

In January of 2004, the monetary base of the Russian Federation in the broad definition<sup>6</sup> increased by 3 per cent in comparison with the figures registered in December of 2003 and made RUR 1971.5 billion as on February 1, 2004. In February, the amount of cash in circulation (as adjusted for cash balances of crediting organizations) made RUR 1194.3 billion, or was by 2.5 per cent below the level registered in December of 2003. The amount of accounts of crediting organizations with the Central Bank of Russia diminished by 12.3 per cent (to RUR 267.4 billion) in January, the mandatory reserves reached RUR 277.5 billion (increasing by 3.8 per cent in comparison with the figures registered in December of 2003). The amount of banks' deposits in the Bank of Russia increased 2.1 times up to RUR 183.5 billion. As on February 1, the amount of the CBR liabilities concerning repurchase of securities was at RUR 48.9 billion, what was by 62.4 per cent above the level observed on January 1 of 2004.

**Changes in the Monetary Base and in the Gold and Foreign Currency Reserves in 2003 - 2004.**



*Figure 2.*

In February, the amount of payments pertaining to the public foreign debt of the Russian Federation was circa US \$ 2466.6 million, including US \$ 1266.2 million transferred as debt repayment and US \$ 1200.4 million as interest payments. This, in turn, includes US \$ 1128 million paid to official creditor countries as debt repayment and US \$ 1051.7 million as interest payments. In February, payments to international financial organizations made US \$ 129.6 million and US \$ 37.5 million, respectively. As concerns

<sup>6</sup> The Monetary Base in broad definition includes cash in circulation, the funds in mandatory reserves, and funds in commercial banks' correspondent accounts with the Bank of Russia.

Eurobonds, in February there were transferred US \$ 8.6 million as debt repayment and US \$ 111.2 million as interest payments. The total amount of public foreign debt related payments in 2004 is estimated to make US \$ 16.1 billion, including US \$ 9 billion of debt repayment and US \$ 7.1 billion of interest payments.

According to preliminary estimates, in December the Russia's monetary base calculated according to the money survey method (including forex denominated deposits) increased by 9.52 per cent from RUR 3.62 trillion to RUR 3.96 trillion. Over the year (2003), this indicator increased by 39.4 per cent. The real change in the values of the monetary base indicators in 2003 was somewhat less, since January 1 of this year the Central Bank of Russia has started to include in its composition also the interest on household and legal entities' deposits. According to the RF CB, the respective adjusted time series may be published soon.

*P. Trounin*

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## **Financial Markets**

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In February, positive dynamics were on the whole observed across different sectors of the Russian financial market. The situation on the market of Ruble denominated government bonds demonstrated the optimistic moods of investors at the background of extremely high liquidity observed in the banking sector and stabilization of the US dollar exchange rate. The stock market continued to grow reaching its next historical maximum of 656.97 points. The situation on the market of corporate securities was somewhat worse: the quotations of securities have stabilized and remained at practically same levels.

### **The Market for Government Securities**

In February, there were observed no significant changes in yields of government forex denominated bonds. On the whole, the major factor significantly affecting the dynamics of this segment was the dynamics of prices of base assets – the US Treasury bills. The quotations of Russian Eurobonds grew somewhat until approximately the second week of the month as a result of the decline in the yields of American securities, which reacted to the information about the US labor market situation. At the same time, the market positively reacted to the statement made by A. Greenspan about the stability of the base interest rates in the nearest future. The resulting growth in the American segment was reflected by the dynamics of Russian securities. However, the Russian Eurobond segment also reacted to domestic news: on February 24, the market rolled back after it was announced that the RF Government was dismissed.

Thus, as on February 24 the yield to maturity of Russian Eurobonds RUS-30 was 7.05 per cent p.a. (end of January: 7.24 per cent); RUS-18: 6.78 per cent p.a. (end of January: 6.86 per cent). Besides, on the same date the yield to maturity of the Russian Eurobonds was: Minfin bonds, 7<sup>th</sup> tranche: 6.28 per cent; Minfin bonds, 6<sup>th</sup> tranche: 3.87 per cent; Minfin bonds, 5<sup>th</sup> tranche: 5.36 per cent; RUS-07: 4.20 per cent. Therefore, over February the levels of yields of all Russian Eurobonds have somewhat increased in comparison with the figures registered at end-January of 2004.



FIGURE 1.

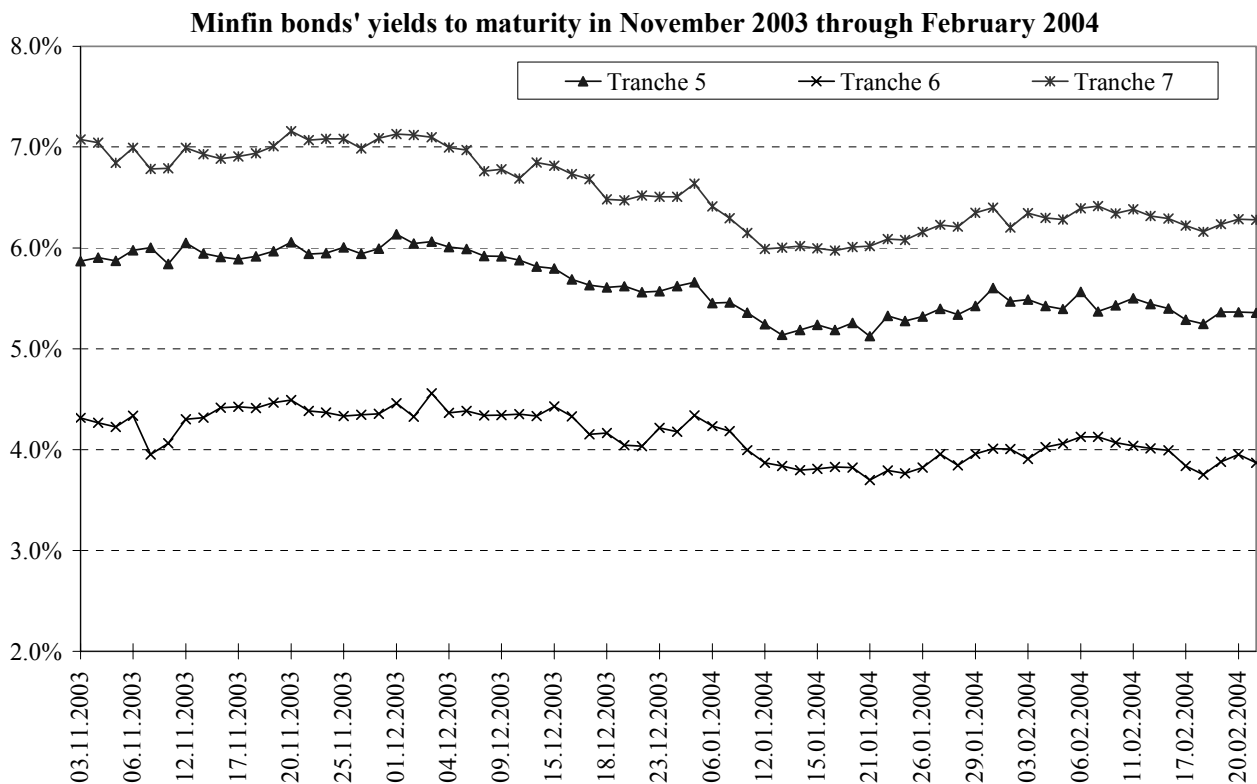
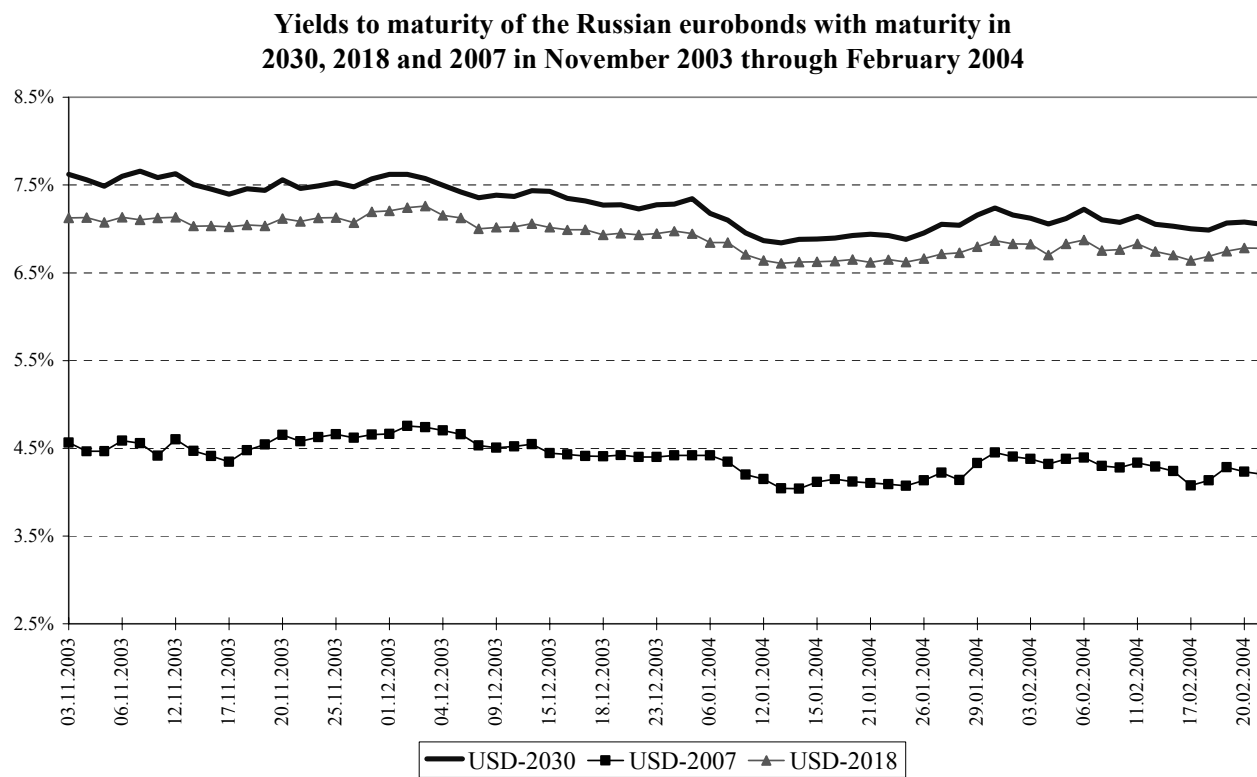


FIGURE 2.



Over the month, the dynamics of the market of Ruble denominated public debt demonstrated a clear upward trend. The major factors of growth were as before the high level of liquidity in the banking sector, low level of interest rates on the market of interbank credits, and stabilization of the exchange rate. The Ruble liquidity in the banking sector remained at a rather high level in February: in February, the average

balances of correspondent accounts of credit organizations with the Bank of Russia made RUR 237.45 billion, what was somewhat above the respective indicator registered in January (RUR 223.3 billion).

It should be also noted that the growth was observed even at the background of considerable primary supply on the market. Over the period from February 2 to 18, the aggregate turnover of the secondary GKO OFZ market made about RUR 56.1 billion, while the average daily turnover was at RUR 4.5 billion. Therefore, the activity of market participant somewhat increased in comparison with January of the preceding year.

In the same period, there took place several auctions for the placement of Ruble denominated government bonds. The aggregate par value amount of the placement made RUR 34 billion. The weighed average yields of the placements fluctuated from 2.1 per cent to 8.15 per cent per annum.

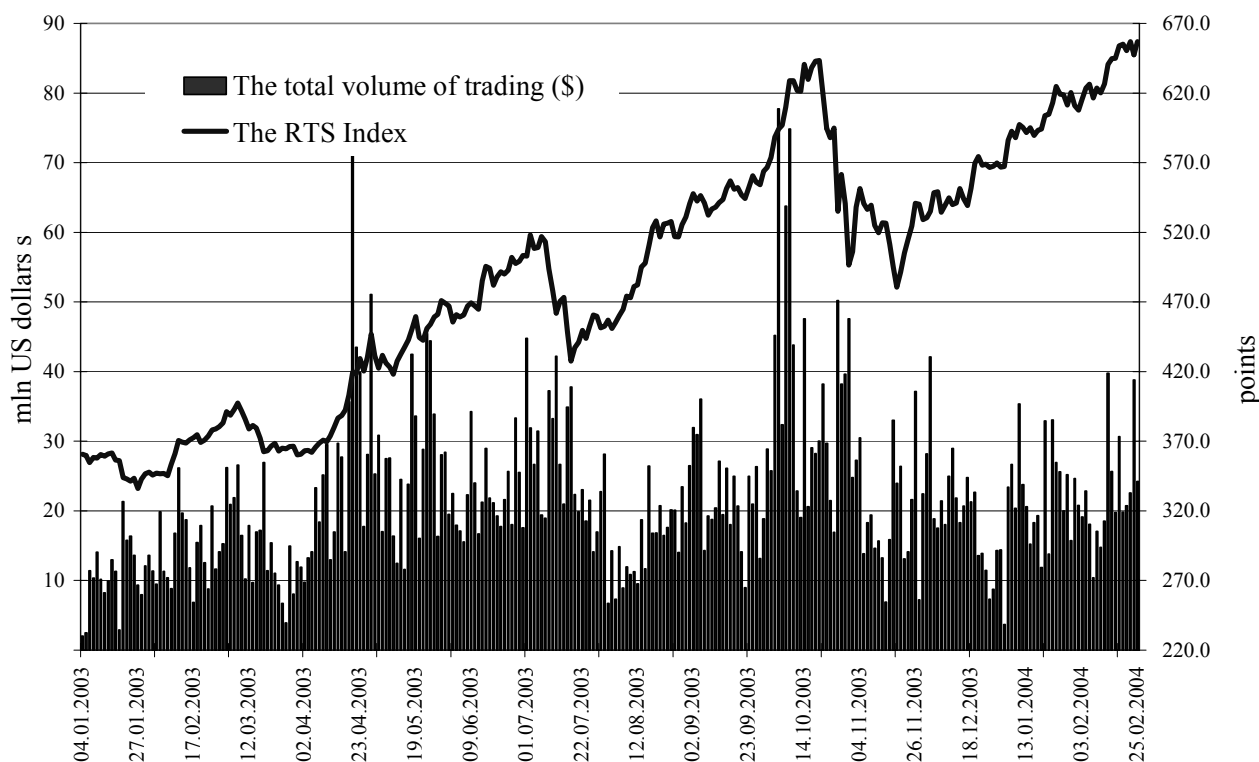
As on February 25, the amount of the GKO – OFZ market made RUR 335.44 billion at par and RUR 364.41 billion at the market value. The duration of the GKO-OFZ market portfolio was 1077.18 days.

## The Market for Corporate Securities

### Situation on the stock market.

In February, positive trends in quotation dynamics prevailed on the Russian stock market. As a result, the market reached its next historical maximum of 656.97 points (at closure on February 25). Leaving aside several days of adjustment, the market grew over the whole period under observation from the beginning of the month till February 25: the index increased by 49.1 points (8 per cent) in comparison with its value registered on February 2. The major domestic factors behind the continuing growth of the market of Russian stocks were as before the extremely high level of liquidity in the banking sector and stabilization of the US \$ / RUR exchange rate. It should be specifically noted that the index significantly fell on February 24 (for one day) because of the dismissal of the RF government. On that day the index declined by 9.29 points.

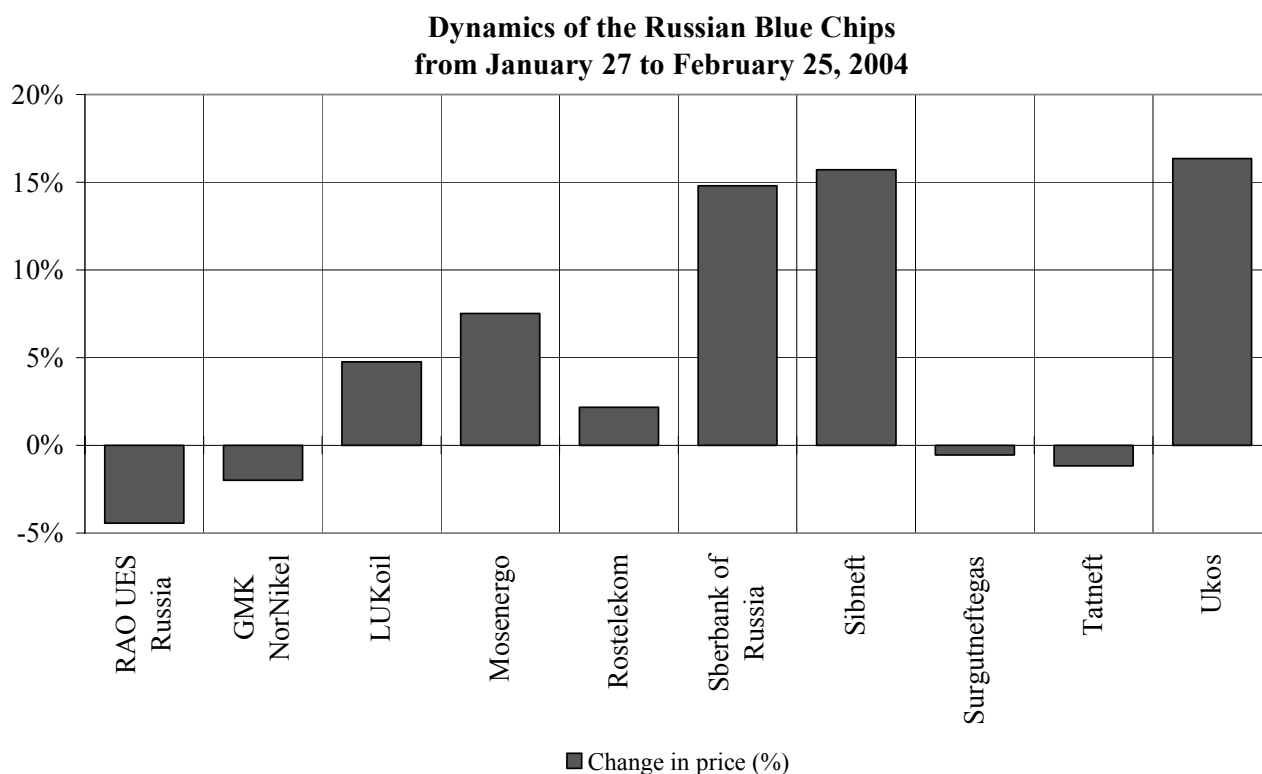
FIGURE 3.



In the period from February 2 to 25, the turnover in the RTS trading amounted to US \$ 383.5 million, what was somewhat above the indicators registered in January of 2004. The average daily turnover at the RTS insignificantly declined in comparison with the respective indicator registered in this January and made about US \$ 22.56 million (US \$ 22.9 million in January). The highest volume of trade at the RTS (US \$ 39.7

million) was observed on February 12; the lowest trade volume (US \$ 10.38 million) was observed on February 6.

An analysis of the dynamics of the most liquid stocks on the domestic market reveals that not all securities demonstrated increase in the market value. After a long period of downfall in prices observed over preceding months, YUKOS shares again became leaders in terms of growth in prices. YUKOS stocks rose by 16.35 per cent in the period from January 27 till February 25. YUKOS was followed by shares in Sibneft and RF Sberbank, which rose by 15.71 per cent and 14.8 per cent respectively over this period. The Mosenergo stocks went up at a twice slower rate (7.52 per cent). At the same time, certain blue chips demonstrated a decline over the period under observation. For instance, RAO UES stocks declined somewhat (-4.43 per cent), as well as Norilsk Nickel (-1.98 per cent), Surgutneftegaz (-0.56 per cent), and Tatneft (-1.17 per cent). *FIGURE 4.*



In February, the RAO UES of Russia shares took the top position by the volume of turnover in the RTS<sup>7</sup>: the total transactions amounted to about 26 per cent. The amount of transactions with the shares in YUKOS was somewhat below that demonstrated by the RAO UES of Russia (16.22 per cent). The shares of LUKoil and Norilsk Nickel followed: the volume of transactions with these companies' shares made 12.89 percent and 9.96 per cent of the total turnover. Thus, the aggregate percentage of transactions with the shares of only these four companies was 65.23 per cent of the total traded turnover on the classical RTS stock market from February 2 till February 25 and remained at the same level as was registered in January of 2004.

As on February 25, the top five leaders of the national stock market by capitalization looked as follows<sup>8</sup>: YUKOS: US \$ 33.75 billion, LUKoil: US \$ 23.17 billion; Surgutneftegaz: US \$ 21.38 billion; Sibneft: US \$ 15.74 billion; MMC Norilsk Nickel: US \$ 14.01 billion.

**The market for term contracts.** In February, the RTS market for term contracts (FORTS) demonstrated an increase in the trading activity of participants. Thus, in the period from February 2 till February 25 the volume of trade in futures and options at the RTS amounted to about RUR 18.98 billion (93.25 thousand transactions; 2.54 million contracts), what was by practically 37.5 per cent above the respective indicators registered in the preceding month (RUR 13.8 billion, 73.9 thousand transactions; 1.76 million contracts).

As usual, futures contracts account for the greatest percentage of transactions: the volume of trade in these contracts reached RUR 18.16 billion (2.35 million contracts, 90.6 thousand transactions) over the period

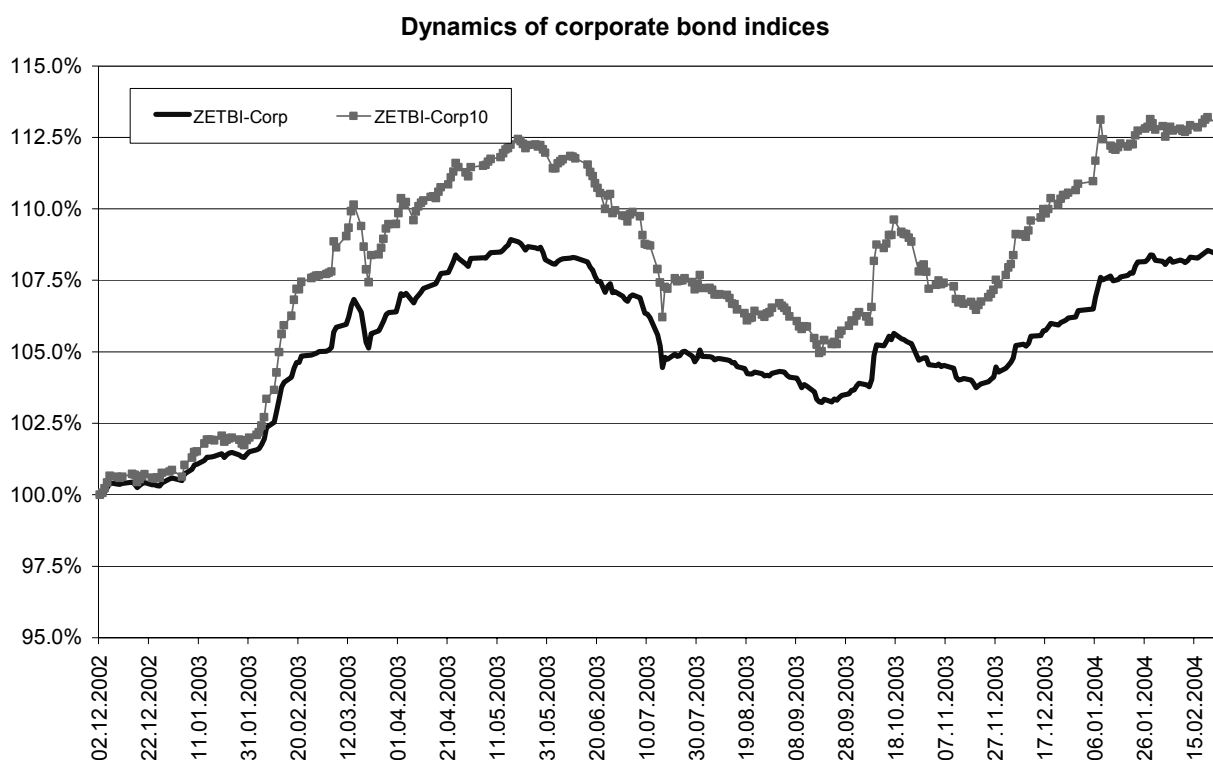
<sup>7</sup> On the classical stock market.

<sup>8</sup> According to the RTS.

under observation. As before, options were in a much lower demand: the respective amount of trading made about RUR 810.67 million. The maximum trading volume was observed on February 24 and made RUR 1.99 billion, while the minimum trading volume (RUR 725.1 million) was registered on February 11.

**Corporate bond market.** The situation on the market of corporate Ruble denominated bonds was stable over the month: the quotations of blue chips did not change significantly. The major reason of this was the absence of factors, which could affect price rise in the future, as well as the stabilization of the US \$ exchange rate. Since the beginning of the month, the price index of corporate bonds traded at the MICEX<sup>9</sup> increased only by 0.28 points (0.25 per cent) and the index of ten most liquid corporate sector bonds increased by 0.12 points (0.1 per cent). In the period from February 2 till February 24 the total turnover in the bond sector of MICEX was RUR 28.6 billion. In February, the average daily turnover made RUR 1.786 million. In February, there was observed a further growth in activity of issuers on the primary market. For instance, among the most significant events of the month on the primary corporate bonds market, there may be mentioned the placement of Gazprom A3 series bonds amounting to Rub. 10 billion with the face value of the bond at RUR 1000 and 3 year maturity. The coupon rate was set at 4 per cent, payments should be paid every 180 days. The placement price at MICEX was registered at 100.69 per cent of the face value, what corresponded to the effective yield to maturity at 8 per cent per annum. There were registered 326 bids totaling to RUR 15.88 billion.

FIGURE 5



**External factors affecting the dynamics of the Russian stock market.** In February, the growth in prices continued on the world oil market. Thus, in the period from February 2 till February 26 of 2004, the price of Brent oil on the world market increased by US \$ 2.93, or about 9.93 per cent. It should be noted that early in the month the prices declined in anticipation of stability of OPEC quotas and at the background of growing US fuel reserves. However, at the OPEC summit held on February 10, it was unexpectedly for all market operators and analysts decided to decrease the extraction quotas, what resulted in the reversal of the trend. According to the cartel Chairman, next summit could reduce quotas even further, what he explained by the probable seasonal decline in demand for oil and, therefore, downfall in current price levels.

<sup>9</sup> The indices of corporate bonds traded at the MICEX that have been used for the calculations are calculated by Zenit Bank.

FIGURE 6.

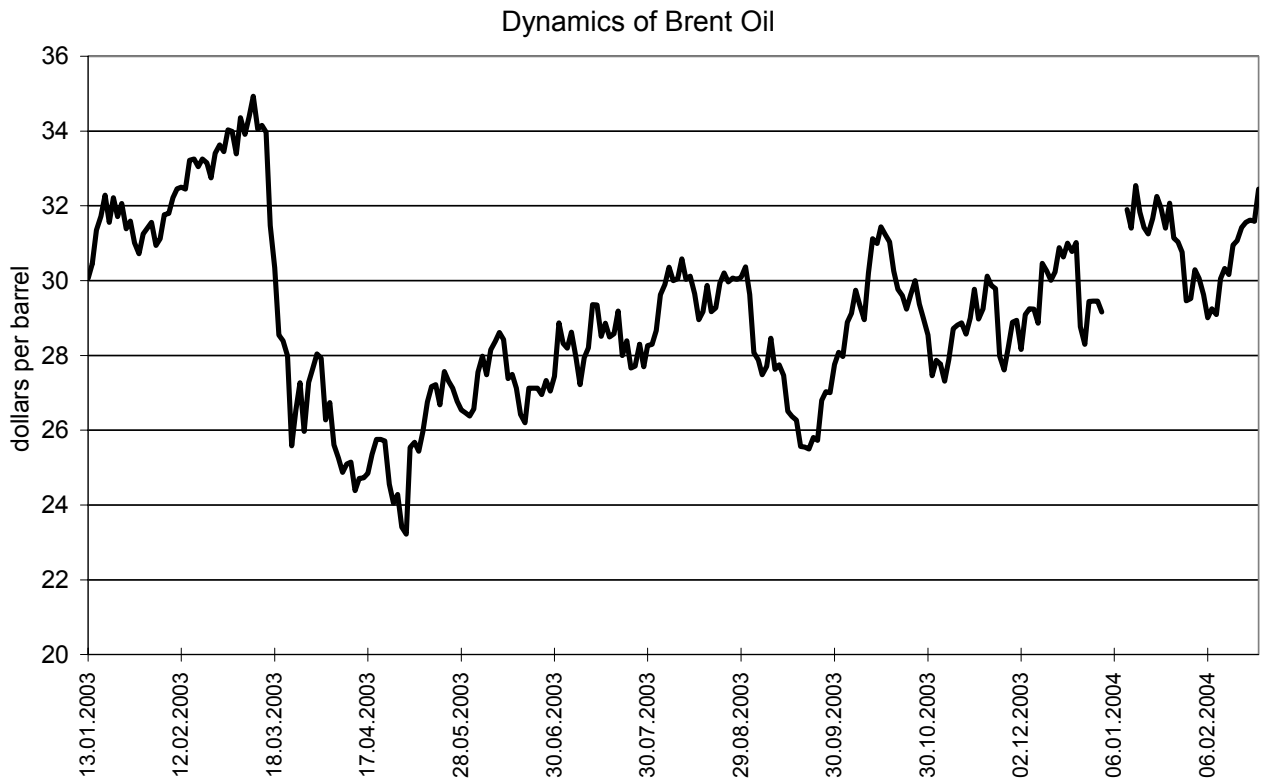
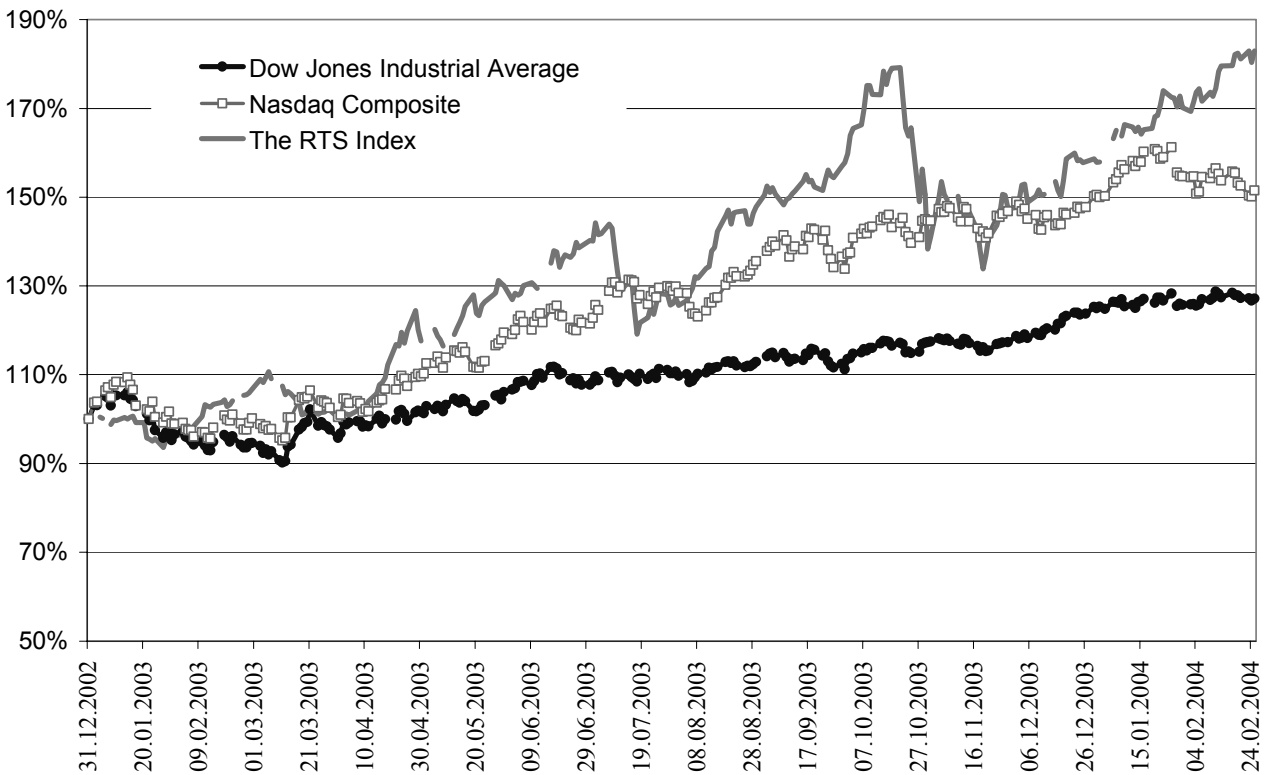


FIGURE 7.



In February, the dynamics of stock markets in developed countries were characterized by different trends. For instance, over the month (year), from January 26 till February 25 the US stock indices NASDAQ and

S&P500 declined respectively by 6.08 per cent (+ 0.81 per cent) and 1.01 per cent (3.17 per cent). European stock indices demonstrated insignificant positive dynamics with the exception of German indicator DAX-30, which declined by 3.23 per cent (-0.58 per cent). On the whole, on the Asian stock markets there also prevailed downward trends. According to the results of the month (year), Nikkei-225 (Japan) changed by - 2.86 per cent (-1.56 per cent), Straits Times (Singapore) by -2.8 per cent (4.29 per cent). On the markets of developing countries there was observed a certain worsening of the business situation, what was demonstrated by a decrease in the composite index calculated by the agency MSCI – according to the results of the month (year) it increased by only 0.25 per cent (+ 6.28 per cent).

Macroeconomic statistics remain the major factor behind the negative dynamics observed on the American stock market, since the majority of company financial statements in the corporate sector turned out to be better than expected. For instance, the market paid close attention to the data on the unemployment level in the US. European indexes still react to the situation on the forex market, where Euro continues to rise in comparison with the US \$, what negatively affects export oriented companies and pushes indexes down.

As before, the dynamics of the Russian stock market are most considerably affected by the situation on the world oil market, while dynamics of the world capital market concern investors on the domestic market less. It should be again stressed that internal factors affect the dynamics of the Russian stock market most significantly.

### **Corporate news.**

#### *The NK LUKoil*

In the end of this January, the NK LUKoil won the tender for the right to prospect and develop natural gas and gas condensate deposits at Block A of Saudi Arabia Kingdom, which, according to experts, is the most prospective as concerns the high probability to discover commercial resources of natural gas and gas condensate. In order to implement the project, in the nearest future there will be established a joint venture with the state owned oil company Saudi Aramco, where LUKoil should have the 80 per cent interest. The signing of the concession agreement between the Saudi Arabia government and the extracting company as concerns prospecting and development of the natural gas and gas condensate deposit at Block A for 40 years is planned in March of 2004.

In February, the company approved the new plan of oil extraction for 2004, where the target indicator of growth in oil extraction was set at 6 to 7 per cent. Therefore, the oil extraction in 2004 is planned at the level of 86.2 to 87 million metric tons depending on the availability and efficiency of transport capacities.

#### **The OAO Mosenergo**

The Board of Directors of the RAO UES of Russia approved the plans relating to the reorganization of the OAO Mosenergo at its meeting on January 30, 2004. It is planned to reform the company in accordance with the base reorganization variant of the RAO UES of Russia. The project complies with the terms of Agreements with the government of Moscow and the Moscow oblast, signed in September of 2003. It is envisaged that in the process of reorganization of the OAO Mosenergo there will be created four generating companies (which should be integrated in the composition of wholesale generating companies), the city and oblast distributing companies (power supply networks), a heating network company, a selling, management, and main network companies, as well as companies carrying out construction, design, repair, and other services by separating these companies from the Mosenergo. All other assets shall remain in the reorganized OAO Mosenergo, including 17 electrical power plants. In accordance with the Agreements, after the reorganization of the company the Governments of the city of Moscow and the Moscow oblast will be granted the right to increase their shares in respective network companies up to and over 51 per cent via new issues of shares. The meeting of OAO Mosenergo with respect to the company reorganization should be held in the first six months of 2004.

On February 24, in accordance with the decision taken by the OAO Mosenergo Board of Directors, the international assessor Ernst & Young evaluated the market value of one ordinary share in the OAO Mosenergo. The evaluation was conducted in order to determine the fair price of redemption of shares from shareholders, who are uninterested in the reform of the company. According to the final results of the assessment, as on October 1, 2003, the market value of one registered ordinary share in the OAO Mosenergo (taking into account the fact that such shares do not constitute the controlling interest) should be 1 Ruble and 84 kopeks, or US \$ 0.06.

### **The OAO Gazprom**

On January 28, OAO Gazprom presented the non-audited consolidated intermediate brief reports for nine months (until September 30) of 2003, made in accordance with International Accounting Standards (IAS). Over nine months, the sales earnings (minus excises, VAT, and customs payments) increased by RUR 155.87 billion, or by 35 per cent as compared with the figures registered in the respective period of 2002 and made RUR 597.38 billion. Over the same period of time, the operating costs of the company increased by 21 per cent in comparison with the figures registered in the respective period of 2002 and made RUR 597.38 billion, what was primarily caused by a growth in expenditures for labor, purchase of natural gas, transit, repairs, electrical power, and processing, as well as a growth in amortization. The amount of net profit in the first nine months (until September 30) of 2003 made RUR 126.44 million.

### *The OAO GMK Norilsk Nickel*

In early February, the GMK Norilsk Nickel announced that proceeds and profits of the company in 2003 will be significantly below the expected levels. There were pointed out two major causes of these results. First, nickel sales were unevenly distributed over the year: the larger part of the stocks was sold in the 1<sup>st</sup> quarter, when prices were below the average annual price at the London Metal Exchange. As a result of this uneven distribution of nickel sales, the average annual selling price of the company was below the average annual market price. Second, it is probable that the affiliated company Stillwater will have to write off the accounting assessment of some of its production assets and decrease evaluation of its ore reserves in the balance sheet in the case the palladium prices remain at the current low level.

### *The RAO UES of Russia*

On February 18, the RAO UES of Russia published the financial statement of the RAO UES of Russia Group for the first nine months of 2003 (IAS). The aggregate assets of the Group made RUR 103.9 billion as on September 30, 2003, what was by 12 per cent above the indicators registered in the beginning of the year. The earnings from the core business made RUR 419.8 billion, what was by 23 per cent above the figures registered in the respective period of the preceding year. The expenditures increased by RUR 42.4 billion up to RUR 382.6 billion, what was primarily caused by an increase in costs of fuel and purchased electrical power. As a result, over the first nine months of 2003 the profit the RAO UES of Russia Group from the core business made RUR 37.2 billion, what is practically 17 times more than the indicator registered in the first nine months of 2002 (RUR 2.2 billion). The net profits of the RAO UES of Russia made RUR 16.6 billion, what was below the indicator registered in the respective period of 2002.

### **The OAO Rostelecom**

The international ranking agency Standard&Poor's granted the company the corporate governance ranking at the level of 6.4 points according to a 10 point scale. According to the ranking agency report, this decision was taken because Rostelecom improved its policy with respect to disclosure of information, granted free access to the information about the company, as well as maintained active relations with investors. According to the agency, Rostelecom is ahead of similar Russian companies as concerns transparency standards and relations with investors, and is at the same level with many other companies in the telecommunications sector.

In mid-February, the company published its financial statement for the first nine months of 2003 (IAS). The consolidated proceeds over this period increased by 20.8 per cent and made US \$ 738.7 million. The amount of net profit in the first nine months of 2003 made US \$ 36.4 million as compared with US \$ 90.9 million registered in the respective period of 2002.

### **The OAO NK YUKOS**

On January 28, OAO YUKOS presented the non-audited consolidated financial statement for the 3<sup>rd</sup> quarter and first nine months of 2003, made in accordance with US GAAP. Proceeds and other earnings from operation activities in the 3<sup>rd</sup> quarter and 9 months of 2003 increased to US \$ 4.476 billion and US \$ 12.199 billion respectively, demonstrating the growth by 32.5 per cent and 53.5 per cent in comparison with the respective indicators for 2002. The net profit in the 3<sup>rd</sup> quarter made US \$ 1.324 billion as compared with US \$ 850 million registered in the 3<sup>rd</sup> quarter of 2002. As concerns the first nine months of 2003, the net profit

increased by 71.3 per cent as compared with the indicators observed in 2002 and made US \$ 3.546 billion in comparison with US \$ 2.070 billion in 2002.

*Table 1.*

**Dynamics f International Stock Market Indices**

<b>Data as of February 25, 2004</b>	<b>Value</b>	<b>Change within the month (%)</b>	<b>Change since the beginning of the year (%)</b>
RTS (Russia)	656.97	6.08%	12.10%
Dow Jones Industrial Average (USA)	10601.62	-0.94%	1.84%
Nasdaq Composite (USA)	2022.98	-6.08%	0.81%
S&P 500 (USA)	1143.67	-1.01%	3.17%
FTSE 100 (UK)	4507.5	1.39%	-0.06%
DAX-30 (Germany)	3995.34	-3.23%	-0.58%
CAC-40 (France)	3702.63	0.73%	2.94%
Swiss Market (Switzerland)	5811.5	1.10%	4.10%
Nikkei-225 (Japan)	10658.73	-2.86%	-1.54%
Bovespa (Brazil)	21609.0	-11.26%	-3.72%
IPC (Mexico)	9926.67	3.79%	22.28%
IPSA (Chile)	1531.23	6.42%	3.14%
Straits Times (Singapore)	1868.28	-1.67%	4.29%
Seoul Composite (South Korea)	866.87	-0.25%	5.55%
ISE National-100 (Turkey)	18707.11	1.91%	-2.30%
Morgan Stanley Emerging Markets Free Index	470.958	0.25%	6.28%

**The Foreign Exchange Market.** In February, on the domestic forex market there was observed stabilization of the US \$ exchange rate. On the whole, over the month US \$ grew by RUR 0.02 (0.08 per cent) and made RUR 28.5156 per US \$. The US \$ exchange rate has stabilized at the level of about RUR 28.5 per US \$ because of a number of factors, among which there may be noted the favorable macroeconomic situation in the country, as well as the situation on the world forex and oil markets. The aggregate volume of trade in the US Dollar at the SELT in the period from February 2 till February 24 made US \$ 14.2 billion, increasing in comparison with the respective figures registered in the first three weeks of January of 2004 (about US \$ 13 billion) by about US \$ 1.2 billion. The average daily turnover made US \$ 889 million over this period, what was somewhat below the respective January indicator (US \$ 929.45 million). During the period under review the highest volume of trade in the US Dollar, about US \$ 3.38 billion, was observed on February 10 (about US \$ 2 billion in January); the lowest volume, US \$ 389.1 million, was observed on February 16.



FIGURE 8.

Dynamics of the Official USD/RUR and EUR/RUR Exchange Rates in 2003-2004

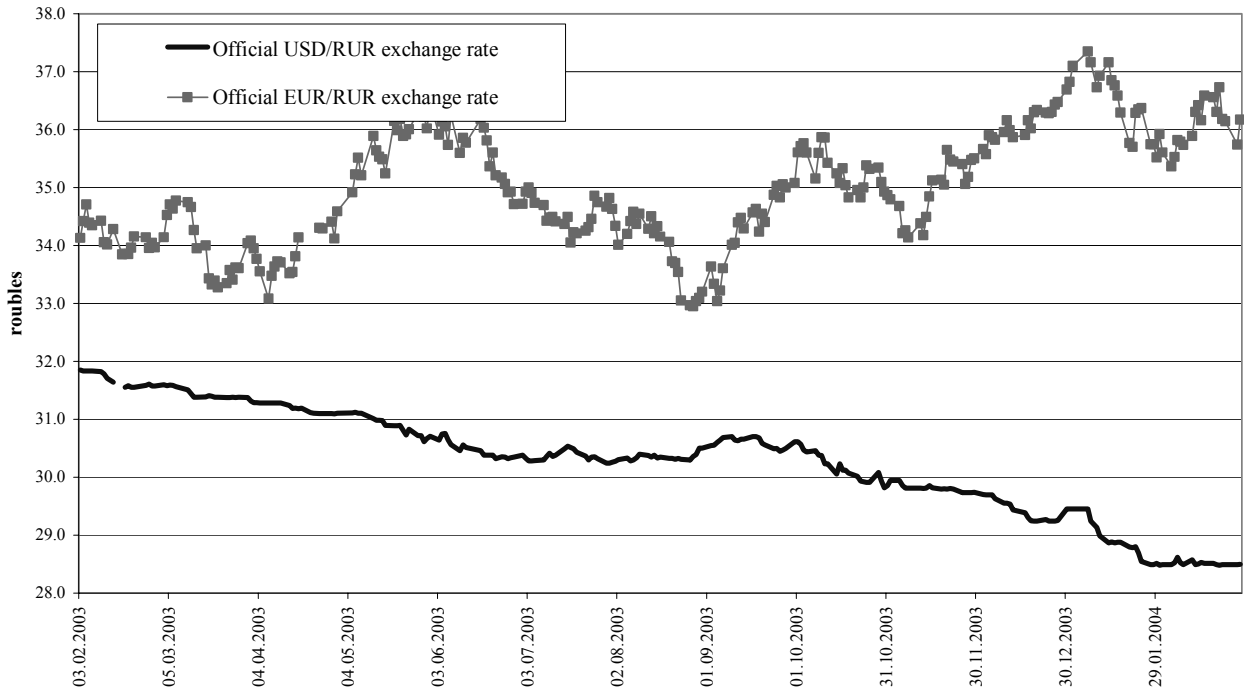


FIGURE 9.

Dynamics of the Dollar/Euro Exchange Rate on the International Markets



On the world forex markets, by the end of the month the exchange rate of US \$ against Euro practically did not change, as on February 26, the rate was registered at US \$ 1.2498 per Euro, what was by 0.8 cents above the level observed in the beginning of February. The insignificant difference in the exchange rate may be explained by the considerable fall of Euro registered on February 26. On the contrary, during the month the US \$ / Euro exchange rate reached US \$ 1.2838 per Euro. On the whole, the dynamics of Euro against US \$ are still determined by the enormous deficit of the US balance of payment and current account.

The dynamics of the Euro - Ruble rate were mainly determined by the trends on the world market. In the period from February 3 till February 28 the European currency grew by RUR 0.14 (0.41 per cent) and made RUR 35.5076 per Euro. The aggregate turnover of trade at the SELT amounted to Euro 127.6 million in the period from February 2 till February 24, what was slightly above the respective indicator registered in the first three weeks of January (Euro 108.56 million). The highest trade volume of Euro was registered on February 2 at Euro 17.87 million, and the lowest, Euro 3.52 million, on February 16.

*TABLE 2. FINANCIAL MARKETS INDICATORS*

<b>Month</b>	<b>October</b>	<b>November</b>	<b>December</b>	<b>January</b>	<b>February*</b>
Monthly inflation rate	1,0%	1,0%	1,1%	1,8%	1,3%
Inflation rate annualized on the basis of this month's trend	12,68%	12,68%	14,03%	23,87%	16,8%
CB RF refinancing rate	16%	16%	16%	14%	14%
Annualized yield to maturity on OFZ issues (%)	7,26%	6,74%	7,63%	6,48%	5,8%
Volume of trading in the secondary GKO-OFZ market for the month (RUR billion)	14,60	5,02	20,58	31,77	20,0
Yield to maturity on Minfin bonds at the end of the month (% p.a.)					
5th tranche	6,10%	5,99%	5,62%	5,60%	5,4%
6th tranche	4,38%	4,36%	4,18%	4,01%	3,9%
7th tranche	7,08%	7,09%	6,51%	6,40%	6,3%
8th tranche	5,17%	5,09%	5,16%	4,77%	4,6%
Yield to maturity of Eurobonds at the end of the month (% p.a.)					
2005	3,22%	3,16%	3,05%	2,83%	2,8%
2007	4,65%	4,66%	4,42%	4,45%	4,2%
2010	5,98%	5,92%	5,80%	5,79%	5,6%
2018	7,26%	7,19%	6,97%	6,86%	6,8%
2028	7,57%	7,50%	7,34%	7,33%	7,2%
2030	7,75%	7,57%	7,28%	7,24%	7,1%
INSTAR-MIACR rate (% p.a.) on interbank overnight loans at the end of the month	9,76%	7,75%	7,75%	2,15%	1,2%
Official RUR / US\$ exchange rate at the end of the month	29,8584	29,7387	29,4545	28,4916	28,5156
Official RUR / Euro exchange rate at the end of the month	34,8657	35,5021	36,8240	35,3635	35,5076
Average annualized growth in RUR / US\$ exchange rate	-2,46%	-0,40%	-0,96%	-3,27%	0,08%
Average annualized growth in RUR / Euro exchange rate	-0,60%	1,83%	3,72%	-3,97%	0,41%
Volume of trading at the stock market in the RTS for the month (US\$ million)	867,33	374,55	416,89	432,75	430
Value of RTS-1 Index at the end of the month	513,96	529,27	567,25	611,10	665
Change in value of RTS-1 Index during the month (%)	-9,67%	2,98%	7,18%	7,73%	8,8%

\* Estimate

*D. Polevoy*

## The Real Sector: Factors and Trends

In accordance with the Regulations of elaboration and presentation of data approved by the RF Goskomstat, the RF Ministry of Economic Development and Trade, and the RF Finance Ministry, the RF Goskomstat preliminary estimated GDP in 2003 and more precisely determined the indicators registered in 2002 and 2001. For more precise evaluation of the GDP amounts and dynamics there were used the data of annual statistical reports presented by large and medium sized organizations, agricultural producers, the results of the census of small businesses, sample surveys of not for profit organizations servicing households, and individual entrepreneurs engaged in trade activities, as well as the indicators of the balance of payments formed by the Bank of Russia, and the Finance Ministry report on the administration of the consolidated budget.

The adjusted amount of GDP in 2001 made Rub. 8943.6 billion, GDP of 2002 made Rub. 10834.2 billion. The adjustment of indicators primarily concerned the characteristics of the structure of production across sectors of the economy and GDP revenue formation. The index of GDP growth in 2002 as compared with 2001 figures made 104.7 per cent (as compared with 104.3 per cent according to the official publications of 2002), with the index deflator – 115.7 per cent.

In 2003, GDP was calculated basing on the operative data on the operations of large and medium sized organizations, sample surveys of small businesses, preliminary data on foreign trade statistics presented by the State Customs Committee, and the Finance Ministry reports. According to the preliminary estimates, the amount of Russia's GDP in 2003 made Rub. 13304.7 billion in current market prices, demonstrating a 107.3 per cent growth in the real volumes in comparison with the figures observed in 2002.

The development of the Russian economy in 2003 was most significantly affected by the following factors: an intensive growth in the sector of services; increasing influence of external demand and growing contribution of fuel industry in industrial recovery; outpacing rates of growth in investment in fixed assets as compared with GDP dynamics and final demand; more similar dynamics of real wages and labor productivity; persistence of high consumer demand at the background of changes in the household propensity to save.

The changes in the structure of GDP produced in 2002 and 2003 were determined by outpacing rates of growth in services in comparison with dynamics of production of goods. While in 2003 the added value in the sector of production of goods increased by 7.0 per cent, market services grew by 8.3 per cent. The growing indicators of the sector of services closely correspond to the level of business activity and structural shifts in the economy. In 2003, the dynamics of market services were most significantly affected by the accelerating rates of growth in services rendered by transport, communications, trade, commercial activities ensuring market operation, and transactions with real estate.

*Table 1*

### Indexes of GDP volumes as broken down by the sectors of economy in 2001 through 2003, in % of the preceding year

	2001	2002	2003 <sup>*)</sup>
Gross domestic product	105,1	104,7	107,3
Production of goods	106,5	103,6	107,0
Industry	104,9	104,0	107,0
Construction	109,9	102,7	112,1
Production of services	103,6	105,5	107,4
Market services	104,3	106,0	108,3
Transport	103,2	103,4	105,6
Communications	117,9	116,7	128,6
Trade	103,9	108,1	110,3
Non-market services	99,4	102,5	102,0

\*) preliminary estimates

Source: RF Goskomstat

As concerns the sector of goods, the changes in the structure of production were most significantly affected by the ratio between industry and construction. In 2003, there was overcome the deceleration in the rates of industrial development observed since the 4<sup>th</sup> quarter of 2000, and which could be explained by the impact of the increase in production costs and declining profitability resulting from changes in relative prices of the domestic and external market. In 2003, the increase in industrial output made 7.1 per cent as compared with 3.8 per cent registered in the preceding year.

The positive dynamics of development of construction have been observed since the 3<sup>rd</sup> quarter of 1999 and was supported by the expansion of output of capital goods and increasing scale of investment in fixed assets. In 2003, the growth in earnings of the economy, caused by the increasing effectiveness of external economic operations and expansion of the domestic market capacity provided an additional impetus for the growth in demand for construction works. The amount of commissioned construction works in 2003 increased by 12.5 per cent as compared with the minimum (2.7 per cent) registered in the whole period of recovery growth in 2002.

The dynamics of production and structure of economic growth in 2003 were favorably affected by the positive changes in the world market situation: the growth in prices was supported by the high demand for hydrocarbon resources and metals. The rates of growth in the foreign trade turnover increased from 108.3 per cent in 2002 to 124.1 per cent in 2003. The active monthly balance of trade made about US \$ 5 billion on the average, what is comparable with the record high registered in 2000. The improved terms of trade resulted in an increase in the balance of trade up to US \$ 59.6 billion in 2003 as compared with US \$ 46.6 billion registered in 2002.

According to the Bank of Russia, the increase in the amount of exports was ensured by both the growth in volumes of Russia's exports and the price factor. In 2003, the amount of Russia's exports, according to the Ministry of Economic Development and Trade, made US \$ 134.4 billion and increased by 25.3 per cent in comparison with the figures registered in the respective period of the preceding year. In the same period, import of goods made US \$ 74.8 billion, what was by 22.7 per cent above the level registered in 2002. The relative reduction in prices of imported raw materials, and material and technical resources has in the end significantly affected the changes in the competitive environment and revealed the problem zones of growth. For instance, while the dynamics of consumer imports were restrained by rather strong positions of Russian producers of food products, the increase in imports of investment goods resulted in the squeezing of Russian producers from the market.

The situation of the world and Russian market determined the operative reaction of domestic business aimed at the restoration of processes of the transformation of the export earnings of the economy into expansion of the domestic market. Since 2003, the intensive growth in investment demand dominated in terms of influence on the dynamics and structure of the Russian economy. The share of investment in fixed assets in GDP as at the end of 2003 exceeded the average level observed in 1999 through 2002 by 1 percentage point and made 17.4 per cent.

The accumulated potential of development will permit to control the situation in the consumer sectors. As concerns the structure of commodity resources of retail trade, in 2003 the share of imports practically stabilized. In the 1<sup>st</sup> quarter it made 45 per cent, in the 2<sup>nd</sup> and 3<sup>rd</sup> quarters – 43 per cent, what corresponds to the value of this indicator registered in 2002. Therefore, the increase in the household effective demand was practically evenly satisfied by imported and domestic products. However, the aggregate influence of domestic factors proved to be insufficient to compensate the increasing impact of the external demand on the rates of economic growth. According to the estimates of the RF Ministry of Economic development and Trade, the internal factors (growth in investment in fixed assets and household incomes, as well as a 30 per cent rise in prices of Russian oil on the world market) accounted for about 60 per cent of growth in GDP observed in 2003. The contribution of domestic demand in the GDP dynamics was registered at about the average level of 1999 through 2000.

An analysis of the nature of economic development in the recovery period reveals that the growth in earnings of the economy from external economic activities rather significantly affected the dynamics and proportions of the final use in GDP.

A specific feature of economic growth in 2001 through 2003 was the increase in the scale of gross savings. Due to the exceptionally favorable combination of factors of high business activity of domestic business and the price situation on the world market of raw materials, the share of gross savings has been registered at 28.6 per cent to 36.7 per cent of GDP over the last 5 years. These developments permitted to fully service public obligations pertaining to the foreign debt and social programs. In 2003, under the influence of growing export earnings of the economy and increasing inflow of foreign investment on the one hand, and the decelerating rates of growth in final household consumption at the background of increasing propensity to save on the other hand, the gross national savings grew up to 32.5 per cent of GDP as compared with 30.1 per cent of GDP registered in 2002. an analysis of the capital account illustrates the gradual easing of the burden of operations vis-à-vis the rest of the world on the economy, however, the asymmetry of gross savings, resources of gross accumulation, and investment in fixed assets did not

diminish. In 2000 through 2003, the share of investment in fixed assets in GDP made on the average 16.5 per cent, what constituted about half of savings.

Table 2

**Structure of GDP utilization in 2001 through 2003, in % of the total**

	2001	2002	2003*)
Gross domestic product	100	100	100
Including:			
Expenditures for final consumption	65,7	69,2	67,8
Of households	48,2	50,4	49,7
Of state institutions	16,3	17,6	16,9
Gross accumulation	21,9	20,3	20,8
Gross accumulation of fixed capital	18,8	18,0	18,4
Change in tangible current assets	3,1	2,3	2,4
Net exports	12,4	10,5	11,4

\*) preliminary estimates

Source: RF Goskomstat

The persistence of the stable dynamics of final consumption based on the growth in real wages and salaries and household incomes was accompanied by the redistribution of incomes from enterprises to households and resulted in the increase in production costs. The systemic growth in expenditures for wages and salaries had a negative impact on the dynamics of production profitability. Besides, the reduction of the rate of return was also related to the growth in material costs as a result of increase in wholesale prices of and tariffs on products and services of natural monopolies, while prices of final goods set by producers of industrial products changed more smoothly. As concerns the economy at large, in 2003 the profitability made 10.9 per cent, while this indicator in industry was registered at 14.4 per cent and decreased by almost 10 percentage points in comparison with the figures observed in 2000.

Table 3

**Structure of GDP formation as broken down by revenues in 2001 through 2003, in % of the total**

	2001	2002	2003*)
Gross domestic product	100,0	100,0	100,0
Including			
Pay to employees (including concealed pay)	43,0	46,6	46,1
Net taxes on production and imports	15,7	14,1	13,7
Gross profit of the economy and gross mixed revenues	41,3	39,3	40,2

\*) preliminary estimates

Source: RF Goskomstat

In 2003, at the background of an intensive growth in production there was observed a trend towards more similar dynamics of labor productivity and wages and salaries. The increase in labor productivity, registered in 2003 made about 8.0 per cent, while over 2002 this indicator changed from 0.2 per cent (in the 1st quarter) to 3.6 per cent (in the 4th quarter). In the course of implementation of radical institutional reforms there can be hardly expected fast results related to the increasing efficiency of the use, and the impact of this process on the changes in the indicators of efficiency of enterprises' operations and organizations remains at the moment very weak and instable.

In 2004, the economic situation was determined by the impact of trends and factors formed in the preceding year. In January of 2004, as compared with the figures registered in the respective period of the preceding year there persisted the intensive growth of production in industry, trade, and transport, which in aggregate accounted for almost 3/5 of the produced GDP. For the first time over the last 5 years, in the beginning of the year there has been observed an intensive expansion of domestic demand. Accelerating rates of growth in investment affected the dynamics of mechanical engineering and construction works. As concerns the external demand, there also persist the trends observed in 2003. the favorable starting conditions permit to expect that high rates of economic growth will persist in 2004.

*O. Izryadnova*

## IET Business Survey: Industry in February of 2004

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The start of recovery in sales has not justified the hopes of enterprises: the satisfaction with demand continues to decline. However, producers could balance demand and output at the expense of an increase in finished stocks. It should be noted that producers could do this without hoarding. In the case sales not increase in the next few months, as it is expected, the enterprises would have to reassess their finished stocks and output estimates.

In February, the dynamics of sales of industrial products for cash began to recover after the now already traditional deceleration of the growth rates observed at the end of the year and at the time of the “holiday” fall early in the next year. The rates of changes in effective demand became positive and make on the average + 4 per cent (in terms of the balance) across industries. Over the preceding 5 months, this indicator has declined from + 19 per cent to –26 per cent. Both at the end of 2003 and 2002, the downfall in sales was observed over 4 months, in 2001 – over 3 months. The growth in amounts of sales (or, at least, certain deceleration of decline) was registered by surveys across all industries. Only power engineering experienced deteriorating cash sales. It should be however noted that these developments are observed in the industry every year.

The recovery of the minimal growth in sales has not been sufficient for enterprises as yet. Evaluations of the demand on the “above norm – below norm” scale declined in February by yet 7 points, while the total downfall in the balance of evaluations since the beginning of the year made 17 points. As a result, evaluations of demand fell from the level of –39 per cent - -41 per cent to the level observed in the beginning of the year (see the Figure). The share of evaluations of demand as “normal” also declined to 36 per cent in January and February of 2004, while in the second half of 2003 it made 52 per cent on the average. The deterioration of the balance and decline in the share of “normal” assessments was observed across all industries with the exception of power engineering and light industry.

The growth in demand allowed enterprises to increase their output. After the traditional decline in January (which, however, turned out to be minimal in 2002 through 2004), the rates of growth in production increased from –8 per cent to + 11 per cent (in terms of the balance). The growth in output started in all industries with the exception of power engineering, where growth decelerated, and food industry (the rate of decline decelerated). The highest indicators of growth were registered in chemistry, petrochemistry, forestry complex, and light industry.

Evaluations of finished stocks practically have not changed over the last 4 months. Russian industry retains an insignificant (as compared with the figures registered in 2001 through 2003) excess of finished stocks, although the rates of growth in sales first decelerated and then declined in this period. Output also decelerated, however, not so much as demand. The most probable explanation of this situation is that producers hope for the restoration of an intensive growth in sales in the next few months and prepare for this event by storing a part of output at warehouses. However, the developments in February did not justified these expectations. At the moment, the largest finished stocks are registered in the industry of construction materials, light industry, chemistry and petrochemistry. Mechanical engineering demonstrated the practical absence of finished stocks (balance at + 1 per cent), while the share of “normal” evaluations reached 62 per cent, what is the absolute maximum in the industry.

Low investment activity of enterprises was traditionally observed in the first months of the year, and the beginning of 2004 was not a pleasant exception. The intensity of purchases of machinery and equipment declined to –8 per cent (in terms of the balance) from –2 per cent registered in the 4<sup>th</sup> quarter of 2003. The positive balance was registered only in fuel industry (+ 17 per cent), power engineering, forestry and woodworking (+ 7 per cent each). In other sectors there prevailed enterprises reporting about declines in purchases. Especially considerable prevalence of such reports was observed in mechanical engineering (-15 per cent) and food industry (-6 per cent).

Evaluations of the actual financial and economic standing of enterprises did not principally change in the beginning of 2004 as compared with the figures registered in the 4<sup>th</sup> quarter of the preceding year. In 2003, the balance increased by 16 points and reached its absolute maximum (see the Figure). At present, the majority of enterprises (66 per cent) assess their actual standing as satisfactory.

Estimates of changes in demand further improved by 10 points in February and reached the absolute maximum in the whole period of monitoring (1992 through 2004). A growth in sales is expected at 40 per cent of enterprises, while only 5 per cent of enterprises apprehend a decline (+ 35 per cent in terms of the

balance). The most optimistic forecasts were registered in construction industry (+ 52 per cent), chemistry and petrochemistry (+ 45 per cent), light industry and mechanical engineering (+ 44 per cent each).

In February, forecasts of changes in output practically did not change. For the second month running, about half of Russian industrial enterprises plan to increase output, while only 6 to 7 per cent plan to decrease it. Because of this, production plans of enterprises could be more adjusted for demand evaluations. While in January plans of changes in output coincided with forecasts of sales at 68 per cent of enterprises, at present this figure makes 78 per cent. In 2003, the average value of this indicator was 70 per cent.

*S. Tsukhlo*

## Regions: Dynamics of Industrial Output

The past 2003 was characterized both by many persisting trends of 2002, and certain specifics. The interregional differences, primarily as concerns the differences in rates of growth in industrial output, were affected by the changes in the rates of growth across individual industries (see Table 1). Similarly to 2002, in 2003 the most favorable dynamics were observed in the fuel industry, while the industries primarily oriented towards the domestic market (light and food industries, mechanical engineering) dropped behind even more. Accordingly, among the regions leading in terms of rates of growth in 2003 (see Table 2), there were much more RF subjects, where the raw material industries played more important role as compared with 2002. These regions include the Arkhangelsk oblast (because of the Nenets AO, where the index of industrial output (143.3 per cent) was the highest among all regions in 2003), the Orenburg, Tomsk, and Tyumen (thanks to the Khanty Mansi and Yamal Nenets AOs) oblasts.

*Table 1*

**Indices of industrial output across major industries in 2002 through 2003 (%)**

<b>Industries</b>	<b>2003</b>	<b>2002</b>
Power engineering	101,0	99,3
Fuel industry, including	109,3	107,0
- oil extracting industry	111,2	108,7
- oil processing industry	102,0	104,7
- natural gas industry	105,2	103,2
- coal mining	108,2	96,4
Ferrous metallurgy	106,2	103,0
Non-ferrous metallurgy	104,4	106,0
Chemistry and petro-chemistry	109,4	101,6
Mechanical engineering and metal working	101,5	102,0
Wood, woodworking, pulp and paper industry	106,4	102,4
Industry of construction materials	106,2	103,0
Light industry	97,7	96,6
Food industry	105,1	106,5
<b>Total industry</b>	<b>107,0</b>	<b>103,7</b>

IOI – index of industrial output

The industries oriented towards the domestic market grew at faster rates in the regions, where the conditions for such growth were most favorable. Due to their high market capacities, the City of Moscow, Moscow oblast, and the Leningrad oblast remained among the regions leading in terms of rates of growth in industrial output (see Table 2). The Kaliningrad oblast has been positively affected by the special economic zone treatment, which created the favorable conditions for development of import substitution.

As concerns the dynamics of industrial output in 2003, the more favorable situation in comparison with 2002 was reflected not only in higher national rates of growth in industry, but also in the diminishing number of regions, where there was observed a decline in industrial output. While in 2002 there were 19 such regions, in 2003 there remained only 9. Among them are four autonomous okrugs: Taimyr, Komi Permyak, Ust Ordynsk, and Buryat AOs, characterized by low levels of industrial development; the Republics of Kalmykia, Altai, Ingushetia (which could be affected by the struggle against the offshore nature of their economies on the part of the federal authorities (Ingushetia was a leader among all regions as concerns the decline in industrial output – by 15 per cent); the Magadan and Kirov oblasts (where IOI made 10.1 per cent and 1.0 per cent respectively). With the exception of the Magadan and Kirov oblasts, in other regions a decline in industrial output was registered also in 2002.

As concerns federal okrugs, the worst situation, as in the preceding years, was observed in the Far East okrug (see Table 3). However, it should be noted that a positive fact is that in this macro-region the downfall in industrial output was at last reversed and there were registered indications of growth. Among the RF subjects composing the Far East okrug, the Khabarovsk krai (the region with the highest level of industrial development and most diversified structure of industrial production in the Far East) demonstrated the highest rates of growth (7.2 per cent).

Table 2

**Regions demonstrating the most and least favorable industrial output dynamics in 2002 through 2003\***

Regions	IOI, 2003 in % of 2002	Regions	IOI, 2002 in % of 2001
Republic of Mordovia	122,6	Leningrad oblast	135,6
Leningrad oblast	120,9	City of St. Petersburg	131,4
Arkhangelsk oblast	119,5	City of Moscow	114,2
Orenburg oblast	116,3	Republic of Buryatia	113,8
Moscow oblast	115,9	Lipetsk oblast	112,5
Kaliningrad oblast	114,5	Republic of Dagestan	112,4
Tomsk oblast	114,4	Tomsk oblast	111,0
Kursk oblast	112,8	Yevreyskaya AO	111,0
Republic of Buryatia	112,1	Omsk oblast	110,8
Republic of Mari El	111,9	Orenburg oblast	110,5
City of Moscow	110,4	Republic of Mordovia	110,0
Tyumen oblast	110,2	Krasnodar krai	109,5
Omsk oblast	110,0	Ulyanovsk oblast	108,9
Chita oblast	109,8	Moscow oblast	108,7
Karachayevo Cherkess Republic	109,4	Kaliningrad oblast	108,5

\* without autonomous okrugs

Table 3

**Characteristics of industrial output across federal okrugs**

Federal okrugs	IOI, %		Share in the national industrial output (in %)	
	2003	2002	2003	2002
Central federal okrug	109,3	107,8	22,20	22,33
North West federal okrug	111,1	116,4	12,16	11,69
Southern federal okrug	105,1	103,2	6,34	6,44
Privolzhski federal okrug	106,5	102,2	22,51	22,75
Ural federal okrug	109,5	105,4	19,55	19,59
Siberian federal okrug	106,6	104,0	12,27	12,04
Far East federal okrug	104,7	99,1	4,98	5,16
<b>Russian Federation</b>	<b>107,0</b>	<b>103,7</b>	<b>100,00</b>	<b>100,00</b>

The North West federal okrug retained its leading positions in terms of the rates of growth in industrial output, the same okrug demonstrated the most significant increase in its share in the national industrial output. More favorable situation in export oriented industries as compared with the industries oriented towards the domestic market resulted in the fact that the Ural federal okrug outpaced the Central federal okrug in terms of rates growth in industrial output. The only region of the Ural okrug where there were registered rates of growth in industrial output below the national average was the Kurgan oblast (IOI made there 102.5 per cent), which is the least economically developed region in this okrug.

It should be also noted that in 2003 the interregional differences in terms of the dynamics of industrial output were less pronounced in comparison with the interregional differences observed in 2002. It is also demonstrated by the data across federal okrugs: while in 2002 the indicators of the industrial output index varied from 99.1 per cent to 116.4 per cent, in 2003 they made from 104.7 per cent to 111.1 per cent (see Table 3).

O. Kuznetsova

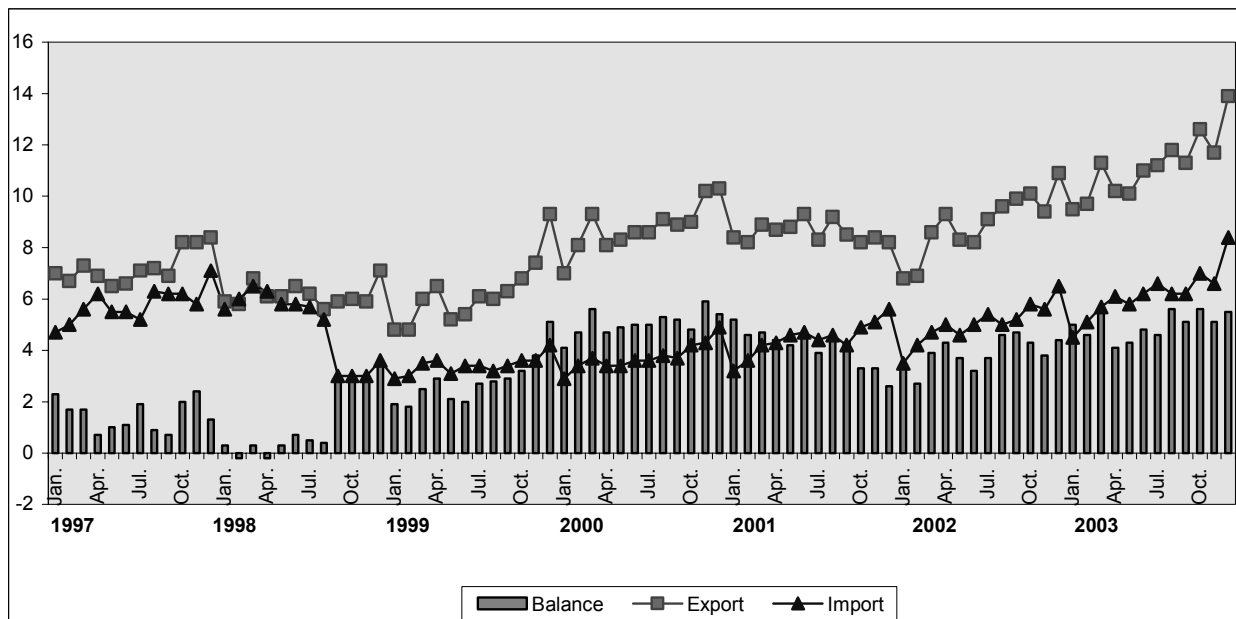


## Foreign Trade

In December of 2003, the Russia's foreign trade turnover (according to the balance of trade methodology) reached US \$ 22.3 billion, what is the record high in the last 15 years. It should be noted that both export and import indicators were registered at their highest levels. In December of 2003, Russian exports made US \$ 13.9 billion, what is by 18.9 per cent above the figures registered in November of 2003 and by 26.3 per cent above the level observed in December of 2002. Export to countries outside NIS made US \$ 11.6 billion (by 24.8 per cent above the respective indicator of the preceding year).

Russian imports in December of 2003 made US \$ 8.4 billion, what is by 26.5 per cent above the figures registered in November of 2003 and by 28.5 per cent above the level observed in December of 2002. It should be noted that the imports from countries outside NIS made US \$ 6.6 billion (by 26.6 per cent above the figures registered in December of 2002).

### Main indicators of Russia's foreign trade (in US \$ bln.).



Source: RF Goskomstat

In December of 2003, the Russia's active balance of trade made US \$ 5.5 billion, what was by 9.2 per cent above the figures registered in November of 2003 and by 233.2 per cent above the level observed in December of 2002. the active balance of trade vis-à-vis countries outside NIS made US \$ 5 billion (a growth by 8.9 per cent in comparison with this indicator registered last December).

The exceptionally favorable dynamics of world prices of oil and other energy resources accounted for the unprecedented rates of growth in exports. In December of 2003, the Brent oil price was above the respective indicator of 2002 by 7.4 per cent. In 2003, the average annual Urals and Brent oil prices exceeded the respective price of 2002 by about 13 per cent.

*Table 1.*

### The average monthly world prices in December of the respective year

	1996	1997	1998	1999	2000	2001	2002	2003
Oil (Brent), USD / barrel	22,8	17,8	11,5	24,1	25,6	19,0	27,48	29,51
Natural gas, USD / 1 mil Btu	3,093	2,393	2,251	2,558	8,713	2,694	4,873	6,469
Gasoline, USD / gallon	0,6691	0,5648	0,3739	0,6986	0,7649	0,5398	0,836	0,889
Copper, USD / metric ton	2273,3	1834,7	1601,6	1748,1	1914,4	1528,7	1618,6	2187,8
Aluminum, USD / metric ton	1459,9	1535,5	1305	1470,7	1562,5	1346,3	1376,2	1553,8
Nickel, USD / metric ton	6920,0	6099,0	4202,0	7984,2	7315,4	5219,5	7255,0	14060

Source: calculated in accordance to the data presented by London Metal Exchange (UK), International Oil Exchange (London)

Prices of the Russian natural gas remained at a high level. The average contract price in December of 2003 increased by 32.8 per cent in comparison with the respective indicator observed in December of 2002.

In 2003, on the market of non-ferrous metals there prevailed an upward trend in prices, what was primarily caused by the fast rates of growth in demand for metals on the part of China, the recovery of demand in Japan, and the general optimistic forecast of development of the economies - major consumers of metals.

The appearing signs of recovery of the world economy facilitated a growth in prices on the market of non-ferrous metals. The nickel prices grew especially significantly. By the end of the year, the nickel price has reached the record high over the last 14 years – US \$ 14060 per metric ton. The factor behind the growth in nickel prices already continuing unceasingly for several months running was the increase in the consumption of this metal, especially in China.

In 2003, the average annual nickel, copper, and aluminum prices increased in comparison with the figures observed 2002 by 55.2 per cent, 12.1 per cent, and 5.5 per cent respectively.

According to the data for December of 2003, the turnover of trade between Russia and CIS member countries made US \$ 4.02 billion; exports grew by 34.8 per cent and imports – by 36.2 per cent respectively in comparison with the figures registered in December of 2002. In the last months of 2002 the amounts of imports and exports grew at practically same rates.

In February, the most discussed topic relating to the relations between Russia and neighboring countries was the problem of natural gas exports to Belorussia. Russia has again reduced deliveries of natural gas to Belorussian consumers by 30 per cent, since Belorussian consumers received the total last contracted volume of natural gas (516 cubic meters). The Belorussian party continued to insist on non-market price of deliveries, even below the actual cost. At present, in Russia natural gas is sold at prices ranging from US \$ 28 to US \$ 35 per one thousand cubic meters, while the range of prices in export contracts makes from US \$ 50 to US \$ 110. For instance, Azerbaijan, a country extracting own natural gas, purchases it from Gazprom at US \$ 52, while Georgia pays more than US \$ 60.

The natural gas issue became an urgent problem of the Russia – Belorussia relations at the end of 2003, when Belorussia failed to meet the approved schedule of payments relating to outstanding debts amounting to over US \$ 130 million and tried to drag out the negotiations concerning the creation of a joint Russian and Belorussian enterprise intended to manage its natural gas transportation system. Besides, the Belorussian party demanded to increase deliveries at the Russian internal prices three times by 2010, what was at variance with the intergovernmental agreement concluded in 2002, where the volumes of delivery of Russian natural gas were set at the level of 10.2 billion cubic meters a year.

At present, the negotiations about extension to Belorussia of a Russian credit targeted for payments in accordance with the Belorussian import contracts are underway. Belorussia had to agree to the market terms of the credit and adjustment of its amount to the agreement with Gazprom on natural gas deliveries at the higher price of US \$ 50 per one thousand cubic meters.

The new Customs Code, which entered into force on January 1, 2004, does not envisage the regime of processing in the customs territory (tolling). Tolling is the processing in some country of raw materials supplied by foreign customers. External tolling does not affect the domestic market, therefore the supplier does not pay VAT and customs duties. There is also internal tolling, in this case foreign companies purchase raw materials in the processing country and exports the final product. Until 2002, in Russia there existed both external and internal tolling, introduced by the Russian authorities in 1991 and 1995 respectively, in the beginning of 2002 the internal tolling in Russia was abolished.

Tolling operations in Russia were most frequent in the aluminum industry, they were also used in non-ferrous metallurgy, light industry, and chemistry.

In order to compensate financial losses of the companies, which had used the tolling regime, the RF Government abolishes the export duty on aluminum oxide, unalloyed aluminum, and aluminum alloys. These measures were undertaken in relation to the fact that since January 1, 2004, domestic producers of aluminum have started to pay 18 per cent VAT in stead of the zero tax rate. Governmental resolution No. 39 of January 23, 2004, was enacted in February of 2004. The same resolution sets the export duty on crude aluminum at 5 per cent of the customs value..

In February, the relations between Russia and the EU have somewhat deteriorated, what was reflected in the resolution adopted at the summit of UE Foreign Ministers requesting Russia to automatically extend the agreement on partnership and cooperation with the European Union, in force since 1997, to the ten countries joining EU on May 1, 2004. In the case Russia fails to comply, Brussels threatens Moscow with economic

sanctions. However, Russia is not ready yet to revise its relations with the countries of the former socialist camp and refuses to extend the current agreement with EU to the joining countries.

However, it is not the only problem in relations between Moscow and Brussels. European Union has for a long time requested Moscow to ratify the Kiyoto Protocol and liberalization of the natural gas sector (otherwise, EU is ready to bloc Russia's accession to WTO).

At the same time, the accession of the former Baltic Republics and former COMECON member countries to the European Union will result in Russia's annual losses ranging from Euro 150 million to 300 million. The new EU members will have to introduce the common European customs duties on steel and bread imports (at present these commodities are exempted from taxes), diversify sources of delivery of energy resources at the expense of reduced imports from Russia, etc. Simultaneously, in accordance with the EU – Russia agreement there should be reduced Russian customs duties on goods imported from East European countries.

This January, the Russian Federation put forward its list of requests concerning the trade relations with EU countries. As a compensation for its losses, Russia requests customs privileges, increase in import quotas for its goods, abolish visas for Russian citizens, and provide financial aid to the Kaliningrad oblast. However, the list of Russia's requests was flatly declined by the European Union.

EU is the key partner of Russia, the enlarged EU will account not for present 36 per cent, but over 50 per cent of the Russia's foreign trade turnover. The share of Russia in the EU trade will also rise almost twofold. Changes of this scale require to search for decisions helping to adjust to the realities. It concerns both the renewal of the existing package of agreements and legal acts serving as the basis of cooperation, and negotiations on the terms of trade with individual goods. It is necessary to find such compromises, which reduce to the minimum the potential loss and permit to substantially develop cooperation.

*N. Volovik, N. Leonova*

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### **Privatization: some results of 2003**

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The most significant novations of 2003 were, first, the started gradual implementation of the elements of the new Concept of management of federally owned property (approved at the RF Government meeting held on February 6, 2003), second, a certain definiteness (at least theoretical) as concerns the schedule of privatization of strategic objects still owned by the state (until 2008). The expected in the few next years certain quantitative acceleration of the privatization process is directly related to these novations. First of all, it concerns the "unloading" of remaining minority blocks of shares and corporatization of state owned unitary enterprises with consequent sale of shares in these enterprises.

The Prognosis Plan (Program) of privatization for 2003 was approved by the RF Government Resolution No. 1155-r of August 20, 2002 (amended on October 9, 2002). The data on the renewable revenue sources are presented in Table 1. The expected revenues from privatization in 2003 should have made, according to preliminary estimates, Rub. 15 to 20 billion, later the Government adjusted these figures up to Rub. 51 to 54 billion. It seems that this amount was set forth because there was expected the sale of several large blocks of shares, probably Svyazinvest (there were set several different options, from 25 per cent minus 2 shares to 75 per cent minus 1 share), 23.76 per cent of shares in the Magnitogorsk integrated iron and steel works, 26 per cent minus 1 share in Rosgosstrakh, 25.5 per cent of the Sibir air company, 21.78 per cent of shares in the Central Telegraph, and a number of others. As a rule, 90 to 95 per cent of revenues are derived from privatization of 25 to 30 blocks of shares.

However, in contradistinction to the past years, in 2003 there were registered no large privatization transactions, which sharply increase budget revenues derived from nonrenewable sources. The last block of shares in the oil company Lukoil (7.6 per cent) will not be sold earlier than in 2004, and for privatization purposes it is planned to include the company in the New York Stock Exchange listing.

The block of shares in the telecommunications holding Svyazinvest (25 per cent minus 2 shares) planned for privatization over all recent years, may be sold not earlier than in 2005, after there will be completed the reorganization processes in the holding, tariff reform, and there will be settled the problem of social burden of regional companies. Taking into account the growing attractiveness of the telecommunications stocks, an immediate sale of the shares is not feasible at all. Although it is too early to discuss possible terms of the sale (as the example of, for instance, Slavneft reveals, radical changes may be made practically every day), there should be noted one of the existing options envisaging the auction sale of blocks of shares in regional companies of the holding (at least four interregional affiliated companies are included in the list for year

2004). In the case this variant is realized, it is highly probable that the industry will encounter the whole spectrum of problems caused by the “double” privatization of oil companies in the 1990s (at that time, in the first round of sales there were sold extracting companies, and the holdings with the rest state owned blocks of shares were sold later).

The sale of 23.7 per cent in the Magnitogorsk integrated iron and steel works (as a matter of fact, the last large state owned asset in the industry) encounters difficulties not only because of the rivalry of several large metallurgic groups. Although there was taken the decision to hold an open auction, the enterprise must be first withdrawn from the list of strategic enterprises, what requires approval of the RF President.

It is a well known fact that in 2002 serious conflicts between different corporate groups took place with respect to privatization tenders in the coal mining, transport industry (ports, etc.), and oil industry (first of all, Slavneft). On the contrary, in 2003 there was observed less conflicts in the course of the privatization process, at least as concerns the largest transactions. However, it is not an evidence of harmonization of relations between largest oil and metallurgical groups, it may be only an evidence that by 2003 there were exhausted privatized (offered for sale) assets, which could be used for creation of integrated groups in a number of industries.

Accordingly, the real (without transactions made in 2002) budget revenues derived at the expense of sales of property in 2003 were rather insignificant. In fact, the amount of revenues (without transactions made in 2002) was even below the preliminary set target (Rub. 15 to 20 billion) making about Rub. 12 billion.

Table 1.

**Privatization and utilization of federally owned  
property: the dynamics of revenues, Rub. million**

	1999*	2000	2001	2002	2003	2004 (estimate)
<b>1. Nonrenewable sources, total</b>	<b>8 547,4</b>	<b>31 367,1</b>	<b>10 110,6</b>	<b>14 700,7</b>	<b>95 237,6</b>	-
1.1. Privatization (number of enterprises)	8 547,4	31 367,1 (320)	9 990,6 (170)	12 703,8	90 660,3 **	35 000 – 40 000
1.2. Sales of property owned by FSUE and military property	-	-	-	-	585	-
1.3. Sales of land and intangible assets	-	-	120,0	1 996,9	3 992,3	-
<b>2. Renewable sources, total</b>	<b>8 720,5</b>	<b>18 790,1</b>	<b>29 122,6</b>	<b>36 762,2</b>	<b>41 142,9</b>	<b>38 700</b>
2.1. Dividends (number of enterprises)	848,1 (600)	3 675,1 (1050)	6 478,0 (782)	10 402,3 (747)	12 395,2	12 500
2.2. Lease of property	2 191,4	3 427,2	4 896,1	7 657,9	9 573,9	8 700
2.3. Lease of land	-	-	3 917,0	4 400,0	197***	-
2.4. Share in FSUE profits (number of enterprises)	-	-	209,6 (131)	914,2 (809)	2 387,6	3 200
2.4. JV Vietsovpetro	5 675,0	11 687,3	13 621,9	13 388,8	16 200	14 300
<b>Total</b>	<b>17 261,9</b>	<b>50 157,2</b>	<b>39 233,2</b>	<b>51 462,9</b>	<b>136 380,5</b>	<b>73 000 – 80 000</b>

\* For the dynamics observed in 1995 through 2002, see: Russian Economy in 2002. Trends and Perspectives. M., IET, 2003, p. 367.

\*\* In fact, about Rub. 82 million, or about 95 per cent are revenues from *transactions made in 2002* (Rub. 58.7 billion for 74.95 per cent of Slavneft shares and Rub. 775 million for 5.9 per cent of shares in Lukoil), which were transferred to the budget in 2003. Accordingly, the RF Property Ministry used both transactions in accounting for both 2002 and 2003. It should be also noted that the payment for the sale of the block of shares in Lukoil, sold on December 4, 2002, were received by the budget only on May 8, 2003, and the concrete recipient of revenues derived over that period (dozens millions of dollars) is still unknown. In the case the said transactions are excluded, renewable sources clearly dominate both in 2002 and 2003.

\*\*\* Rental payments for federally owned land, after delimitation.

Source: RF Property Ministry, authors' calculations

As concerns budget revenues, the trends related to the domination of revenues from utilization of state owned property, observed in 2001 and 2002, have persisted.

According to the data presented by the RF Ministry of Property Relations, the aggregate revenues of the federal budget from privatization and utilization of state owned property made over Rub. 135 billion in 2003. The aggregate revenues related to the utilization of federal property made Rub. 41 billion, including Rub. 9.5 billion from the lease of federal property, Rub. 12.4 billion at the expense of dividends on shares in federal ownership, Rub. 16.2 billion from the RF share in the joint venture Vietsovetpetro, Rub. 197 million from rental payments for land (after delimitation), Rub. 2.4 billion as transfer of a share in profits of federal state owned unitary enterprises (organizations) and military property, Rub. 4 billion from sales of land. Revenues derived from sales of property and blocks of shares in joint stock companies carried out by RFFI and property funds in RF subjects made Rub. 90.6 billion, although *more than 90 per cent of this amount was received at the expense of two transactions concluded in 2002*, the revenues from which were received only in 2003 (blocks of shares in Lukoil and Slavneft).

The Government reviews dividends on state owned blocks of shares as the most important renewable source of budget revenues. The dynamics of this indicator observed over the last few years indicate a considerable increase in respective payments (see Table 1). In 1996, only 35 per cent of public joint stock companies paid dividends on state owned blocks of shares. While in 1998, 273 joint stock companies with state participation transferred to the federal budget Rub. 574 million, in 2002, 747 joint stock companies transferred Rub. 10400 million. These dynamics are clearly related to the growing activity of the RF Property Ministry.

At the same time, as the analysis of the aggregate growth in dividend payments across 95 companies in 2001 through 2002 reveals, the growth in dividend payments across the group of comparable enterprises made 263 per cent (without Sibneft dividends – 171 per cent). In 2002, there was for the first time observed a general sharp increase in dividend payments across Russian corporations not related to the Ruble devaluation and the sharp changes in the financial results of enterprises (as it was the case, for instance, after the crisis of 1998)<sup>10</sup>. To a considerable extent, this growth was caused by an increase in dividend payments on ordinary shares, what was, in turn, caused by a number of reasons: policies of corporate government and capitalization growth pursued by a number of large companies, pressure of industry-specific holding companies (RAO UES in power engineering, Svyazinvest in telecommunications), and the reduction of rates of taxes on dividends.

In this connection it may be assumed that the significant success of the RF Property Ministry efforts with respect of increase in dividend payments related to federally owned blocks of shares observed in 2000 through 2003 are related not only to more intensive work with issuers, but also to the objective processes underway in the corporate sector of the Russian economy since early 2000s. Besides, many enterprises are not ready to increase their dividend payments to the state as a shareholder. For instance, Alrosa, where the state owns 37 per cent of the authorized capital, was ready to pay only 10 to 12 per cent of its net profits in 2003, however, it actively rejects the approach of the RF Property Ministry, which considers the possibility to increase the company's dividend payments of 2003 by three times. It is apparent that these factors will determine the perspectives of this source of state revenues.

The growth in proceeds from the RF share in the joint venture Vietsovetpetro, especially the noticeable increase in 2003 in comparison with the target, could be hardly attributed exclusively to the efforts of the RF Property Ministry. The major cause is apparent (oil prices), however, there should be also taken into account the extremely detailed regulation of the operations of this enterprises conducted yet in the 1990s.

On the contrary, revenues represented by a share in profits of state owned unitary enterprises should be hardly viewed as a considerable and prospective source of revenues. This is related both to the program of gradual liquidation of SUE institution, and the reorganization of the remaining (in perspective) SUE in state structures working to meet state needs.

An element of the new Concept of management of federally owned property is a three year privatization program. For the first time such a document (the Prognosis Plan (Program) of privatization of federally owned property for 2004 and key guidelines of privatization of federally owned property till 2006) was approved by the RF Government Resolution No. 1165-r of August 15, 2003. There is envisaged the following schedule of activities:

- 2003 – privatization of state owned blocks of shares up to 2 per cent of authorized capital;

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<sup>10</sup> Danilov Yu. A. Osnovnye tendentsii dividendnoi politiki rossiyskikh predpriyatii v 2002 godu, (Major trends of dividend policies of Russian enterprises in 2002), Report at the seminar of GU-VshE "Institutsionalnye problemy rossiyskoi ekonomiki" (Institutional problems of the Russian economy), 2003.

- 2004 – withdrawal of the state from all joint stock companies where the state owns less than 25 per cent interest;

- 2005 - withdrawal of the state from all joint stock companies where the state owns from 25 per cent to 50 per cent of interest (for instance, withdrawal from capitals of power construction complex, companies engaged in fishery, external economic activities, mechanical engineering, and cinematography);

- 2006 – withdrawal of the state from all non-strategic joint stock companies where the state owns more than 50 per cent of interest (for instance, civil aircraft companies not engaged in activities aimed to ensure state security and safety of flights, companies in chemistry and petrochemistry, geology, a number of branches of agriculture), including the sale of shares in joint stock companies created in the process of FSUE transformation;

- by 2008 – the completion of privatization of federally owned property, which is not used for performance of state functions of the RF, finalization of formation of the system of management of public sector property, a twofold increase of revenues from utilization of property.

According to the RF Property Ministry estimates, in order to implement this program it is necessary annually sell 4000 joint stock companies (including reorganized FSUE). In order to reorganize about 6000 FSUE by 2006 (as it is planned), it is necessary to simultaneously amend regulatory and legal acts in order to remove the limitations on privatization of more than 3000 remaining FSUE. By the end of 2008, the state should own no more than 2000 FSUE and 500 different blocks of shares. So, it may be noted that the ownership reform in Russia will be completed in accordance with a rather radical scenario.

It seems that this program is too ambitious, what is determined by a number of factors. First, the real progress of privatization in the period when the law on privatization of 1997 had been in force clearly indicates that the organizational potential of authorities with respect to a fast reforming of the public sector seriously contradicts its quantitative limitations, i.e. its scale. Thus, in 1998 through 2002, according to the official data there were privatized only 749 enterprises (organizations, objects) in federal ownership. Second, the problem of residual blocks of shares, discussed since the mid-1990s traditionally persists. Over the last 10 years (after the completion of mass privatization of 1992 though 1994), the number of minority blocks in state ownership has gradually diminished, however, the respective rates make to believe that this problem will not be settled in three years. Third, the said program indirectly presupposes practically complete liquidation of the institution of state unitary enterprises, what is conceptually justified. However, it should be noted that it is not the first plan of a sharp reduction of the state presence in the economy: the RF Property Ministry has already several times planned a massive reduction of the number of SUE, but these plans, as it is well known, were opposed by branch Ministries.

*A. D. Radygin*

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## **February of 2004: Political and economic outcomes**

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The major outcome in February of 2004 was the unexpected dismissal of the M. Kasyanov's Cabinet of Ministers on February 23, 2004. According to the majority of experts, it could be expected only after the election of the new RF President as set forth by the Constitution. However, the RF President took this step, as he had said, in order to inform voters about his views about the personal composition of the Cabinet before the Presidential elections, while characterizing the performance of the government as "satisfactory." Later, the former Prime Minister noted that he did not expect the decision to dismiss the government. Whoever heads the Cabinet in the present situation (it could be hardly expected that there is appointed any odious figure), it is no doubt too early to draw any conclusions about the political and economic course of the state and its possible changes. The government must first declare its program. The only fact, which may be evaluated today, is the persistence of the Russian practices of sudden and unsubstantiated appointments and dismissals in spite of numerous statements about the "stability" of the regime and society.

Another important news of February was the address of RF President Putin to the persons representing him as the candidate in the elections, which was held on the MSU premises on February 12, 2004. In fact, it was his first program speech in the framework of the election campaign. Besides, the speech was aimed express his vision of almost a decade of Russian history. In his speech, the President addressed the following issues.

First, he positively assessed the democratic and market economy institutions. V. Putin noted that "the transition to democracy and market economy in the early 1990s was most actively and decisively supported by citizens of Russia, who made their final and, I want to stress it once more, irrevocable choice in favor of

freedom. It was a tremendous and real achievement of the Russian people, I think, it was one of the most tremendous achievements of our nation in the 20<sup>th</sup> century.<sup>11</sup>” Second, Putin assessed his preceding four year term. He evaluated as successes liquidation of regional separatism (sometimes escalated to armed conflicts, as in the North Caucasus), accumulation of a sufficient reserve to meet foreign debt payments (settlement of the “problem of 2003”), positive dynamics of “all social indicators”, a 30 per cent growth in GDP, growth in real cash household incomes 1.5 times, a significant reduction of unemployment, and, at last, stabilization, as he said, “...our life becomes free of the ambiguity of perspectives, uncertainty, and impossibility to make any long term plans. The society, as it seems, could at last overcome the fear of painful consequences of the reforms.” However, Putin also expressed his dissatisfaction with the rates and results of many transformations. Among the urgent problems he cited inefficiency of state apparatus, persistence of raw material orientation of the economy, administrative arbitrariness of the law enforcement system, inefficiency of education and health care, non-transparency of mineral wealth utilization.

Putin indicated rather liberal recipes of further progress – reduction of the tax burden, modernization of natural monopolies, mineral wealth utilization based on auctions, development of mortgage and improvement of the pension system envisaging the right of citizens to dispose of their pension savings.

As concerns the political sphere, according to Putin there should be strengthened the system of political competition, free and responsible mass media, and civil society. The President stressed that “...only a developed civil society can ensure the inviolability of democratic freedoms, guarantees of human and civil rights. In the end, only free people can ensure economic growth, prosperity of the state. In brief, it is the alpha and omega of economic success and economic growth. I want to stress once more: freedoms and rights of citizens are the highest values determining the sense and content of state work.”

In February it was also preliminary evaluate the practical measures aimed at implementation of the President’s initiatives. As concerns the strengthening of political competition, the attention may be drawn to the fact that this speech was for half an hour broadcasted by state owned TV channels, although the program was not paid from the electoral fund. Expectations that the RF Central Election Commission warn these TV channels or require them to grant similar free air time to other candidates did not come true. The RF Central Election Commission stated that television only “informed” citizens about the President’s activities.

Over the past month, the official competitors of the President repeatedly discussed the possibility to withdraw their candidacies as a sign of protest against the unequal conditions of the election campaign. For instance, G. Zyuganov, the CPRF leader, stated that candidate N. Kharitonov nominated by the party would withdraw his candidacy if Putin refuses to participate in the televised debates. Similar statements were made by I. Khakamada, S. Glazyev, I. Rybkin. However, later these statements were disavowed in accordance with the functions performed by the candidates. According to available information, the competitors of the President do not intend to monitor the elections.

As concerns the sphere of party development, there may be noted the widening split in the Rodina (Homeland) bloc. Last month, the group supporting D. Rogozin held an inaugural congress of the similarly named political party. At the same time, the public rhetoric of S. Glazyev and D. Rogozin indicates that any reconciliation is impossible and they can not be members of the same organization. There was also noted the first appointment of a former leader of right wing organizations at a top post (V. Lukin was appointed as the RF ombudsman).

In February, there took place the next serious terrorist act – the explosion in the Moscow metro took at least 40 lives. The investigation is far from completion, however, it is considered that it was a terrorist act carried out by Chechen fighters, what looks rather plausible.

The “YUKOS case” also progresses. The immediately satisfied claims of foreign offshore companies closely affiliated with Sibneft conserve the situation not allowing YUKOS shareholders to take control over Sibneft they purchased or receive back more than US \$ 3 billion paid for that company. There should be also noted the statement of L. Nevzlin, now a political emigrant, who informed Putin about his readiness to exchange shares in YUKOS for release from custody of M. Khodorkovsky, P. Lebedev, and others. This statement might be viewed as a provocation, however, at the same time there was changed the structure of the authorized capital of the Gibraltar offshore company Group Menatep, where well known shareholders were replaced with new offshore companies. It should be noted that such changes correspond to the legally sound implementation of a transaction “shares for freedom.”

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<sup>11</sup> See the official web site at <http://www.putin2004.ru/>

In February, the conflict between the Russian Federation and Belorussia over tariffs on natural gas supplied to Belorussia and transit tariffs. The attempt of Belorussian authorities, which failed to make the next<sup>12</sup> contract for supply of Russian natural gas with Russian enterprises, to take the gas from transit pipelines resulted in the stoppage of all natural gas deliveries. The President of Belorussia publicly insulted the Russian authorities. Under the threat of a technological catastrophe, Belorussia had to sign new contracts, however, at the same time it both raised transit tariffs and received the next state credit from the RF. Expert opinions are mixed, however, it should be noted that as concerns numerous economic conflicts with CIS member countries, the latter, as a rule, force upon their Russian partners any conditions under the threat of physical infringement of existing legally binding obligations.

As concerns the sphere of economy, there should be noted the actual revision of several, as it seemed long ago settled economic issues. First, it concerns the introduction of so called "VAT accounts," which caused sharp reactions on the part of the Russian business. In the course of the meeting presided by M. Kasyanov, the former Prime Minister, the officials of the Finance Ministry and CB RF were requested to elaborate alternative methods to improve tax collection and measures aimed to prevent criminal schemes of "false imports." Second, key Ministries failed to agree on the widely discussed idea of differentiation of payments for the use of natural resources, what could allow officials to apply different financial requirements to different companies. There was chosen the concept of certain increase in existing fees (subsoil tax, export customs duties) without changing the procedures of their calculation.

At last, there was announced that the RF Ministry of Economic Development and Trade worked out the draft law "On the specifics of decision making in the sphere of state regulation of business activities." The law is aimed at restriction of departmental powers to issue bylaws. For instance, the document envisages that all departmental bylaws should first pass preliminary examination carried out by expert and advisory councils at the RF government. Besides, in the course of examination, these documents should be publicly discussed. According to the decisions taken by the expert and advisory councils, the special authorized federal authority should decide if it is feasible or unfeasible to approve such a bylaw. Experts have great expectations on the approval of this draft law, although, naturally, it is subordinated to the guarantees of the basic rights of inviolability of person and private property.

*S. Zhavoronkov*

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## **Forecasting certain macroeconomic indicators<sup>13</sup>**

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Below are presented the results of forecasting of the future values of the M2 monetary aggregate, monetary base, and gold and foreign exchange reserves in the period from March to May of 2004 basing on time series models ARIMA (p, d, q). It should be noted that since November of 2003 IET has monthly published the bulletin of model based calculations of short term forecasts of social and economic indicators observed in the Russian Federation (see [www.iet.ru](http://www.iet.ru)).

### **Monetary indicators**

Future values of the monetary aggregate M2 and the monetary base basing on the models of time series of respective indicators calculated by the CB RF<sup>14</sup> in the interval from October of 1998 till December of 2003. Table 1 presents the results of calculations of estimated values and actual values of these indicators over the respective period of the preceding year. It should be noted that since the monetary base is a CB RF policy tool, its forecasts based on time series models are rather conventional and that future values of this indicator are rather determined not by internal characteristics, but decisions taken by the CB RF.

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<sup>12</sup> Although the prices were raised by one third, they were still twice below the level of world prices

<sup>13</sup> For the purposes of this presentation, a forecast is defined as an estimate of the future values of the indicator obtained basing on a model with the best statistical qualities. For more details of the modeling of time series see, for instance: S. Sinelnikov-Murylev, R. Entov, S. Drobyshevski, V. Nosko, A. Yudin (2001) "Econometric Analysis of Time Series of Key Macroeconomic Indicators," Moscow, IET.

<sup>14</sup> The data for each month are presented in accordance with the methods of CB RF as in the beginning of the next month



Table 1

**Forecast of monetary aggregate M2 and monetary base for March through May of 2004.**

Period	M2		Monetary base	
	Rub. billion	Increment to the preceding month	Rub. billion	Increment to the preceding month
March, 2004	3307.5	2.6%	1359.3	2.1%
April, 2004	3399.6	2.8%	1474.5	8.5%
May, 2004	3490.9	2.7%	1516.7	2.9%
<b>Memorandum: actual values in respective periods of the preceding year (increment to the preceding month)</b>				
March, 2003		4.8%		3.2%
April, 2003		4.7%		8.7%
May, 2003		5.2%		3.8%

On the whole, it may be asserted that the obtained forecasts across all estimated indicators in the period from March till May of 2004 are more moderate as compared with the actual data collected over the respective period of the preceding year. It should be noted that as concerns the monetary base, there is forecasted its significant growth in April of 2004 (about 8.5 per cent), however, in comparison with the figures registered in the respective period of the preceding year this seasonal peak in terms of growth rates is also forecasted to be at a more moderate level. As concerns the aggregate M2, its dynamics are more stable (the average monthly increment is at 2.7 per cent as compared with the figures registered in the preceding month).

**Gold and foreign exchange reserves**

This section presents the results of statistical evaluation of future values of gold and foreign exchange reserves of the Russian Federation obtained proceeding from the assessment of the time series model of gold and foreign exchange reserves based on the data presented by the CB RF in the interval from October 1998 till January of 2004. It should be noted that this indicator is forecasted without taking into account the decrease in reserves caused by the repayment of the foreign debt, due to this fact, values of amounts of gold and foreign exchange reserves for the months when there were made payments related to the foreign debt may turn out to be estimated too high in comparison with the actual data.

Table 2

**Forecast of gold and foreign exchange reserves for March through May of 2004 and the actual values registered in the respective period of the preceding year.**

Period	ARIMA model based forecasts	
	US \$ million	Increment to the respective month of 2003
March, 2004	92248	4.5%
April, 2004	96492	4.6%
May, 2004	101011	4.7%
<b>Memorandum: actual values in respective periods of the preceding year</b>		
	US \$ million	Increment to the respective month of 2002
March, 2003	55525	4.6%
April, 2003	59847	7.8%
May, 2003	64882	8.4%

Table 2 presents the results of calculation of estimated values of gold and foreign exchange reserves of the Russian Federation in March through May of 2004 and their actual values in the respective period of the preceding year. The forecasted average monthly increment in the amount of gold and foreign exchange reserves is expected to be at 4.6 per cent, what is significantly below the values of the respective indicator registered in the preceding year.

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## **Concepts and technical specifications pertaining to elaboration of draft federal laws discussed by the RF Government at its meeting of February 26, 2004**

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At the meeting of the RF Government held on February 26, 2004, there were discussed concepts and technical specifications pertaining to elaboration of draft federal laws with respect to such issues as amendments to certain chapters of the RF Tax Code relating to improvement of taxation of small businesses, draft federal law “On special economic zones in the Russian Federation,” the concept and technical specifications pertaining to elaboration of the draft federal law “On amendments to the federal law “On audit” and some other draft federal laws.

Most interesting are the concept and draft technical specifications pertaining to elaboration of the draft federal law “On amendment of chapters 26.2 and 26.3 of the RF Tax Code as concerns the improvement of taxation of small businesses,” as well as the concept and draft technical specifications pertaining to elaboration of the draft law “On special economic zones in the Russian Federation.”

The elaboration of the draft federal law “On amendment of chapters 26.2 and 26.3 of the RF Tax Code as concerns the improvement of taxation of small businesses” was caused by the necessity to take measures aimed at simplification of the system of registration of the objects of taxation and settlement of a number of problems not regulated by the tax legislation currently in force.

In order to enhance the efficiency of application of the simplified system of taxation, it is proposed to more clearly define provisions of chapter 26.2 of the RF Tax Code:

- Introduce the provision allowing to make annual changes (increase) the level of taxpayers’ earnings (in the situation of growing GDP and consumer prices of goods, works, and services) making them eligible for simplified system of taxation;
- More clearly define the eligibility requirements pertaining to the simplified system with respect to individual categories of taxpayers;
- Grant taxpayers the right to change the chosen object of taxation as concerns the taxpayers, who have switched to the simplified system since January 1, 2003, choosing earnings as the object of taxation (in relation to amendment of article 346<sup>16</sup> making it possible to include the cost of goods purchased for resale in the composition of expenditures (diminished by the amount of VAT on purchased goods, works, services);
- More clearly define the mechanism of determination of the tax base in the process of switching from the general tax treatment to the simplified system of taxation and from the simplified system of taxation to the general tax treatment;
- More clearly define the procedures governing VAT taxation in the simplified taxation system, the procedure governing offset of input VAT;
- More clearly define the composition of earnings pertaining to entrepreneurial activities taken by individual entrepreneurs into account in the course of determination of the objects of taxation.

In order to settle the issues not regulated by the current version of chapter 26<sup>3</sup> of the Code, it is proposed to make the following amendments.

Provisions of chapter 26<sup>3</sup> of the Code stipulate that the system of taxation in the form of the single tax on imputed earnings with respect to certain activities may be applied, for instance, as concerns such type of entrepreneurial activity as public catering on premises less than 150 square meters. At the same time, there develops public catering carried out via organizations having no special premises for servicing clients. In this connection, it is proposed to introduce necessary amendments to in chapter 26<sup>3</sup> of the Code, which determine the physical indicator and base profitability of public catering carried out via organizations having no special premises for servicing clients. Besides, it is proposed to more clearly define mechanisms permitting to ensure separate registration of property, obligations, and economic operations of taxpayers, who, alongside with activities subject to single tax on imputed earnings are engaged in other types of entrepreneurial activities, as well as more clearly define the procedure of calculation of the adjustment coefficient of base profitability  $K_1$  and the procedure of changing of the adjustment coefficient of base profitability  $K_2$ .

It is also envisaged to more clearly define certain provisions concerning the terms used for purposes of chapter 26<sup>3</sup> of the Code.

From our point of view, the introduction of indexation of the level of taxpayers’ earnings in the situation of growing GDP and consumer prices of goods, works, and services is not dangerous, however, granting of the right to change the chosen object of taxation to individual categories of taxpayers is not always desirable.

We believe that any change concerning objects of taxation should be limited, since this right provides possibilities for manipulations and abuses, for instance, for medium sized enterprises. However, taking into account changing circumstances (adoption of the provision permitting to include the cost of goods purchased for resale in the composition of expenditures) the persons indicated in the law should be granted the right to make such a choice once in a strictly limited period of time.

No doubt, that it was necessary to take the step to more clear definition of the mechanism of determination of the tax base in the process of switching from the general tax treatment to the simplified system of taxation and from the simplified system of taxation to the general tax treatment. Besides, we find it necessary to more clearly define the procedure of calculation of the adjustment coefficient of base profitability  $K_1$  and the procedure of changing of the adjustment coefficient of base profitability  $K_2$ .

Besides, at the meeting of the RF Government there was discussed the concept and draft technical specifications pertaining to elaboration of the draft law **“On special economic zones in the Russian Federation.”**

The basic concept of the draft federal law “On special economic zones in the Russian Federation” is to create favorable conditions for development of the economic and scientific potential of the country, attraction of investment in the national economy via creation and functioning of special economic zones (hereinafter referred as SEZ).

The law defines special economic zones as a part of the RF territory, where in accordance with the federal law “On special economic zones in the Russian Federation” and other legislative acts of the RF there is established a special regime for carrying out of entrepreneurial and investment activities, and where there is introduced the regime of a free customs zone.

The draft federal law envisages creation of two types of SEZ:

- industrial and manufacturing zones;
- technological zones (intended for introduction of new technologies).

As concerns the **creation** of SEZ, there should be observed the principle of limited territory. At the same time, SEZ territories should not coincide with territories of administrative and territorial entities. However, SEZ territory may overlap territories of several such entities, including territories of two and more RF subjects.

Decisions on creation of SEZ should be taken by the RF Government taking into account such factors as the needs of the national economy concerning respective products, organization and development of production of the given type, sufficient resource potential of the respective territory, the degree of urbanization of the territory allocated for SEZ, etc. The decision on creation of SEZ should be made in the form of a resolution of the RF Government simultaneously with the approval of the agreement on creation of SEZ made between the RF government, the executive authorities of the RF subject, and local governments of municipal entities.

The agreement on creation of SEZ made between the RF government, the executive authorities of the RF subject, and local governments of municipal entities on the territory of which it is planned to create the SEZ should determine sources of financing for creation of the respective infrastructure indicating shares of different budgets, the package of measures aimed to ensure development and adequate material and technical equipment of SEZ, obligations of federal, regional, and municipal authorities pertaining to their participation in establishment of the regime of carrying out entrepreneurial and investment activities on the territory of SEZ, rights and obligations of the parties engaged in the SEZ functioning.

By the time the RF Government takes the decision to create a SEZ in the territory of a RF subject, there should be no objects (with the exception of objects in the state and / or municipal ownership) owned by legal entities and individuals on the territory allocated for creation of SEZ.

The RF Government and the RF subject, on the territory of which the SEZ is created, should have the right to initiate the creation of SEZ. The RF subject should submit an application to the RF Government, which should organize tenders in the case there are several applications requesting creation of SEZ of the same type.

In the case private investment is attracted to create SEZ infrastructure, the private investor should be a party in the said agreement. In this case, the agreement should indicate the terms and forms of the distribution of earnings derived from the use of the SEZ infrastructure aimed to compensate the private investor for capital expenditures and ensure that such an investor derives profits.

The decision to terminate SEZ should be taken by the RF Government in the form of a resolution of the RF Government.

The general management of SEZ situated in the RF territory should be vested with a federal executive authority specifically authorized to elaborate and implement the unified state policy in the sphere of creation and functioning of SEZ.

**SEZ Directorate**, should be a territorial body managing SEZ and in the majority of cases acting as the joint representative of the state and municipal entities as concerns the relations with SEZ residents pertaining to carrying out of activities in the SEZ territory.

SEZ Directorate should register legal entities as SEZ residents, in certain cases annul registration of legal entities as SEZ residents, keep the register of SEZ residents, issue certificates of SEZ residents, manage the land plot, where the SEZ is located, perform other functions.

**Special regime of activities** on the SEZ territory should be applied to Russian and foreign legal entities properly registered as SEZ residents.

Residents of SEZ should be the legal entities registered in the SEZ territory and having an investment agreement with the SEZ Directorate. The legal entity should be granted the status of SEZ resident since the day the SEZ Directorate enters the registration in the special register and issues the certificate of SEZ residency. The status of SEZ resident should lose this status only basing on a court ruling.

Residents of SEZ should have the rights and bear obligations necessary only for carrying out entrepreneurial and / or investment activities in the SEZ territory in accordance with the purposes and objectives of the SEZ. SEZ residents should have no right to be a founder (participant) of organizations, including SEZ residents; participate in the managing bodies of organizations, including SEZ residents; maintain separate units outside the SEZ territory. Besides, residents of technological zones should have no right for grants, subsidies, and subventions from the federal budget.

**Amount of capital investments** (with the exception of intangible assets) envisaged by the investment project intended for implementation in the territory of an industrial zone should exceed the Ruble denominated amount equal to Euro 10 million calculated in accordance with the exchange rate set by the CB RF on the date of agreement on such a project.

The draft law envisages **stabilization clauses** to the effect that it should be prohibited to apply any regulatory and legal acts of the Russian Federation deteriorating the legal and /or economic situation of SEZ residents in comparison with their situation before the adoption of such laws and other regulatory and legal acts for a 10 year term. However, the regulatory and legal acts of the RF adopted for protection of the Constitutional system, morals, health, rights and lawful interests of other persons, national defense, and state security should be applicable.

In order to create incentives for investment activity of SEZ residents, the draft law envisages specifics of tax treatment of SEZ residents, administrative regime, use of land, sets the regime of free customs zone.

#### **Administrative regime in SEZ territory**

The special administrative regime established in the SEZ territory envisages that:

State control authorities should have the right to inspect SEZ residents only in the course of complex inspections and in compliance with the federal law “On protection of rights of legal entities and individual entrepreneurs in the course of state control (supervision)” with the exception of customs and tax control carried out by officers of the customs and tax authorities of the RF;

Complex inspections should be performed not less frequently than once in three years over the period not exceeding two weeks on the initiative of the SEZ Directorate by the control authorities supervising the activities of SEZ residents;

In the case in the course of complex inspections performed by officers of state control authorities there are revealed violations of the RF legislation currently in force and mandatory requirements to SEZ residents set in the SEZ territory, the violator should be subjected to the special inspection performed with the purpose to control the compliance with the order to eliminate the revealed violations. In the case it is established that the SEZ resident failed to comply with the order to eliminate the revealed violations within next two months, as revealed in the course of the special inspection, the SEZ Directorate should annul registration of such a SEZ resident.

#### **Tax treatment of SEZ residents**

The special tax treatment of SEZ residents should be introduced by RF subjects and local governments within their terms of reference. The laws of RF subjects and regulatory and legal acts of local authorities may exempt SEZ residents from the tax on property of organizations, land tax, and the profit tax as concerns the share of the tax assigned to the regional and local budgets. Organizations not granted the status of SEZ

resident, but carrying out their activities in SEZ territory should pay taxes and fees in the framework of the general treatment set forth by the RF legislation on taxes and fees.

#### **Customs treatment**

The customs regime introduced in the SEZ territory (free customs zone) should be established at the moment the RF Government takes its decision on creation of the SEZ.

Free customs zone is a customs regime introduced in the SEZ territory envisaging that imported equipment and materials necessary for implementation of the investment project are located and used within the respective territorial boundaries or premises (localities) without payment of customs duties, taxes, and bans and restrictions set in accordance with the RF legislation concerning state regulation of external economic activities, while domestic goods are located and used on conditions applicable to exports under procedures determined by the RF customs legislation.

The customs regime of free customs zone can not be applied to certain types of goods, for instance, imported to the SEZ territory but not necessary for the implementation of investment projects on the part of SEZ residents, goods imported to the SEZ territory by persons not granted the status of SEZ residents, which are used by production or other economic activities by persons not being SEZ residents, etc.

Imports to the SEZ territory and exports from the SEZ territory should be within the competence of RF customs authorities and may be permitted only on condition of compliance with the respective customs regime and terms set forth by this federal law and other RF legal acts. RF customs authorities should have the right at any time inspect goods located in the special economic zone guiding by the procedures of the respective customs regime.

#### **Regime of land use in the SEZ territory**

Land plots within the SEZ territory should be leased to SEZ residents by the SEZ Directorate basing on its authority to manage the land transferred to the SEZ Directorate in accordance with the agreement concluded in the course of creation of SEZ between the RF Government, the authorities of the respective RF subject, and respective local authorities.

In the case the SEZ resident loses the respective status in accordance with the procedures set forth by the investment agreement within a certain period (less than the period of SEZ functioning), it should result in the termination of the respective lease agreement and forced withdrawal of immovable property located on such a land plot by selling the said property via public auction. Other SEZ residents and the persons indicating their intent to become SEZ residents should have the right to participate in such an auction.

In order to implement the provisions of the draft law, it would be necessary to amend the RF Tax Code and the RF Civil Code, to work out and adopt a number of bylaws, which are intended to concretize individual stipulations of the draft law concerning the process of creation and functioning of special economic zones.

According to the RF Government, creation of a network of special economic zones in a number of regions will accelerate Russia's integration in the world economy and will allow to redistribute world flows of goods and capitals in the interests of the Russian Federation. The functioning of SEZ will allow to moderate the negative impact of such factors as the lack of confidence in the authorities and decisions taken by the authorities, insufficient development of business infrastructure, high level of administrative and bureaucratic burden on business on the business and investment activity in the Russian Federation.

*E. A. Bolshakova* **Review of economic legislation: February of 2004**

### **I. FEDERAL LAWS of the Russian Federation**

1. "ON AMENDMENTS TO THE FEDERAL LAW 'ON MORTGAGE (PLEDGE OF REAL ESTATE)'" of February 5, 2004, No. 1-FZ

Enters into force on the day of promulgation

The law removes the ban on mortgage of farm lands owned by agricultural organizations, farmers, and allotted for personal subsidiary plots. It is envisaged that in the case on the mortgaged plot of farm land there are buildings and facilities (including those being in the process of construction), or other objects integral to the real estate and owned by the same owner on the same terms, the real estate should be mortgaged only together with such integral objects. The recovery of mortgaged plots defined as farm land should not be enforced until the end of the respective period of agricultural works taking into account the time necessary to sell the produce or processed produce. This requirement should be in force until November 1 of the year, in which the mortgage related liabilities or part thereof should be met in the case the mortgage sets no other date. The law "On mortgage (pledge of real estate)" was also amended to the effect that the leaser of a land

plot (a citizen or a legal entity) should have the right to mortgage the leasehold within the terms of the lease agreement and with the consent of the owner of the land plot.

## **II. RESOLUTIONS OF THE GOVERNMENT of the Russian Federation**

1. “ON APPROVAL OF THE RULES GOVERNING TRANSFER OF ADDITIONAL REVENUES OF THE FEDERAL BUDGET, REMAINING ANNUAL BALANCES OF THE FEDERAL BUDGET, AND PROCEEDS FROM PLACEMENT OF THE STABILIZATION FUND TO THE STABILIZATION FUND OF THE RUSSIAN FEDERATION” of January 23, 2004, No. 31

According to item 2, Article 96.2 of the RF Budget Code, there were approved the Rules governing transfer of additional revenues of the federal budget, remaining annual balances of the federal budget, and proceeds from placement of the Stabilization Fund to the Stabilization Fund of the Russian Federation. The Rules set forth the procedures governing calculation and transfer of the said financial resources to the RF Stabilization Fund. The respective calculations should take into account: the estimated rate of the export customs duty on crude oil proceeding from the base oil price determined to be US \$ 12.7 per metric ton; the rate of the export customs duty on crude oil in the reporting month as determined by the RF Government; the estimated rate of the tax on extraction of mineral resources (oil); the rate of the tax on extraction of mineral resources (oil); the average Rub. / US \$ exchange rate in the reporting month set by the Central Bank of the Russian Federation; the average price of crude Urals oil in the reporting month.

2. “ON APPROVAL OF THE PRINCIPLES OF PRICE DETERMINATION IN THE SPHERE OF HOUSING AND PUBLIC UTILITIES” of February 17, 2004, No. 89

The principles of price determination in the sphere of housing and public utilities determine key principles and methods of price determination as concerns services for maintenance and repairs of housing, lease of residential housing, and tariffs on communal services, as well as the rules governing regulation and setting of the said prices and tariffs. The resolution sets forth that determination of the said prices and tariffs should take into account national standards, sanitary requirements and regulations, other legislative acts of the Russian Federation, RF subjects, as well as acts of local governments regulating terms, quality, frequency and volumes of works on maintenance and repairs of housing and rendering of communal services.

3. “ON DETERMINATION OF THE PER CAPITA SUBSISTENCE LEVEL AS BROKEN DOWN BY MAJOR SOCIAL AND DEMOGRAPHIC GROUPS OF THE POPULACE IN THE RUSSIAN FEDERATION IN THE FOURTH QUARTER OF 2003” of February 12, 2004, No. 74

The Resolution sets the per capita subsistence level in the Russian Federation in the 4<sup>th</sup> quarter of 2003 at Rub. 2143, for employable population – at Rub. 2341, for pensioners – at Rub. 1625, for children – at Rub. 2113..

4. “ON APPROVAL OF THE RULES OF GRANTING OF BUDGET LOANS FOR LIQUIDATION OF TEMPORARY CASH GAPS FROM THE FEDERAL BUDGET TO BUDGETS OF RF SUBJECTS” of February 14, 2004, No. 83

According to item 3, Article 137 of the RF Budget Code and in order to enhance the efficiency of expenditure of the Federal Budget financial resources there were approved the Rules governing the granting of budget loans for liquidation of temporary cash gaps from the federal budget to budgets of RF subjects. The temporary cash gap occurring in the process of administration of the RF subject consolidated budget is defined as the shortage of budget revenues necessary for covering of targeted budget expenditures of the RF subject, which occurs in a certain period of the financial year even in spite of utilization of the sources of financing of the budget deficit. In the case such a temporary cash gap occurs or is expected to occur, the executive body of the RF subject may address the RF Finance Ministry the request to grant a budget loan. Budget loans should be granted for a term at or below 6 months within a given financial year. Targets of budget loans and terms of repayment thereof should be set by the federal law on the next financial year budget.

## **III. INSTRUCTIONS AND ORDERS**

1. Order of the RF Tax Ministry of December 31, 2003, No. BG-3-09/731 “ON APPROVAL OF SPECIFICS OF REGISTRATION OF ORGANIZATIONS OR INDIVIDUAL ENTREPRENEURS AS PAYERS OF THE TAX ON EXTRACTION OF MINERAL RESOURCES BY TAX AUTHORITIES”

Registered by the RF Justice Ministry on January 21, 2004, No. 5447.

According to item 3 of Article 335 of the RF Tax Code, there were determined the specifics of registration of organizations or individual entrepreneurs as payers of the tax on extraction of mineral resources by tax authorities. The previous procedure approved by order No. BG-3-09/551 of the RF Tax Ministry of

December 14, 2001, which determined that respective taxpayers should be registered basing on their applications, was therefore invalidated. According to the newly approved regulations, organizations and individual entrepreneurs should be registered by the tax authority of the jurisdiction, where the respective subsoil area is situated, as payers of the said tax within 30 days since the day of state registration of the license (permit) to use the subsoil plot, basing on the notification about the granting of the rights to use mineral resources sent by the authority responsible for the keeping of the record or registration of users of natural resources and licensing of activities relating to the use of such resources. The respective tax authority should complete registration procedures within 5 days since the day it receives the aforesaid notification (however, not later than 30 days since the day of the state registration of the license (permit) for the use of the subsoil plot). Within the same period, there should be handed out or mailed to the taxpayer the notification made in accordance with forms No. 9-NDPI-1 or No. 9-NDPI-2 approved by the Order. In the case the taxpayer is granted the right to develop several subsoil plots and the said taxpayer is not registered as the payer of the subsoil tax by any tax authority of RF subjects, the office of the RF Tax Ministry in one of the RF subjects upon receiving respective data and basing on the Resolution concerning determination of the tax authority authorized to register the organization of individual entrepreneur as a payer of the subsoil tax according to form No. 9-NDPI-3 approved by this Order, transfers the said data to the local authority of the jurisdiction, where one of the subsoil plots is situated. The right to choose the authorized tax authority should be vested with the respective department of the RF Tax Ministry, which should base on such consideration as convenience of interaction between the taxpayer and the respective tax authority, territorial remoteness from the location of the subsoil plot, and other factors.

2. Letter of the RF Tax Ministry of January 27, 2004, No. OS-6-03/86 “ON SPECIFICS OF KEEPING PURCHASE BOOKS AND SALE BOOKS AS CONCERNS PAYMENTS RELATING TO VALUE ADDED TAX”

Due to the fact that since January 1, 2004, the value added tax rates should be reduced to 18 per cent, it is explained that before the respective changes are introduced in the Rules governing the keeping of received and issued invoices, purchase and sale books as concerns payments relating to value added tax approved by the RF Government resolution No. 914 of December 2, 2000, taxpayers (tax agents) should have the right to add to the sale and purchase books the column setting the rate of the tax rate at 18 per cent for the purposes of registration of received and issued invoices containing the said rate.

*I. V. Tolmacheva*