

**RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES**  
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## The State of the Federal Budget

In the first ten months of 2003, the revenues of the state budget (cash execution) made 19.5 per cent of GDP, while expenditures made 16.8 per cent of GDP (see Table 1). Therefore, the federal budget surplus made 2.6 p. p. of GDP.

*Table 1*

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

	X'02	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
Revenues														
Corporate profit tax	1.7%	1.6%	1.6%	1.2%	1.1%	1.4%	1.5%	1.4%	1.4%	1.4%	1.3%	1.3%	1.3%	
Personal 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%	
VAT, special tax and excises	3.1%	3.1%	3.1%	2.4%	2.7%	2.8%	2.9%	2.9%	2.8%	2.8%	2.8%	2.7%	2.7%	
Tax on foreign trade and foreign trade operations	8.9%	8.9%	8.9%	11.2%	10.1%	9.9%	9.6%	9.6%	9.2%	9.1%	8.9%	8.7%	8.6%	
Other taxes, duties and payments	6.9%	6.9%	6.9%	8.5%	7.4%	7.2%	7.2%	7.2%	6.9%	6.9%	6.8%	6.7%	6.6%	
Total- taxes and charges	2.0%	1.9%	2.0%	2.7%	2.7%	2.6%	2.4%	2.3%	2.2%	2.2%	2.1%	1.9%	1.9%	
Non- tax revenues	2.8%	2.9%	3.0%	3.4%	3.4%	3.4%	3.5%	3.5%	3.4%	3.4%	3.4%	3.3%	3.4%	
Revenues, total	2.1%	2.1%	2.1%	0.5%	1.7%	2.0%	2.2%	2.1%	2.0%	2.0%	2.0%	2.0%	2.0%	
Expenditure	18.6%	18.5%	18.6%	18.8%	19.0%	19.4%	19.6%	19.4%	18.8%	18.7%	18.4%	18.0%	17.9%	
Public administration	1.5%	1.4%	1.4%	17.5%	8.5%	1.3%	1.2%	1.7%	1.6%	1.5%	1.5%	1.5%	1.4%	
National defense	20.2%	20.1%	20.1%	20.8%	20.6%	20.9%	21.0%	21.3%	20.6%	20.4%	20.0%	19.6%	19.5%	19.4%
International activities														
Judicial power	0.4%	0.4%	0.5%	0.3%	0.3%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	
Law enforcement and security activities	2.4%	2.5%	2.7%	1.5%	2.1%	2.6%	2.7%	2.7%	2.6%	2.6%	2.6%	2.5%	2.5%	
Fundamental research	0.3%	0.3%	0.3%	-0.3%	0.0%	0.2%	0.2%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%	
Services provided for the national economy	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	
Social services	1.4%	1.5%	1.7%	1.1%	1.4%	1.7%	1.7%	1.7%	1.8%	1.7%	1.7%	1.7%	1.7%	
Servicing of public debt	0.2%	0.3%	0.3%	0.1%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	
Other expenditure	1.3%	1.3%	1.5%	0.2%	0.4%	0.5%	0.6%	0.7%	0.8%	0.8%	0.8%	0.9%	0.9%	
Expenditure, total	5.5%	5.6%	5.6%	1.5%	1.8%	2.0%	2.3%	2.2%	2.2%	2.2%	2.2%	2.1%	2.1%	
Loans, redemption exclusive	2.2%	2.0%	2.0%	1.7%	2.9%	3.0%	2.3%	2.1%	2.0%	1.8%	2.0%	2.0%	1.8%	
Expenditure and loans, redemption exclusive	3.9%	3.9%	3.8%	6.6%	7.1%	7.0%	7.0%	7.1%	7.1%	7.1%	7.0%	6.9%	6.8%	
Budget deficit (-)	17.8%	18.0%	18.7%	12.7%	16.4%	17.7%	17.7%	17.7%	17.5%	17.4%	17.3%	17.1%	16.8%	17.0%
Domestic financing	2.4%	2.1%	1.4%	8.1%	4.2%	3.2%	3.3%	3.6%	3.0%	3.0%	2.7%	2.5%	2.6%	2.4%
Other taxes, duties and payments	-0.5%	-0.2%	0.6%	-6.6%	-1.7%	-1.0%	-1.0%	-0.5%	0.3%	0.0%	0.3%	0.2%	-0.1%	-0.1%
Total- taxes and charges	-1.9%	-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%
Non- tax revenues	-2.4%	-2.1%	-1.4%	-8.1%	-4.2%	-3.2%	-3.3%	-3.6%	-3.0%	-3.0%	-2.7%	-2.5%	-2.6%	-2.4%

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

As compared with the figures registered in January through October of 2002, the budget revenues decreased by 0.7 p. p. of GDP in January through October of 2003, while expenditures increased by 1.0 p. p. and budget surplus respectively increased by 0.2 p. p. of GDP. At the same time, without SST the budgetary revenues decreased by 0.3 p. p. of GDP and made 16.8 per cent of GDP. VAT accounted for the major share of federal tax revenues – 36.9 per cent of the total tax revenues what is practically at the level observed in the respective period of 2002.

According to preliminary estimates, the cash execution of federal budget revenues made 19.4 per cent of GDP in January through November of 2003, what is by 0.5 p. p of GDP below the respective level observed in January through November of 2002. At the same time, the cash execution of expenditures made 17.0 per cent of GDP (18.0 per cent of GDP in 2002); therefore, over 11 months of 2003, the surplus made 2.4 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 through November of 2003 made 18.1 per cent of GDP (see

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

Table 2), while on December 1 of 2002 this indicator was at 19.4 p. p. of GDP. The amount of revenues of the federal budget decreased by 0.7 per cent of GDP in comparison with the figures registered in the respective period of the preceding year and made 19.4 per cent of GDP in January through November of 2003. Therefore, the surplus of the federal budget in terms of fulfilled funding in the first ten months of 2003 has increased by 0.6 p. p. in comparison with the figures registered in the respective period of 2002 and made 1.3 per cent of GDP.

Table 2

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

	XI'02	XI'02	I'03	II'03	III'03	IV'03	V'03	VI'03	VII'03	VIII'03	IX'03	X'03	XI'03
Total	20.1%	20.1%	20.8%	20.6%	20.9%	21.0%	21.3%	20.6%	20.4%	20.0%	19.6%	19.5%	19.4%
Public administration	0.6%	0.5%	0.5%	0.6%	0.6%	0.6%	0.6%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%
National defense	2.9%	2.6%	2.5%	3.1%	3.3%	3.2%	3.1%	3.0%	2.9%	2.8%	2.7%	2.8%	2.9%
International activities	0.3%	0.3%	-0.2%	0.1%	0.2%	0.3%	0.3%	0.3%	0.3%	0.2%	0.2%	0.2%	0.2%
Judicial power	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%
Law enforcement and security activities	1.8%	1.7%	1.9%	2.2%	2.3%	2.2%	2.2%	2.1%	2.0%	1.9%	1.9%	1.9%	1.9%
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 provided for the national economy	1.5%	1.5%	0.6%	0.8%	0.9%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.1%
Social services	5.8%	5.7%	2.5%	2.7%	2.7%	2.9%	2.7%	2.6%	2.5%	2.4%	2.3%	2.3%	2.4%
Servicing of public debt	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%
Other expenditure	4.0%	3.8%	6.8%	7.5%	7.3%	7.2%	7.4%	7.3%	7.2%	7.2%	7.0%	6.9%	6.9%
Total expenditure	19.4%	18.7%	16.8%	20.5%	20.9%	20.2%	19.9%	19.2%	18.8%	18.6%	18.3%	18.0%	18.1%
Профицит (+) / дефицит (-)	0.7%	1.4%	4.0%	0.2%	0.0%	0.8%	1.4%	1.3%	1.6%	1.3%	1.3%	1.5%	1.3%

According to the estimates of the Revenue Ministry, in November of 2003 tax revenues of the federal budget made about Rb. 105.7 billion (without the single social tax). In real terms the revenues made 231.0 per cent of the level registered in January of 1999, while the respective indicator was at 241.0 per cent in 2002 and 247.3 per cent in 2001 (see Table 3).

It should be noted that in November of 2003 the revenues generated by the single social tax made Rb. 29.5 billion. Thus, in November of 2003 the RF Revenue Ministry transferred to the federal budget taxes and fees amounting to about Rb. 135 billion, what was by 0.8 per cent above the month's target.

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%
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%	

\* Без учета ЕСН.

<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.

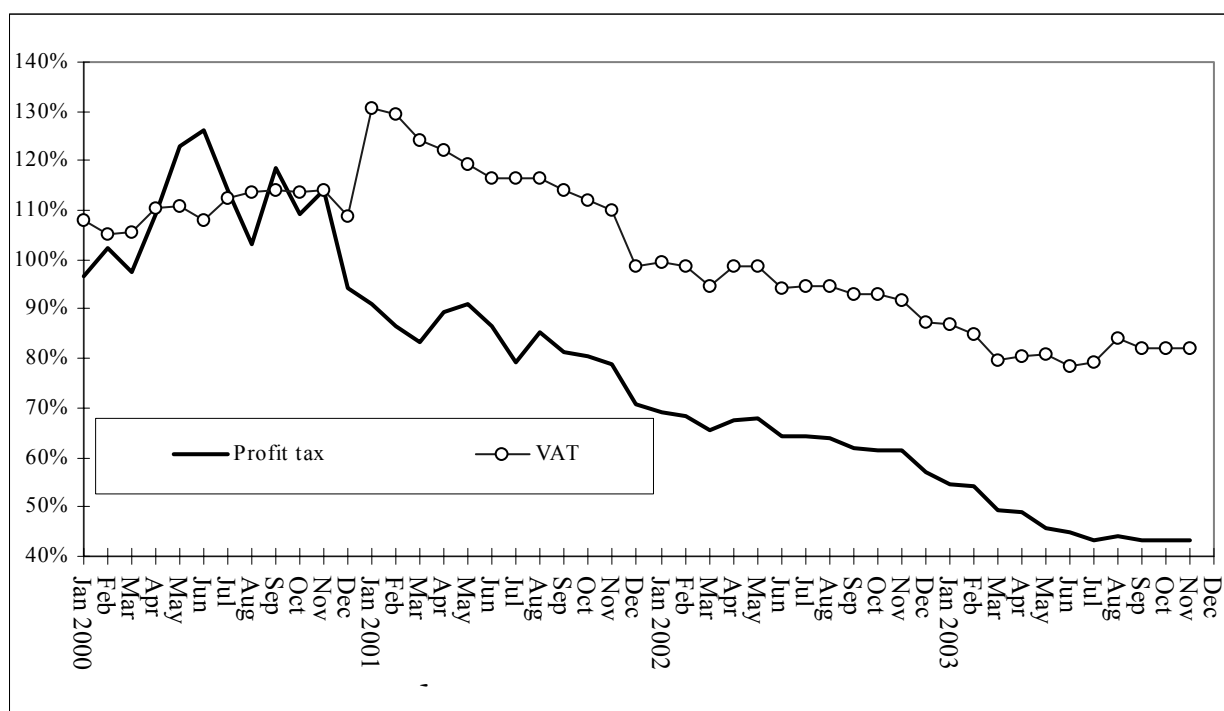


Fig. 1. Real tax arrears to the federal budget (in % to July 1999)

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. 251.5 billion as on November 1, 2003, increasing by Rub. 3.3 billion in October of 2003, while the arrears of the profit tax increased by Rb. 0.4 billion and made about Rb. 28.4 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	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	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		
Taxes	25,6%	24,4%	25,6%	27,4%	27,1%	26,0%	26,1%	25,7%	5,1%	5,1%		
Revenues	32,0%	30,3%	31,5%	33,4%	33,6%	32,2%	32,2%	31,6%	1,0%	0,9%		
Expenditures	20,7%	25,3%	27,7%	28,8%	28,8%	28,6%	28,7%	28,5%	8,3%	7,9%		
Deficit	11,3%	5,0%	3,8%	4,5%	4,7%	3,5%	3,6%	3,1%	2,7%	3,0%		

\* Без учета ECH

The revenues of the consolidated budget in September of 2003 made 30.9 per cent of GDP, including tax revenues (without SST) at 25.1 per cent of GDP (see Table 4). Expenditures of the consolidated budget decreased by 0.4 p. p. in comparison with the figures registered in September of 2002 and made 27.9 per cent of GDP. As on September 1, 2003, the surplus of the consolidated budget made 3.0 per cent of GDP, what is by 0.3 p. p. of GDP above the level observed in the respective period of 2002.

*A. Razin, S. Ponomarenko.*

## **Special VAT accounts in Russia: an analysis of possible consequences<sup>4</sup>**

At present, in Russia there are actively debated the prospects of the introduction of special accounts to be used for payment of the value added tax. On December 1, 2003, the RF Finance Ministry submitted to the RF Government the respective draft legislative acts aimed at the introduction of special VAT accounts. We have briefly analyzed possible positive and negative consequences of the introduction of this system.

### **1. The RF Finance Ministry proposals as concerns the introduction of the VAT accounts system**

In accordance with the RF Government's instructions, the RF Finance Ministry has worked out and presented to the Cabinet of Ministers on December 1, 2003, the respective draft legislative acts aimed at the legislative substantiation of the introduction of special accounts for payment of the added value tax. The RF Government has received for consideration draft federal laws "On amendments to the Tax Code of the Russian Federation" and "On amendments to certain legislative acts of the Russian Federation in connection to the amendments made to the Tax Code of the Russian Federation."

These draft laws are aimed to introduce the following amendments in the Russia's tax legislation:

(1) There should be introduced such a tool of administration of the value added tax as VAT accounts. These accounts should function under a special regime: for instance, it is envisaged that only financial resources pertaining to operations relating to VAT payments to the budget and other taxpayers should be entered to and charged off these accounts. In particular, it is stipulated that financial resources should be entered to a VAT account:

- from VAT accounts of other persons in the course of payments for goods (works, services);
- from the current account, which the owner of the VAT account has with the same bank;

<sup>4</sup> The considerations presented in this material are a generalization of the Institute for the Economy in Transition (IET) studies focusing on the analysis of the impact of the possible introduction of special accounts for VAT payments in the Russian Federation (in particular, such materials as "On the use of short-lived enterprises with the purpose of the value added tax evasion and the use of special bank accounts for fighting this type of tax evasion," "Using special VAT accounts in the Republic of Bulgaria: key conclusions for Russia," "A preliminary assessment of withdrawal of enterprises' working capital as a result of the introduction of special VAT accounts") presented to the RF Finance Ministry, the RF Ministry for Economic Development and Trade, and those published on the IET web site: [www.iet.ru](http://www.iet.ru)

- from other VAT accounts of the owner of the VAT account;
- from the budget in the case of refund of VAT and penalties;

At the same time, financial resources should be charged off a VAT account:

- to VAT accounts of other persons in the course of payments for goods (works, services) or refund of amounts entered to the VAT account without grounds for such a transfer;
- to other VAT accounts of the owner of the VAT account;
- to the budget in the course of payment of VAT and penalties, as well as in the case VAT and penalties are exacted without recourse to the court, or in a way of completion of the liquidation or bankruptcy proceedings.

(2) Opening of at least one special VAT account in addition to the current account should be mandatory for all persons engaged in entrepreneurial activities, including the persons exempted from taxpayer's obligations. At the same time, it is also envisaged that state authorities (local governments) should also open VAT accounts in order budget organizations could conduct their VAT related transactions.

(3) Any exaction of funds from VAT accounts should be enforced only on the account of VAT related liabilities and penalties imposed for non-prompt payment of VAT. At the same time, in the case an organization is liquidated, the balance of funds on the VAT account after the liquidated organization pays the value added tax and penalties should be transferred to the budget.

The proposed amendments to the laws "On execution proceedings" and "On insolvency (bankruptcy) of credit organizations" in fact envisage that in the case there are initiated bankruptcy proceedings, the funds in the debtor's account may be transferred to other VAT accounts only in accordance with the demands for transfers of the value added tax, while after the completion of bankruptcy proceedings the debtor's VAT account should be closed and the balance transferred to the budget.

(4) The draft law does not envisage that financial resources transferred from the master current account of an enterprise to its VAT account may be returned to its current account. However, there exists a possibility to obtain a VAT refund from the budget in the specified cases (for instance, in the case of taxation at the zero rate, excess of tax deductions over the size of the tax base) to be transferred both to the VAT account, and the current account of an enterprise.

(5) Repeated infringements of responsibilities related to the management of VAT accounts should be a ground permitting tax authorities to apply for the recall of the banking license.

(6) Banks should have no right to conduct expenditure operations relating to newly opened VAT accounts before receiving from the tax authority an acknowledgement that it received the notification of the opening of a VAT account by the respective person.

(7) Banks should submit to the tax authorities (not later than on the 5<sup>th</sup> of the month next to the preceding month) a report in electronic format about all transactions related to VAT accounts, including a personal bank account statement and the documents (indicating product codes, invoice numbers and dates), basing on which all entries relating to the VAT account were made. Repeated infringements of this responsibility should be a ground permitting tax authorities to apply to the Central Bank for the recall of the banking license, as well as take a decision prohibiting such banks to conduct operations concerning the opening of and making payments relating to VAT accounts.

(8) Funds may be transferred from one VAT account to any other VAT account even in the case such transfers are not related to payments for taxable goods (works, services). However, the owner of the VAT account, into which an amount was entered on the grounds other than the payment of VAT, or without a relevant ground, should transfer this amount back into the payer's VAT account within 14 days after receiving this amount.

(9) There is introduced the concept of invoice registers, which should include all issued and received invoices. These registers should be submitted to the tax authorities in electronic format and on paper medium, while an invoice not included in such a register can not be a ground permitting to accept the amount of VAT presented for refund or deduction.

(10) There is established a procedure, according to which operations relating to transfer of VAT to suppliers should be carried out exceptionally as transfers of funds from the buyer's VAT account to the VAT account of the supplier notwithstanding the form of payment stipulated by the respective transaction (barter, offset, letter of credit, check, promissory note, etc.).

(11) Only the VAT amounts transferred from the buyer's VAT account to the VAT account of the supplier for taxable goods (works, services) should be accepted for deduction. The amounts of the value added tax paid to suppliers in cash should be not deducted from the taxpayer's tax base with the exception of VAT

amounts paid in relation to travel subsistence expenses and hospitality costs, but included in the expenses accepted for deduction as concerns the tax on the profit of organizations. At the same time, VAT amounts paid as cashless transfer of funds not from the VAT account of an organization or an individual entrepreneur should be neither deducted from the tax base, nor included in the composition of expenditures related to the profit tax, but included in the composition of extraordinary charges for organizations or not included in the expenditures (occupational deductions) for individual entrepreneurs.

(12) Deduction of VAT amounts paid in relation to import of goods should be allowed as an exception without the transfer of VAT amounts to the budget from the VAT account. Therefore, the procedure currently in force remains unchanged, as it envisages that the importer may advance the VAT and customs duties to an authorized person with the purpose that these amounts be later transferred to the budget in the course of the customs clearance of imported goods. A similar exception is retained for deduction of VAT amounts paid for goods imported from the territory of the Republic of Belarus since the Russian Federation and this country trade under the regime envisaging VAT collection at the rates of the country of origin.

(13) As a compensating measure, the draft law envisages liberalization of the procedures governing refund of VAT collected at the 0 per cent rate, as well as the transition to acceptance for deduction of VAT amounts paid for capital construction operations under the general procedures (at present, deduction of VAT amounts paid by the supplier in the course of capital construction operations is made not earlier than the commissioned capital construction object is registered).

## **2. Advantages of the special VAT accounts system**

The major argument in favor of the introduction of special VAT accounts is the necessity to take tax administration measures preventing VAT evasion via short-lived enterprises. At the same time, in the case there is chosen the variant recommended at the moment by the Finance Ministry, the following advantages of VAT accounts expected by supporters of the introduction of such accounts may be listed.

- (a) an increase in VAT generated revenues at the same tax rate;
- (b) elimination of the present distortions, using which unscrupulous taxpayers, whose tax evasion costs are relatively low, have competitive advantages over conscientious taxpayers fully meeting their tax relating obligations;
- (c) the new regime would not result in a significant rise in taxpayers' compliance costs;
- (d) the overall efficiency of tax administration will improve due to the higher transparency of the VAT system;
- (e) in the short term outlook, there are no other methods of prevention of the currently used tax evasion methods.

## **3. Major disadvantages of the VAT accounts system**

Opponents of the proposed introduction of special VAT accounts doubt items 1 (a) – 1 (e), stated by supporters of VAT accounts. At the same time, it should be noted that neither supporters, nor opponents of VAT accounts have reliable results of studies along two avenues necessary to either confirm or reject the trueness of statements 1 (a) – 1 (c). There should be analyzed the following aspects of this problem:

- (a) the present scale of VAT evasion basing on the use of short-lived enterprises (i.e., the only type of tax evasion to prevent which VAT accounts are intended);
- (b) the scale of increase in compliance costs (in particular, the costs the taxpayer will bear for administration of special accounts and tax authorities' costs for tax administration).

It is impossible to evaluate the trueness of statements 1 (a) – 1 (b) without answering the first question. The lack of correct evaluations pertaining to the second avenue of research does not permit to evaluate the trueness of statement 1 (c). At the same time, a preliminary study of revenues generated by the value added tax in a number of economies in transition and developed countries conducted by the Institute for the Economy in Transition indicated that the amount of VAT budget revenues in the Russian Federation, which makes 6.5 per cent to 7 per cent of GDP, is at an average level among the countries included in the study taking into account the average tax rate, level of economic development, and other factors.

## **4. Certain trends in changes of the indicators characterizing charging and payment of the value added tax in Russia**

Unfortunately, numerous changes in the structure of reporting on tax payments transferred to the budget system, published by the RF Revenue Ministry (previously, the State Tax Service) over the last 5 to 8 years, do not permit to thoroughly analyze the trends observed in the key indicators of the value added tax in a medium term outlook. An analysis of such indicator as VAT generated revenues of the RF consolidated budget reveals that since 1993 have made from 6 per cent to 7 per cent of GDP reaching the minimum (5.7



per cent of GDP) in 1998 and the maximum (7.1 per cent of GDP) in 2001. According to our estimates, such a level of budget revenues generated by the value added tax at the respective tax rates corresponds to the level of development of the Russian economy and tax system. At the same time, since 1992 there has been observed an insignificant decline in the VAT generated revenues of the federal budget and at present it is impossible to judge if this decline is a stable trend (taking into account the growth registered in 2001).

Basing on the reporting data (Form 5nbn) for 2001 through the first six months of 2003 published by the RF Revenue Ministry, there can be presented the following information concerning the amounts of accrued VAT and respective tax deductions in the first six months of 2001 through 2003 (see Table 1).

Table 1

**Data on the accrued VAT and the amount of VAT presented for deduction  
in the first six months of 2001 through 2003**

	As on 1 July, 2001		As on 1 July, 2002		As on 1 July, 2003	
	Rub. thous.	% GDP	Rub. thous.	% GDP	Rub. thous.	% GDP
<b>Total accrued VAT</b>	<b>1 355 200 461</b>	<b>33,5%</b>	<b>1 622 648 501</b>	<b>33,9%</b>	<b>2 167 179 202</b>	<b>36,0%</b>
including:						
- realization of goods (works, services)	1 156 591 214	28,6%	1 346 569 069	28,1%	1 774 797 996	29,4%
- transfer for own needs	3 055 965	0,1%	2 945 509	0,1%	7 641 050	0,1%
- building and assembly works (BAW) for own consumption	3 140 605	0,1%	4 948 719	0,1%	8 418 548	0,1%
- amounts relating to payments for taxable goods works, services)	20 912 217	0,5%	221 614 608	4,6%	330 822 688	5,5%
- amount earlier accepted for deduction after the receipt of exemption	1 882 707	0,0%	6 033 310	0,1%		0,0%
- realization of goods (works, services) by tax agents		0,0%	6 405 429	0,1%	8 451 791	0,1%
- advance and other payments	169 617 753	4,2%	5 718 933	0,1%	1 007 076	0,0%
- unconfirmed right to apply the 0 % rate		0,0%	28 412 924	0,6%	36 040 053	0,6%
<b>Tax deductions</b>	<b>1 066 057 989</b>	<b>26,4%</b>	<b>1 250 517 971</b>	<b>26,1%</b>	<b>1 738 877 598</b>	<b>28,8%</b>
including:						
<i>I. Purchase of goods (works, services)</i>	<i>861 350 708</i>	<i>21,3%</i>	<i>999 835 955</i>	<i>20,9%</i>	<i>1 376 448 710</i>	<i>22,8%</i>
- purchased fixed assets and intangible assets		0,0%	64 785 237	1,4%	58 322 137	1,0%
- purchased materials for performing BAW for own consumption		0,0%	4 268 755	0,1%	8 600 769	0,1%
- purchased materials transferred for performance of BAW on tolling terms		0,0%	1 883 976	0,0%	1 980 910	0,0%
- VAT amounts presented for deduction by contractor organizations performing capital construction		0,0%	8 266 051	0,2%	27 497 364	0,5%
- purchased noncommissioned capital construction objects		0,0%	6 156 249	0,1%	1 882 017	0,0%
- performance of BAW for own consumption	2 787 067	0,1%	4 191 082	0,1%	8 530 024	0,1%
- other	858 563 641	21,2%	910 284 605	19,0%	1 269 635 489	21,1%
<i>II. Import of goods to the RF customs territory</i>	<i>32 088 898</i>	<i>0,8%</i>	<i>45 856 228</i>	<i>1,0%</i>	<i>58 932 889</i>	<i>1,0%</i>
- from countries outside NIS		0,0%	39 529 424	0,8%	51 343 964	0,9%
- from CIS member countries		0,0%	6 326 804	0,1%	7 588 925	0,1%
<i>III. Other deductions</i>	<i>165 691 447</i>	<i>4,1%</i>	<i>204 825 788</i>	<i>4,3%</i>	<i>303 495 999</i>	<i>5,0%</i>
- VAT accruals relating to advance payments and prepayments (as concerns the return of advances)	164 365 284	4,1%	195 735 636	4,1%	298 046 913	4,9%

	As on 1 July, 2001		As on 1 July, 2002		As on 1 July, 2003	
	Rub. thous.	% GDP	Rub. thous.	% GDP	Rub. thous.	% GDP
- VAT amounts paid by tax agents	3 411 381	0,1%	4 530 230	0,1%	7 583 428	0,1%
- tax on goods (works, services) in the case of return (rejection) thereof	472 042	0,0%	1 414 202	0,0%	3 027 761	0,1%
- VAT amounts previously included in deductions but subject to restoration	2 557 260	0,1%	5 505 696	0,1%	10 339 516	0,2%
- VAT amounts acceptable for deduction pertaining to operations not confirmed to be taxable at the 0 % rate		0,0%	8 651 416	0,2%	5 177 413	0,1%
<b>VAT accruals payable as per declarations</b>	<b>289 142 472</b>	<b>7,2%</b>	<b>372 130 530</b>	<b>7,8%</b>	<b>428 301 604</b>	<b>7,1%</b>
<b>VAT amounts pertaining to the operations confirmed to be taxable at the 0 % rate</b>	<b>90 755 056</b>	<b>2,2%</b>	<b>127 554 886</b>	<b>2,7%</b>	<b>175 207 738</b>	<b>2,9%</b>
<b>VAT accruals minus confirmed refunds</b>	<b>198 387 416</b>	<b>4,9%</b>	<b>244 575 644</b>	<b>5,1%</b>	<b>253 093 866</b>	<b>4,2%</b>
<b>Transferred to the RF Revenue Ministry budget*</b>	<b>204 068 680</b>	<b>5,0%</b>	<b>235 256 830</b>	<b>4,9%</b>	<b>297 868 605</b>	<b>4,9%</b>
<b>including current accruals</b>					259 471 429	4,3%
<b>VAT generated revenues of the federal budget</b>	268625732	6,6%	336 246 288	7,0%	419 552 069	7,0%
<b>GDP</b>	4041900000		4790500000		6028000000	

\* as on July 1, 2001, and July 1, 2002, the presented data on accrued VAT pertain to domestic realization only due to the unavailability of the respective information in the RF Revenue Ministry reporting

Source: RF Revenue Ministry (Form 5nbn, Section 2), RF Goskomstat, author's calculations

The presented data reveals that in the first six months of 2003 there was observed a growth in the amounts of both accrued tax and tax deductions. Thus, the amount of accrued VAT increased from 39.9 per cent of GDP in the first six months of 2002 to 36 per cent of GDP in January through July of 2003. At the same time, the amounts of VAT presented for deduction over the respective period increased from 26.1 per cent of GDP to 28.8 per cent of GDP, while the amount of VAT on operations confirmed to be taxable at the 0 rate increased from 2.7 per cent of GDP to 2.9 per cent of GDP. As a result, the amount of VAT accruals payable to the budget as per declarations minus confirmed refund at the zero rate declined from 5.1 per cent of GDP registered in the first six months of 2002 to 4.2 per cent of GDP in January through June of 2003. In spite of this decrease, the VAT generated revenues of the federal budget in the first six months of 2003 were at the level observed in the respective period of 2002<sup>5</sup>.

Basing on the presented data, it can be concluded that in spite of the outpacing rate of growth in tax deductions and the amount of tax presented for refund at present there no sufficient grounds to state that there is observed a growth in tax evasion endangering the stability of the federal budget and requiring urgent measures to be taken in the sphere of tax administration. At the same time, it may be assumed that the 2 per cent increase in tax deductions observed as concerns purchased goods (works, services) not relating to capital construction, is in part caused not only by economic growth, but also tax evasion via the use of short-lived enterprises. This type of evasion requires a thorough analysis of the situation in Russian and international experience aimed at working out measures effectively preventing such tax evasion.

##### **5. Impact of the introduction of VAT accounts on budget revenues**

As it has been mentioned above, the major argument in favor of the introduction of VAT accounts in Russia is decreasing tax evasion and growing budget revenues generated by the value added tax. At the same time, the major objective of the reform is the removal of possibilities to evade taxation resulting in a more neutral tax system and lesser competitive advantages of unscrupulous taxpayers.

The reform of the VAT collection mechanism is aimed at the attainment of effectiveness of taxation (greater neutrality, fairness, predictability of the tax system, lower costs borne by taxpayers and

<sup>5</sup> The situation where tax revenues of the federal budget remain at the previous level may be caused by such factors as an increase in VAT revenues collected by customs authorities in the course of import of goods, delays in refund of VAT to exporters, work on recovery of debts and exaction penalties and fines from taxpayers.

administrative costs). In the case an increase in budget revenues is a result of the reform, it will be, apparently, a positive development, however, it shall not be counted on in the course of planning of the reform<sup>6</sup>. In any case, introduction of accounts should not be accompanied by a reduction in the rates of the value added tax.

In the case the scale of VAT evasion via short-lived enterprises is high, and at the same time there are no other similar methods of tax evasion (both assumptions need additional testing), the present draft system of VAT accounts (envisaging introduction of a number of extremely strict measures, including the impossibility to withdraw funds from VAT accounts, refusal to reckon paid VAT amounts in certain cases, etc.) shall result in an increase in budget revenues generated by domestic VAT in the case it is approved.

However, even in the case the introduction of the VAT accounts system results in lesser tax evasion, there are factors limiting the capacity of this system to increase tax revenues:

(a) Simplification of procedures and faster VAT refunds in the case of taxation at the zero rate (mostly to exporters) are named among the advantages of the VAT accounts system. On the one hand, this decision should result in higher effectiveness of the value added tax. On the other hand, it will result in a decline in VAT budget revenues both in the transitional period and in the future.

(b) The assumed increase in VAT accruals per unit of value of realized goods (works, services) means that the effective tax burden on the economy will increase (on assumption that short-lived enterprises conduct their activities in collusion with end sellers). The increase in the tax burden will result in a growth in prices. The price rise may result in shrinking demand and a decline in VAT revenues. It is difficult to evaluate this effect in quantitative terms, however, its probability is extremely high.

(c) Beside price effects, a more heavy effective tax burden on the economy may result in an increased tax evasion on the part of firms, which at the moment do not evade taxes, but whose full compliance costs are comparable to their evasion costs. It means that in the case expenditures for tax administration grow, or the amount of tax liabilities increase, many taxpayers will find it more feasible to evade taxation, i.e. there will be observed the effect opposite to the legalization of revenues in 2001 resulting from the introduction of the flat tax rate on personal incomes and the regressive scale of the single social tax.

In this situation, VAT generated revenues may decline, and the probability of such an effect is high in the case the costs borne by taxpayers in relation to compliance with the tax legislation increase as a result of the reform.

It is also necessary to take into account the fact that such costs borne by the taxpayer are to a certain degree constant expenditures and, therefore, they will disproportionately grow at the small and medium sized enterprises. At the same time, tax evasion costs (for instance those relating to the transition to settlements in cash unaccounted for) are relatively low for small and medium sized businesses, therefore tax revenues generated by this sector may significantly decline.

(d) The proposed scheme blocks only one mechanism of tax evasion, at the same time failing to prevent evasion from other taxes. The possible growth in the VAT evasion costs borne by the taxpayers using short-lived enterprises due to the introduction of VAT accounts may result in the use of other methods of evasion from both VAT and, to a greater degree, other taxes (settlements in cash unaccounted for, false exports, overstatement of expenditures acceptable for deduction from the profit tax, etc.), what may prevent a growth in the tax revenues of the consolidated budget<sup>7</sup>.

## **6. Elimination of distortions created by the tax legislation currently in force**

On the one hand, the improvement of efficiency of the tax system is an objective of the reform and according to the intentions of its authors the taxpayers presently evading the taxation should loose their advantages over scrupulous taxpayers. On the other hand, the uneven distribution of taxpayers' compliance costs will result in advantages of large enterprises over small and medium sized businesses.

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<sup>6</sup> It should be noted that the objectives of increase or decrease in tax revenues should be primarily attained by changes in the tax rate.

<sup>7</sup> In this connection it should be noted that taxpayers take decisions concerning tax evasion or compliance basing on the ratio between marginal business costs borne in relation to tax compliance and evasion (in this case costs are broadly defined and include not only costs borne in relation to payment of taxes or economy resulting from tax evasion, but also benefits relating to transparency of business or costs of sanctions imposed in the case authorities detect tax evasion). In the case the costs of VAT payment and the use of the existing VAT evasion methods simultaneously grow while other characteristics of the tax system remain constant, taxpayers may shift their efforts towards evasion from other taxes or the search for other VAT evasion methods.

It also should be mentioned that in order to make the argument about elimination of distortions in taxation with the use of VAT accounts true, it is necessary to assume that there are a sufficiently large number of taxpayers not using short-lived enterprises for tax evasion purposes. However, in the case this assumption is true (i.e. that in Russia there exists a sufficiently large share of taxpayers not evading taxation), the necessity to struggle with this phenomenon using the proposed cost-intensive methods is not quite apparent.

As an example of distortions created by the presently proposed system of VAT accounts there may be named the stipulation envisaging that in the case an organization is liquidated, the balance of funds on the VAT account after the liquidated organization pays the value added tax due to the budget and its suppliers should be transferred to the budget. At the same time, as it will be indicated below, there are sufficient number of cases where the taxpayer will have to credit the VAT account from the current account before expected VAT amounts are transferred by buyers. In fact, the recommended procedure will result in a situation where amounts entered to the VAT account from the taxpayer's current account not subject to return to the current account, will, eventually, be transferred to the budget.

#### **7. Taxpayers' costs of compliance with the tax legislation**

Lower costs borne by taxpayers in relation to compliance with the tax legislation may be named among priorities of any tax reform. At the same time, according to estimates of both supporters and opponents of VAT accounts, the envisaged measures will result in an increase in such costs. Evaluations differ both as concerns the scale of losses borne by taxpayers, and distribution of these losses across different groups of taxpayers (large, medium, small) and sectors of the economy.

Taxpayers' costs, as a rule, are defined as withdrawal of working capital, costs of administration of additional bank accounts, issue and processing of additional payment orders, training of personnel, etc. It may be noted that taxpayers will bear the following costs not related to the withdrawal of working capital:

- All persons engaged in entrepreneurial activities, including organizations and individual entrepreneurs exempted from taxpayer's obligations, without any exception should open VAT accounts. At the same time, one of the advantages of the regime relieving the taxpayer of tax obligations is a decline in compliance costs borne by small businesses. However, it may be assumed that such expenditures will increase in the result of the imposition of the responsibility to administer additional bank accounts.

- The responsibility to inform tax authorities about all operations relating to VAT accounts of clients (indicating product codes, invoice numbers and dates) may result in significant costs borne by banking organizations, which may pass these costs on their clients. Moreover, vesting tax authorities with the right to prohibit banks carry out operations relating to VAT accounts (as well as apply to the Central Bank for the recall of the banking license in the case of repeated infringements of the procedure governing the submission of such data) provides tax authorities with unjustifiably broad powers concerning regulation of banking activities.

- Prohibiting banks to conduct operations relating to newly opened VAT accounts before receiving from the tax authority an acknowledgement that it received the notification of the opening of a VAT account by the respective person is an additional limitation on the actual start of entrepreneurial activities and will result in more barriers to market entry, especially for small businesses. The actual prohibition to accept for deduction from the tax base VAT amounts paid by the taxpayer in the course of purchase of goods (works, services) for cash.

As it has been noted above, at present there are no substantiated estimates of the majority of taxpayers' costs relating to the reform of the legislation pertaining to the value added tax. At the same time, we have evaluated the withdrawal of enterprises' working capital resulting from VAT collection via special accounts. The estimated withdrawal of working capital may be caused by two factors:

- at present, while there is no special VAT accounts system in place, the taxpayer may dispose of the VAT amounts received in the composition of payments for realized goods (works, services) at the taxpayer's discretion;

- there arises the necessity to credit the VAT account at the moment the system of VAT accounts starts to operate, for instance, in the case of large purchases, not simultaneous purchases and sales made by the taxpayer, at the beginning of functioning of any enterprise (what is related to purchase of fixed assets, materials, services, etc.)<sup>8</sup>.

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<sup>8</sup> As concerns newly established enterprises, they are especially vulnerable to such losses, since even before any sales the taxpayer would have to purchase raw materials, fixed assets, etc. at the same time transferring 15 per cent of these amounts to the VAT account, while the only possibility to return these amounts to the current account is via the

It should be noted that while the first factor behind the withdrawal of working capital is of temporary nature and is related to the impossibility to use the amounts in the special account for purposes not relating to VAT payments, the second factor results from the necessity to withdraw the amounts not related to VAT received in the composition of payments for realized goods (works, services) and enter them to the VAT account.

Taking into account the fact that the tax period for the value added tax makes 1 month, while the amount of the tax should be transferred to the budget before the 20<sup>th</sup> of the month following the tax period, and assuming that taxable purchases and sales are made evenly over the tax period, as well as the taxpayer's wish to fulfill the obligations to the budget as late as possible before the deadline, it may be concluded that the average time of withdrawal of working capital will make 35 days<sup>9</sup> in the case the system of VAT accounts is introduced.

According to the data presented by the RF Revenue Ministry (Form 1-NDS), in January through July of 2003 the amount of VAT accruals to the budget as per declarations submitted in 2003 made Rub. 593.2 billion, or Rub. 98.9 billion for a 35 days period. Taking into account the fact that in 2004 the base VAT rate will be reduced to 18 per cent, the average tax rate will decline from 18.9 per cent to 17.1 per cent (calculated basing on the data on VAT accruals in January through July of 2003 presented in the reporting form 5-nbn). Correspondingly, the amount of withdrawn funds will make Rub. 89.5 billion in prices of 2003, or 0.68 per cent of GDP (proceeding from the estimated GDP at Rub. 13250 billion in 2003).

As it has been noted above, when the system of special VAT accounts is in place, taxpayers' working capitals may be withdrawn for the crediting of special accounts because of uneven distribution of the time and amounts of purchases and sales (for instance, in the case VAT from the special account is transferred to the budget, it may happen that the balance is insufficient to transfer VAT due to suppliers; in the situation where a company makes purchases in the beginning of the month and sales evenly over the month it will be necessary to credit the special account from the current account). In the case no amounts are entered to the special VAT account, the necessity to make purchases results in the necessity to credit the special account, at the same time, the proposed scheme does not presuppose the possibility to return funds from the special account to the current account. It is rather difficult to estimate losses, however, it may be assumed that this amount will make about a half of monthly VAT payments, or 0.3 per cent of GDP.

### **8. Major conclusions for Russia**

Summarizing the considerations discussed above, the following conclusions may be drawn as concerns the possible impact of the use of special VAT accounts in Russia.

(a) It can not be denied that the introduction of mandatory use of special VAT accounts will result in an increase in revenues of the federal budget, however, first, the scale of this increase can not be estimated, and, second, public costs (i.e. costs borne both by taxpayers and the state, decrease in the revenues of other budgets in the budget system, etc.) relating to this reform may exceed the benefits brought about by the growth in federal revenues. In particular, preliminary estimates of the freezing of enterprises' working capital in the result of the introduction of special VAT accounts carried out by IET demonstrate that the amount of withdrawn funds may make over Rub. 100 billion.

(b) At present, there are neither substantiated estimates, nor methods and data permitting to evaluate in quantitative terms the scale of VAT evasion, effectiveness of the measures proposed to prevent such evasion, benefits and costs borne by the public as the result of the introduction of special VAT accounts.

(c) The proposed measure is a technical one and is aimed to prevent a concrete method of tax evasion, the use of which is caused by a number of flaws in the system of legislative regulation and enforcement on the whole, rather than in the tax system. In this connection, it is not apparent the feasibility of the attempts to cope with systemic flaws via extremely cost intensive technical measure.

(d) Among all states collecting VAT, only Bulgaria introduced special accounts as a measure ensuring VAT collection. At the same time, taking into account the specifics of the Bulgarian tax system and the Bulgarian economy on the whole, it can not be maintained that the Bulgarian experience will be useful for Russia. A mechanical recalculation of the budget effects observed in Bulgaria in the result of the introduction

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procedure of VAT refund from the budget in the case of excess of tax deductions over the size of the tax base bearing all costs associated with this procedure.

<sup>9</sup> Proceeding from the assumption that taxable purchases and sales are made evenly, the term of withdrawal of working capital over the tax period will make 15 days. After the completion of the tax period and before the moment of VAT payment to the budget this term will increase by 20 days.

of special accounts basing on the Russian data demonstrate that depending on the period the increase in VAT generated revenues may make from 0.2 per cent of GDP to 1 per cent of GDP (however, these evaluations are a priori incorrect).

(e) The assumption that prevention of tax evasion via special VAT account will result in elimination of distortions in the economy and removal of competitive advantages of unscrupulous taxpayers is not a proven fact. The proposed reform, both as concerns the introduction of VAT accounts and recommended compensatory measures will result in an increase in costs borne by small and medium sized businesses, as well as newly established enterprises.

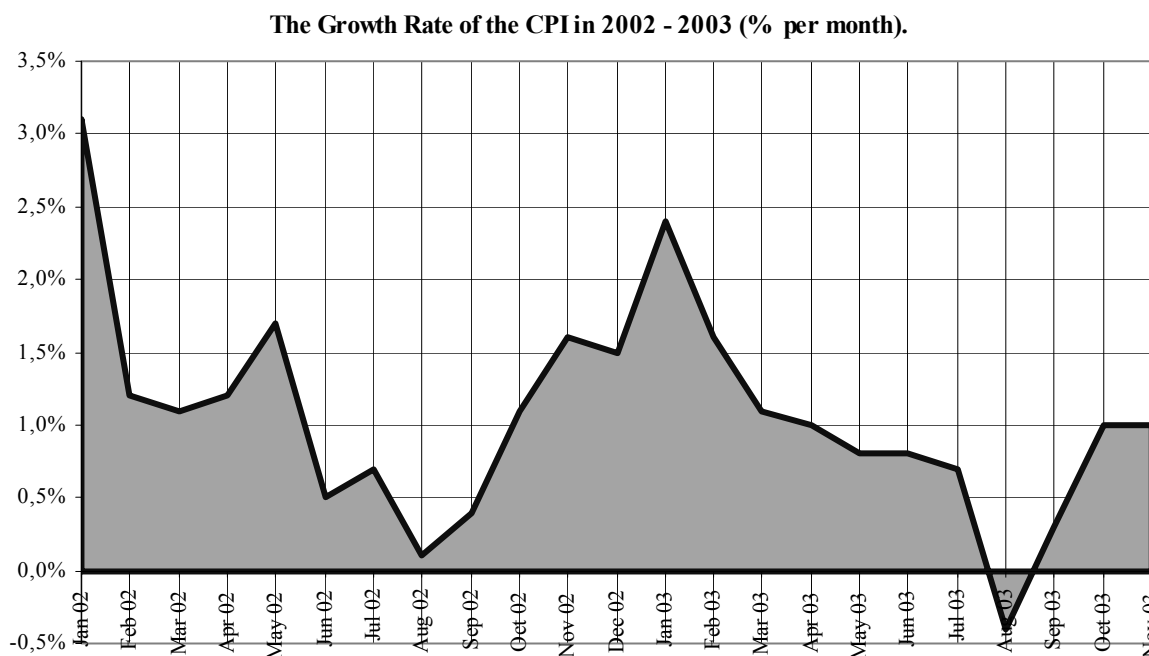
(f) Taking into account the considerations discussed above, as well as the results of a possible additional analysis of the problem, it is necessary to work out a package of measures of tax administration preventing VAT evasion efficiently and at the minimal public cost.

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## Monetary Policy

In November, inflation observed on the consumer market remained at the October level and made 1.0 per cent (see *Figure 1*). It should be noted that in November of the last year the growth in prices significantly accelerated making 1.6 per cent as compared with 1.1 per cent registered in October. The moderate rates of inflation observed on the consumer market was primarily caused by the stability of administratively regulated tariffs on paid services. The respective index made 100.0 per cent in November (100.6 per cent in October). The latter development relates to the absolute reduction of tariffs on a number of products (services) of natural monopolies: the average tariffs on electrical power for households decreased by 2 per cent, fares charged by the main railroad transport fell by 4.4 to 9.0 per cent. At the same time, base inflation<sup>10</sup> (1.4 per cent in October, 1.1 per cent in November) remained at a significantly higher level than that registered in the beginning and middle of 2003. Therefore, it outpaced the general consumer price index, what is untypical for the 4<sup>th</sup> quarter, when the seasonal dynamics of prices of vegetables and fruits usually accelerates.

*Figure 1.*



Source: RF Goskomstat

<sup>10</sup> The Base Consumer Price Index (BCPI) is an indicator reflecting the inflation rate on the consumer market. It leaves out of account the seasonal (prices of fruits and vegetables) and administrative (tariffs on regulated types of services etc.) factors, calculated by the State Committee for Statistics of the RF.

According to the authors' evaluations, in December the growth in consumer prices will not exceed 1.3 per cent. Therefore, the preliminary forecast of annual inflation rates makes from 12.0 to 12.2 per cent, what practically corresponds with the highest limit of inflation set by the governmental forecast for 2003.

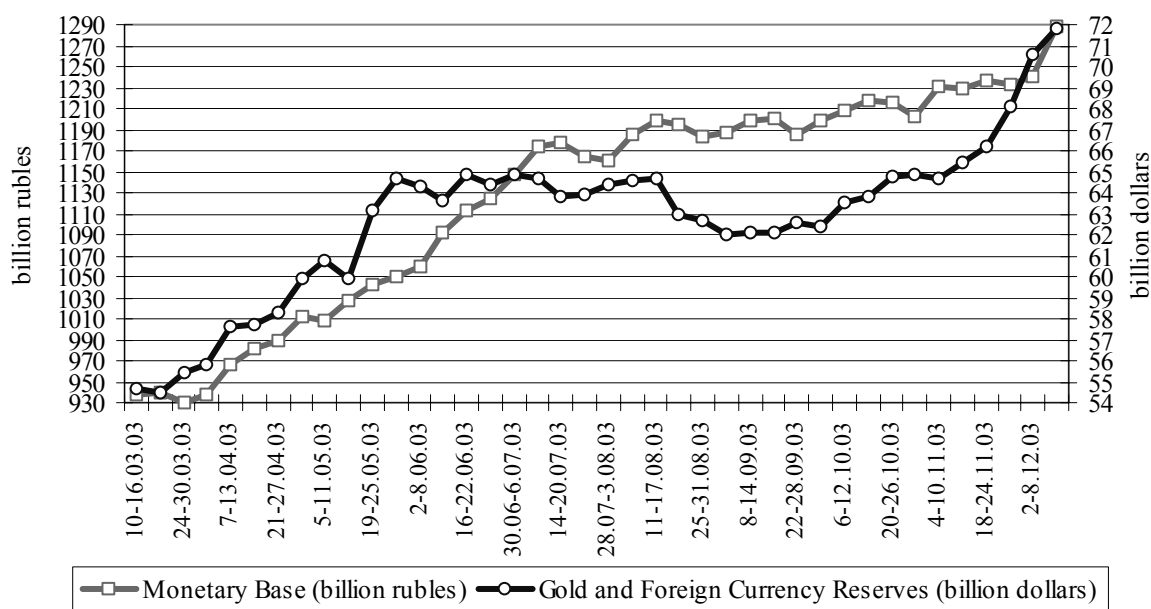
Gold and foreign exchange reserves of the Bank of Russia increased by US \$ 3.2 billion (5.0 per cent) in November, reaching US \$ 68.2 billion as on December 1 (see Fig. 2). Over 11 months of this year, the growth in reserves made US \$ 20.4 billion, or 42.6 per cent. As on January 1, the reserves made US \$ 47.8 billion. The percentage of foreign exchange reserves in the overall foreign reserves increased by US \$ 3.2 billion, or by 5.3 per cent, reaching US \$ 64.4 billion in November. Over the 10 months of this year, the growth in reserves made US \$ 17.1 billion, or 35.85 per cent. On the whole, foreign exchange reserves increased by US \$ 20.4 billion, or by 46.2 per cent over 11 months of this year. The amount of gold in the composition of the reserves remained practically at the same level over the whole year (US \$ 3.739 billion as on January 1 and US \$ 3.744 billion as on November 1).

As on December 5, the amount of gold and foreign exchange reserves of the Bank of Russia made US \$ 70.6 billion. Therefore, it increased by US \$ 2.5 billion over the week. Such a significant growth in gold and foreign exchange reserves in 5 working days has been registered for the first time since May 23 of this year, i.e. in the last six months. In the next week, the reserves increased further by US \$ 1.2 billion reaching the level of US \$ 71.8 billion. The increase in the gold and foreign exchange reserves is registered for the fifth week running (+ US \$ 7.1 billion).

These rates of increase in the gold and foreign exchange reserves over 20 working days have been record high since the Central Bank started to publish information about its gold and foreign exchange reserves. As a result, the present level of the reserves is by US \$ 5.8 billion above the target for the growth in gold and foreign exchange reserves in 2003 recently indicated by O. Vyugin, the First Deputy Chairman of the Bank of Russia. The factor behind this development was the massive purchase of US dollars carried out by the national bank on the domestic market.

Figure 2.

**Changes in the Monetary Base and in the Gold and Foreign Currency Reserves in 2002 - 2003.**



In November of 2003, the monetary base of the Russian Federation in the broad definition<sup>11</sup> increased by 2.6 per cent from RUR 1500 billion to RUR 1540 billion as on December 1, 2003. In January through November, the broadly defined monetary base increased by 24.9 per cent (from RUR 1233 billion registered

<sup>11</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.

in the beginning of the year). In November, the amount of cash in circulation (as adjusted for cash balances of crediting organizations) grew from RUR 1034 billion to RUR 1062 billion, or by 2.7 per cent (by 30.5 per cent since the beginning of the year). In November, the amount of deposits in the Bank of Russia increased by 16.4 per cent up to RUR 6.4 billion. The amount of the CBR liabilities concerning repurchase of securities did not change remaining at RUR 55.5 billion.

According to preliminary estimates, in October the Russia's monetary base calculated according to the money survey method (including forex denominated deposits) declined by 0.84 per cent from RUR 3572.95 billion to RUR 3543.05 billion. In January through October, this indicator increased by 24.65 per cent (according to the adjusted data, as on January 1 its amount was at RUR 2842.41 billion). The amount of money outside banks (aggregate  $M_0$ ) was at RUR 975.8 billion as on November 1, having grown by 1.95 per cent over the month. This indicator increased by 27.66 per cent over the ten months of the year (as on January 1, it made RUR 764.4 billion).

In December of 2003, Russia transferred US \$ 1414.5 million as its foreign debt repayment. This, in turn, included US \$ 693.4 million paid to official creditor countries, banks and companies: US \$ 617.5 million as debt repayment and US \$ 76.8 million as interest payments. The payments to international financial institutions made US \$ 190.8 million: 182.3 million as debt repayment and US \$ 8.5 million as interest payments respectively. Besides, in December, US \$ 529.4 million were transferred as the payment of interest on RF Eurobonds.

As on January 1, 2003, the amount of the public foreign debt of RF was at US \$ 122 billion, or 35 per cent of GDP; it is expected that by the end of the year it shall diminish to US \$ 119 billion, or 27.5 per cent of GDP.

In December, the RF CBR announced that it intends to reduce the rate of mandatory allocations into the Fund of Mandatory Reserves (FMR) for banks in the 1<sup>st</sup> quarter of 2004.

*P. Trounin*

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## **Financial Markets**

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

In the period from November 24 till December 19, an apparent decline in the yields of traded instruments was observed on the market of Russian forex denominated public debt. On the whole, in the late November and early December the market dynamics were determined by investors' expectations for the results of the Parliamentary elections. Nevertheless, after the elections this uncertainty factor was eliminated, what facilitated a decline in the yields of sovereign forex denominated bonds. Thus, on December 19 the yield to maturity of Russian Eurobonds RUS-30 was 7.27 per cent p.a. (end of November: 7.57 per cent); RUS-18: 6.95 per cent p.a. (end of November: 7.19 per cent). Besides, on the same date the yield to maturity of the Russian Eurobonds was: Minfin bonds, 7<sup>th</sup> tranche: 6.47 per cent; Minfin bonds, 6<sup>th</sup> tranche: 4.05 per cent; Minfin bonds, 5<sup>th</sup> tranche: 5.62 per cent; RUS-07: 4.42 per cent. Therefore, over December the levels of yields of all sovereign Eurobonds have significantly decreased.

Over the month, the market of Ruble denominated public debt has been affected by a rather high level of liquidity in the banking sector. Among other most important factors of the growth observed on the market, there may be noted the results of the elections indicating the stability of the political course, stable indicators of economic growth in Russia, as well as the depreciating US dollar. Over the period from December 1 to 19, the aggregate turnover of the market made about RUR 10.7 billion, what was significantly above the respective indicator registered in the first three weeks of November (RUR 6.5 billion) while the average daily turnover was at RUR 766 million (RUR 467 million in November).

In the same period, there took place a regular auction for the placement of OFZ - AD. The par value amount of OFZ - AD 46001 placement made RUR 3 billion. At the auction the demand was registered at RUR 1.9 billion, while the actual amount of placement made RUR 1.8 billion. The cutoff price was set at the level of 108.65 per cent of the face value (income of 8.24 per cent per annum), while the weighed average yield registered after the completion of the auction was at 8.17 per cent.

As on December 23, the amount of the GKO - OFZ market made RUR 293.22 billion at par and RUR 314.6 billion at the market value. The duration of the GKO-OFZ market portfolio was 902.85 days.



FIGURE 1.

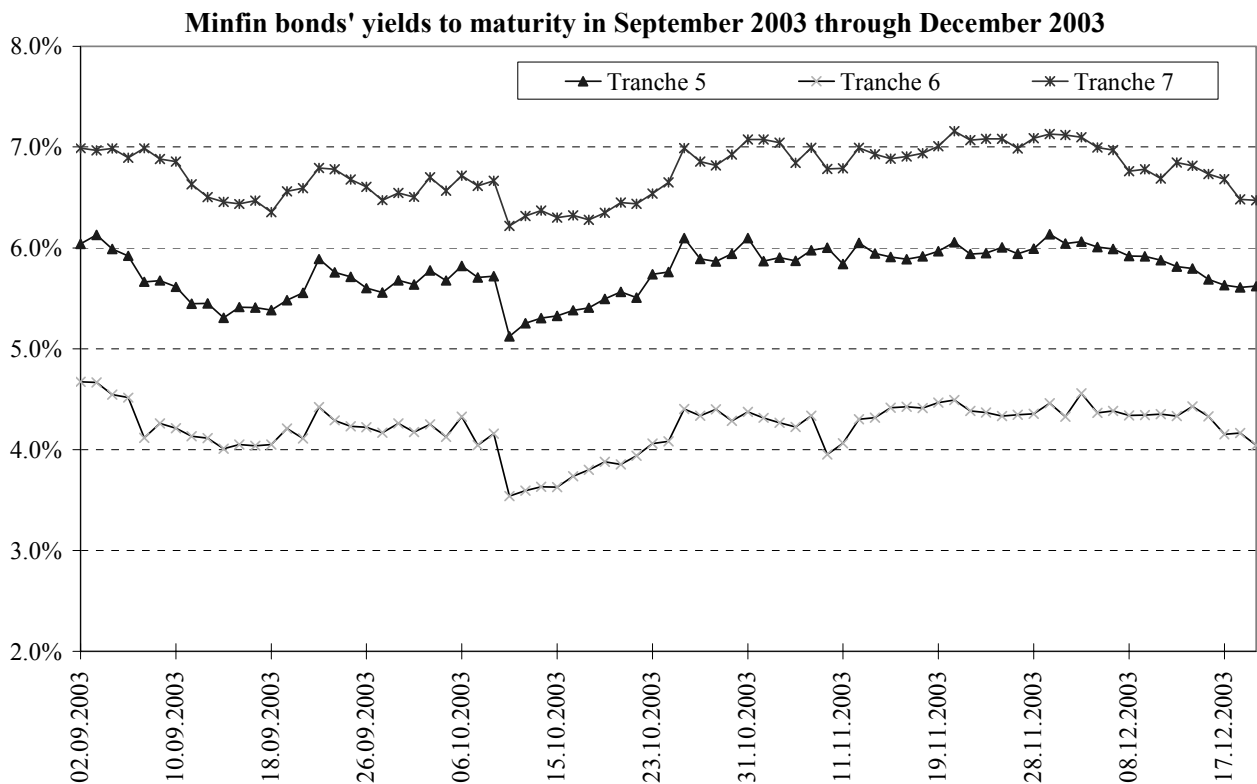
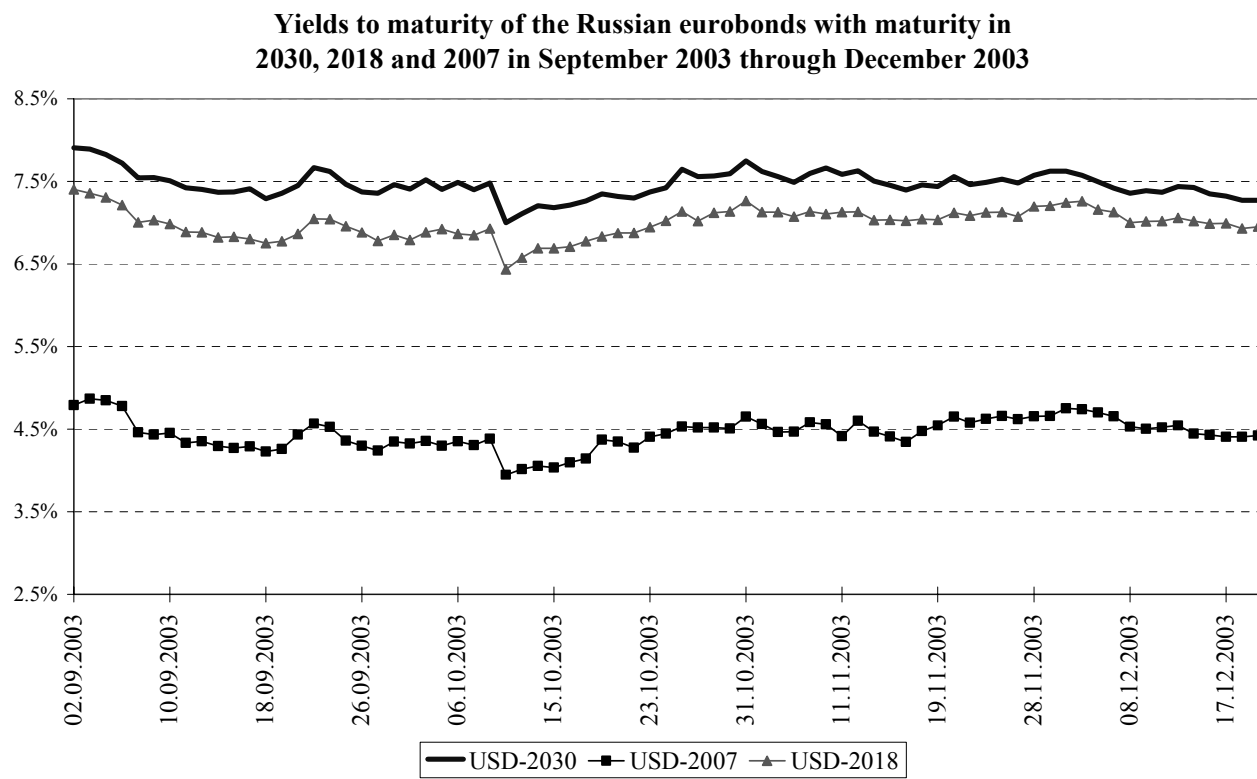


FIGURE 2.

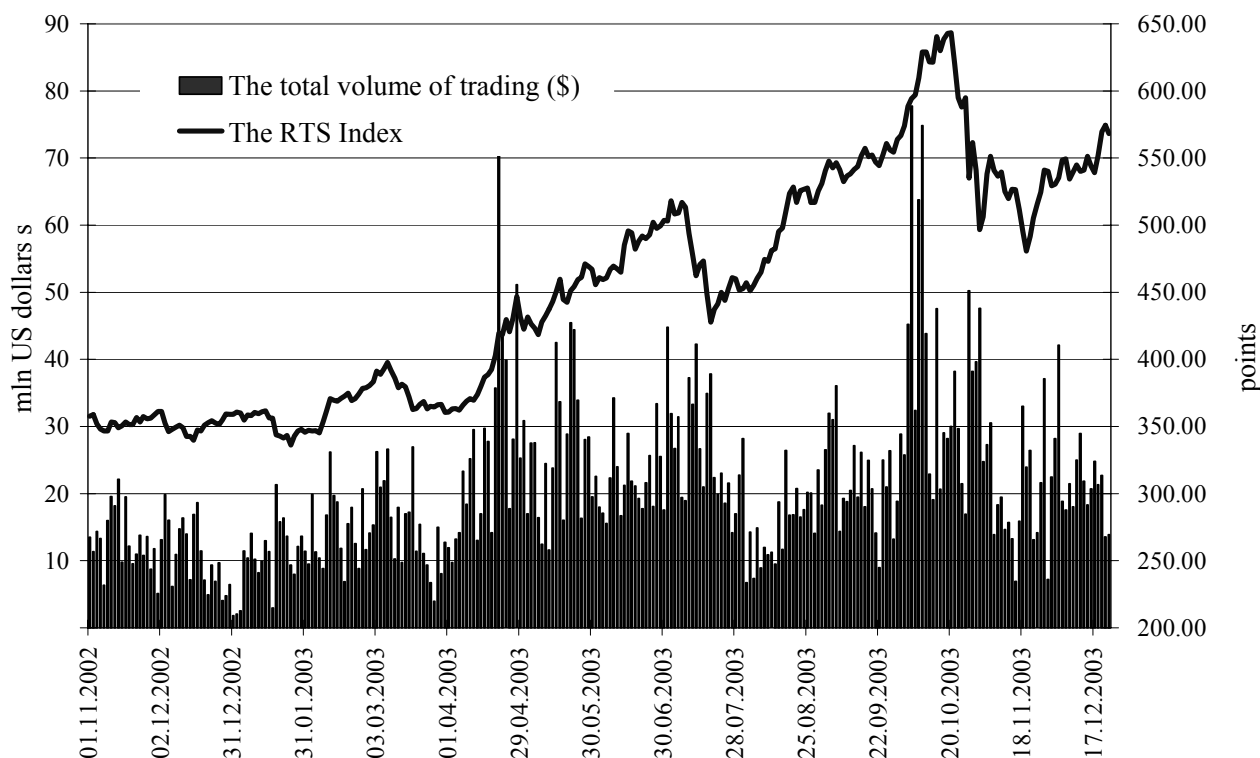


## The Market for Corporate Securities

### Situation on the stock market.

A sharp downfall in quotations observed on the Russian stock market in November was somewhat reversed in December. After the Duma elections the situation on the whole was characterized by declining risks of political uncertainty: in general, foreign investors demonstrated their confidence in the Russian market. The major factors behind the growth observed on the market were the victory of the Presidential party, favorable national macroeconomic indicators, and the high level of oil prices. In spite of a number of negative corporate news (cancellation of the YUKOS and Sibneft merger, extension of the time of holding in custody of M. Khodorkovsky) in the period from November 28 till December 23 the RTS index increased by 38.95 points, what corresponds to a growth by 7.36 per cent.

FIGURE 3.

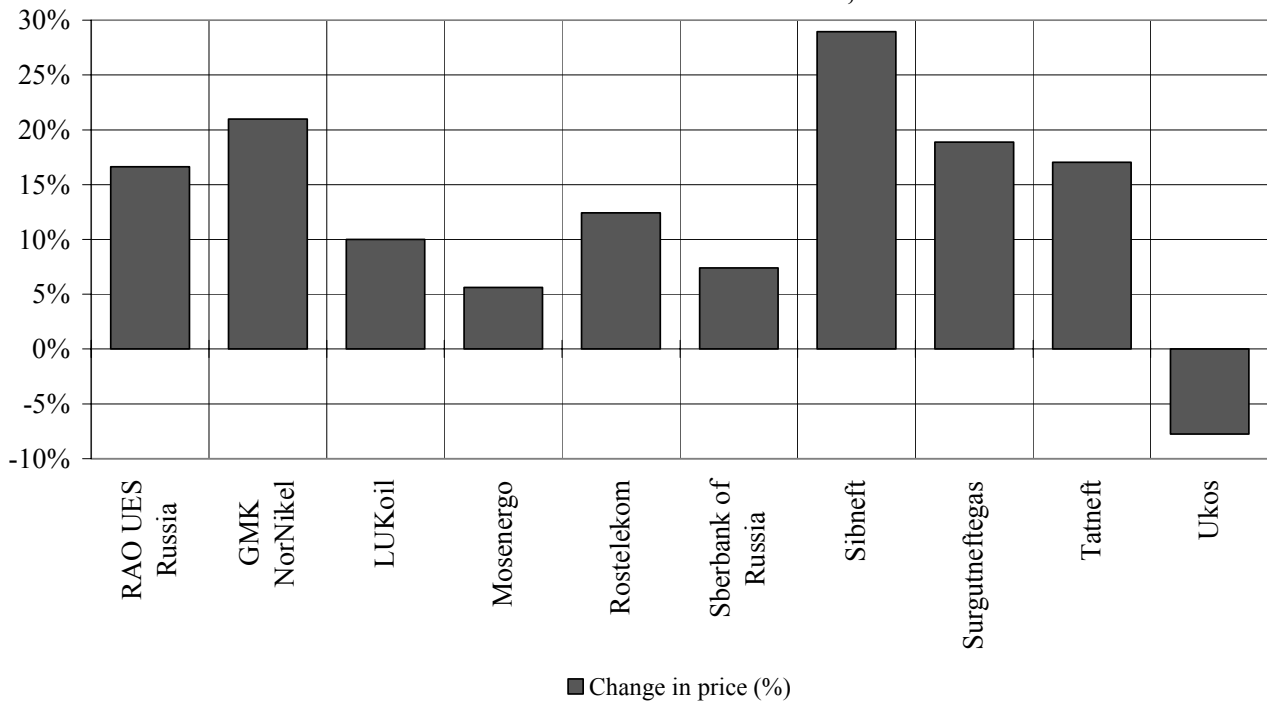


In the period from December 1 to 23, the turnover in the RTS trading amounted to US \$ 356.99 million, what was significantly above the respective indicator observed in the preceding month (in the first three weeks of November, the turnover in the RTS trading was about US \$ 286 million). The average daily turnover at the RTS has somewhat increased in comparison with the respective indicator registered in this November and made US \$ 22.3 million (US \$ 20.4 million in October). The highest volume of trade at the RTS (US \$ 42.1 million) was observed on December 2; the lowest trade volume (US \$ 13.5 million) was observed on December 22. Therefore, the dynamics of the Russian stock market and indicators of activity demonstrate that the market experiences a recovery of investors' confidence after the significant decline observed in November.

It is worth a special mentioning that according to the results of the month there was observed an increase in the market value across all blue chips with the exception of YUKOS (in the period from November 24 till December 23). Thus, the leaders of the growth in prices were shares in Sibneft whose quotations rose by 28.96 per cent over the period under observation. These stocks were followed by shares in Norilsk Nickel (20.98 per cent), Surgutneftegaz (18.8 per cent), Tatneft (17.03 per cent), and RAO UES of Russia (16.63 per cent). The only outsider on the market was YUKOS, whose shares declined even more by the end of the month. At the background of the information that the merger with Sibneft was cancelled, the value of YUKOS stocks declined by 7.77 per cent.

FIGURE 4.

**Dynamics of the Russian Blue Chips  
from November 24 to December 23, 2003**



From December 1 till December 19, the RAO UES of Russia shares took the top position by the volume of turnover in the RTS<sup>12</sup>: the total transactions amounted to 26.45 per cent. The amount of transactions with the shares in YUKOS was somewhat below that demonstrated by the RAO UES of Russia (19.07 per cent). The shares of LUKoil followed: the volume of transactions with this company's shares made 15.95 percent of the total turnover. In spite of the fact that Rostelekom accounted for significantly smaller share of the RTS turnover did not prevent the company to be the fourth in terms of turnover of its stocks. Thus, the percentage of transactions with the shares of only these four companies was 67.25 per cent of the total traded turnover on the classical RTS stock market during the period under observation and remained at the same level as was registered in November of 2003.

As on November 23, the top five leaders of the national stock market by capitalization look as follows<sup>13</sup>: YUKOS: US \$ 29.06 billion, Surgutneftegaz: US \$ 21.096 billion; LUKoil: US \$ 19.46 billion; MMC Norilsk Nickel: US \$ 14.01 billion; Sibneft: US \$ 13.5 billion.

**The market for term contracts.** In December, the RTS market for term contracts (FORTS) demonstrated a decrease in the trading activity of participants in comparison with the figures registered in November. Thus, in the period from December 1 till December 23 the volume of trade in futures and options at the RTS amounted to about RUR 15.9 billion (79.9 thousand transactions; 2.1 million contracts), what was somewhat below the respective indicators registered in the preceding month (RUR 17.6 billion, 82.2 thousand transactions; 2.57 million contracts).

As usual, futures contracts account for the greatest percentage of transactions: the volume of trade in these contracts reached RUR 14.74 billion (1.94 million contracts, 77.29 thousand transactions) in the period from December 1 till December 23. As before, options were in a much lower demand: the respective amount of trading made about RUR 1.189 billion. The maximum trading volume was observed on December 5 and made RUR 1.726 billion (as compared with RUR 1.64 registered in November), while the minimum trading volume (RUR 395.66 million as compared with RUR 701.6 million in November) was registered on December 22.

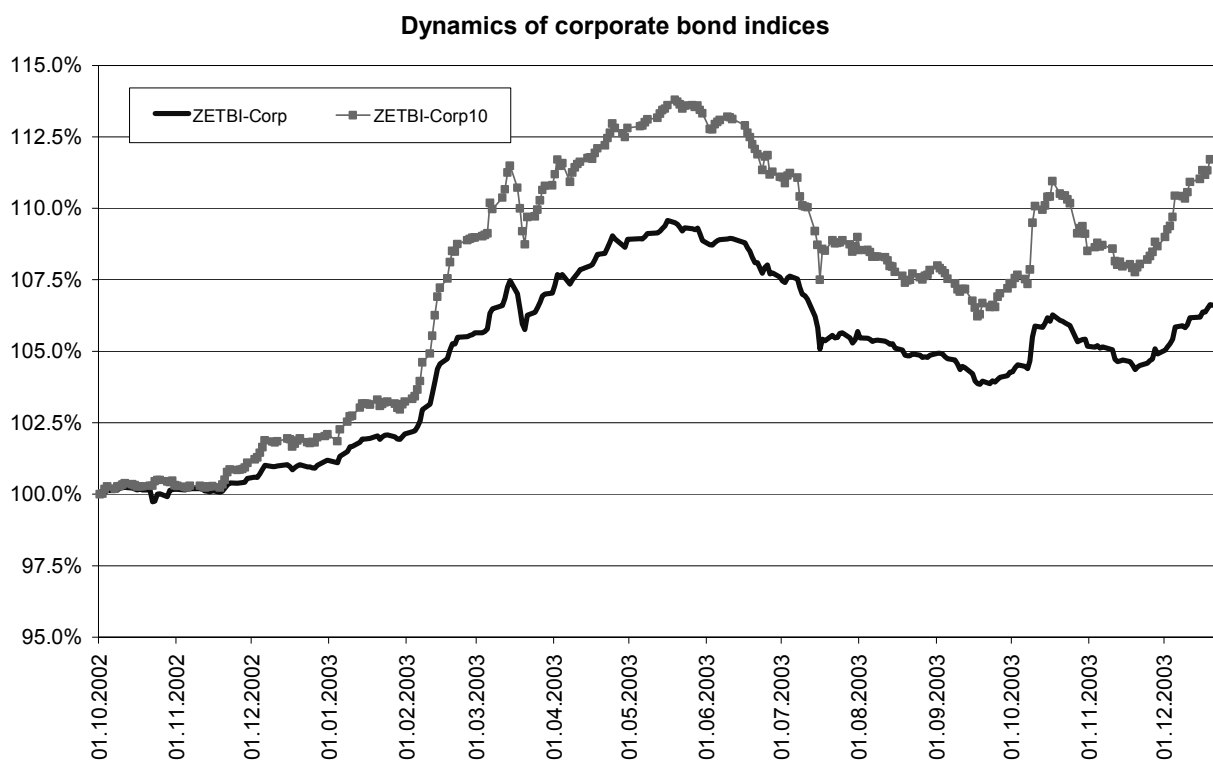
<sup>12</sup> On the classical stock market.

<sup>13</sup> According to the RTS.

**Corporate bond market.** The situation on the market of corporate bonds closely followed the development observed in other segments of the Russian financial market. In the late November, on the market there was observed a significant growth in quotations of corporate bonds issued by Russian issuers, which stopped as the market experienced a one day adjustment after the information about the cancellation of the Sibneft – YUKOS merger had become public. However, already on the following day the quotations recovered. The dynamics of quotations demonstrate the growing influence of macroeconomic factors. The respective factors include the Ruble appreciation, a decline in the estimated inflation rates to the targets set forth by the budget indicators (12 per cent) for 2003, and sufficient level of the Ruble liquidity. Besides, the insufficient amount of the primary market facilitates a growth in prices of Russian corporate bonds.

In the period from November 28 till December 19 the total turnover in the bond sector of MICEX was RUR 6.9 billion, what was by about RUR 4.8 billion below the respective figures registered this November (RUR 11.7 billion). In December, the average daily turnover made RUR 495.1 million, what was somewhat below the respective indicator registered in November (RUR 616.1 million). In the period from November 28 till December 19, the price index of corporate bonds traded at the MICEX<sup>14</sup> increased by 1.81 points (1.66 per cent) and the index of ten most liquid corporate sector bonds decreased by 3.11 points (2.78 per cent).

FIGURE 5

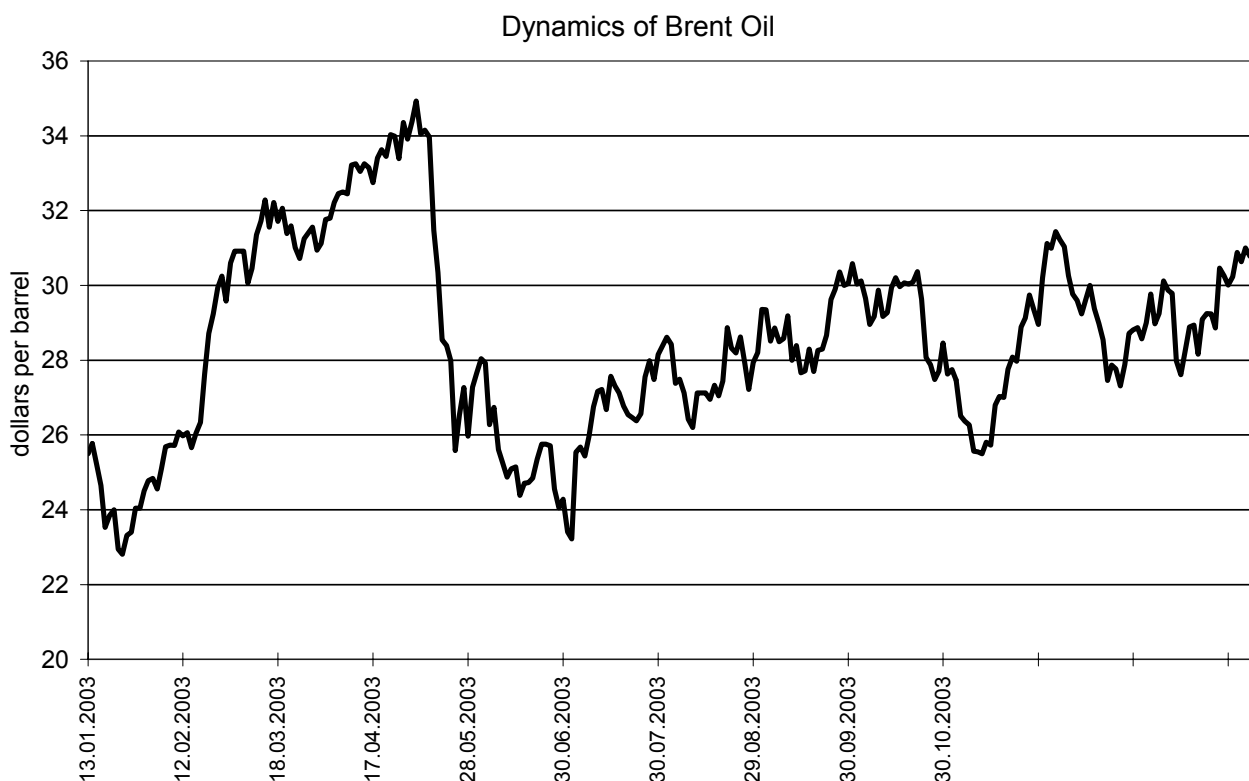


**External factors affecting the dynamics of the Russian stock market.** In the period from December 1 till December 23, an upward trend in prices was observed on the world oil market. At the OPEC summit held in the beginning of the month, it was decided to leave the extraction quotas unchanged, what the representatives of the cartel motivated by the observed balance of demand and supply. On the whole, the market expected exactly such a decision, therefore it did not affect the price level. In the middle of the month, a certain decline in prices was observed after the information that the US troops had captured S. Hussein was made public. By December 18, the US fuel reserves dropped to the minimal level (according to the US Energy Information Administration (EIA)) at which oil processing plants could steadily operate. According to the data published by EIA and the American Petroleum Institute (API), the US fuel reserves declined across practically all positions, what facilitated a further growth in quotations. However, the

<sup>14</sup> The indices of corporate bonds traded at the MICEX that have been used for the calculations are calculated by Zenit Bank.

expiration of the term of the January WTI futures was accompanied by the close out of this contract, what resulted in a “technical” drop in quotations observed on the market. In the beginning of the last week of the month, the market demonstrated a significant decline in prices, what may be explained by the statement made by the Indonesian Minister of Oil Industry, who should become the Chairman of OPEC on January 1, 2004. His statement that the current level of prices was too high and that it was necessary to increase quotas contradicted to the forecasts that quotas might be further reduced at the February summit of OPEC member countries. The market reacted to these statements by a drop in quotations: in one day, (from December 22 to 23) the Brent price fell by US \$ 2.25 and at the close of the exchange was at US \$ 28.77 per barrel. Due to this fact, in the period from November 28 till December 23 the world Brent prices declined by US \$ 0.12 per barrel (- 0.42 per cent).

FIGURE 6.

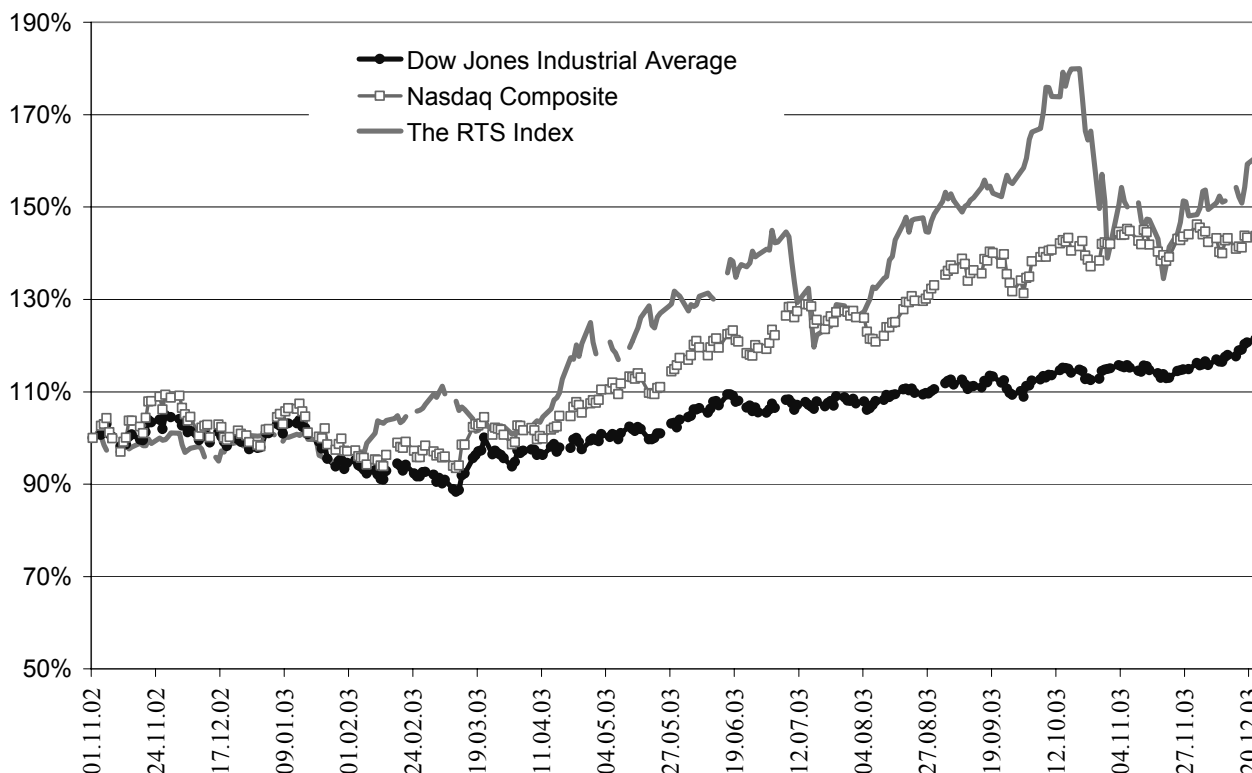


In December, an improvement in the business situation was observed on the world stock markets. For instance, according to the results of three weeks of the month (year) the US stock indices NASDAQ and S&P500 increased by 1.42 per cent (42.37 per cent) and 4.18 per cent (20.63 per cent). The DJIA index also demonstrated positive dynamics – the rate of increase according to the results of the month (year) made 6.09 per cent (20.22 per cent). European stock indices also demonstrated positive rates of growth: FTSE 100 (UK) grew during the month (year) by 1.33 per cent (10.89 per cent), DAX 30 (Germany), by 5.13 per cent (26.20 per cent), CAC-40 (France), by 2.58 per cent (9.79 per cent). The Asian stock markets were characterized by the following changes in their respective indicators over the month (year): Nikkei-225 (Japan) grew by 4.14 per cent (19.04 per cent) during the month (year), while Seoul Composite (South Korea), by 6.4 per cent (21.29 per cent). On the markets of developing countries there was observed a certain improvement of the business situation, what was demonstrated by an increase in the composite index calculated by the agency MSCI – according to the results of the month (year) it grew by 7.38 per cent (36.01 per cent).

According to the results of the first trading week of the month, the quotations on the US stock market were characterized by different trends, what could be explained by contradictory economic statistics indicating a significant decline in the rates of growth in the US economy. However, a number of positive statistical reports and positive corporate news published over the two next weeks of the month facilitated a growth in prices of the stocks of US companies. The meeting of the FRS Open Market Committee, which retained the US interest rate at the same level. However, negative factors, among which there should be mentioned the

further depreciation of the US dollar against Euro and growth in oil and gold prices, were also at work on the market.

FIGURE 7.



Generally speaking, as before the dynamics of stock markets in Europe echoed the situation on the US market. On the one hand, at the background of high world oil prices shares in oil companies were in demand, what facilitated a growth in European stock indicators. At the same time, the weakening of the dollar against Euro on the world forex market has an extremely negative effect on export oriented companies of the European Union, whose competitiveness deteriorates.

### Corporate News.

#### *The OAO Sibneft*

On December 18, the company Millhouse Capital appointed the company Citygroup as the advisor on the issues pertaining to the cancellation of the merger between YUKOS and Sibneft. Major YUKOS shareholders and the company Millhouse Capital have reached an agreement in the framework of which 92. per cent of shares in Sibneft, at present owned by YUKOS, should be returned to the previous major shareholders.

#### *The OAO Mosenergo*

The Board of Directors of the RAO UES of Russia approved the plans relating to the reorganization of the OAO Mosenergo. It is planned to reform the company in accordance with the base reorganization variant set forth in the RAO UES of Russia Strategy "5 + 5." It is envisaged that in the process of reorganization of the OAO Mosenergo there will be created four generating companies (on the base of GRES – 4, GRES – 5, GRES – 24, and Zagorsk GAES respectively, which, according to the executive order of the RF Government 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 plan of reform envisages that

shareholders of the RAO UES of Russia should directly participate in the authorized capital of the Moscow generating company, Moscow oblast power supply network company, and repair enterprises.

*The OAO GMK Norilsk Nickel*

The gold mining company “Polyus,” 100 per cent of shares in which owns the GMK Norilsk Nickel, won the auction for the right to use for prospecting and extraction of gold ore at the “Titimukhta” deposit. The final bidding of the winner amounted Rub. 298 million 850 thousand 200, while the starting price was set at Rub. 7 million 286 thousand 200. The license shall be valid for a 20 year term. The license requires that the company should complete the prospecting of the deposit before the end of 2005 and operate at the full capacity not later than in 2007. It is planned that after the enterprise is in full operation, “Polyus” should extract not less than 2 metric tons of gold a year.

The “Titimukhta” deposit (situated in the North Yenisei district of the Krasnoyarsk krai) was discovered in 1990. Five ore solids were detected within the ore zone. The balance sheet gold reserves make 34 metric tons 278 kilograms. The average percentage of gold in the ore is estimated to be at 2.2 to 9.5 gram per metric ton. The deposit is designated for open mining.

*The OAO NK YUKOS*

At its meeting held on October 28, 2003, the extraordinary meeting of the company’s shareholders took the decision to pay dividends for the first 9 months of 2003 in amount of RUR 59.9 billion, what makes RUR 26.78 per one ordinary share. According to the decision of the shareholders’ meeting, the dividends will be paid before February 28, 2004, to the NK YUKOS shareholders registered in the register of shareholders as on September 25, 2003.

*Table 1*

**Dynamics of International Stock Market Indices**

<b>Data as of December 23, 2003</b>	<b>Value</b>	<b>Change within the month (%)</b>	<b>Change since the beginning of the year (%)</b>
RTS (Russia)	568.22	10.17%	57.49%
Dow Jones Industrial Average (USA)	10341.26	6.09%	20.22%
Nasdaq Composite (USA)	1974.78	1.42%	42.37%
S&P 500 (USA)	1096.02	4.18%	20.63%
FTSE 100 (UK)	4440.9	1.33%	10.89%
DAX-30 (Germany)	3903.34	5.13%	26.20%
CAC-40 (France)	3500.09	2.58%	9.79%
Swiss Market (Switzerland)	5417.2	2.12%	10.57%
Nikkei-225 (Japan)	10372.51	4.14%	19.04%
Bovespa (Brazil)	21688.4	10.14%	86.97%
IPC (Mexico)	8607.96	5.43%	37.65%
IPSA (Chile)	1468.53	3.24%	42.55%
Straits Times (Singapore)	1720.92	3.24%	28.43%
Seoul Composite (South Korea)	801.88	6.40%	21.29%
ISE National-100 (Turkey)	18242.01	24.80%	68.32%
Morgan Stanley Emerging Markets Free Index	430.639	7.38%	36.01%

**The Foreign Exchange Market.** The US \$ depreciation against the Ruble may be primarily explained by the growth in the volumes of Russia’s exports. On the other hand, an important factor behind the US \$ dynamics is the inflow of foreign capital caused by the growth observed in the national economy and higher attractiveness of Russian assets. An important factor significantly affecting the exchange rate fixing was a sharp depreciation of the US \$ against Euro. Throughout the period from November 29 till December 24, the US \$ exchange rate decreased by more than 49 kopecks making RUR 29.245 per US \$.

In the period from December 01 till December 19, the total volume of trade in the US Dollar at the SELT was US \$ 9.97 billion (the average daily turnover made US \$ 712.2 million over this period), increasing in comparison with the respective figures registered in November of 2003. During the period under review the highest volume of trade in the US Dollar, about US \$ 1.6 billion, was observed on December 15 (about US \$ 1 billion in November); the lowest results, US \$ 328.15 million, were observed on December 2.

FIGURE 8.

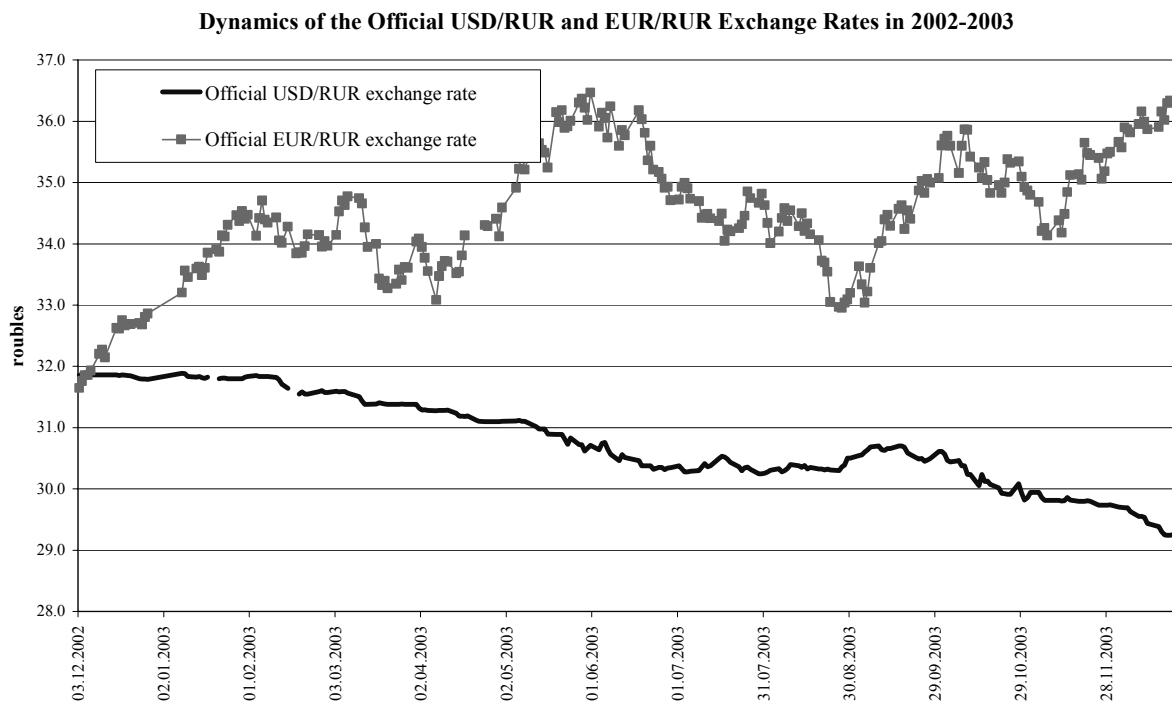
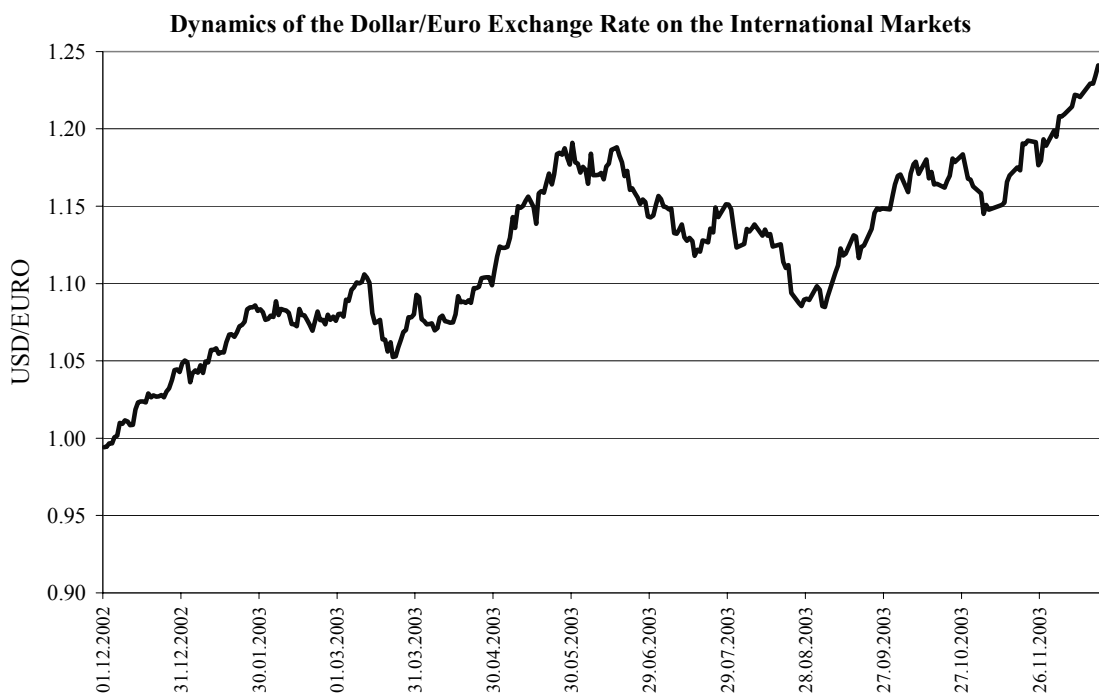


FIGURE 9.



Ruble liquidity in the banking sector significantly increased in December of 2003 as compared to the November level, on December 24 the balances in credit institutions' accounts with the Bank of Russia were at RUR 233.5 billion, what was practically two times above the average levels registered in the end of November.



On the world forex markets, during the month on the whole there was observed a continuing depreciation of US \$ against Euro. Among the key factors affecting the dynamics of US \$, there should be noted the reduction of the interest rates in the USA and the growing deficit of the current account and the US budget. On the world forex markets, the rate of the Euro grew against the Dollar by 5 cents (by 4.37 per cent as compared with the US \$ / Euro exchange rate registered on November 28) and according to the data as on December 23 made US \$ / Euro 1.241.

The dynamics of the Euro - Ruble rate were mainly determined by the trends on the world market. The strengthening of the Euro against the US Dollar in the world markets was followed by an increase in the Euro - Ruble rate observed in December. In the period from November 28 till December 23 the European currency grew by 78 kopecks (2.19 per cent) from the level of RUR / Euro 35.5 to RUR / Euro 36.28. The total turnover of trade at the SELT amounted to Euro 91.7 million in the period from December 01 till December 19 (in November: Euro 117.4 million). The highest trade volume of Euro was registered on December 18 at Euro 8.38 million, and the lowest, Euro 3.84 million, on December 1.

Table 2

### Financial Markets Indicators

Month	August	September	October	November	Dec.*
Monthly inflation rate	-0,4%	0,3%	1,0%	1,0%	1,1%
Inflation rate annualized on the basis of this month's trend	-4,70%	3,66%	12,68%	12,68%	14,03%
CB RF refinancing rate	16%	16%	16%	16%	16%
Annualized yield to maturity on OFZ issues (%)	6,54%	6,15%	7,26%	6,74%	7,1%
Volume of trading in the secondary GKO-OFZ market for the month (RUR billion)	13,00	12,87	14,60	5,02	12,0
Yield to maturity on Minfin bonds at the end of the month (% p.a.)					
5th tranche	6,00%	5,68%	6,10%	5,99%	5,6%
6th tranche	4,61%	4,26%	4,38%	4,36%	4,1%
7th tranche	6,92%	6,55%	7,08%	7,09%	6,5%
8th tranche	5,60%	4,96%	5,17%	5,09%	4,9%
Yield to maturity of Eurobonds at the end of the month (% p.a.)					
2005	3,35%	2,93%	3,22%	3,16%	3,0%
2007	4,81%	4,35%	4,65%	4,66%	4,4%
2010	6,09%	5,70%	5,98%	5,92%	5,8%
2018	7,28%	6,85%	7,26%	7,19%	6,9%
2028	7,64%	7,26%	7,57%	7,50%	7,3%
2030	7,81%	7,46%	7,75%	7,57%	7,3%
INSTAR-MIACR rate (% p.a.) on interbank overnight loans at the end of the month	3,9%	22,0%	9,76%	7,75%	2,0%
Official RUR / US\$ exchange rate at the end of the month	30,5036	30,6119	29,8584	29,7387	29,25
Official RUR / Euro exchange rate at the end of the month	33,2001	35,0751	34,8657	35,5021	36,45
Average annualized growth in RUR / US\$ exchange rate	0,81%	0,36%	-2,46%	-0,40%	-1,64%
Average annualized growth in RUR / Euro exchange rate	-4,13%	5,65%	-0,60%	1,83%	2,67%
Volume of trading at the stock market in the RTS for the month (US\$ million)	329,97	490,78	867,33	374,55	450
Value of RTS-1 Index at the end of the month	531,00	568,97	513,96	529,27	570
Change in value of RTS-1 Index during the month (%)	16,19%	7,15%	-9,67%	2,98%	7,7%

\* Estimate

D. Polevoy

## **Corporatization and maintenance of state control in the corporate sector in 2000 through the first six months of 2003.**

Corporatization, as a privatization method, played a significant role at the stage of mass privatization (1992 through 1994) and over first two to three years of cash privatization (in 1995 through 1997), however, later the sales of shares of enterprises was used less frequently. It would suffice to mention that in the last three years (in 2000 through 2002) in the course of privatization there were established less than 450 joint stock companies, what is below the figures registered in 1997. In 2003, the process of corporatization somewhat recovered. In the first six months 114 state and municipally owned unitary enterprises (without federal enterprises subject to privatization by the RF Property Ministry) were transformed into public joint stock companies, what is almost 1.7 times above the value of this indicator registered in the respective period of the preceding year.

As it is apparent basing on the data presented above, the role of corporatization as a special type of privatization has not been so significant over the three last years<sup>15</sup> as in the preceding period. However, there should be noted certain characteristics of formation of the share capital of privatized enterprises over this period. One of the most important features of this process was the degree to which the state maintained its property control after the enterprise was formally transferred to the corporate sector (see *Table 1*).

*Table 1*

### **Creation of joint stock companies, where state participation was maintained in the course of privatization in Russia in 1997 through 2003**

Period	Number of enterprises where a block of shares was owned by the state or a municipal entity		Number of enterprises subject to the special right "Golden share"	
	units	share in the total number of created JSC, %	units	share in the total number of created JSC, %
1997	84	16,9	58	11,7
1998	142	39,4	28	7,8
1999	101	39,1	42	16,3
1997-1999	327*	29,4*	128*	11,5*
2000	72	36,2	8	4,0
2001	59	47,2	2	1,6
2002	38	30,4	1	0,8
2000-2002	169*	37,6*	11*	2,4*
2003, I half year	...	...	1	0,9

\* - calculated as the sum of values registered in each year over the indicated period and does not represent the number of JSC with state participation by the beginning of 2000 and 2003, since some of the previously assigned blocks of shares have been sold.

Source: Statisticheskiye byulleteni o khode privatizatsii gosudarstvennykh i munitsipalnykh predpriyatiy (obyektov) za yanvar – dekabr (Statistical bulletins on the progress of privatization of state and municipally owned enterprises (objects) in January through December) of 1997 (p. p. 33-35), 1998 (p. p. 58 - 61, 121 - 124), 1999 (p. p. 58 - 61, 121 - 124), 2000 (p. p. 41 - 43, 98 - 100), 2001 (p. p. 40 - 42, 97 - 99), 2002 (p. p. 40 - 42, 97 - 99); Sotsialno-ekonomicheskoye polozheniye Rossii. Yanvar – iyul 2003 (Social and economic situation in Russia. January through July of 2003), p. 139, M., RF Goskomstat, author's calculations.

In 2000 through 2002, the share of public companies where blocks of shares were in the federal, regional, or municipal ownership significantly increased (37.6 per cent in 2000 through 2002 as compared with 29.4 per cent in 1997 through 1999), although in the absolute terms the number of such enterprises declined almost two times (169 units in 2000 through 2002 as compared with 327 units in 1997 through 1999). There is observed an apparent trend towards a sharp decline in the use of special right "Golden share." While in

<sup>15</sup> This fact may be explained by the changes in the statistical reporting. Previously, corporatization as a special type of privatization was accounted for as a number of joint stock companies created since the beginning of the year. Since 2000, the number of newly established joint stock companies may be calculated as a sum of enterprises (objects) privatized via the sale of shares of public companies at auctions and commercial tenders, sale of shares to employees, at specialized auctions, and enterprises transformed in public companies where 100 per cent of shares are owned by the state of a municipal entity. It can not be excluded that this change in definitions resulted in the inconsistency of reporting before and after 2000.

1997 through 1999 there were registered 128 such public joint stock companies, in 2000 through 2002 the number of such enterprises made 11 units. As a result, the aggregate share of enterprises where the state maintained any form of property control after formal corporatization remained practically at the same level as in 1997 through 1999 (40 per cent). Unfortunately, the official statistical reporting has failed to present the data on public companies where blocks of shares were transferred in trust management or in holding companies.

The comparison of key characteristics of the state property control in the course of corporatization of enterprises of different ownership forms in 2000 through 2002 and the three preceding years brings rather interesting results (see Table 2).

Table 2

**State participation in capital maintained in the course of creation of joint stock companies of different ownership forms in 1997 through 2002**

Period, ownership form prior to corporatization	Public JSC, total	Public JSC where blocks of shares are in the federal, regional, or municipal ownership		Public JSC where 100 % of shares are in the federal, regional, or municipal ownership		Public JSC granted the special right "golden share"		Public JSC where all shares designated for sale were sold	
		unit	%	unit	%	unit	%	unit	%
2000	199	72	36,2	6	3,0	8	4,0	96	48,2
- federal	36	9	25,0	-	-	3	8,3	12	33,3
- regional	138	58	42,0	5	3,6	5	3,6	71	51,4
- municipal	25	5	20,0	1	4,0	-	-	13	52,0
2001	125	59	47,2	12	9,6	2	1,6	55	44,0
- federal	11	5	45,5	-	-	-	-	6	54,5
- regional	93	51	54,8	12	12,9	1	1,1	37	39,8
- municipal	21	3	14,3	-	-	1	4,8	12	57,1
2002	125	38	30,4	16	12,8	1	0,8	44	35,2
- federal	10	1	10,0	1	10,0	-	-	2	20,0
- regional	94	29	30,9	10	10,6	-	-	22	23,4
- municipal	21	8	38,1	5	23,8	1	4,8	20	95,2
2000-2002	449	169	37,6	34	7,6	11	2,4	195	43,4
- federal	57	15	26,3	1	1,8	3	5,3	20	35,1
- regional	325	138	42,5	27	8,3	6	1,8	130	40,0
- municipal	67	16	23,9	6	8,9	2	3,0	45	67,2
Memorandum:									
1997-1999	1114	327	29,4	28	2,5	128	11,5	431	38,7
- federal	312	56	17,9	1	0,3	37	11,9	131	42,0
- regional	602	192	31,9	18	3,0	81	13,5	215	35,7
- municipal	200	79	39,5	9	4,5	10	5,0	85	42,5

Source: Statisticheskiiye byulleteni o khode privatizatsii gosudarstvennykh i munitsipalnykh predpriyatiy (obyektov) za yanvar – dekabr (Statistical bulletins on the progress of privatization of state and municipally owned enterprises (objects) in January through December) of 1997 (p. 66), 1998 (p. 78), 1999 (p. 78), 2000 (p. 64), 2001 (p. 63), 2002 (p. 63). M., RF Goskomstat, author's calculations.

First, it should be noted that joint stock companies created in 2000 through 2002 mainly based on the enterprises owned by RF subjects before their corporatization (325 public companies out of 449, i.e. almost three fourths (about 54 per cent in 1997 through 1999). The share of companies created on the base of federal enterprises made less than 13 per cent (28 per cent in 1997 through 1999), while the rest (about 15 per cent) were previously in municipal ownership (less than 18 per cent in 1997 through 1999).

Second, the aggregate share of enterprises where the state maintained its property control (for instance, owning a block of shares or using the special right "golden share") after corporatization at the federal and regional level changed insignificantly. As concerns public companies created on the base of federal enterprises, this indicator made 31.4 per cent (as compared with 29.8 per cent registered in 1997 through 1999), and 44.3 per cent for public joint stock companies established on the base of enterprises owned by RF subjects (as compared with 45.4 per cent observed in 1997 through 1999). On the contrary, as concerns public companies created on the base of municipally owned enterprises, there the specific weight of enterprises where property control of local authorities

was maintained significantly declined from 44.5 per cent registered in 1997 through 1999 to 26.9 per cent in 2000 through 2003. It should also be noted that in the course of corporatization of federal and regional enterprises there increased the share of public companies where blocks of shares were owned by the state, while in the course of corporatization of regional and municipal enterprises the similar development was registered in the case of the share of public companies where 100 per cent of shares were owned by the authorities of respective level.

Third, the indicator of the share of public joint stock companies all shares in which were sold may be an indicator of quality of work of state agencies regulating property relations, attractiveness of property designated for sale, and investment climate. From this point of view there may be noted an increase in the share of such enterprises at the regional (from 35.7 per cent to 40 per cent) and municipal (from 42.5 per cent to 67.2 per cent) levels. On the contrary, the share of such public JSC created basing on enterprises in federal ownership decreased from 42 per cent to 35 per cent.

The regional and sectoral specifics of state control maintained in the course of corporatization taking place in 2000 through 2002 look as follows.

The creation of joint stock companies on the base of former state and municipally owned enterprises in 2000 through 2002 took place only in 36 out of 89 RF subjects, while in the preceding years the statistics did not register the appearance of new joint stock companies in the course of privatization only in 23 regions. From this point of view there should be mentioned Moscow (147 JSC), St. Petersburg (69 JSC), Tatarstan (51 JSC), Bashkortostan, Samara, and Chelyabinsk regions (24 JSC each), Ulyanovsk oblast (17 JSC), Kemerovo oblast (13 JSC), and Arkhangelsk oblast (12 JSC). In other regions, over the three preceding years in the course of privatization there were created not more than 10 joint stock companies. Therefore, it makes sense to compare the degree to which the state maintained its property control in newly created joint stock companies across territories only as concerns the regions listed above.

Most broadly this method was used in Tatarstan (blocks of shares in all newly created joint stock companies were owned by the state or municipalities), the Arkhangelsk oblast (over 58 per cent of JSC where blocks of shares were owned by the state or municipal entities), Moscow (49 per cent of JSC partially owned by the state and municipalities and 4.1 per cent of JSC subject to the “golden share” rule). On the contrary, in St. Petersburg only one tenth of newly created joint stock companies were partially owned by the state, although there were registered no cases where the “golden share” was used, while in the Samara and Ulyanovsk oblasts at no newly created joint stock companies there were used procedures of the state property control.

It also should be noted that the use of special right “golden share,” which sharply declined in 2000 through 2002 as compared with the figures registered in 1997 through 1999, was detected only in 6 regions, while 6 out of total 11 cases were observed in Moscow. The occurrence of newly created joint stock companies, where 100 per cent of shares were owned by the state, also was highly concentrated. Out of 34 enterprises (across 7 regions), where such procedures were implemented, the majority of cases were observed in national republics: 14 in Tatarstan, 7 in Bashkortostan, 4 in Udmurtia, 2 in Tyva, 1 in Yakutia.

As concerns these features of corporatization across sectors, it should be noted that in 2000 through 2002 retail trade (70 units), industry (40 units, including 12 units in mechanical engineering and metal working), and construction (22 units) were leading in the terms of creation of joint stock companies where the controlling interest was owned by the state. The largest number of public companies with the “golden share” right was established in the motor industry (3 units) and construction (2 units). Out of 34 joint stock companies, where 100 per cent of shares were owned by the state and municipalities, 15 were registered in industry (including 5 units created in mechanical engineering and metal working), 5 – in construction, and 4 – in transport and communications.

Since the total number of newly created joint stock companies was small, across the majority of sectors there were observed situations where the share of enterprises, where procedures of the state property control remained in place after corporatization, was extremely high. The only exceptions were ferrous metallurgy, light industry, enterprises rendering freight handling and forwarding services, where all newly created (although very few) joint stock companies were free of the state participation in their capital, as well as printing industry, motor industry, wholesale trade, public catering, enterprises engaged in material and technical supply and sales activities, housing and public utilities, consumer services, and certain services of the social sphere where the share of joint stock companies with state participation was below 30 per cent. At this background there stands out retail trade, where blocks of shares in almost 54 per cent of newly created joint stock companies were owned by the state or municipalities.

Therefore, an analysis of the corporatization process taking place in 2000 through 2002 reveals that the state (at all levels) and municipal entities retained a high degree of property control over enterprises whose shares were

sold. The degree of this control did not diminish in comparison with the period of the economic crisis and political uncertainty observed in 1997 through 1999. Moreover, this control became even more tight because of the growing share of enterprises, where blocks of shares were owned by the state. The main field of corporatization were the regions, which in some ways altered the national privatization model and focused on a gradual privatization while maintaining a high degree of property control over enterprises after their formal transition to the corporate sector in the 1990s.

This situation results from the completion of the mass corporatization of state owned enterprises taking place in the mid-1990s. Since the late 1990s, the enterprises, privatization of which depended on certain legislatively set requirements and was associated with the implementation of typical control procedures, have been actively involved in the privatization process. Therefore, it seems logical that among joint stock companies created in 1997 through 2002 there was observed a higher specific weight of enterprises, where the state retained direct (via owning controlling interests) or indirect (via inclusion of the “golden shares” in authorized capitals) property control.

In this connection it should be noted that the RF Property Ministry considers corporatization of state owned unitary enterprises as the major model of transformation of the economic agents existing at present in this organizational and legal form in a medium term outlook. This scheme presupposes the delegation of state representatives to the Boards of Directors of joint stock companies created on the base of state owned unitary enterprises (SUE), what has become an ordinary procedure in the last years. In this case, it becomes apparent that the burden on state authorities increases, since they will have to operate in the framework of the corporate law. In this connection there arises the necessity to carry out a difficult double task: increase the number of state representatives in the managing bodies of joint stock companies and at the same time ensure that they are highly skilled specialists receiving an adequate material remuneration for conscientious execution of their responsibilities.

The possibility to really improve realization of the state interests in the sphere of corporate governance depends on the actually used tool kits and concrete mechanisms. The further necessary components of the improvement of the management of state owned blocks of shares should be:

- more clearly defined and regulated activities of the persons representing state interests at stock companies by introducing amendments to the current normative acts pertaining to these issues (for instance, adjustment of the Model contract for representation of state interests of 1996 as amended in 1998, which still remains in force, to the new requirements);
- settle the issues pertaining to the introduction of a mechanism creating incentives for the work of each state representative by allotting to them a certain share of dividends derived from state owned blocks of shares;
- ensure the representation of state interests at the largest and most important joint stock companies by the state officials, who should work in this sphere full time and whose activities should be annually determined by the RF Government;
- improve and gradually broaden practices of the use of trust management mechanism pertaining to the federally owned blocks of shares in non-strategic enterprises;
- differentiate the approach to the evaluation of state representatives’ efficiency depending on the size of the state owned block of shares and the capacity to influence the decision making process.

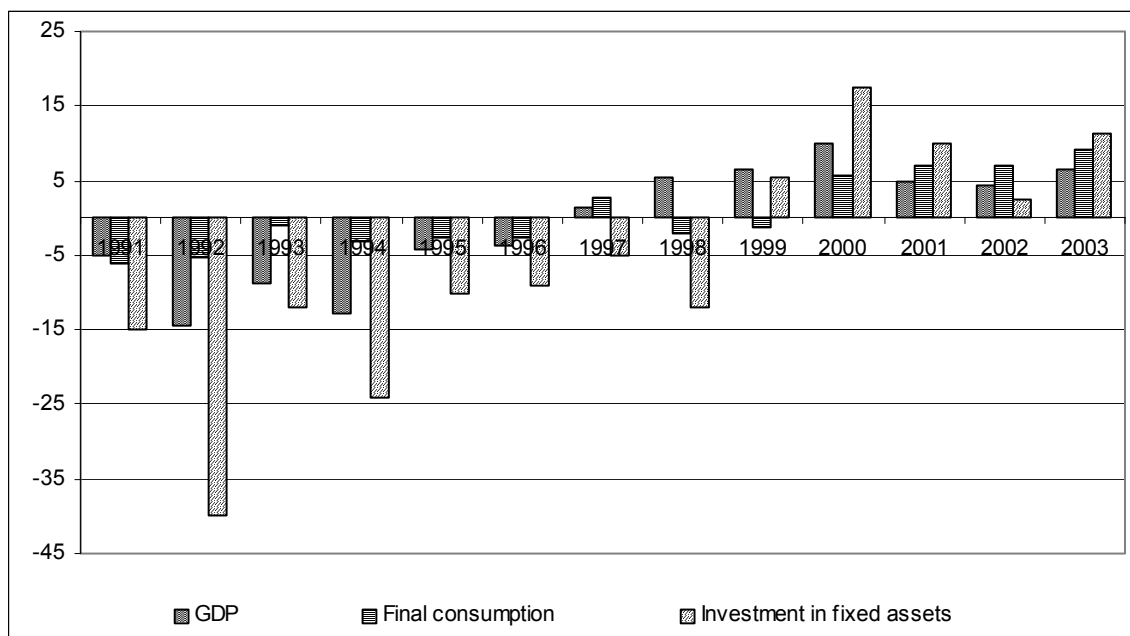
The human resource policy pursued by the state becomes especially important in the process of the management of state owned property. At this time, alongside with a better training of managers, the issues of human resources selection and decisive prevention of abuses become especially important. Leaving aside the possibility to use the stipulations pertaining to the civil and criminal law (although not excluding the introduction of special amendments aimed at the ensuring state interests in the case of abuses on the part of professional state representatives), there may be recommended a number of rather apparent measures aimed at the solving of these problems:

- introduce a stipulation requiring that the persons earlier dismissed because of the abuses of their responsibilities (setting forth a detailed description of the nature of such abuses and due sanctions) should not be allowed to engage in the management of state owned property in the future and set up a database of the persons who at any time represented state interests pertaining to the management of property (directors of SUE, state representatives at stock companies, trust managers);
- introduce a stipulation requiring that the directors of unitary enterprises and state representatives at joint stock companies should inform the authorities about their incomes and property.

G. Malginov

## Investment in the Real Sector

The recovery of outpacing rates of investment in fixed assets in comparison with the GDP dynamics and final consumption was a specific feature of 2003. According to the preliminary estimates for 2003 published by the Ministry of Economic Development and Trade, the increase in investment in fixed assets will make 11.2 per cent, while GDP will increase by 6.6 per cent as compared with 2.6 per cent and 4.3 per cent respectively registered in the preceding year.



*Figure* Changes in GDP dynamics, final consumption, and investment in fixed assets in 1991 through 2003, in % of the figures registered in the preceding year.

The acceleration of the rates of investment demand was caused by an extremely favorable combination of internal and external factors of economic growth. On the one hand, a growth in the revenues of the economy facilitated by positive changes in the business situation on the world market guaranteed the prompt repayment and servicing of the foreign public debt and enabled the state to meet its social obligations; on the other hand, it cumulatively affected the nature and efficiency of functioning of the investment and related sectors of the economy. The recovering activity of Russia's businesses resulted in an increase in the balanced financial result in the economy at large 1.58 times, and 1.55 times in industry as compared with the figures registered in January through August of 2002, what permitted enterprises and organizations increase their investment expenditures.

The recovery growth observed in 1999 through 2003 is characterized by the formation of a rather stable trend towards a decrease in the share of enterprises' own funds in the structure of the sources of financing of investment expenditures. In 1999 through 2003, the share of own funds in the structure of the sources of financing of investment in fixed assets decreased from 52.4 per cent to 46.2 per cent.

The trend towards an increase in investment activity was also supported by the formation of the large potential of private investment. In 2003, a source of support of investment activity was the expansion of crediting of the real sector on the part of the banking system. The reduction of the refinancing rate by the Bank of Russia from 25 per cent in March of 2002 to 18 per cent in February and 16 per cent in June of 2003 has increased the attractiveness of investment in the real sector of the economy. The low real cost of credit resources allowed enterprises to attract significant borrowings for financing of investment projects. In 2003, at the background of diminishing share of own funds in investment in fixed assets by 1.6 p. p. in comparison with the figures registered in January through September of 2002, there was observed a trend towards an increase in the share of bank credits by 0.9 p. p. and borrowings of enterprises by 2.7 p. p.

A positive factor of the investment process in 2003 was the growing share of credits extended by foreign banks in the financing of investment (by 0.3 p. p. in comparison with the figures registered in the preceding year. In the first six months of 2003, for the first time since the beginning of reforms, there was registered a

net inflow of capital in the Russia's economy. While high rates of economic growth persisted in 2003, there was observed the recovery of positive dynamics of growth in foreign direct investment in the Russia's economy. In January through September of 2003, the increase in foreign investment made 61.9 per cent in comparison with the figures registered in the respective period of 2002, while foreign direct investment grew by 77.3 per cent.

The decrease in the share of budget resources in financing of investment expenditures by 0.9 p. p. was accompanied in changes in proportions of the federal budget and the budgets of RF subjects. It should be noted that while over the last five years the gradual decrease in the share of budget resources in financing of investment occurred at the background of increasing share of funds provided by RF subjects, in January through September of 2003, on the contrary, exactly expenditures of the federal budget significantly affected the dynamics of investment activity. According to the data presented by the RF Finance Ministry, the amount of funds from the federal budget allotted for financing of state capital investment increased by Rub. 9.0 billion in comparison with the figures registered in January through October of 2002. In January through September of 2003, Rub. 51.5 billion, or 88.5 per cent of the year limit, was used for financing of the Federal targeted investment program. In January through September of 2003, the amount of financing of the Federal targeted investment program increased by Rub. 10.1 billion as compared with the figures registered in the respective period of the preceding year.

*Table*

**Structure of investment in fixed assets across sources of financing in January through September of 2002 through 2003, in % of the total**

	Jan. – Sep., 2002		Jan. – Sep., 2003	
	Rub. billion	in % the total	Rub. billion	in % the total
Investment in fixed assets	882,6	100,0	1128,3	100,0
Including:				
Own funds	429,1	48,6	520,8	46,2
Of which:				
Profits at the disposal of organizations	176,3	20,0	194,1	17,2
Borrowed funds	453,5	51,4	607,5	53,8
Of which:				
Bank credits	38,2	4,3	58,5	5,2
Including credits of foreign banks	4,2	0,5	8,8	0,8
Borrowings from other organizations	51,6	5,9	96,7	8,6
Budget resources	175,6	19,9	212,2	18,8
Including:				
Federal budget	49,2	5,6	73,8	6,5
Budgets of RF subjects	115,6	13,1	130,0	11,5
Extra-budgetary funds	21,3	2,4	11,3	1,0

Source: RF Goskomstat

The growth in earnings of enterprises and organizations, household savings, and growing activity of the banking sector have positively affected the nature of development observed in 2003 and permitted to overcome the decline in investment activities formed in 2001 through 2002. However, In spite of the accelerating rates of growth in investment demand, there is still a significant potential for growth: the gap between gross savings and accumulation in fixed assets does not diminish and makes more than 10 per cent of GDP. According to the preliminary results of 2003, the share of investment in fixed assets in GDP will remain at the level registered in 2002 and will make 16.2 per cent, while the preliminary estimates published by the Ministry of Economic Development and Trade indicate that in 2004 these indicators will be in the interval from 16.7 per cent to 17.0 per cent.

*O. Izryadnova*

**Foreign investment in the Russia's economy**

As on October 1, 2003, the accumulated foreign capital in the Russia's economy, including the investment from CIS member countries, made about US \$ 53.6 billion. The total amount of foreign investment in the non-financial sector of the Russian economy (not taking into account the monetary and credit regulating

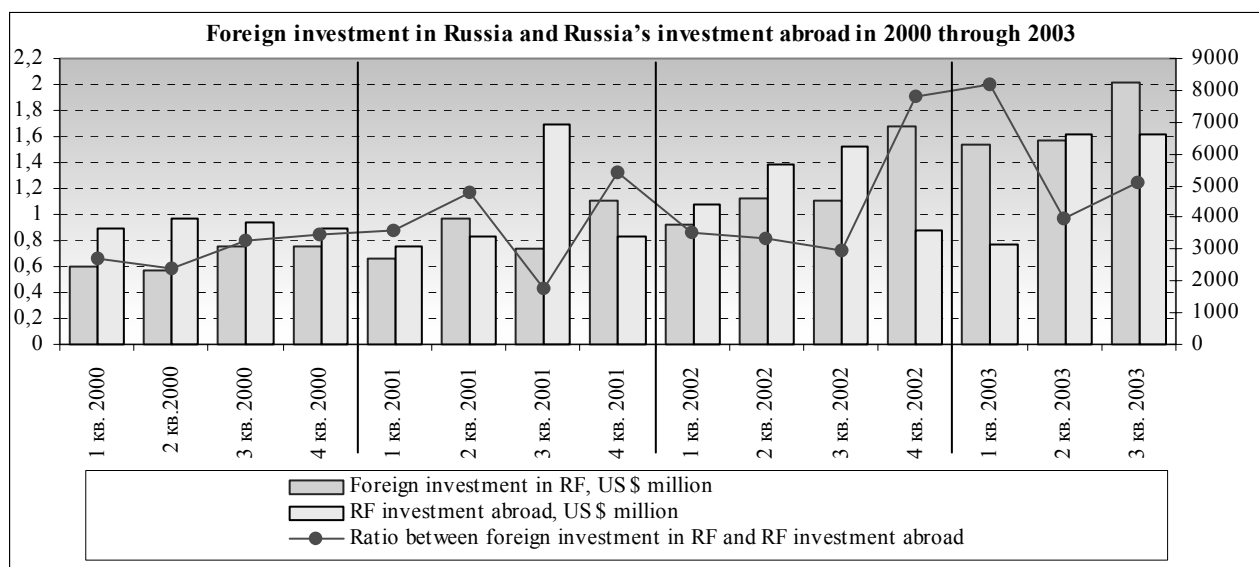
authorities, commercial and savings banks, and including Ruble denominated investment in US \$ equivalent made US \$ 20.9 billion in the nine months of 2003.

Table 1

**The structure of foreign investment in the Russia's economy  
in January through September of 1999 through 2003**

	Total, US \$ mil.				In % of the preceding year			
	Total	Direct	Portfolio	Other	Total	Direct	Portfolio	Other
1999	6 467	3 132	9	3 326	-30,4	55,5	21,3 times less	-53,0
2000	7 888	3 154	59	4 675	22,0	0,7	6,6 times more	40,6
2001	9 721	2 920	292	6 509	23,2	-7,4	4,9 times more	39,2
2002	12 905	2 631	224	10 050	32,8	-9,9	-23,3	54,4
2003	20 899	4 665	81	16 153	61,9	77,3	2,8 times less	60,7

Source: RF Goskomstat

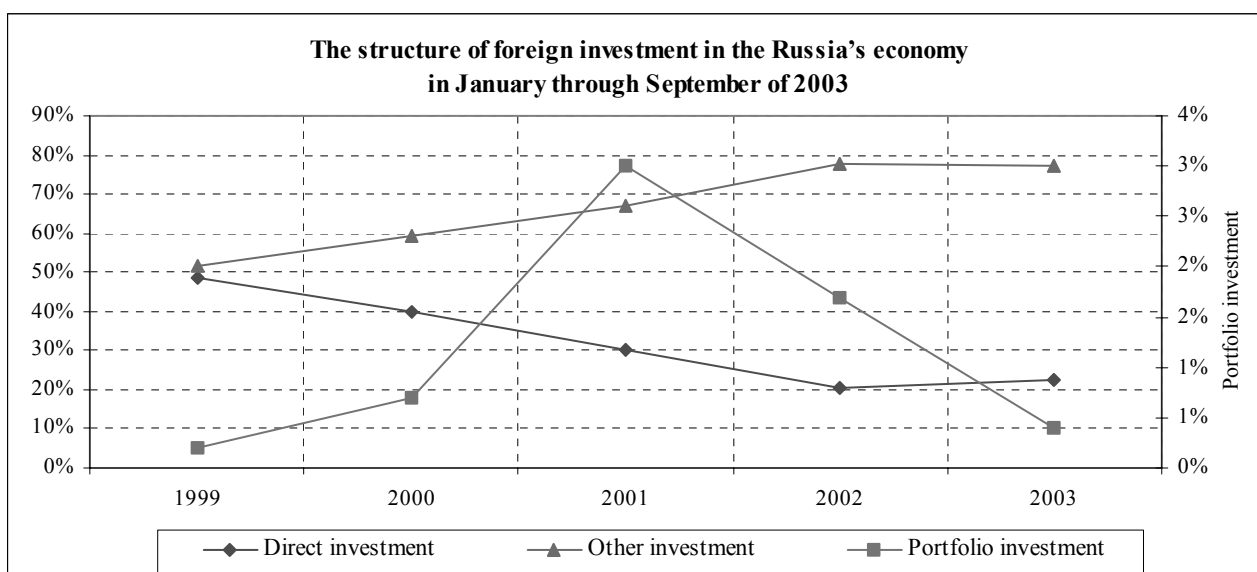


Source: RF Goskomstat

Over the first nine months of 2003, the investment in the Russia's economy exceeded outflow of capital by US \$ 4.55 billion. In the preceding years, there were observed opposite developments. For instance, in the first nine months of 2002, the amount of capital outflows from Russia exceeded investment by US \$ 3.4 billion. The respective indicators registered in the first nine months of 2001 and 2000 made US \$ 3.7 billion and 4.2 billion respectively.

The growth in foreign direct investment observed in the first nine months of 2003 was an indication of improving investment climate and increasing confidence of foreign investors in the Russia's economy. Over the last few years, in the period from January till September there has been observed a decline in foreign direct investment. As concerns the results of the period from January till September of 2003, the rates of growth in foreign direct investment outpaced the respective indicator of aggregate foreign investment, what resulted in an increase in the specific weight of direct investment in the total investment up to 22.3 per cent (20.4 per cent in the first nine months of 2002).





Source: RF Goskomstat

Because of the outpacing rates of growth in foreign investment in the sphere of trade and public catering (+ 69.1 per cent in January through September of 2003 as compared with the figures registered in January through September of 2002), transport and communications (+ 106.6 per cent), as well as general commercial activities relating to market servicing (+ 72.9 per cent) in comparison with the rates of increase in investment in the sphere of production (+ 53.2 per cent), the share of the latter in the total amount of foreign investment in the Russia's economy declined to 36.3 per cent over the first nine months of 2003.

Table 2

**Sectoral structure of foreign investment in the Russia's economy  
in January through September of 2001 through 2003**

	US \$ mil.			Change in comparison with preceding year, %			In % of the total		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Industry	3 755	4 950	7 581	13,0	31,8	53,2	38,6	38,4	36,3
Transport and communications	1 011	427	882	-28,7	-57,8	106,6	10,4	3,3	4,2
Trade and public catering	3 413	5 292	8 948	114,5	55,1	69,1	35,1	41,0	42,8
Commercial activities relating to market servicing	617	1 131	1 956	262,9	83,3	72,9	6,3	8,8	9,4
Finance, credit, insurance, pensions	115	105	226	-55,3	-8,7	115,2	1,2	0,8	1,1
Other sectors	810	1 000	1 306	-28,2	23,5	30,6	8,3	7,7	6,2

Source: RF Goskomstat

In January through September of 2003, the largest share of the total amount of investment in production (36.8 per cent or US \$ 2.77 billion) was directed to the development of the fuel and energy complex (25.9 per cent or US \$ 1.34 billion in January through September of 2002). The positive fact was that foreign direct investment accounted for 44 per cent of the total investment in this sector (35.1 per cent in the first nine months of 2002).

Over the same period, the share of mechanical engineering, the development of which determines the formation of the active portion of fixed assets, in the aggregate amount of investment in this sector increased to 7.8 per cent (6.1 per cent in January through September of 2002). At the same time, in absolute terms the foreign investment in mechanical engineering made US \$ 588 million, what was by 93.4 per cent above the level registered in January through September of 2002.

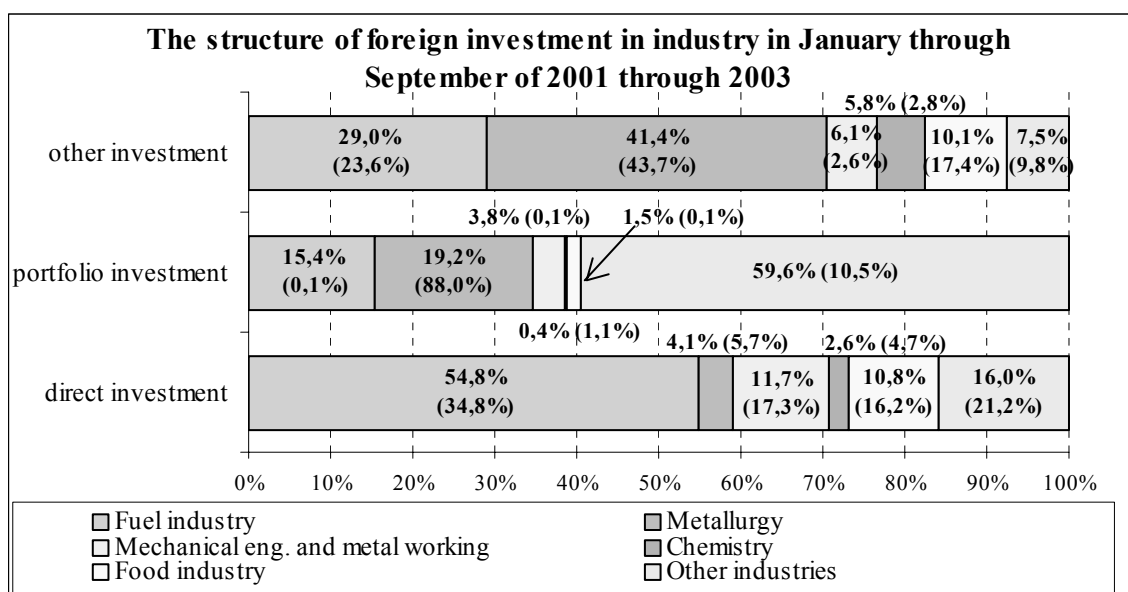
As concerns base industries, in 2003 a 6.3 per cent decline in the amounts of investment in comparison with the figures registered in 2002 was observed in the food industry.

Table 3

**The structure of foreign investment in industry in January through September of 2001 through 2003**

	US \$ mil.			In % of the total			Change in comparison with the respective period of the preceding year, %		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Total industry, including:	3755	4950	7581	100%	100%	100%	+13,0%	+31,8%	+53,2%
Fuel industry	591	1282	2770	15,7%	25,9%	36,5%	+39,4%	+116,9	+116,1%
Metallurgy	1148	1748	2306	30,6%	35,3%	30,4%	+53,7%	+52,3	+31,9%
Mechanical engineering and metal working	404	304	588	10,8%	6,1%	7,8%	+12,2%	- 24,8	+93,4%
Food industry	1038	831	779	27,6%	16,8%	10,3%	-17,6%	- 19,9	-6,3%
Wood working, pulp and paper industry	176	197	281	4,7%	4,0%	3,7%	-3,8%	+11,9	+42,6%
Other industries	398	588	857	10,6%	11,9%	11,3%	+13,4%	+47,7	+45,8%

Source: RF Goskomstat



Source: RF Goskomstat

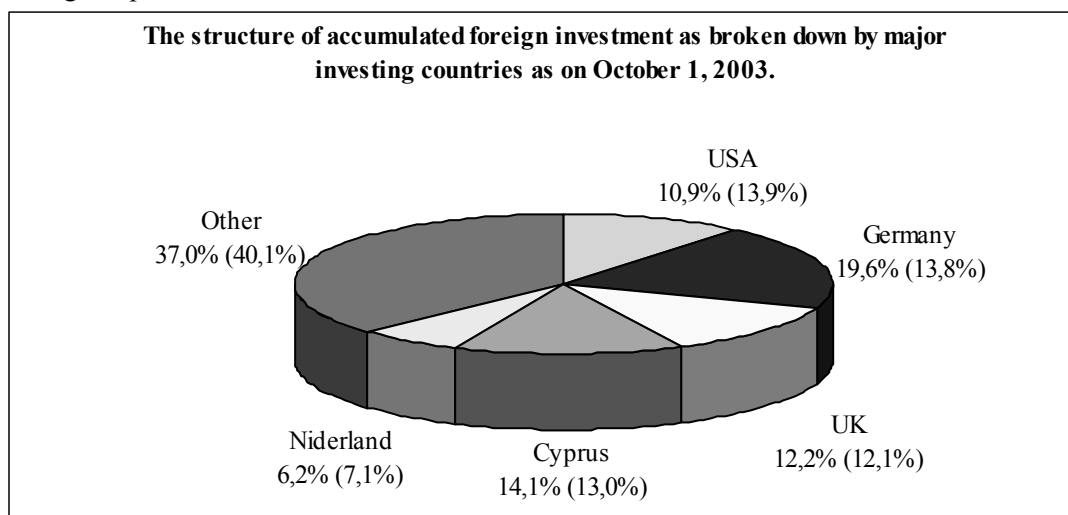
The structure of foreign investments in industry is characterized by a higher specific weight of direct foreign investment (29.3 per cent in the first nine months of 2003) as compared with the respective structure of the aggregate amount of foreign investment in the Russia's economy. At the same time, there were observed significant changes in the structure of foreign investment in industry as compared with the figures registered in 2002.

Thus, the share of fuel industry in the structure of foreign direct investment made in industry in January through September of 2003 increased 1.6 times. At the same time, in absolute terms the foreign direct investment in this industry made US \$ 1.2 billion, what was 3 times above the figures registered in the preceding period.

The results of the first nine months of this year demonstrate that portfolio investors sharply decreased their investment in metallurgy. The amount of portfolio investment in ferrous and non-ferrous metallurgy dropped 16.2 times and made only US \$ 5 million.

As concerns the geographical structure of attracted foreign investment observed in in January through September of 2003, the leading positions in this sphere are held by Germany (US \$ 3.7 billion, or 17.7 per cent of the foreign investment attracted in January through September of 2003), UK (US \$ 3 billion, or 14.4 per cent), Cyprus (US \$ 2.9 billion, or 13.9 per cent), Luxemburg (US \$ 1.77 billion or 8.5 per cent), and France (US \$ 1.75 billion or 8.4 per cent). At the same time, the most intensive growth in investment over the first nine months of 2003 was demonstrated by Luxemburg (2.6 times) and Japan, whose investment increased 2 times (up to US \$ 626 million). An increase in investment in the Russia's economy was observed across all major investing countries.

The structure of accumulated foreign investment as broken down by major investing countries as on October 1, 2003, somewhat differed from the respective structure of foreign investment made in Russian in January through September of 2003.



Source: RF Goskomstat

In January through September of 2003, German entrepreneurs demonstrated their interest in the sphere of trade and public catering by investing in this sector US \$ 2.2 billion, or 59.9 per cent of the aggregate German investment made over the first nine months of 2003 (US \$ 1.3 billion in the first nine months of 2002). According to the results of the first nine months of 2003, industry attracted US \$ 788 million, or 21.3 per cent of the total investment from Germany (US \$ 502 million or 24.7 per cent in the first nine months of 2002), while the German investment in communications increased 7.2 times up to US \$ 408 million (11 per cent of the total amount of investment attracted from Germany).

British investors preferred to invest in trade and public catering, as well as industry. These spheres of the Russia's economy accounted for 51.3 per cent (US \$ 1.5 billion) and 27.4 per cent (US \$ 826 million) of the total investment from UK to the Russia's economy made over the first nine months of 2003. The British investment in general commercial activities relating to market servicing made 17.4 per cent (US \$ 525 million). In January through September of 2003, these spheres of the Russia's economy accounted for 43.2 per cent (US \$ 739 million), 28.9 per cent (US \$ 494 million), and 24 per cent (US \$ 410 million) of the total investment from UK to the Russia's economy.

The larger part of the French investment (US \$ 1.4 billion or 81.6 per cent of the total investment from France registered in January through September of 2003 as compared with US \$ 396 billion, or 40.6 per cent of the respective investment from France registered in the first nine months of 2002) was made in the industrial sector, primarily fuel industry where France invested US \$ 1.1 billion, or 76.5 of the total industry related French investment (US \$ 140 billion, or 35.4 per cent of the respective investment from France registered in the first nine months of 2002). At the same time, the specific weight of France in the total foreign investment in industry made in January through September of 2003 increased to 18.8 per cent (8 per cent in the first nine months of 2002).

The fact that the international ranking agency Moody's increased the ranking of the RF by two grades at once (up to the investment level Baa3) in the early October of 2003 is an indication (although this level is the lowest of the investment ranking group) that foreign investors believe in Russia ability to promptly meet its debt obligations both in the short term and long term outlook.

*E. Ilykhina*

## The Real Sector: Factors and Trends

The economic recovery observed in 1999 through 2003 occurred at the background of simultaneous recovery of positive dynamics in both the sector of production of goods and services sector. While the added value in the production sector increased by 6.4 per cent in January through September of 2003, market services grew by 7.6 per cent. 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.

In the last years, retail trade was a most dynamically developing sector of the economy. After the amounts of retail trade decreased more than by 10 per cent in comparison with the figures registered in 1997, over the next four years, as the effective household demand recovered due to the active implementation of policies aimed at the growth in the real household incomes, the turnover of retail trade has grown at the rates outpacing GDP dynamics. In 2003, the index of turnover of retail trade made 143.2 per cent as compared with its level registered in 1999, while GDP grew by 28.4 per cent.

The growing demand for industrial goods was accompanied by increasing use of transport capacities. In January through November of 2003, the commercial freight turnover grew by 7.2 per cent, while industrial output increased by 6.8 per cent. Export oriented industries had the most important impact on the changes in demand for transport services. The increase in the freight turnover of pipeline transport made 8.1 per cent as compared with the figures registered in January through October of 2002, while the amount of oil freight increased by 12.5 per cent, oil products – by 9.1 per cent, and natural gas – by 7.9 per cent. Oil export capacity grew due to the commissioning of the second stage of the Baltic pipeline system able to transport up to 18 million metric tons of oil. As concerns the rates of growth in freight of staple goods by the railroad transport, oil, oil products, ferrous and non-ferrous ores, and products of ferrous metallurgy retain their leading positions.

In 2003, there was observed a growing demand for communications services. In January through November of 2003, the rates of increase in rendered communications services made 21.8 per cent exceeding the figures registered in the preceding year by 6.4 p. p. New communications operators account for about 3/5 of the total amount of communications services and more than half of household communications services.

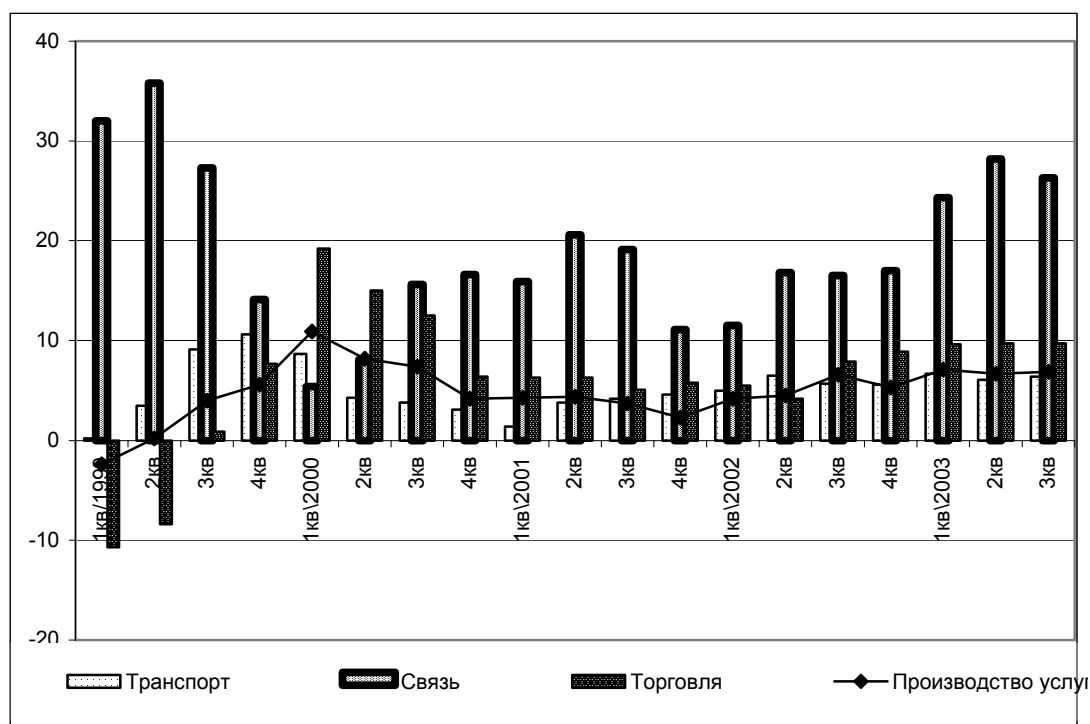


Fig. 1. Changes in rates of growth in services sector in 1999 through 2003, in % of the figures registered in the respective period of the preceding year.

The ratio between production and construction most significantly affects the changes in the structure of output in the sector of goods. The positive dynamics of development of construction registered since the 3<sup>rd</sup> quarter of 1999 has been supported by growing output of capital goods and increasing investment in fixed assets. The growth in the revenues of the economy observed in 2000 through 2001, which was caused by improving efficiency of external economic operations and increasing capacity of the domestic market gave an additional impetus to the growth in demand for construction works. Over this period, the average annual rates of increase in construction works made 13.4 per cent, while the respective indicator in industry was registered at 8.3 per cent. In 2001 through 2002, there was observed a gradual slowdown of the rates of industrial development to 4.2 per cent caused by gradual decline in exports and the relative deterioration of the price situation on the world market. The investment sphere reacted to the changes of the situation on the domestic market with a lag, but more sharply. To a certain degree these developments may be explained by the higher sluggishness of the investment complex functioning in the structure of the national economy. Stagnation of investment activities observed in the 1<sup>st</sup> quarter of 2002 determined the slack dynamics of growth in construction works and production of capital goods. In 2002, there was registered the minimal level of growth in construction output over the period of recovery and made 2.7 per cent.

The negative impact of low investment demand on the dynamics of industrial development observed in 2002 was strengthened by the fact that, on the one hand, the potential of growth at the expense of utilization of competitive reserve capacities has been exhausted and, on the other hand, the present technologies and the state of fixed assets facilitated the trend towards a decline in efficiency of utilization of both labor and capital.

In 2003, the qualitative specifics of economy was the transition to the investment model of growth. At the same time, it should be noted that this development was facilitated by the forming trend towards an increase in labor productivity and transformational shifts in the structure of employment and demand for labor. According to the results of the first three quarters of 2003, the increase in labor productivity made about 7.5 per cent, while over 2002 the changes in this indicator made from 0.2 per cent (1<sup>st</sup> quarter) to 3.6 per cent (4<sup>th</sup> quarter). According to the data obtained in the course of sample surveys of employment conducted in 2003 (Goskomstat), the size of employment in the economy declined by 0.5 million persons in comparison with the figures registered in the respective period of the preceding year and made 65.8 million persons. The coefficient of tension (the number of unemployed citizens registered with employment agencies per vacancy) increased from 1.3 to 1.7. Enterprises pursue rather active policies aimed at the restructuring of employment and enhancing of efficiency of labor time utilization. As compared with the figures registered in January through September of 2002, the number of part time employees (working only a part of the working week or working day) decreased by 24 per cent, at the same time, the number of workers on mandatory administrative leaves declined by 387 thousand, or 25 per cent.

The decline in employment was registered primarily in industries manufacturing goods, while in the sector of services the employment increased by 271 thousand persons. According to the estimates published by the Ministry of Economic Development, in January through June the growth in labor productivity in industry made 112.1 per cent and outpaced the output dynamics by 5.3 p. p. A growth in productivity of labor is registered across practically all industries and is accompanied by changes in the dynamics and structure of demand for labor. As concerns the fuel and energy, metallurgical, and chemistry and forestry complexes, there the outpacing rate of labor productivity in comparison with wages and salaries is supported at the expense of improving efficiency of labor. Exactly in these industries there was registered the most massive reduction of jobs as compared with the figures observed in the respective month of 2002.

A decline in demand for labor occurs at the background of significant growth in profits of enterprises and increase in their investment activity. The comparison of the data on employment size across industries and other macroeconomic indicators demonstrates that increasing productivity of labor, especially in the sector of production of goods, allows enterprises to diminish labor costs via the restructuring of employment. The share of persons dismissed due to redundancy, liquidation of organizations or own businesses decreases at the background of the growing share of inexperienced and untrained persons. At the same time, while the general trend towards decrease in the number of jobs persists, the demand for skilled labor grows. The stronger impact of these factors is the reflection of the receptivity of the modern national economy to new market signals and is extremely important for further economic growth.

The interest to an analysis of the efficiency of labor utilization in the period of recovery growth is determined by the widening gap between the dynamics of real wages and salaries and productivity of labor in favor of the former. The support of the dynamics of domestic demand based on the growth in real wages,

salaries, and household incomes results in redistribution of earnings from enterprises to the population, what initiates a growth in production costs. In 1999 through 2002, the share of expenditures for remuneration of labor in the structure of production costs in the economy at large increased by 1.3 p. p., while the respective indicator registered in industry made 2.2 p. p. The systematic growth in expenditures for wages and salaries negatively affected the dynamics of profitability of production. In 2003, at the background of an intensive growth in production the were observed converging dynamics of real wages and salaries and labor efficiency. However, at the moment the impact of this process on the changes in indicators of efficiency of enterprises and organizations is extremely weak and unstable.

*O. Izryadnova*

## **IET Business Survey: Industry in December**

The results of the December survey of 2003 unfortunately demonstrate that the negative trend observed in the dynamics of the Russia's industry over the last few years still persists. At the end of the year, there was again registered an absolute decrease in sales and decelerating rates of growth in output.

The balance of changes in effective demand further decreased by 10 points in December and became negative as in the Russia's manufacturing industry there was registered an absolute decline in cash sales. Since August of 2003 this indicator has decreased by 26 points. In 2002, a decline in sales started yet in November, and while in December of that year the balance made –13 per cent, at present it makes –7 per cent. It proved to be the best result in the three last years (see the Figure). No decline in sales was registered only in power engineering, forestry, wood working, pulp and paper, and food industries. Reports on decreasing demand prevail across other industries. Especially significant prevalence of negative answers was registered in construction industry, metallurgy, and light industry.

However, in 2003 enterprises principally changed their attitude to cash demand. Over the year, the balance of assessments of effective demand increased from –65 per cent to –39 per cent (August), the share of answers "normal" – from 32 per cent to 55 per cent (September, December – 54 per cent). The best results registered this year were the best also in the last ten years (see the Figure). At the same time, the balances of demand evaluation have always been and remain negative: assessments "below norm" still prevail across industries. Enterprises still experience lack of effective demand to utilize all their preserved and idle capacities.

However, non-cash payments gradually become less important in the Russia's industry (see the Table). In 2003, the share of cash in payments made, on the average, 84 per cent, barter – 6 per cent, and promissory notes and offsets – 9 per cent.

*Table*

**The share of cash, barter, promissory notes,  
and offsets in sales of products in 2003 (%)**

Shares	I quart.	II quart.	III quart.	IV quart.
Cash	84	82	84	85
Barter	7	6	5	5
Promissory notes and offsets	8	10	9	8

Source: IET Industrial Surveys.

In the situation where capacities are excessive and cash sales are instable, in the Russia's industry there persists a lack of non-cash transactions. Enterprises believe that they need greater amounts of barter, promissory note, and offset transactions. This year, there were registered no principal changes in enterprises' attitudes to such transactions. In 2003, surveys registered lack of barter, promissory notes, and offsets across practically all industries. Only in power engineering, chemistry, and petrochemistry the annual balances were positive – in these industries there prevailed enterprises where amounts of non-cash transactions were excessive.

However, in December production failed to follow demand. While the balance of changes in demand constantly declined and became negative this month, the December balance of changes in output ceased to decrease and remained at + 14 per cent to + 15 per cent. Output grows at the background of declining demand. This conclusion was also confirmed by calculations based on micro-data. The share of enterprises

where production outpaced demand increased up to 32 per cent, while the average value registered over the preceding 11 months made 25 per cent. In December of 2002, this indicator made 27 per cent, as at that time enterprises followed demand more accurately. At present, the most significant gap between output and demand is registered in metallurgy (51 per cent), forestry complex (50 per cent), mechanical engineering (34 per cent), and light industry (32 per cent).

The outpacing rates of growth in output has not yet resulted in excessive overstocking of finished goods. In December, the balance of evaluations of finished stocks increased only by 5 points and was close to the average level observed in January through September. It should be noted that in October there was registered a untypical for the last three years disposal of finished stocks. Therefore, what occurs at present is only the recovery of the preceding (traditional) stocks of finished goods used to rapidly meet new orders.

Estimates of changes in demand stabilized at the level from 0... to + 1 per cent after having declined to the minimal (for 2003) values. I.e., Russian enterprises on the whole expect no growth in sales in early 2004. A growth is probable only in metallurgy. In other industries it will either decrease (light and food industries, forestry, construction industry), or remain at the same level (power engineering, chemistry, petrochemistry, mechanical engineering).

Although plans of output seem more optimistic in comparison with forecasts of changes in demand (+ 17 ... + 21 per cent), they also were at the year's minimum. In the nearest future, the absolute decline in output is possible not only in the industry of construction materials (the seasonality factor), but also in food industry. The most optimistic plans were registered in power engineering and non-ferrous metallurgy.

*S. Tsukhlo*

### **Oil and natural gas sector**

The price situation on the world oil markets determined the development of the oil and natural gas sector of the Russian economy in 2003. Since over 60 per cent of the oil produced in the country are exported (including both crude oil and oil products), while domestic prices are significantly below the level of world prices, exactly world prices are the key factor determining the earnings and financial standing of the Russian oil industry. Due to the fact that production of oil in Iraq decreased in the result of the war and OPEC member countries had in place the limitations on oil extraction, the world oil prices were at an exceptionally high level. In October and November, the average price of the oil basket of OPEC member countries was above the upper target price threshold (US \$ 22 to US \$ 28 per barrel) set by the organization. The average price of Russian Urals oil was close to US \$ 28 per barrel on the world (European) market (see Table 1).

*Table 1*

**World oil prices in 1999 through 2003, US \$ per barrel**

	1999	2000	2001	2002	2003 1 quart	2003 2 quart	2003 2 quart	2003 October	2003 Novemb er
Brent, UK	17,97	28,50	24,44	25,02	31,49	26,03	28,38	29,65	28,73
Urals, Russia	17,30	26,63	22,97	23,73	29,24	23,86	27,05	27,99	27,63
OPEC oil basket	17,47	27,60	23,12	24,34	30,45	25,87	27,43	28,35	28,48

Source: OECD International Energy Agency.

The development of the oil and natural gas sector of the economy in 2003 is characterized by persisting trend towards an increase in extraction of oil and oil products formed in 2000 through 2002. In January through November, the total volume of oil output increased by 11.1 per cent in comparison with the figures registered in the respective period of the preceding year reaching the record high in the post-reform period, while the output of primary processed oil increased by 2.9 per cent. An increase in extraction of natural gas first registered the last year, continued (see Table 2). There was observed a certain increase in investment activity, especially in the natural gas sector: in January through October the volume of oil production drilling grew by 3.9 per cent as compared with the respective period of the preceding year, while natural gas production drilling increased by 40.9 per cent in January through September of 2003. At the same time, due to a certain decline in the volume of drilling observed last year, the commissioning of new oil wells was down by 5.1 per cent. The decline in the volumes of oil surveying drilling continued (oil drilling decreased by 10.7 per cent in January through October in comparison with the figures registered last year), what may be explained by sufficient levels of available reserves, while natural gas drilling increased (by 11.9 per cent in January through September in comparison with the figures registered in the respective period of the

preceding year). The degree of processing of oil in the oil processing industry increased from 70.2 per cent in January through October of 2002 to 70.5 per cent in the respective period of this year. The share of high octane gasoline in the total amount of motor gasoline increased from 49.3 per cent in January through October of 2002 to 51.6 per cent this year.

Table 2

**Oil, oil products, and natural gas output, in % of the respective period of the preceding year**

	1999	2000	2001	2002	2003 January -October
Oil	100,3	105,9	107,7	108,7	111,1
Gas condensate	104,7	103,8	106,7	112,8	108,1
Primary oil processing	102,9	102,7	103,2	103,3	102,9
Motor gasoline	102,2	103,6	100,6	104,9	101,3
Diesel fuel	104,2	104,9	102,0	104,7	101,9
Furnace fuel oil	94,8	98,3	104,2	107,1	100,9
Natural gas, cub. m. billion	99,7	98,5	99,2	101,9	103,6
Oil gas, cub. m. billion	103,2	102,5	105,0	110,5	120,7

Source: RF Goskomstat.

Over the last few months, there was observed a significant growth in prices of oil and oil products occurring on the domestic market. In November, the average domestic oil price (producers' price) in dollar terms increased to US \$ 70.7 per metric ton. The average motor gasoline price has reached US \$ 231.2 per metric ton, what is the record high over the whole post reform period. In the last few months, prices of natural gas demonstrated a downward trend (see Table 3). Figures 1 and 2 present the dynamics of oil, natural gas, and oil products prices on the domestic market. As the graphs demonstrate, domestic prices of oil and motor gasoline in dollar terms reached the historical maximum over the last few months.

Table 3

**Domestic oil, oil products, and natural gas prices (in US \$) in 1999 through 2003 (average wholesale prices of enterprises, US \$ / metric ton)**

	1999 Dec.	2000 Dec.	2001 Dec.	2002 Dec.	2003 March	2003 June	2003 September	2003 October	2003 November
Oil	37,0	54,9	49,9	60,7	54,3	53,8	67,5	73,0	70,7
Motor gasoline	171,9	199,3	151,5	168,8	192,4	191,9	223,6	228,9	231,2
Diesel fuel	125,0	185,0	158,5	153,8	201,9	182,2	205,5	211,8	209,1
Furnace fuel oil	46,1	79,7	47,1	66,1	78,2	59,9	90,4	88,9	79,0
Gas, US \$ / thos. c. m.	2,2	3,1	4,8	5,9	6,2	6,2	6,1	4,9	4,4

Source: calculated on the basis of RF Goskomstat data.

In January through September of 2003, the oil exports increased by 17.1 per cent in comparison with the figures registered in the respective period of the preceding year, while export of oil products grew by 3.3 per cent (see Table 4). In January through September, the share of exports in commodity resources of diesel fuel made 57.1 per cent, furnace fuel oil – 56.4 per cent, motor gasoline – 14.3 per cent. The high level of world oil prices was the factor behind the significant growth in export proceeds. In January through September of 2003, the amount of oil exports increased by 34.9 per cent as compared with the figures registered in the respective period of the preceding year.

The import of oil products increased. For instance, in January through September of 2003, imports of motor gasoline grew by 70.7 per cent in comparison with the level registered in the respective period of the preceding year, while the share of imports in the gasoline resources increased from 0.1 per cent to 0.2 per cent. However, the specific weight of imports remains rather low. For instance, in the first six months of 1998, i.e. before the Ruble devaluation, the specific weight of imports in the gasoline resources made 8.7 per cent, while in 2001 it was at 0.4 per cent.

At the same time, there was registered a decline in natural gas exports in comparison with the figures registered last year, what was caused by low effective demand on the part of CIS member countries (in January through September of 2003 natural gas exports to these countries fell by 8.9 per cent).



Table 4

**Export of oil, oil products, and natural gas from Russia, in % of the respective period of the preceding year**

	<b>2002</b>	<b>2003</b>
	<b>January through September</b>	<b>January through September</b>
Oil, total	113,2	117,1
including:		
Export to non-CIS countries	108,1	117,7
Export to CIS countries	145,6	114,5
Oil products, total	116,7	103,3
Including:		
Export to non-CIS countries	117,3	102,8
Export to CIS countries	101,9	116,3
Natural gas, total	103,4	101,7

Source: RF Goskomstat.

At the OPEC December summit, the member countries of the organization decided to retain the quotas on oil extraction set on November 1 of 2003, which envisaged a decrease in oil extraction by 900 thousand barrels a day. This development allows to expect that the world oil prices will remain at a rather high level in the short term, and, accordingly, the rather favorable external conditions for the Russia's oil industry and the national economy on the whole will persist.

*Fig. 1.* Average wholesale oil and natural gas prices set by enterprises in US \$ terms in 1992 through 2003, US \$ / metric ton, US \$ / thous. c. m.

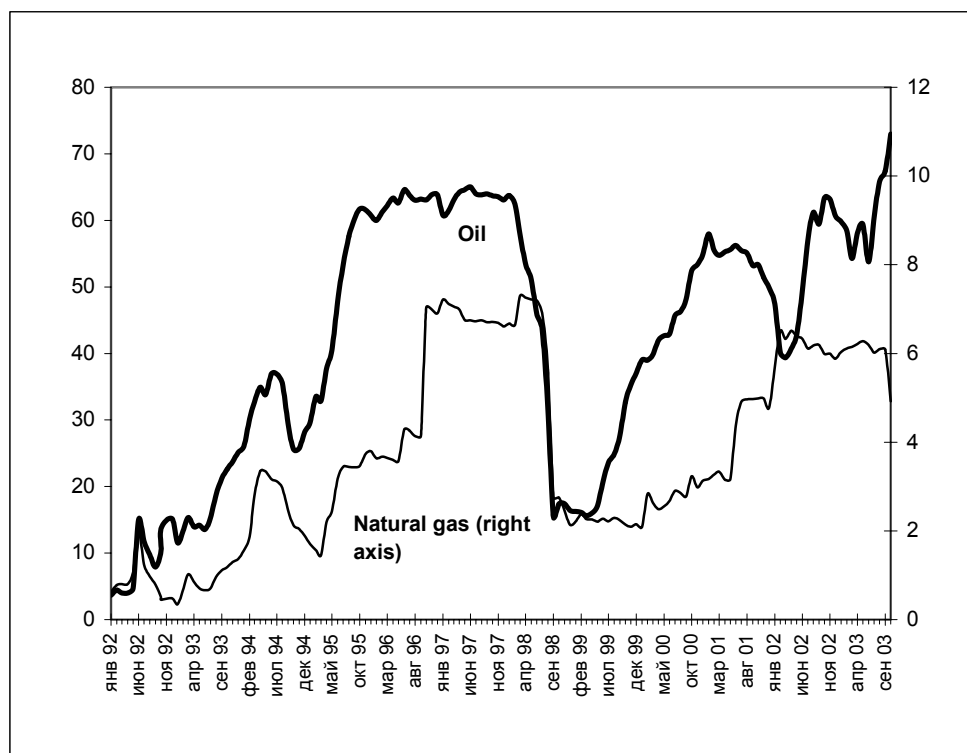
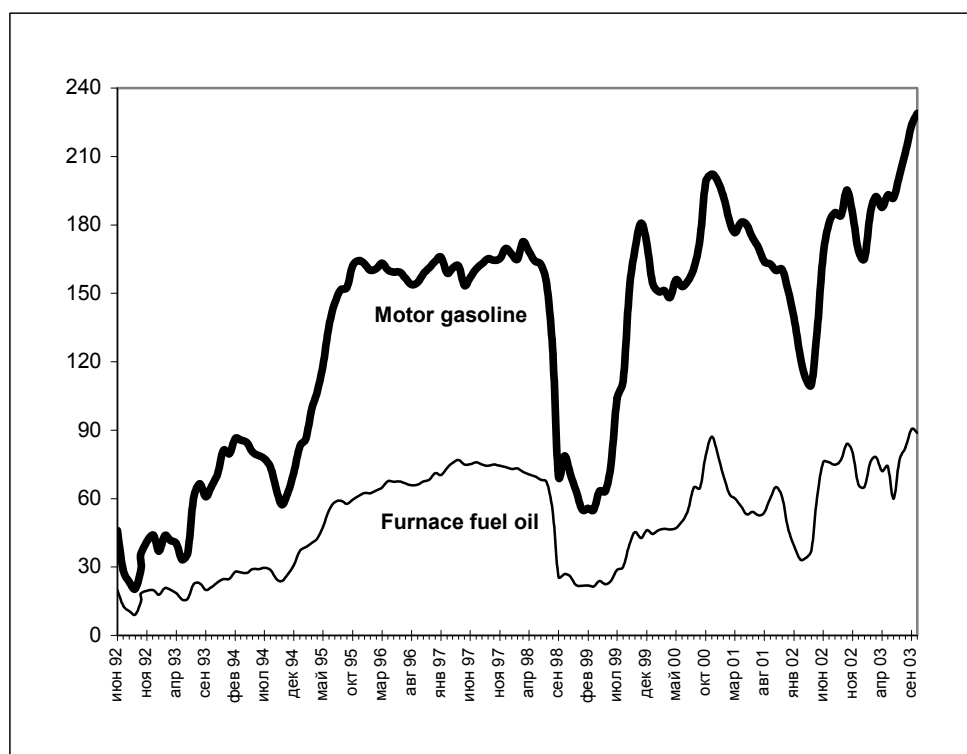


Fig. 2. Average wholesale motor gasoline and furnace fuel oil prices set by enterprises in US \$ terms in 1992 through 2003, US \$ / metric ton



Yu. Bobilev

## New regime of sugar market regulation in Russia

The world market of sugar is one of the most regulated food markets. Less than one fourth of the world sugar output is sold on a free market. Russia is a major player on the world sugar market: it buys about 4-5 million tons of sugar (both raw and white) annually. So, the world price for sugar is largely shaped by Russia's behavior on this market. Changes in respective domestic demand have an effect on the world price. Besides, prices on the world sugar market (similarly to most markets of raw materials) are very volatile. Given the current situation on the world sugar market Russia has to support home production of sugar beets as a damper mitigating the effect of world market fluctuations on domestic market.

But the world average cost of processing sugar out of beets is higher than that of processing it out of cane. That is why almost all countries growing beets implement rigid protectionist policies. Sugar production is the most regulated production in the world and all attempts to liberalize trade in sugar have failed. Russia also has to render certain support to domestic production of sugar beets in order to protect itself from too much dependence on fluctuations on the non-free world market.

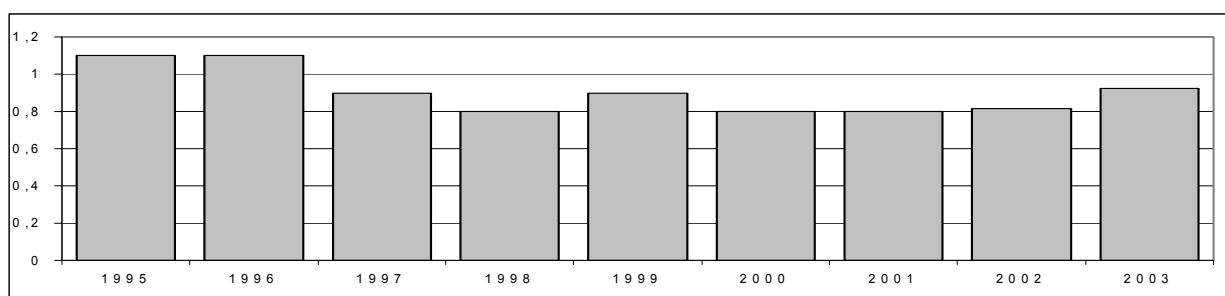
It's logical to assume that the rate of protection should be set so that to ensure competitiveness of white sugar produced out of sugar beets grown and processed at average costs with, first, sugar processed at the same average costs out of imported raw sugar, and, second, with imported white sugar. But if applied, such an approach to protection mechanism will preserve the non-efficient production structure both in sugar beets growing and in sugar processing: production becomes profitable for many marginal producers that failed to restructure their business during the reform years. In agriculture it's certainly due to soft budget constraints that shaped in the past 11 years. Such a protectionist measure will only hinder the needed restructuring. Thus to encourage higher efficiency both in the primary production and in processing it's more rational to determine the necessary protection rate on the basis of modal, i.e. the most typical, production terms.

In this case the current rate of protection for raw sugar is according to our estimates a little bit below the required level while that for white sugar is excessive, i.e. it unduly lowers the efficiency of sugar consumption in the country.

Now let's consider a possible mechanism of protection. It can be effected using different tools and their combinations: tariff quotas, production quotas, flexible, fixed and seasonal duties. Let's review some of the potential approaches currently discussed in the agrarian establishment.

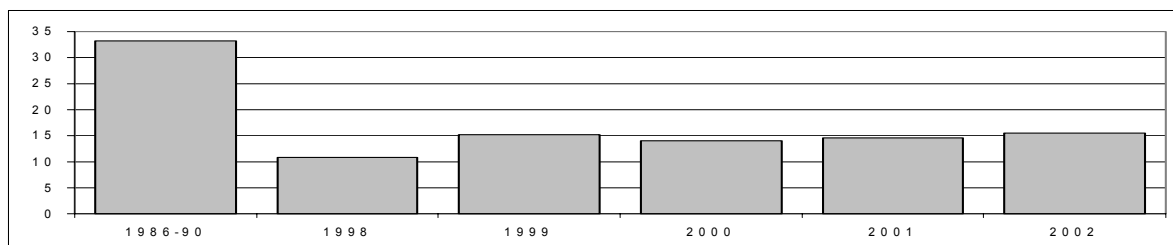
First of all, this is the mechanism of tariff quotas for raw sugar and seasonal duties on white sugar applied in the past three years. As we have stressed in earlier publications, the current quota mechanism has failed to notably increase sugar beets production in Russia (Picture 1 and Picture 2). In 2003 the planted area enlarged but this was due to a sharp drop of grain production profitability in the previous season rather than to raw sugar import constraints. On the other hand, the then effective mechanism of quotas was accompanied with the growth of domestic retail prices for white sugar (and, correspondingly, for products containing sugar) and also of wholesale sugar prices for industrial consumers. Finally, the quota mechanism for raw sugar in combination with seasonal duty on white sugar resulted in larger imports of sugar substitutes. Quota auctions not only increased direct costs of purchasing raw sugar but also resulted in higher associated costs: consumers of raw sugar had to get credits for buying quotas and thus enlarged their expenditures even more.

Picture 1. Russia: Areas planted in sugar beets, million hectares



Source: RF State Committee for Statistics.

Picture 2. Russia: Gross production of sugar beets, million tons



Source: RF State Committee for Statistics.

Production quotas, i.e. the lower limit of sugar production out of sugar beets for all sugar plants, could be void of tariff quota's drawbacks, but sugar production is not a licensed one and thus control and effective punishment for violating this constraint become hardly possible.

The enforcement of seasonal duties on white sugar results in corresponding growth of raw sugar imports.

The advantages of fixed duty are its simplicity and the highest efficiency in influencing market. But given high volatility of world sugar prices it becomes a stiff mechanism transferring all world market fluctuations to the domestic market.

Thus the most adequate mechanism of sugar market regulation in the current situation could be flexible import duties equal to the difference between domestic support prices set for the whole year and the world prices.

Such a mechanism is transparent for all market agents, is not fraught with corruption, ensures flexibility of regulation enabling to preserve balance between interests of both sugar consumers and producers in Russia.

Besides, it's necessary to introduce duty on all sugar products (with sugar contents above a certain percent determined by technical experts of Russian sugar industry). Only then the tariff protection will be efficient and the government won't have to take *ad hoc* protective measures against import of sugar syrup, caramel, etc. (further in the list will be corn sweeteners and chemical sugar substitutes). Almost all countries regulating sugar import regulate the market of sugar products as well.

In December 2003 a new mechanism of sugar market regulation was introduced in Russia – the flexible import tariff. It actually sets the level of raw sugar support price at 470 US dollars per ton presuming that the basis of “Caribbean Sea – Krasnodar region” deliveries is 100 dollars per ton. The world price is determined on the basis of New York Board of Trade (CSCE/NYCE) quotations. The principal formula for calculating the size of duty is as follows: the support price less delivery basis and less the average monthly price for raw sugar at the exchange. Since the first two variables are fixed, the duty will be determined by the world price: the higher it is, the lower is the duty. So, the world market fluctuations are mitigated on the domestic market ensuring certain stability for both buyers and sellers.

So, the idea is good but its implementation details may result in its utter discredit.

First, the support price for raw sugar is set at 470 US dollars per ton although such an amount could be enough even for white sugar (the difference between prices for white and raw sugar is approximately 50 US dollars per ton). In other words, the support price for raw sugar is at least 50 US dollars per ton higher than it should be thus fostering further retail price rise.

Second, the method of binding import tariff to the average exchange price is non-transparent. The new regulation specifies 9 intervals of exchange price change, and the import duty size is to be determined for each of them. However, the exchange price intervals and import duty intervals do not coincide. Besides, uncertainty on the market is provoked by the mechanism of import duty calculation. The draft specifies that the Ministry of economic development and trade publishes the mean arithmetical exchange price by the 15<sup>th</sup> next month. The duty comes in force beginning from the 1<sup>st</sup> following month. So, the duty for  $t$  month will be based on exchange price in  $t-2$  month. It's too a risky mechanism: e.g. exchange prices in  $t$  month can be low and the duty is correspondingly high, while in  $t+1$  month the situation can differ radically. Then the import of raw sugar in  $t+2$  month will be unduly costly. In other words, the proposed mechanism does not mitigate the world market volatility and can even aggravate it thus inciting speculative trends on the market.

Third, the flexible duty is introduced only on raw and white sugar while the mechanisms for other sugar products remain as they were. This is certainly fraught with the market situation when the import of sugar products will become much more lucrative than the import of raw sugar. This will entail the forming of a group of speculators, i.e. the phenomenon that contradicts the strategy of ensuring stability on agrifood markets in the country.

*E. Serova*

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## Foreign Trade

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In October of 2003, the Russia's foreign trade turnover grew by 20.1 per cent in comparison with the figures registered in the respective month of the preceding year and made US \$ 19.1 (according to the balance of trade methodology). At the same time, the amount of exports made US \$ 12.4 billion (a historical high in all the post-Soviet years), while imports were registered at the record high over the last 6 years (US \$ 6.7 billion). The foreign trade turnover grew by 9.1 per cent in comparison with the figures registered in the respective month of the preceding year.

The growth in exports by 23 per cent in comparison with the figures registered in October of 2001 was primarily determined by the persisting favorable business situation on the world markets.

In October, the oil market demonstrated an upward trend in prices. The average Urals oil price made US \$ 28.2 per barrel (a 9.6 per cent growth in comparison with the September figures), while the Brent oil price was registered at US \$ 29.6 per barrel (an increase by 9.2 per cent). The major factors behind the rise in prices were the decision of the OPEC member countries to decrease oil extraction by 900 thous. barrels per day since November 1, 2003, and the high seasonal demand for oil and oil products, especially in the USA, at the background of a relatively low level of reserves in oil storage tanks.

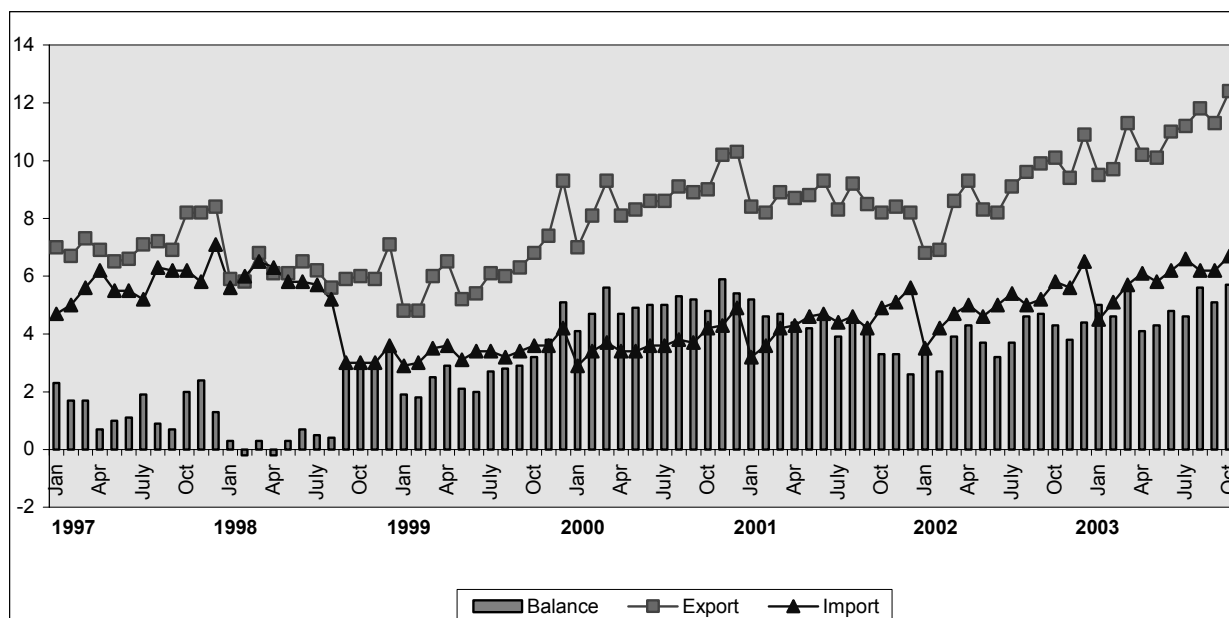
In the first ten months of 2003, the average prices of Russian oil (Urals) were by 15.5 per cent above the figures registered in the respective period of 2002, while Brent oil price was above the respective indicator by 17.5 per cent.

The prices of Russian natural gas remained high. For instance, over 10 months of the year the average contract price increased by 27.8 per cent in comparison with the figures registered in the respective period of the preceding year.

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 end-October, the current nickel price has reached the record high over the last 14 years – US \$ 11950 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. The average nickel, copper, and aluminum prices increased over 10 months of the year in comparison with the figures observed in the respective period of the preceding year by 34.1 per cent, 10.1 per cent, and 5.1 per cent respectively.

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



Source: RF Goskomstat, Central Bank of Russia

*Table 1.*

**The average monthly world prices in October of the respective year**

	1996	1997	1998	1999	2000	2001	2002	2003
Oil (Brent), USD / barrel	24,08	17,9	12,8	24,1	32,14	21,45	27,2	29,6
Natural gas, USD / 1 mil Btu	2,742	2,346	2,205	2,558	5,767	2,649	4,144	5,162
Gasoline, USD / gallon	0,67	0,569	0,421	0,699	0,895	0,603	0,801	0,841
Copper, USD / metric ton	1968,5	1900,7	1659,2	1748,1	1838,6	1405,1	1519,0	1916,4
Aluminum, USD / metric ton	1341,1	1538,5	1354,2	1470,7	1473,5	1280,8	1313,2	1474,8
Nickel, USD / metric ton	7060,9	6240,5	4262,4	7984,2	7353,2	4836,8	6840,9	11030,4

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

In October of 2003, the real Ruble / US \$ exchange rate exceeded the level registered in the respective month of 2002 by 16 per cent. Besides, the level of GDP increased by 7.3 per cent in comparison with the level observed in October of 2002. Higher purchasing power of Ruble in relation to US \$ and growing proceeds in the economy objectively facilitated higher levels of imports.

As a result, in October of 2003 the amount of import of goods increased by 14 per cent in comparison with the levels registered in the respective month of 2002. At the same time, imports from CIS member countries grew significantly more: by 27 per cent as compared with the level registered in October of 2002, while imports from countries outside CIS increased by 11 per cent. As a result, the share of CIS member countries in imports decreased by 2 p. p. in comparison with the level registered in October of 2002 and made 79 per cent.

Imports grew at a more slow rate than exports, what resulted in a significant increase in the active balance of trade up to US \$ 5.7 billion, what is above the level registered in October of 2002 by US \$ 1.5 billion.

On December 15, 2003, there were enacted new duties on import of cars manufactured 3 to 7 and more years ago. The rate of the import duty on cars manufactured seven and more years ago was set at 2 Euro per 1 cubic cm of motor capacity. Import duties on cars aged 3 to 7 years makes 25 per cent of their customs values, but not less than Euro 0.55 per 1 cubic cm. The duty on newer cars remained without change.

It should be reminded that previously Russian citizens had to pay from Euro 1.4 to Euro 3.2 for import of cars manufactured seven and more years ago (depending on the respective motor capacity). Import duties on the cars aged 3 to 7 years made from Euro 0.85 to Euro 1.8 per 1 cubic cm. The duty on newer cars (manufactured up to 3 years ago) made 25 per cent of their customs values, but not less than Euro 1.8 per 1 cubic cm.

However, since January 1, 2004, there will be imposed new rates of import duties on foreign cars. The Government introduces the procedures imposing single rates of customs duties and taxes with respect to the cars manufactured less than three years ago (i.e. defined as new) and imported by individuals.

The amount of customs duties will be calculated basing on the data on the vehicle price presented by the manufacturer. The ad valorem component of the single rate has been determined proceeding from the rates of duties and taxes used in the trade turnover and makes 48 per cent (100 per cent plus 25 per cent of duty multiplied by 1.18 of VAT). For each value category there is set forth the specific component calculated basing on the data about categories of new vehicles most frequently transferred by individuals across the customs border.

Previously, Russian citizens preferred to purchase used foreign cars, however, the last year this trend was broken. The Russian motor market gradually changes shape as the consumer is ready to pay more for cars of better quality. The increase in the import duties on used cars, improving living standards of Russian citizens, the development of crediting related to purchase of vehicles to the level of effective demand – all these factors facilitated a growth in the Russian consumers' interest in new foreign and domestically manufactured cars.

Unfortunately, Russian motor factories benefited from the new customs duties less than foreign manufacturers. Although Russian citizens began spending less on older used cars, their demand turned to new cars manufactured abroad.

In 2003, the sales of cars manufactured in Russia increased by only 3 per cent (up to 870 thousand cars), while import of new foreign vehicles increased by 45 per cent (up to 170 thousand cars). At the same time, the production of foreign cars on the territory of Russia grew 5 times (up to 55 thousand). The Russian car manufacturers could somewhat improve their financial standing by adjusting their wholesale Ruble prices to the rates of inflation.

It is expected that already next year, in the case the present rates of growth in the import of vehicles in Russia persist, the Russian market will reach the quantitative and qualitative parameters making it attractive for the top foreign car manufacturers, who may establish their production capacities in Russia. Therefore, basing on the experience of developing countries, an increase in import duties on new foreign vehicles to the prohibitive level might create incentives for foreign large companies to build their own factories in Russia. At the same time, these duties could protect from imports both traditional domestic manufacturers and newly established motor factories.

The market of sugar still present an urgent problem for the Russian Government. On January 1, 2004, there was introduced a new procedure governing the regulation of import of unrefined sugar in Russia – “floating” duties on unrefined sugar determined on the base of prices registered at the New York exchange. Before the 15<sup>th</sup> of each month, the RF Ministry of Economic Development and Trade should submit to the State Customs Committee the data obtained via the monitoring of prices over the preceding month. The RF State Customs Committee should determine the amount of the import duty to be exacted since the 1<sup>st</sup> of the next month. The higher is the exchange price, the lower is the duty on unrefined sugar. In the case the average monthly price at the New York exchange is below US \$ 99.21 per metric ton, the duty should make US \$ 270 per metric ton. In the case the price is from US \$ 99.22 to US \$ 112.44, the duty should make US \$ 250; in the case the price is from US \$ 112.45 to US \$ 125.66, the duty is US \$ 235; in the case the price is from US \$ 125.67 to US \$ 141.1, the duty is US \$ 221; in the case the price is from US \$ 141.11 to US \$ 154.32, the duty is US \$ 206; in the case the price is from US \$ 154.33 to US \$ 167.55, the duty is US \$ 194; in the case the price is from US \$ 157.56 to US \$ 182.98, the duty is US \$ 180; in the case the price is from US \$ 182.99 to US \$ 198.42, the duty is US \$ 164; in the case the price is at US \$ 198.43 and above, the duty should make US \$ 140 per metric ton. The duty on refined sugar will make US \$ 340 per metric ton in 2004.

It is planned to impose the following duties on imported beet sugar: US \$ 250 per metric ton in the first six months of 2004 and US \$ 270 per metric ton in the last six months of 2004.

At present the import of unrefined sugar is regulated by the tariff quota (3.95 million metric tons). This year the duty on unrefined sugar imported within the quota makes Euro 95 per metric ton, while sugar imported in an excess of the quota is subject to duties at Euro 200 to Euro 230 per metric ton. The quota is distributed via auctions. At present the average wholesale sugar price in Russia makes US \$ 410 to US \$ 430 per metric ton, what is by US \$ 60 to US \$ 80 below the cost of unrefined sugar imported within the quota.

*N. Volovik N. Leonova*

## **Grant financing of Russian science: trends and assessments**

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In November of 2003, in the system of tender based grant financing there occurred an event nicknamed “velvet revolution.” The RF Government issued its executive order (No. 1708-r of November 26, 2003) dismissing academician M. Alfimov, the Chairman of the Board of the Russian Fund of Fundamental Research (RFFR) from his post before his term in office expired and replacing the academician with a little-known researcher who in fact was not in any way related to the fundamental science. It should be noted that this change of the chairman was not anticipated both by the members of the RFFR Board, and the fund’s employees: they all, including the dismissed Chairman, just had to face this fact. The leading scientists, including two Nobel prize laureates, have signed a letter supporting Alfimov, however, it produced no effect<sup>16</sup>. This event could have been regarded as an accident concerning only the RFFR, if a similar situation did not arise at another state scientific fund – the Russian Humanitarian Scientific Fund (RHSF) earlier this year. At RHSF, the managing director, who for some time also held the post of the Deputy Chairman of the Board, had to resign and soon a person little known in the humanitarian academic community was appointed as the Chairman of the Board.

The replacement of the chairpersons of two leading scientific funds of the country is only one manifestation of a rather consistent trend towards a gradual transformation of the mechanism of tender based grant financing based on an independent and objective selection of projects by turning funds in the structures dependent on the government and state agencies. For instance, in 2001 the funds were forced to amend their charters and both RFFR and RHSF became federal agencies subordinated to the government, while the very term “grant” was practically eliminated from their charters. In 2002 through 2003, there took place the unfruitful discussion about the necessity to adopt special legislation pertaining to state scientific funds confirming their unique status and setting forth the principle methods of their operation, i.e. independency of any particular governmental structure, provision of gratuitous non-repayable targeted financial support in the form of grants via tenders, and set forth the definition of the term “grant.” It was also envisaged to include in the law stipulations concerning the transfer of the rights for the intellectual property resulting from the work of respective grant recipients in their ownership on the condition of commercial use of such property, as well as procedures governing organization of tenders (differing from those set forth for the state procurement of R&D). There was also discussed the necessity to work out more clearly defined mechanisms of experts’ rotation and schemes permitting to invite foreign experts in order to render expert findings more objective.

Since at present the Funds are budget organizations, according to the legislation currently in force they can not dispose of the budget resources at their discretion, because they are not included in the structure of the state executive authorities. Both the Moscow State University and the Russian Academy of Science experienced the same problems in 2003 and had to struggle for their independence by seeking financing via special entries in the budget. Both the Moscow State University and the Russian Academy of Science could preserve their status as direct budget recipients by convincing the government that they are “symbolic organizations.” As concerns the Funds, they could not appeal to their “symbolic” status, and, therefore, in July of 2003 a special meeting of the Board of the RF Ministry for Industry, Science, and Technologies was convened to decide their fate in spite of the fact that exactly the Funds were “symbolic organizations” of the post-Soviet science, since they are one of the few new modern mechanisms disposing of budget resources in the most democratic, transparent, and efficient way. The Board took the decision that it was necessary to ensure that the state scientific funds receive the full amount of financial resources set forth for these purposes in the normative acts of the government, and these financial resources should be listed in the budget law for

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<sup>16</sup> RFFI: kartina maslom // Poisk, No. 49, 5.12.2003, p.3; A.Vaganov. Fundamentalnoi nauke nashli novogo rukovoditelya // Nezavisimaya gazeta - nauka, No. 18, 10.12.2003, p.11.

2004 in the budget entry “Fundamental research and promotion of the scientific and technological progress.” There was also decided that the Funds should retain their status of direct budget recipients. Although the budget for 2004 confirmed the Funds’ status as managers of budget resources, the respective standards of financing have not been met for the second year running. The budget law for 2003 allotted to the Funds not 8.5 per cent<sup>17</sup> of the expenditures targeted in Section 06 “Fundamental research and promotion of the scientific and technological progress” as it was stipulated by the legislation, but only 6.9 per cent. According to the budget for 2004, RFFR should be financed at 5.1 per cent of the amount targeted for Section 06 (in stead of 6 per cent), while RHSF will receive 0.84 per cent (in stead of 1 per cent).

Yet last year, the management of the Funds characterized the events described above - transformation of Funds in budget organizations, the delaying of legislative fixation of their special status, decrease in financing of state scientific funds – as an offensive against the very concept of tender based grant financing<sup>18</sup>.

At the same time, it can not be maintained that the funds were inflexible or not ready for a compromise. For instance, the RFFR management easily agreed to amend the charter and transform the fund in a budget organization, although it clearly understood the dangers associated with the change in the legal and organizational form of the fund. Further, last year RFFR considered the possibility to finance certain initiative projects basing on state priorities, although earlier its position was that the Fund should support only best scientific projects and use the results of grant distribution as the base for determination of new prospective avenues of research similarly to the international practices of drawing maps of science formed on the base of bibliometric analysis.

The Funds are well known in the scientific community, since many researchers could receive additional financing, visit a science conference, subscribe for foreign scientific periodicals, purchase certain equipment or reagents, publish their works. As a matter of fact, the number of programs run by the Funds increased, and they attempted to close a few “gaps” at once by financing research projects, renewing the material base of scientific organizations, supporting the youth in order to prevent the “brain drain.” However, it should be noted that since RFFR and RHSF distribute only 7 per cent (in the case the standards of financing are met) of the total budget investment in science, their capacities for financing of each individual initiative is very limited. As a result, it may appear that they fail to complete or effectively support any of the initiatives. Besides, the Funds should not fully substitute base financing, for instance, they should not renew and support the material base of scientific research and form the informational infrastructure. It is important to maintain the balance between the state financing and management in the sphere of science and self-organization of the scientific community carried out via the Funds.

The combination of hopes pinned on the funds, on one hand, and their limited capacities and deteriorating standing resulting in impossibility to meet the needs of the scientific community, on the other hand, was reflected in the mounting criticism of the Funds in Russia, what was revealed by the results of a survey carried out in 2003.

In the summer and autumn of 2003, IET conducted a mail survey among researchers working in 10 regions of Russia. The results of the survey demonstrated that 80.3 per cent of female researchers and 92.9 per cent of male researchers approved of the grant system of financing. However, many of those positively evaluating the grant system commented that they approve of this system only in principle while negatively assessing the mechanism of grant financing formed in Russia. It should be taken into account that survey covered not only activities of domestic funds, but also foreign organizations supporting Russian science.

The resulting evaluation of the funds’ activities was rather neutral or negative than positive. It was an illustrative fact that the share of negative assessments was higher in the regions most remote from Moscow or St. Petersburg, since a most frequent reproach was that around the funds there had formed established groups of grant recipients, primarily consisting of Moscow and St. Petersburg researchers. No doubt that the researchers who did not receive any grants from the funds or received such grants seldom were most negatively minded. Many of the respondents belonging to this group shared the opinion that the funds are unable to support innovative ideas since in the course of selection of projects they take guidance from such criteria as opinions of the authoritative scientific society, which supports only established theories and concepts and evaluates the proposed projects depending on how well they fit in the structure of other studies

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<sup>17</sup> It concerns three state funds – RFFR, RHSF and the Fund for promotion of small enterprises in the scientific and technical sphere.

<sup>18</sup> Rossiyskaya ekonomika v 2002 godu: tendentsii i perspektivy. Issue 24. M.: IET, 2003, p.304.



in a certain scientific school and the degree to which the proposed method of research is time tested. In other words, funds are supporting the “normal science” (according to T. Kun) and not the “competing paradigms,” therefore it impossible to achieve a scientific breakthrough in the framework of grant financing.

Funds were also characterized as a mechanism giving rise to a new form of sponging, since the requirements to the results of the studies supported by the funds are much softer than to contracts.

It should be noted that respondents’ opinions mainly based on their personal experience of dealing with domestic funds. On the whole, the respondents lacked information about funds operating in the country: researchers primarily knew domestic state funds – RFFR, RHSF, the Fund for promotion of small enterprises in the scientific and technical sphere, as well as 5 to 7 foreign funds (INTAS, ISTC, the Civilian Research and Development Fund (CRDF), McArthurs Foundation, TACIS, NATO programs).

The respondents prizing the grant system stated that today grants are the only possibility to survive and work, visit conferences, purchase equipment, connect to Internet, i.e. in fact maintained that the scientific process is based exclusively on grants. Another positive feature of the grant system was that they provided moral incentives for work, disciplined, taught to formulate research objectives, manage research teams, study scientific management. It was also noted that grants are very important for young researchers not only as material support, but as a means teaching to carry out independent scientific research, a way to get rid of infantilism characteristic of the community of young scientists.

On the whole, there was detected a very emotional and biased attitude to scientific funds. No doubt, some of complaints could have been unfair in the case grants were a source supplementing the base financing. However, exactly because today funds have to perform a number of irrelevant tasks substituting for other sources of financing, the level of respective expectations is set too high, even crucially high. It is a characteristic fact that while the attitude to funds was very much biased, there was voiced no criticism concerning the distribution of 91.5 per cent of budget resources carried out outside the funds. But it is a well known fact that these resources are primarily expended for maintenance of buildings, payment of communal services, and wages, salaries, and relating bonuses.

According to the respondents, it is of primary importance that the funds pay more attention to the programs aimed at the financing of the material and informational base of the scientific process, as well as those creating incentives for institutional changes, including support of innovative activities. Therefore, the survey revealed that as concerns the further development of science, researchers rely rather on the funds than the state and expect that the funds assume all major responsibilities relating to the creation of conditions suitable for scientific activities.

There was also found out that the funds operate in certain information “vacuum” and lack feedback. As a rule, the funds only announce programs and place application forms on their web sites or publish such information in mass media. However, they very seldom try to inform researchers about the procedures governing selection of projects, names of the experts evaluating applications, changes in priorities and principles of their operation, as well as the results of their programs.

The state attitude to the funds was clearly revealed by the recent incidents and it would hardly facilitate the changes in the funds’ policies making them more transparent, objective, and less clan-oriented (the latter accusation was most frequent with respect to both domestic and foreign funds). Besides, the trend towards insufficient budget financing of the state funds may persist, what may seriously endanger the financial well being of the Russian scientific complex in the situation where foreign (especially American) financing of the Russian science is declining. As a matter of fact, in 2003 several large US state agencies, which financed different initiatives in the sphere of science and education in Russia, announced about the completion of their programs, what affected both natural and social sciences. Although Russia is more actively participating in different EU initiatives, it does not compensate for losses suffered as the result of closing of the US programs. First, the presence of the US programs and funds was most significant over the whole post-Soviet period, and, second, the European Union admits Russia not as an equal, but only as a supplement partner, and Russian scientists may have to work in the framework of projects in which Europe, but not necessarily Russia, is interested.

As concerns the prospects of development of tender based mechanism of financing of the Russian science on the whole, certain hopes may be pinned on the reform of the system of Federal Targeted Programs (FTP), a number of which relate to the sphere of science.

In the sphere of science and technology, FTP were always seen not as a real mechanism of tender based financing, but as yet another way of redistribution of budget financing with very soft reporting requirements. Obligations of both customers and contractors were formal. In the sphere of science and technology, the

majority of FTP were formed yet in the Soviet time and have been only cosmetically adjusted since then. Besides, there were too many such programs, what resulted in the dilution of financial resources (on the whole, it is characteristic of the state program financing).

At present, the Ministry of Economic Development and Trade proposes to increase the share of state expenditures distributed on the principles of program targeted financing in the budget from 8.7 per cent (in 2003) to 40 per cent and tighten the control over the utilization of financial resources. The tightening of control envisages that only the Cabinet of Ministers would have the right to make current amendments to the running programs, while the heads of state agencies – clients should be personally responsible for the attainment of respective objectives and utilization of financial resources. At last it was recognized that targeted expenditures are more progressive and the maximal increase in the share of such financing will result in a more efficient expenditure of budget resources. For instance, it is planned that the development of innovation activities will be financed via the FTP mechanism. The Russian Academy of Science, one of the main lobbyist of the interests of science in the Government, will to a certain extent determine the degree to which the use of the FTP mechanism is expanded in the sphere of science and technology.

*I. Dezhina*

## **Education**

The experimental approbation of the Single State Examination (SSE) envisaging the integration of final school examinations and entrance examinations of the higher education institutions permitted to more clearly detect both positive and negative outcomes of this innovation remaining in the center of an active public discussion.

The scale of the experiment concerning the introduction of the single state examination (SSE) has been significantly increased. The number of the RF subjects participating in the experiment increased from 5 in 2001 to 47 in 2003 (see Table 1). The number of students passing final and entrance (higher education institutions) examinations in the form of SSE increased from 30 thousand registered in 2001 to almost 700 thousand in 2003. The number of non-specialized educational establishments, which had introduced SSE, increased from 2845 in 2001 to 18130 in 2003, while the number of state institutions of higher professional education and their branches accepting entrants basing on the SSE results increased from 16 in 2001 to 464 in 2003. There has also increased the number of secondary vocational training establishments accepting school graduates basing on their SSE results (from 79 in 2001 to 928 in 2003). In 2003, it was agreed upon that institutions of higher education and secondary vocational training establishments run by 20 federal ministries and departments should participate in the experiment.

*Table 1.*

### **Indicators of participation in the experimental introduction of SSE**

	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004 (planned)</b>
Number of RF subjects participating in the SSE experiment	5	16	47	63
Number of students passed SSE, thous.	30	300	700	900
Number of subjects of study for which SSE was introduced	8	9	12	12
Number of higher education institutions and their branches participating in the SSE experiment	16	117	464	-
Number of secondary vocational training establishments participating in the SSE experiment	0	79	928	-
Number of ministries and departments participating in the SSE experiment	3	10	20	-

Source: RF Ministry of Education

The further implementation of the experiment in 2002 / 2003 school year was accompanied by the development of the normative base, organizational, material, and technical resource potentials:

- There were revised and worked out new normative documents and instruction materials regulating the contents and procedures pertaining to SSE, the work of State Examination Commissions (SEC) and

conflict commissions, organization of enrollment in institutions of higher education and secondary vocational training establishments participating in the experiment;

- There were worked out control and measurement materials relating to 12 general education subjects;
- There was improved the technology of SSE;
- The work on the update and creation of federal and regional databases as concerns the approbation of the federal base of SSE results certificates was continued;
- There were trained specialists ensuring SSE operation (organizers, operators, members of subject commission examining knowledge of respective subjects of study, etc.);
- In 47 RF subjects there were worked out the schemes of the experiment, regional programs of organization of SSE, regional normative, instruction, and methodological documents and materials, databases of school graduates, measures of control over SSE, etc.;
- There were determined and implemented the schemes of material, technical, and financial support of RF subjects participating in the experiment at the expense of the funds of the Federal program for the development of education (FPDE) and the Federal targeted program “Development of the uniform educational and informational environment (2001 – 2005)”;
- There was organized and carried out the delivery of equipment to 47 RF subjects, built new communication lines;
- There were implemented measures aimed at the involvement of 464 institutions of higher education and 928 secondary vocational training establishments in the experiment (there were agreed upon the specialties opened for school graduates passed SSE, entrance procedures, organization of enrollment, use of federal databases as concerns the SSE results certificates, etc.);
- There was organized the work on informing interested organizations, educational establishments participating in the experiment, and mass media about the preparation and implementation of the experiment via the special SSE web site ([www.ege.edu.ru](http://www.ege.edu.ru)).

The total expenditures for SSE borne by the FPDE in 2003 made Rub. 586.6 million, including remuneration for the elaboration of tests, training of specialists, purchase of equipment and other expenditures. The average expenditures per a region participating in the experiment made Rub. 12.5 million in 2003.

The evaluation of the outcomes of the SSE experiment voiced at the meeting of the Board of the RF Ministry of Education in the 4<sup>th</sup> quarter of 2003 demonstrated that in the RF subjects participating in the experiment the mobility of school graduates enrolled in institutions of higher education increased, the total number of contestants for enrollment grew, there was also registered an increase in the number of rural school graduates participating in the entrance contests and enrolled in higher education institutions, many graduates could enroll without leaving their places of residence.

An analysis of the results demonstrated by first year students carried out at a number of higher education institutions participating in the experiment revealed that the correlation between the results of SSE and the first examinations at higher education establishments was more significant than the correlation between the results of traditional entrance examinations and the progress demonstrated by students.

According to the participants of the meeting held by the Board of the RF Ministry of Education, the introduction of the system of public observers over the SSE implementation in 2003 resulted in higher public confidence and permitted to better control SSE organization.

On the whole, according to the assessments voiced by the RF Ministry of Education, over three years the SSE experiment:

- Confirmed the possibility to attain objectives set forth at the beginning of SSE implementation;
- Demonstrated the real possibility to combine state final attestation of school graduates and entrance examinations of higher education institutions;
- Permitted to solve the technical problems pertaining to the use of control and measurement materials for SSE.

As concerns the problems, which became apparent in the course of the SSE experiment, according to the RF Ministry of Education, it is necessary and sufficient to take the following measures to solve them:

- More clearly define and develop the normative base of SSE at the federal and regional levels;
- Improve control and measurement materials;
- Improve organizational and technological procedures of SSE;

- Test different variants of organization of information flows at the stages of SSE preparation and implementation;
- Allow representatives of institutions of higher education and secondary vocational training establishments more broadly participate in the experiment at all its stages;
- Develop monitoring relating to the quality of school education in Russia in the framework of the experiment;
- Develop the practices of involvement of public observers.

It is apparent that among the problems indicated by the RF Ministry of Education there were no problems relating to the financing of the SSE system after the completion of the experiment. It should be noted that even at present the financing from the federal budget is strained, and the RF Ministry of Education agrees to include new regions in the SSE experiment only in the case they participate in co-financing of SSE. The FPDE program, which funds the major share of expenditures for the SSE experiment should cease the financing after its completion in 2005. At the same time, organization of SSE on regular basis in all regions will require about Rub. 800 million a year in the case the present level of expenditures persists (proceeding from the amount of expenditures registered in 2003, minus expenditures for purchase of equipment).

Yet another problem requiring special attention is the lack of a clear and efficient technology of enrollment basing on the SSE results. As a matter of fact, an entrant sending his / her SSE results to several institutions of higher education may be accepted by several of these institutions, however, the entrant can present the original documents to only one of them. Other higher education institutions will have to wait for a certain number of days before enrolling the “second wave” of entrants many of whom may by that time be enrolled in other institutions of higher education (maybe less prestigious). As a result, a number of higher education institutions may have enormous enrollment problems they would fail to cope with by the beginning of the new school year (what is highly probable taking into account the well known flaws in the operation of the Russian post service and the traditional summer transport problems).

The next potential serious problem is related to the fact that the city of Moscow participates in the experiment. In 2003 / 2004, the Moscow Government agreed to carry out the experiment only in half of city administrative districts (about 50 per cent of Moscow schools) and put forward a number of additional requirements, which create special conditions for Moscow. The major requirement is to use a combined test for Russian language and literature and to conduct SSE not in the specially designated facilities, but in schools allowing the presence of school teachers.

Apparently, in the case in even one region there is set forth a special SSE procedure, it will destroy its whole construction, since SSE results become incomparable. This approach to SSE makes it impossible not only to enroll entrants basing on the uniform requirements, but prevents the use of SSE results as an indicative evaluation of the quality of work of both unspecialized schools, and regional educational systems.

Besides, regions may use the special conditions granted to Moscow as the basis of their own demands for special treatment, what makes the SSE concept absolutely senseless.

At last, the leading national higher education institution (Moscow Lomonosov University), the only Russian University which officially is outside the jurisdiction of the RF Ministry of Education, has resolutely refused to participate in the SSE experiment (in contradistinction to other Moscow institutions of higher education). Apparently, this development definitely undermines the very concept of SSE.

Therefore, having listed these problems, it is not surprising that the RF Ministry of Education has delayed the terms of transition from the experiment to the mandatory SSE implementation in the Russian Federation from 2005 to 2006.

*I. Rozhdestvenskaya*

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## **Forecasting certain macroeconomic indicators<sup>19</sup>**

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Below are presented the results of forecasting of the monthly indicators of household living standards, the size of employment in the economy, and the total number of the unemployed 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

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<sup>19</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.

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)).

#### Indicators of household living standards

Below are presented the results of forecasting the real wages and salaries and real disposable cash household incomes basing on the models of time series of respective indicators calculated by the RF Goskomstat in the interval from January of 1999 till October of 2003.

Table 1.

#### Forecast of household living standards.

Period	Real disposable cash household incomes	Real wages and salaries
<b>ARIMA model based forecasts (in % of the respective period of the preceding year)</b>		
January 2004	18.2	11.9
February, 2004	17.6	13.6
March, 2004	11.9	10.7
<b>Memorandum: actual values in respective periods of the preceding year (in % of the respective period of the preceding year)</b>		
January 2003	14.8	10.0
February, 2003	17.0	10.6
March, 2003	15.6	8.3

According to the forecasts (see Table 1), the average increase in real disposable cash incomes the 1<sup>st</sup> quarter of 2004 as compared with the figures observed in the respective period of 2003 will make about 16 per cent. The similar indicator of the growth in real wages and salaries according to the obtained forecasts will make about 12 per cent. On the whole, the obtained forecasts demonstrate the persistence of the positive trend in the dynamics of household living standards indicators.

#### Indicators of the size of employment in the economy and the total number of the unemployed

Table 2

#### The results of calculations: forecasted values of the indicators of the size of employment in the economy and the total number of the unemployed

Month	Size of employment in the economy		Total number of the unemployed		
	million persons	rates of growth in comparison with the figures registered in the respective period of the preceding year (%)	million persons	comparison with the figures registered in the respective period of the preceding year	in (%) of the size of employment in the economy
January 2004	65.3 5	1.0	6.05	-5.5	9.3
February, 2004	65.1 7	1.7	6.05	-8.4	9.3
March, 2004	65.2 9	1.1	5.83	-7.5	8.9
<b>Memorandum: actual values in respective periods of the preceding year (million persons)</b>					
January 2003	64.70		6.40		
February, 2003	64.10		6.60		
March, 2003	64.60		6.30		

In order to estimate the future values of the indicators of the size of employment in the economy and the total number of the unemployed, there were used models of time series evaluated over the period from October of 1998 till October of 2003 in accordance with the RF Goskomstat data<sup>20</sup>.

On the whole, the obtained forecasts indicate the persistence of the positive trends in the dynamics of the indicators of the size of employment in the economy and the negative trends in the total number of the unemployed. According to ARIMA models (see Table 2), the average monthly increase in the indicator of the size of employment in the economy makes 1.2 per cent over the forecast period as compared with the figures registered in the respective months of the preceding year. At the same time, it may be expected that the number of the unemployed will diminish (in terms of increases in comparison with the figures observed in respective periods of the preceding year): the forecasted average monthly increase in this indicator is negative and makes on the average (- 7.1 per cent).

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<sup>20</sup> The indicator was calculated in accordance with the International Labor Organization (ILO) methods, the respective figures are as by the end of a period.