Section 1

The Crisis of the Russian Financial System: Key Factors, Economic Policies and Initial Results

The year 1998 was marked in Russia by a dramatic aggravation of a crisis that hit its economy, politics and social sphere. It had been brewing over a long period and assumed an explicit and unambiguous dimension in August. The underlying causes of the crisis were still there after August, although their economic and political forms were now slightly modified. Finally, the August crisis remains a key factor for Russian economic and political development in the current year, 1999.

1.1. Evolution of the Russian financial crisis in 1997-1998[1]

The crisis evolved in four major phases: November to December 1997; January 1998; February to April 1998; May to August 1998. Throughout the period under review risks associated with doing business in Russia were assessed as growing steadily worse. We are referring to risks related to currency convertibility, changes in the credit ratings of the country and its domestic coun-

[1] For more detail pertaining to the period between October 1997 and September 1998 see: *The Russian Economy January through September 1998. Trends and Prospects (Issue 19),* Institute for the Economy in Transition, Moscow, 1998.

terparties, loss of prestige, changes in the tax system that were not investor-friendly, and a negative transformation of the legal environment. Moreover, actual developments followed the worst possible pattern.

A benign situation on the Russian financial markets in September 1997 (with weighted average yields on the GKO-OFZ market down to 20 per cent per annum and the RTS-1 index at about 500 points) made it possible for Boris Yeltsin to declare that from 1999 onwards Russia would no longer need any financial programs from the IMF. (His statement was also meant to prepare the ground for redenomination of the ruble.) At the same time Anatoly Chubais's acknowledgment as the world's best minister of finance in 1997 boosted the prestige of the Russian government and sent a clear message to Western investors that its market reform policy was sustainable in the context of overall stability in Russia.

Hence, even in the early autumn of 1997 the Russian economy followed a generally positive market pattern. However, financial stabilization and an explosion of Russian financial markets developed against a backdrop of fundamental economic challenges: a fiscal crisis, a dramatic worsening of the balance of payments and an increasingly unstable banking system. There was a serious concern over the ratio of short-term government debt to nonresidents and the external reserves of the Central Bank. In the wake of a political scandal over a July 1997 tender for a block of shares in Joint Stock Company Svyazinvest the investors had to downgrade their assessment of Russian political stability and the potential of the "young reformers'" team.

On 27 October 1997, the Dow Jones Industrial Average index fell by a record 554 points, which signaled the beginning of a financial crisis in Russia. It eventually destroyed all the macroeconomic results achieved by 1997 and entailed a change in the course of economic transformation. Obviously, the acute global financial crisis which hit the developed markets and sent prices downwards on a number of emerging markets, was just one factor triggering off a series of destructive processes in Russia.

As early as the first week of the crisis weighted average yields on the government debt market rose from 22 per cent to 28 per cent per annum. There was a dramatic increase in auction sales, with a more than twofold weekly growth of the secondary market, and a concurrent heavy drop in Russian Eurobond quotations.

The RF Central Bank had to choose between a bad and a very bad option. Its first option was to protect the ruble against a big devaluation by increasing interest rates on the government debt market. Its second option was to keep interest rates at a relatively low level through open market transactions. Regrettably, in November 1997 the Central Bank chose the latter option and increased its GKO holding.

It was not until 11 November 1997 that the Central Bank increased its refinancing rate - from 21 per cent to 28 per cent – which was clearly not enough to maintain an equilibrium on the government debt market. Its interventions on the GKO market helped the Bank of Russia to prevent rates rising above 30 per cent until the last week in November. Nevertheless, as nonresidents who had sold their government bond holdings developed a big appetite for foreign exchange, the Central Bank's gold and forex reserves declined at a fast pace, which jeopardized the stability of its exchange rate policy. During November its external reserves plummeted from $22.9 billion to $16.8 billion. The November loss of reserves resulted in a sharp increase in the ratio of short-term debt to international reserves - from 1.9 to 2.7.

The policy just described appears to be a mistake largely responsible for the further development of the crisis. Instead of supporting low interest rates on the GKO-OFZ market, the Bank of Russia should have allowed them to grow until a market equilibrium was reached. Moreover, it should not have permitted a complete liberalization of the domestic debt market for nonresidents as of 1 January 1998; more specifically, it should not have cancelled a guaranteed level of bond yields and a restricted timeframe for profit repatriation. Had there been a timely and significant rise in the refinancing rate and an appropriate growth of interest rates on government securities, attacks on the Russian ruble might have been far less aggressive.

The policy of higher interest rates could have been complemented with higher rates of ruble depreciation. Even though this would have signaled to the investors that there was a higher risk of devaluation, it could have helped stabilize the currency market given an adequate level of external reserves and a predictable behavior of the exchange rate. Such policies could have been implemented by establishing a more narrow currency band with a higher slope. However, the Central Bank failed to take advantage of a possible acceleration in ruble depreciation as it announced, on 10 November 1997, its exchange rate policy targets for 1998-2000, providing for a wider currency band. The announcement sent a negative signal to the markets, showing that the RF Central Bank was committed to maintaining a low rate of ruble depreciation via foreign currency interventions, which was bound to increase exchange rate risks.

Apparently, the alternative measures just described (higher interest rates coupled with higher rates of ruble depreciation) would have had a controversial impact on the financial situation. Some of the investors would have thought that high interest rates would be enough to offset higher risks. The more conservative investors would have continued to export their capital out of Russia. Nevertheless, the most likely result of this policy would have been the emergence of a new equilibrium on the Russian financial markets against the background of a moderate decline in external reserves.

While the Central Bank was pursuing an inappropriate policy the government did not have any meaningful program for reducing government expenditures and the size of the fiscal deficit. Another factor responsible for a deteriorated financial situation was the government reshuffle at the end of November 1997. The reshuffle meant a final abandonment of the program of the 'young reformers" government. Investors no longer believed in the executive authorities' ability to pursue a sound and consistent financial policy.

In the last week of November 1997, the Central Bank, which had lost over a quarter of its international reserves, gave up its efforts to maintain low interest rates and quit the GKO-OFZ market. Weighted average yields on government debt soared to 40 per cent per annum.

The end of 1997 and the start of 1998 were marked by a growing crisis in Southeast Asia. In this context major investment funds chose to redistrubute their investment quotas among various countries and equity markets saw yet another fall in stock prices while GKO and OFZ yields increased.

In January 1998, quotations for Russian securities plummeted down to nearly 30 per cent. The overall decline of the RTS-1 index between 6 October 1997 and end-January 1998 was 50.9 per cent. The fall in quotations for Russian corporate stock was tantamount to a self-supporting process. Having received clients' orders for selling sizeable blocks of their shares, investment companies anticipated a heavy drop in the level of market support and were themselves eager to sell their liquid shares, thereby aggravating the market crisis.

An outflow of portfolio investments from Russia stepped up pressure on the ruble so that at the beginning of the year the official exchange rate of the US dollar grew at a fast pace and forward quotations increased. The Central Bank's attempts in January to boost the rates of ruble depreciation provoked a dramatic rise in GKO interest rates. The market extrapolated the faster growth of the exchange rate to a broader context and responded by a hike in interest rates to offset a drop in foreign currency-denominated yields. The market reaction confirmed that it is generally almost impossible to attempt devaluation in the context of a confidence crisis, short government debt, a high share of nonresidents on the market and low foreign exchange reserves.

The latter half of January was marked by renewed political complications. A substantial reallocation of powers occurred within the government: Chubais's terms of reference were curtailed to economics since the financial sphere became Victor Chernomyrdin’s domain. Boris Nemtsov lost control over the fuel and energy complex. The weakening of the reformers’ positions resulted in even lower investor expectations.

A period of relative stabilization set in on the markets between February and April 1998. Such positive trends were largely due to a series of steps taken by the President and the government, steps that clarified the immediate prospects for economic policy. More specifically, the President advocated a tighter fiscal policy and called for achieving a primary surplus of the federal budget already in 1998. Following a series of reshuffles, the government formulated 12 Key Social and Economic Policy Measures. The document made all members of the government and presidential administration officials personally responsible for implementing specific measures to promote a sound budget, normalize the wage arrears situation, etc.

Meanwhile, some other developments occurred which sent positive signals to the investors. Thus, in February the IMF decided to extend a three-year credit to Russia for another year. Michel Camdessus gave it to understand that Russia would get another $700 million tranche of the credit and that, subject to compliance with all the arrangements, it would be receiving loans until 2000. On February 24, Russia and the UK reached a complete agreement on the terms of Russian debt restructuring within the framework of the Paris Club.

On 10 March 1998, Fitch IBCA rating agency, in spite of all the ups and downs of the Russian financial markets, confirmed Russia’s long-term credit rating for foreign currency-denominated borrowings at BB+ and left its short-term rating at the same B level. On the following day, however, Moody's rating agency downgraded Russia’s credit rating for foreign currency-denominated external debt from Ba2 to Ba3 and for foreign currency-denominated bank deposits, to B1.

On 23 March 1998, the Russian Cabinet of Ministers resigned on the President's order, with Sergei Kiriyenko appointed as acting Prime Minister. The financial markets’ short-term reaction to the government reshuffle was quite positive. Later on, however, economic agents lost their bearings in the political uncertainty that followed, due to a five-week lag before Kiriyenko's final confirmation as Chairman of the Government.

The newly formed government focussed on budget recovery as the thrust of its economic policy. An analysis of the fiscal policy pursued by the Kiriyenko government in the spring and early summer of 1998 shows that it succeeded in preventing a further aggravation of the crisis.

The tax collection record for the first quarter of 1998 proved to be slightly better than in 1997. At the same time the execution of the expenditure side of both the federal and the consolidated budgets in the early half of 1998 was radically different from the previous year. Practically all items in both budgets other than government debt service and government administration expenditures were slashed. The federal budget's defense spending in the first half of 1998 was cut down by approximately 1-1.5 per cent of GDP as against the previous year's level.

A reconstructed budget of Russia's enlarged government (including extrabudgetary funds) in the first half of 1998 shows that tax receipts fell in the first half of 1998 as against 1997 (from 32.6 per cent of GDP to 30.7 per cent). There was an even more significant change in total revenues - 36.5 per cent of GDP as against 33.4 per cent of GDP. A greater decline in consolidated budget expenditure (from 43.2 per cent of GDP to 38.5 per cent of GDP) reduced the deficit of the consolidated budget by 1.6 per cent of GDP.

The final phase of the Russian financial crisis developed as follows: There was a buildup of political instability and higher pressure on foreign exchange reserves in a setting of strained government finances, short domestic debt, a large share of international investors and an emerging banking crisis. Under such circumstances there is a high probability of problems getting even worse even though the government may be pursuing a correct and consistent policy aimed at a sound budget, compliance with investors' rights, etc. Objectively speaking, market reaction is asymmetrical: any economic policy error or bad news entails serious adverse effects while the right steps fail to elicit a positive response from the markets.

In mid-May (right after the Cabinet's confirmation) there was a sharp drop in quotations for government securities. Secondary market trade increased, the RTS-1 stock index fell by 40 per cent and the ruble exchange rate came under heavier pressure. During May the foreign exchange reserves went down by $1.4 billion (nearly 10 per cent).

The State Duma passed a law (eventually signed by the President) on special management of federal government-owned shares in RAO Unified Energy Systems of Russia and other joint stock utilities. The law breached owners' rights by restricting quotas for international investors (to no more than 25 per cent of total stock).

In May Sergei Dubinin addressed a meeting of the government with a warning about an impending crisis in the financial system and a catastrophic buildup in government debt. His statement produced a shock made worse by a lack of transparent statistics with regard to monetary and currency policies.

An early warning sign of an imminent banking crisis was the introduction of external management at Токоbank, which had received substantial loans from Western banks.

The cancellation of a sale of Rosneft as announced on May 26 (due to a fall in its market stock value) deprived the budget of $2.1 billion, which sent a negative signal to the investors.

The government's response to a growing crisis in the Russian financial markets was too slow, which made the crisis even worse. It was not until the end of May that the newly formed Kiriyenko government began to develop anti-crisis measures. A series of statements was issued between May 17 and 19: by the government (on its commitment to a policy aimed at macroeconomic stability), the Central Bank (on the immutability of its currency policy and inadmissibility of monetary financing of the budget), the Ministry of Finance (on an austerity plan for budget expenditure), and the Federal Securities Commission (on securing investors' rights).

On May 29, the government issued a statement on immediate measures to stabilize the financial market and on fiscal policy in 1998. A few days after his Cabinet appointment Boris Fyodorov outlined major ways of improving tax collection in Russia. Financial markets began to show some degree of optimism after Chubais paid a visit to Washington, D.C. between May 29 and 30, to discuss the problem of a large financial aid package for Russia. In the first week of June yields on government debt dropped to 51 per cent and in the second week, to 46 per cent.

Nevertheless, investor confidence was waning in the absence of consistent anti-crisis actions by the government. The June situation was made worse by the slow pace of the Russian government's talks with the IMF on the disbursement of a large aid package.

A massive flight of investors' funds from financial markets led to yet another increase in the GKO interest rate to 50 per cent in the latter half of June. The stock index went down by 20 per cent during the month of June. All this put much more pressure on the ruble exchange rate and forced the Central Bank to carry out large-scale interventions on the currency market.

In spite of an unfavorable situation, on June 10, Russia floated five-year bonds for the amount of $1.25 billion at the rate of 11.75 per cent. On June 24, a new $2.5 billion loan was floated at as high as 12.75 per cent. The high cost of borrowing sent a negative signal to the investors and reduced quotations for other negotiable Eurobonds.

On June 17, Boris Yeltsin appointed Anatoly Chubais a special presidential representative (with vice premier status) for liaison with international financial institutions – a positive move in the eyes of the players on the Russian financial markets. On June 23, the IMF Board of Directors approved the disbursement of another $670 million tranche of its Russian credit. Moreover, the IMF issued a statement in support of the Russian government's measures to prop up its national currency and avoid a major devaluation.

During June 1998, the government was busy developing anti-crisis program measures, notably a planned reduction in gas prices and electricity tariff rates, amendments to tax legislation (VAT to be charged at shipment, introduction of a flat income tax scale, a lower rate of profit tax, higher rates of excise taxes and duties, a limited number of enterprises' settlement accounts, introduction of a sales tax, etc.), and selling government-owned stakes in major Russian corporations (in particular, five per cent of the shares in RAO Gazprom and the government stake in Joint Stock Company Svyazinvest). Sergei Kiriyenko submitted a package of anti-crisis bills in installments for consideration by the State Duma early in July of 1998.

At the time, weighted average yields on the government securities market amounted to 126 per cent per annum. On 8 July 1998, the RF Ministry of Finance canceled auction bids for GKOs and OFZs. On July 13, the Russian government announced its intention to offer the GKO holders an option of converting them into medium- or long-term dollar-denominated bonds, to be redeemed in 2005 and 2018, respectively. The situation turned for the better after an announcement on 13 July 1998, that the IMF, the World Bank and the Japanese government would give Russia $22.6 billion in financial aid, of which $5.6 billion was to be disbursed right after a meeting of the IMF Board of Directors. Between July 13 and 19, weighted average yields on GKOs dropped to 53 per cent. The RTS-1 index went up to 34 per cent during the same week. The next GKO auction scheduled for July 15 never took place, however, and government debt was serviced at the expense of the federal budget. On July 20, an announcement was made that one-year government securities would not be issued any longer.

The State Duma voted down many of the bills in the anti-crisis package proposed by the government in June-July 1998. As passage of those bills was part and parcel of the Russian commitment to the IMF and a condition for the provision of financial support, the size of the aid might be expected to decrease. Nevertheless, as a result of Chubais's talks with the IMF top management the first tranche was cut down by a reasonable amount - from $5.6 billion to $4.8 billion. On July 21, the IMF passed a resolution on disbursing a new aid package to Russia.

Notwithstanding the reduced size of the first tranche, the financial markets' response was positive. Yields on government debt went down to 45 per cent. Further developments, therefore, largely depended on whether the market would receive clear signals from the Russian leaders as to their further measures to normalize the situation. The government did not take any steps, however, to show that it had a coherent plan of action.

The Russian government interpreted a temporary stabilization of the market after July 20 as a sustainable trend, and it was not until the following week that a meeting was arranged, on July 27, between the Prime Minister and a number of key investors to explain the government's plan of action with respect to government debt repayment and service in the near future. The government failed to produce any convincing proof, however, that Russia would be able to meet its commitments before the end of 1998 based on available data on tax revenue and increased international reserves.

In addition to the increasingly more obvious political weakness of the government, which failed to push the package of bills agreed with the IMF through the State Duma, mention should be made of several additional factors which had by early August caused a downturn in the overall situation and led to an uncontrollable chain of further developments.

Firstly, we are referring to a slump on the international financial markets. Secondly, there was a seasonal drop in the proportion of risk assets in the portfolios of key institutional investors – a common occurrence shortly before summer vacations. A serious aggravation of the banking crisis was another major factor provoked by a worsened situation on the financial markets in the context of a tight monetary policy pursued in the first half of 1998. An acute liquidity crisis occurred in the banking system largely due to decreased quotations for Russian government securities denominated in foreign currencies. As they served as collateral for loans granted by foreign banks to their Russian counterparts, the latter were requested to increase their margin calls. To meet these requirements banks began selling their portfolios of GKOs and OFZs and corporate shares with a view to converting the proceeds into foreign exchange. Such moves by the banks made the financial markets even more nervous, including the market for Russian paper denominated in foreign currencies. The first two banks to default on their debts to international lending institutions were SBS-Agro and Imperial.

The above factors combined to produce a serious deterioration in the financial situation in the period between the IMF loan disbursement date and early August. Yields on government debt jumped to 56 per cent and the stock market was falling at accelerated rates. The RTS-1 Index plunged by nearly 30 per cent between the disbursement of the IMF stabilization loan and August 17. International reserves were plummeting at a fast rate: from \$19.5 billion as at July 23 to \$18.4 billion as at July 31 to \$16.3 billion as at August 7.

To sum up our analysis of developments leading up to the climax of the crisis, it is worth noting that, along with its underlying causes listed above, there were two other major factors responsible for Russia's failure to avoid ruble devaluation in August, namely, a lack of support for the government's anti-crisis program from the State Duma and insufficient aid from the IMF. The situation might have been reversed by the G-7 countries' aid to the tune of \$10 billion to \$15 billion. Under the prevailing political situation, however, it would have been unrealistic to expect such help. A devaluation of the ruble was the only feasible option.

The government's plan as announced on August 17 provided for three sets of measures: introducing a floating exchange rate for the ruble with its devaluation to roughly Rb9 per dollar by the end of the year; introducing a three-month moratorium on repayment of Russian banks' external debt; a compulsory GKO-OFZ debt restructuring scheme.

On 15-16 August, the government's plan was agreed with the IMF. The program announced on August 17did not include a domestic government debt restructuring scheme and elicited a negative response from the financial markets. The stock market plunged by a further 29 per cent in just a week. A restructuring scheme was finally published by the government with a one-week delay. The amount of frozen domestic sovereign debt totaled Rb265.3 billion ($42.2 billion at the exchange rate as of 14 August 1998). What remained in circulation were the OFZs totaling Rb75 billion and maturing in 2000-2001.

The Kiriyenko government’s program was never implemented as originally announced. On August 23, the Kiriyenko Cabinet resigned and Victor Chernomyrdin was appointed acting Prime Minister. This decision had some serious economic and political implications. Firstly, the resignation and the statements about a change in economic policy virtually canceled out Russia’s arrangements with the IMF in respect of both an enlarged lending facility program and a stabilization loan (with due regard to the IMF-backed measures as announced on August 17). Secondly, the political crisis introduced much more uncertainty to economic policy.

The above factors generated a new wave of panic on financial and commodities markets. On August 26, the RF Central Bank, having spent considerable reserves to prop up the ruble at low rates vis-à-vis the dollar, suspended trade at the Moscow Interbank Currency Exchange (MICEX) for an indefinite period in an effort to preserve its gold and forex reserves. Regional currency exchanges had to suspend their trade as of August 28. Further on, the Central Bank was no longer able to prevent the ruble from falling due to its depleted forex reserves ($12.46 billion as at September 1).

September 1998 witnessed a further aggravation of an economic and financial crisis arising from the devaluation of the ruble and eroded confidence in the Russian national currency. A devaluation of the ruble by two-thirds and a skyrocketing velocity of money accounted for a rapid rise in consumer prices. In August prices rose by 3.7 per cent and in September, by 38.4 per cent.

Eventually, the rate of inflation slowed down concurrently with a depreciation of the US dollar. This was largely due to the monetary policy pursued by the RF Central Bank. There was practically no change in base money in August despite the fact that the Bank of Russia then spent 5.95 billion US dollars out of its gold and foreign exchange reserves. Apparently, forex interventions were sterilized as a result of open market operations with government debt and the disbursement of stabilization loans to commercial banks.

During September base money increased by 9.5 per cent against the background of dramatically decreased rates of shrinkage of external reserves. At the same time, the inflationary effects of currency issue were largely offset by a decrease of the monetary multiplier due to the withdrawal of household deposits from commercial banks.

In the absence of a market for domestic public borrowing the only indicator of interest rates on Russian debt was now the market for foreign-currency denominated domestic bonds (OVVZs) and Eurobonds. Quotations for third-tranche OVVZs (maturing in 1998) plunged to 40 per cent of their face value as compared to 90 per cent as of early August while the prices of the other OVVZ tranches plummeted down to 10 per cent of their face value. The Eurobonds were rated at 20 per cent to 30 per cent of their face value (as against 70 per cent to 85 per cent before the crisis).

September 1998 saw marked fluctuations in the dollar exchange rate in the Electronic Lot Trading System (commonly known as SELT, to use the Russian acronym). As at August 31, for example, the exchange rate was Rb7.905 to the dollar whereas on September 9, it was as high as Rb20.825. The need to reduce exchange losses on forward contracts due in mid-September accounted for a subsequent drop in the dollar exchange rate to Rb8.67 for the dollar. After the rate was fixed at this level on 15 September 1998, it soared again to Rb16 per dollar. During September the US dollar rate went up by 102.4 per cent.

Following the August drop in quotations, Russian stock prices declined at a slightly slower pace in September 1998. In August the RTS-1 index dropped by 56.2 per cent whereas in September it went down by 33.2 per cent. Since the start of 1998 the RTS-1 index had dropped by 89 per cent and since the beginning of October 1997, by 92.3 per cent.

Data on the interbank ruble loan market shows that that overnight lending rates as of mid-September reached 450 per cent per annum and interest rates on three-day loans, 130 per cent p.a. High earnings from foreign exchange operations ensured repayment of such loans. The September volume of transactions plunged to one-tenth of the August volume.

1.2. Principal Factors Behind the 1998 Financial Crisis

1.2.1. Fiscal Deficit and Government Debt

The principal reason underlying the financial crisis was the failure of all the successive cabinets in Russia to adopt and, more importantly, execute a realistic budget.[2] As a result, the positive trends dominant in 1996 and 1997, such as falling inflation rates, stabilization of the ruble exchange rate, declining interest rates, and an incipient economic uplift, were maintained solely by a tight monetary policy pursued against the background of highly unbalanced government finances. The considerable government finance shortages pushing up government debt and debt servicing, while at the same time depressing the national savings and thinning out the current balance of payments surplus, were a major destabilizing factor in the nation’s socio-economic development.

One of the worst performers among the democratic nations in terms of economic growth, Russia stands level with the USA, and

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[2] We examined in much detail the political, economic, social, and constitutional factors of the fiscal deficit in a survey by the Institute for the Economy in Transition entitled *The Russian Economy January through September 1998. Trends and Prospects (Issue 19)*..

is just behind Britain, in terms of budget strain. The budgetary crisis in post-communist Russia has political roots, not because its government lacks the political will to fight tax evasion and tax arrears. The political color of the budgetary crisis reflects the incompatibility between the level of tax collection by the government, on one hand, and the democratic character of the political regime and the country's economic development, on the other.[3]

The inability to understand the above-named underpinnings of the budgetary crisis has led to wrong moves to end it. It is arguable what extent of tax revenues corresponds best to the growth level of the national economy, its sectoral structure, public well-being, public consumption structure, law-abiding traditions, comprehensiveness of the laws, and many more factors. The fact that attainable tax collection does not rise above 30 per cent of GDP, give or take a few percentage points, may be assumed to have been proved by practical economic experience. Restructuring expenditures, not least cutting them, must, therefore, be pivotal to a balanced budget, a painful admission in both political and social terms.

Between 1991 and 1997, the government slashed public spending by approximately two-thirds, with spending on social programs having dropped by about a third. For all that, the government moved too slowly to cut its spending, far below what was needed to put the budget in balance. Furthermore, budget spending was commandeered by an assortment of lobbies (agribusiness, the military-industrial complex, banks, primary industries, etc.), causing the structure of budgetary spending to get

[3] In principle, a feasible level of tax collection is determined by factors depending on the country's economic development, such as economic structure, the population's educational standards allowing developed tax legislation and appropriate accounting standards to be applied; the level of tax administration; the general level of the population's law abidance and emerging tax payment traditions in society, and the level of social and ethnographic homogeneity of society.
Authoritarian regimes can afford to put far larger resources in the government's hands than is possible under democratic rule. That was actually the case in communist countries.

twisted tortuously out of shape, unable to create conditions for economic growth or maintain a desired level of socio-political stability.

In the period under review (particularly, at the juncture of 1997 and 1998), the government made repeated attempts to discipline federal and local budgetary spending. The Kiriyenko cabinet went, in June and July 1998, as far as developing and adopting a program tailored to these aims. The measures undertaken in this area were, however, hardly more than efforts to identify and plug the drain holes, the problem being far more complex overall: the government had to go back on many of its commitments that could no longer be honored without piling up a precarious pyramid of public debt.

Beginning in 1995, the internal public debt started running up, above all, because of the heavy borrowing on the securities market (see Table 1.1). By early 1998, the domestic debt had gone up to 18.9 per cent of GDP, and to 26.0 per cent of GDP (annualized) toward the close of the year.

Table 1.1

Dynamics of domestic government debt and expenditures on its service

	as at 1 January 1994		as at 1 January 1995		as at 1 January 1996	
	trln Rbs	per cent of GDP	trln Rbs	per cent of GDP	trln Rbs	per cent of GDP
Domestic government debt, of which	35,2	21,7	88,4	14,5	188	11,5
- debt on securities	0,3	0,2	18,9	3,1	85,2	5,2
- debt to Central Bank	29,2	18,0	58,8	9,6	61,0	3,7
Domestic debt service	0,99	0,6	16,1	2,6	38,2	2,3
	as at 1 January 1997		**as at 1 January 1998**		**as at 1 January 1999**	
	in trillions of Rbs	per cent of GDP	in trillions of Rbs	per cent of GDP	in blns of Rbs	per cent of GDP
Domestic government debt, of which	365,5	16,2	501	18,7	751	28,0
- debt on securities	249	11,0	449	16,8	480	17,9
- debt to Central Bank	59,6	2,6	0,0	0,0	0,0	0,0
Domestic debt service	105,7	4,7	96,3	3,6	106,6	4,0

Sources: RF Ministry of Finance, RF Central Bank, Institute for the Economy in Transition

Table 1.2

Dynamics of RF external debt

	USSR debt (in blns of USD)	RF debt (in blns of USD)	Debt service as per cent of GDP
1992	104,9	2,8	0,7
1993	103,7	9,0	0,3
1994	108,6	11,3	0,5
1995	103,0	17,4	0,9
1996	100,8	24,2	0,9
1997	97,8	33,0	0,7
1998	95,0	55,0	1,2

Sources: RF Ministry of Finance, RF Goskomstat, Institute for the Economy in Transition

The swelling domestic debt was pulling up its servicing costs. Between 1995 and 1996, they almost doubled, from 2.6 per cent of GDP to 4.8 per cent of GDP. In 1997 and the first six months of 1998, the servicing costs dipped to 3.6 per cent and 3.9 per cent of GDP, respectively, still unacceptable.

At about the same time, 1996 to 1998, the government started borrowing indiscriminately on foreign financial markets. Table 1.2 illustrates the growth of the federal foreign debt.

The total debt load on the country's economy, at 49.8 per cent of GDP (as at 1 January 1998) was relatively light, by the measure of many other countries across the world.[4]

The domestic debt burdening Russia in 1997 was singularly short-termed, with a large proportion of non-resident debt.

The duration of Russia's domestic debt (the average time before retirement of outstanding GKOs-OFZs) increased from 60 to 90 days over 1995, to 150 days in 1996, and 250 days in 1997. Even though debt duration had crept up to 330 days by August 1998, the

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[4] Russia's own debt as at 1 January 1998, was 7.6 per cent of GDP, that is, 25.2 per cent of the total. In the first eight months of 1998, federal liabilities as a proportion of overall foreign debt, including the debts of the former USSR, reached 36.7 per cent.

funds needed monthly to retire the previous bond issues alone (leaving aside coupon payments on two- to three-year coupon securities, OFZ) had shot up to between 10 per cent and 15 per cent of monthly GDP.

The ratio of short-term domestic debt to household bank deposits, giving an inkling of the total domestic financial savings in Russia, points to a long lead of domestic debt, which continued into the fall of 1997, from spring 1996, when it had topped one.

This situation forced the decision to open the internal public debt market to non-residents. Given the persistent fiscal deficit and limited domestic borrowing sources, the government had no alternative to non-residents: it was either to contrive to narrow the fiscal deficit or to throw the door to the domestic debt market wide open to non-residents.

Starting on 1 January 1998, the Central Bank and the Russian government announced the removal of all restrictions for non-residents entering the Russian debt market (guaranteed yields were waived and restrictions on profit repatriation periods lifted). The presence of non-residents on the GKO-OFZ market was steadily growing. According to the Russian Finance Ministry, non-residents accounted for almost 28 per cent of the market in April 1998.

Another point to be made, the significant easing of foreign capital controls and the consequent decline of government debt servicing costs gave the government an illusion of trouble-free reality, with enough funds to finance the government fiscal deficit, at least in the mid-term. From this perspective, the admission of non-residents to the domestic debt market had a disastrous effect on the government's economic policy by intensifying the moral risks of the soft budgetary policy option, which did not anticipate a rapid contraction of the fiscal deficit and, hence, the need for more public borrowing.

Although foreign borrowings have longer maturity dates than domestic market securities, Russia is beginning, in 1999, to repay the credits and loans it received from international financial organizations in the relatively distant past, while from 2001 on it will have to retire the Eurobonds placed in 1997 and 1998. In the next 10 years, the annual costs of repaying the debts falling due to the international organizations and the interests payments to investors who have purchased Russian Eurobonds will range from \$3.5 billion to \$5 billion. As if it were not enough, the grace period on debt repayment to the London and Paris clubs ends in 2002, boosting significantly annual foreign debt repayments.

Still, it is safe to say that the government debt management policy in 1997 and 1998 did not make full use of external borrowings instead of loading up with domestic debt. The advantages of external borrowings include their longer terms and absence of risks of ruble exchange rate fluctuations for the investors, which together make the price of borrowings less dependent on the current exchange rate policy. In our view, the attempts made in that period to step up external borrowings by floating Eurobonds were not consistent enough. A total of \$14.9 billion worth of Eurobonds was floated in 1997 and 1998. Had consolidation (that is, substitution of long-term debt for short-term debt by altering the ratio of internal to external borrowings) been more forceful, the threat of financial crisis could have been deflated, if not averted.

1.2.2. The Balance of Payments

In analyzing the major changes in the balance of payments figures, it is important to remember the inherent contradictions of Russia’s economic situation in summer 1997. On one hand, the plunge of oil prices at the source fed fears that the ruble was overvalued in the changing market conditions and that, therefore, devaluation could be expected. These expectations were fomented by the rising costs of foreign debt servicing and repayment. The need for an adjustment of the current exchange rate policy and a moderate devaluation of the ruble was obvious in the last quarter of 1997 when a clear trend emerged for the official gold and forex reserves to be used as an important source of deficit financing and the forecasts for the world energy markets pointed to a stubborn price downtrend.

On the other hand, in an economic situation highlighted by a short-term government debt and a high-profile presence of non-residents on the debt market, any attempts to tamper with the exchange rate policy (in particular, attempts to accelerate the gradual devaluation of the ruble) send foreign investors scampering from the financial markets, interest rates shooting up, demand for foreign exchange soaring, the forex reserves thinning out, and the risk of default on government debt and biting devaluation looming up. In the end, the policy of letting the ruble devalue gradually to bring the balance of payments back into equilibrium grinds to a halt. That was what we witnessed in 1997 and 1998.

Starting in the second quarter of 1997, the current account balance was moving solidly into the red (with the sole exception of the fourth quarter of 1997 when the balance stood at no more than $400 million). The key factors accounting for the contraction of the current account balance include the bad market for Russia's main export commodity groups (Figure 1.1 shows Russia's trade balance almost following the fluctuations of world oil prices), and the increased interest payments to non-residents by the government and private sector (the 1997 bottom line puts the total revenues paid for capital services at $8 billion, or 1.75 per cent of GDP, see Figure 1.2).

Despite the continued drop in world oil prices, the Russian trade balance surplus surged thunderously in the third quarter of 1998, propelled by the ruble's devaluation, to $4.35 billion, largely as a result of a cut in imports (to $13.5 billion down from $17 billion in the second quarter). The BOP current account also showed an improvement over the preceding period, to $217 million, which can, matter-of-factly, be fully attributed to the trade balance growth, with the revenue balance surplus standing at $3.4 billion in the third quarter, a tad below the second quarter showing.

Despite the poor showing of the current account, the balance of the current capital and financial account in 1997 and 1998 stayed in the black, at $19.5 billion, or 4.2 per cent of GDP, in 1997, pulling the total balance of payments up into surplus. The 1997 financial account surplus was, however, created by the influx of foreign portfolio investments showing up in the balance of payments,[5] the balance for the remaining

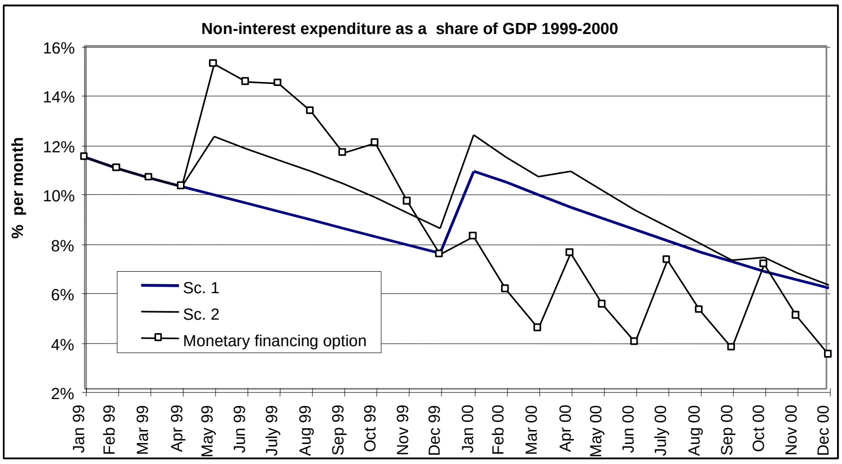
[5] In 1993, non-residents' Russian assets increased at a rate only insignificantly higher than that of Russia's foreign assets, the latter being smaller than the former in 1994. In 1995, residents' foreign portfolio investments rose faster than non-residents' investments in Russia as well. This trend reversed in 1996, however: whereas foreign portfolio investments in Russia were equal to 0.03 per cent of GDP

items of the capital and financial account were swinging over the year between faded red and grayish black.

all through 1995, as compared to 0.42 per cent of GDP for Russian foreign investments, the former grew to 2.21 per cent of GDP in 1996, and the latter slid to 0.04 per cent of GDP. The year 1997 could be rated as a period of the heaviest influx of foreign portfolio investments into Russia: as it closed, the difference between the growth of the non-residents' Russian assets and that of residents' foreign assets topped $46 billion, or 10.02 per cent of GDP, with the influx of foreign investments into Russia registering at 10.06 per cent of GDP. In all, foreign portfolio assets in Russia built up to $56.4 billion (4.4 per cent of GDP) over the three years, leaving the Russian portfolio assets abroad far behind with $1.9 billion (0.15 per cent of GDP).

Fig. 1.1

**RF trade balance and world oil prices
1995 to 1998***



*- trade balance for the 4th quarter of 1998 as estimated by the Bank of Russia.
Sources: RF Central Bank, International Financial Statistics

Fig. 1.2

RF current account and balance of capital services
1995 to 3rd quarter of 1998

Source: RF Central Bank.

Fig. 1.3

Reconstructed balance of investment accounts in RF balance of payments and overall balance
1995 to 3rd quarter of 1998

Source: RF Central Bank, estimates by the book’s authors

The poor showing of the financial balance of payments account in 1997 was precipitated by the restructuring of Russia's liabilities for the debts of the former USSR to the members of the London Club by a bond issue to cover the principal ($22.1 billion) and interest arrears ($6.1 billion). The restructuring was shown in the balance of payments as a reduction of the debt owed by the public sector on contracted loans (reduction of debt arrears) and a corresponding increase in the debt on non-residents' portfolio investments (as a result of securities issue). In order to arrive at BOP accounts giving a true picture for the fourth quarter of 1997, we reconstructed the "portfolio investment" and "general government liabilities" accounts of the Russian balance of payments by reducing residents' liabilities on portfolio investments by the amount of restructured debt and simultaneously increasing general government liabilities (see Fig. 1.3).

An analysis of Russia's 1997 reconstructed balance of payments shows a significant reduction in the balance of the portfolio investment account in the fourth quarter to $906 million (0.72 per cent of GDP) and the total net balance of payments to $9.9 billion (-7.9 per cent of GDP). The movement of foreign portfolio investments reached a critical turnaround point in the fall of 1997. Alongside the sudden collapse of Russian export prices, this factor set off, in late 1997 and the first six months of 1998, a catastrophic swell of the balance of payments deficit held under control by infusions of the Central Bank's diminishing external reserves.

In the last quarter of 1997, its gold and forex reserves dropped by a further $5.9 billion. Even worse, in the second quarter of 1998, Russia posted a trade balance deficit, its first since late 1993, which spread to the non-factor services as well (at over $300 million), the current account deficit continued to run up (hitting well above $4 billion), and foreign debt servicing costs were steadily on the upgrade (net capital services went over the $4 billion mark). The situation made a U-turn in the third quarter of last year: as we said above, the growing trade balance pulled up the current account balance at the cost of an insignificant decrease in capital gains. The default on GKO-OFZ debt falling actually on the last month of the quarter and the huge securities payoffs in July and August helped maintain the net gains deficit at a high level.

The net capital and financial account held in the black through the three quarters of 1998, dipping slightly, to $1.5 billion, in the third quarter. An analysis of the third quarter financial account figures shows the most shattering changes to have occurred in the portfolio and other investment accounts. In particular, foreign portfolio assets in Russia shrank by $726 million over this period, a striking contrast to the quarterly growth of foreign portfolio investments by between $2 billion and $8 billion in the preceding periods.

Among the unfavorable changes in the financial account figures for July to September 1998, the deepest imprint was left by the growth of Russian foreign assets and the dwindling of foreign liabilities, in particular, the bulging of residents' current accounts and deposits abroad ($83 million), draining of non-residents' Russian deposits and current accounts ($1.48 billion), the swelling of Russian export credits and drying up of export of revenues ($4.2 billion), bloating of residents' forex holdings ($1 billion), and even the flight of loans from the banking sector ($3.25 billion).

While in the spring and early summer of 1998 the current balance of payments deficit was contained by attracting foreign portfolio investments and IMF loans and by a run on the Central Bank's gold and forex reserves, by August 1998 the foreign exchange reserves as a source of deficit financing had virtually been bled white (from July 1997 through August 1998, the Central Bank's gold and forex reserved had been left $12 billion short). The crisis shut off all avenues for a continued inflow of portfolio investment, while the first IMF tranche had been spent within a record time to support the ruble exchange rate.

Under these conditions, the BOP deficit in the third quarter of 1998 was financed from two sources: an IMF loan ($4.8 billion) and, until August 25, forays into the foreign exchange reserves (the third quarter claimed $2.3 billion in forex reserves). With the reserves dried up, the only way to maintain a balance of payments equilibrium was to devalue the national currency, which was actually done on August 17, followed soon by a contraction of imports.

When we worked on this survey, we lacked official figures on the Russian balance of payments for the whole of 1998. According to the Central Bank's provisional estimates, however, the trade balance surplus continued to climb up in the fourth quarter of 1998 as well: with exports having dived by 30 per cent from the third quarter, imports had been dented more significantly (by all of 54 per cent). Again, according to Central Bank estimates for 1998 as a whole, the current account posted a deficit of $-0.8 billion, while the trade balance showed a net gain of $14.7 billion, down from $+3.56 billion and $17.5 billion, respectively, in 1997. In respect of the BOP capital account, it is expected that at the 1998 bottom line the net influx of capital into the Russian Federation will pan out at $17.8 billion, including a net capital drain of $6.5 billion from the banking sector and an inflow of $7.1 billion to the corporate sector (in 1997, the corresponding figures were $44.1 billion, $+8.9 billion, and $13.5 billion, respectively). A look at the Russian balance of payments provokes a further question about the sources to repay the external debt principal and interests due in 1999 and pay off the third tranche of the external debt on foreign currency-denominated bonds, the OVVZs (a total of about $18 billion, including $9.2 billion owed by Russia proper). Most likely, given the mix of the above factors (the growing current account deficit, contraction of the Central Bank's gold and forex reserves, the gloomy outlook for loans from international financial organizations or any other investment), this amount will not be paid off. And more, a further devaluation of the ruble would not trigger the coveted cash-earning exports because of their price inelasticity. The only option still left open to the external debt managers in 1999 is to seek a further restructuring of Russia's foreign debt.

Table 1.3

RF balance of payments
1995 to 3rd quarter of 1998 (in millions of USD)

	Q1	Q2	Q3	Q4
		1995		
Current account	5506	2849	-819	425
Goods and non-factor services	4532	3742	1308	1629
Goods (trade balance)	5751	5980	4855	4221
Exports of goods	19059	20399	20494	22711
Imports of goods	-13308	-14419	-15639	-18490
Non-factor services	-1219	-2238	-3547	-2592
To nonresidents	2139	2766	2733	2887
By nonresidents	-3358	-5004	-6280	-5479
Balance of labor and capital services (revenue balance)	886	-883	-2071	-1299
Of which:				
balance of capital services	897	-813	-1923	-1226
To nonresidents	2559	612	410	531
By nonresidents	-1662	-1425	-2333	-1757
Current transfers	87	-10	-57	95
Received	191	174	160	285
Disbursed	-104	-184	-217	-190
Capital and financial account	-6161	-1802	-42	-13845
Capital account	-22	-73	-173	-80
Capital transfers	-22	-73	-173	-80
Financial account	-6139	-1729	131	-13765
Direct and portfolio investment	-1322	106	563	932
Assets	-1564	-150	-93	-23
Liabilities	242	256	656	955
Other investment	-4817	-1835	-432	-14697
Assets	-2624	1035	5794	-656
Forex holdings and deposits	-114	2454	846	1173
Trade credit and авансы	-228	2	8039	227
Loan disbursements (other than past-due)	1817	3748	1408	1585
Arrears	-4156	-3772	-1398	-1228
Other assets	57	-1397	-3101	-2413
Liabilities	-2193	-2870	-6226	-14041
Domestic currency holdings and deposits	193	198	433	1807
Trade credit and авансы	395	-433	-1278	-6774
Contracted loans	-2881	-2758	-5284	-9927
Other liabilities	100	123	-97	853
Reserve asset adjustment	146	-263	187	1006
Net errors and omissions	-3118	791	-4207	8237

	Q1	Q2	Q3	Q4
Overall balance	-3627	1575	-4881	-4177
Financing	3627	-1575	4882	4177
Reserve assets	-96	-5936	-1105	-3249
Exceptional financing	3109	3920	5319	6343
Use of new loans by general government to finance deficit	0	1690	1650	2144
use of IMF loans	0	1690	1650	2144
Payment arrears	899	560	1059	-1387
Deferred payments for official external debt service	2210	1670	2610	5586
Other operations	614	441	668	1083
Use of new loans by general government to finance deficit (other than IMF loans)	614	441	668	1083
1996				
Current account	3829	1759	2183	4339
Goods and non-factor services	3323	3423	4005	6465
Goods (trade balance)	4641	4921	5064	8442
Exports of goods	20872	21940	21918	25833
Imports of goods	-16231	-17019	-16854	-17391
Non-factor services	-1318	-1498	-1059	-1977
To nonresidents	2897	3251	4091	2718
By nonresidents	-4215	-4749	-5150	-4695
Balance of labor and capital services (revenue balance)	483	-1601	-1878	-2293
of which: Balance of capital services	603	-1491	-1781	-2215
To nonresidents	2610	710	446	465
By nonresidents	-2007	-2201	-2227	-2680
Current transfers	23	-62	56	165
Received	151	122	159	333
Disbursed	-128	-184	-103	-168
Capital and financial account	-6700	-5260	-7600	-5569
Capital account	-219	-66	-79	-99
Capital transfers	-219	-66	-79	-99
Financial account	-6481	-5194	-7521	-5470
Direct and portfolio investment	1872	1613	999	6965
Assets	9	-389	-163	-400
Liabilities	1863	2002	1162	7365
Other investment	-8353	-6807	-8520	-12435
Assets	-4792	-8122	-4948	-11441
Forex holdings and deposits	999	-5102	-1423	-4379
Trade credit and авансы	-1626	-1800	-1700	-4375
Loan disbursements (other than past-due)	2424	3123	2267	1685
Arrears	-4612	-2374	-1295	-1195

	Q1	Q2	Q3	Q4
Other assets	-1977	-1969	-2797	-3177
Liabilities	-3561	1315	-3572	-994
Domestic currency holdings and deposits	46	-48	645	674
Trade credit and авансы	75	-434	-571	131
Contracted loans	-3288	-2	-3614	-1325
Other liabilities	-394	1799	-32	-474
Reserve asset adjustment	-400	-798	-196	-90
Net errors and omissions	-2170	-2794	-1133	-2050
Overall balance	-5441	-7093	-6746	-3370
Financing	5441	7093	6746	3370
Reserve assets	-2034	3431	1390	54
Exceptional financing	4718	3102	4486	2581
Use of new loans by general government to finance deficit	1393	1013	677	672
- use of IMF loans	1393	1013	677	672
Payment arrears	725	619	619	729
Deferred payments for official external debt service	2600	1470	3190	1180
Other operations	2757	560	870	735
Use of new loans by general government to finance deficit (other than IMF loans)	2757	560	870	735
1997				
Current account	4040	-14	-853	382
Goods and non-factor services	5055	2502	2038	2958
Goods (trade balance)	6017	3620	3461	4420
Exports of goods	21154	20654	21718	25402
Imports of goods	-15137	-17034	-18257	-20982
Non-factor services	-962	-1118	-1423	-1462
To nonresidents	2915	3437	4265	3516
By nonresidents	-3877	-4555	-5688	-4978
Balance of labor and capital services (revenue balance)	-974	-2362	-2719	-2356
of which: Balance of capital services	-904	-2285	-2617	-2264
To nonresidents	2417	618	569	536
By nonresidents	-3321	-2903	-3186	-2800
Current transfers	-41	-154	-172	-220
Received	126	59	87	77
Disbursed	-167	-213	-259	-297
Capital and financial account	-3846	5484	-2855	20663
Capital account	-115	-317	-187	-179
Capital transfers	-115	-317	-187	-179
Financial account	-3731	5801	-2668	20842
Direct and portfolio investment	5967	9036	3275	30796

	Q1	Q2	Q3	Q4
Assets	-443	-691	-972	-652
Liabilities	6410	9727	4247	31448
Other investment	-9698	-3235	-5943	-9954
Assets	1209	-6295	-9952	-11581
Forex holdings and deposits	-1305	-1936	-4709	-4515
Trade credit and авансы	-859	-883	-1649	-3397
Loan disbursements (other than past-due)	4055	2340	396	212
Arrears	1830	-2736	-1004	-1138
Other assets	-2512	-3080	-2986	-2743
Liabilities	-10907	3060	4009	1627
Domestic currency holdings and deposits	-7492	569	948	1244
Trade credit and авансы	-423	28	120	211
Contracted loans	-2494	2123	2246	198
Other liabilities	-498	340	695	-26
Reserve asset adjustment	48	30	-49	-48
Net errors and omissions	-2479	-1207	-1358	-2709
Overall balance	-2237	4293	-5115	18288
Financing	2237	-4293	5115	-18288
Reserve assets	-1331	-8034	1616	5934
Exceptional financing	2960	2131	2624	-26637
Use of new loans by general government to finance deficit	646	701	677	0
- use of IMF loans	646	701	677	0
Payment arrears	994	1080	1107	-27227
Deferred payments for official External debt service	1320	350	840	590
Other operations	608	1610	875	2415
Use of new loans by general government to finance deficit (other than IMF loans)	608	1610	875	2415
		1998		
Current account	-1612	-4231	217	
Goods and non-factor services	27	-318	3609	
Goods (trade balance)	1170	1121	4354	
Exports of goods	18490	18235	17804	
Imports of goods	-17320	-17114	-13450	
Non-factor services	-1143	-1439	-745	
To nonresidents	2907	3295	3656	
By nonresidents	-4050	-4734	-4401	
Balance of labor and capital services (income balance)	-1261	-3771	-3358	
of which: Balance of capital services	-1156	-3675	-3288	
To nonresidents	2432	760	504	
By nonresidents	-3588	-4435	-3792	

	Q1	Q2	Q3	Q4
Current transfers	-378	-142	-34	
Received	63	62	35	
Disbursed	-441	-204	-69	
Capital and financial account	172	2592	-10083	
Capital account	-92	-189	-105	
Capital transfers	-92	-189	-105	
Financial account	264	2781	-9978	
Direct and portfolio investment	3732	3977	-47	
Assets	-450	-889	268	
Liabilities	4182	4866	-315	
Other investment	-3468	-1196	-9931	
Assets	-3553	-2141	-4817	
Forex holdings and deposits	1943	2002	-1139	
Trade credit and авансы	-96	-1154	-1735	
Loan disbursements (other than past-due)	1847	1603	1283	
Arrears	-3712	-2791	-488	
Other assets	-3535	-1801	-2738	
Liabilities	85	945	-5114	
Domestic currency holdings and deposits	-936	448	-1458	
Trade credit and авансы	-58	119	120	
Contracted loans	1331	-231	-3609	
Other liabilities	-252	609	-167	
Reserve asset adjustment	18	-1	7	
Net errors and omissions	-2241	-1359	-1729	
Overall balance	-3663	-2999	-11588	
Financing	3663	2999	11588	
Reserve assets	892	768	2596	
Exceptional financing	1745	1444	7699	
Use of new loans by general government to finance deficit	669	666	4798	
- use of IMF loans	669	666	4798	
Payment arrears	606	308	2301	
Deferred payments for official external debt service	470	470	600	
Other operations	1026	787	1293	
Use of new loans by general government to finance deficit (other than IMF loans)	1026	787	1293	

Source: RF Central Bank

1.2.3. Vulnerability of the Banking System

As the dollar raced ahead in 1992 to 1994, foreign currency-denominated loans predominated in the structure of commercial banks' assets. The rapid devaluation of the ruble-denominated liabilities allowed them to be used to finance even those projects that were inefficient in foreign exchange terms. The situation changed when the ruble had reached a flat plateau: the high real interest rate on ruble-denominated liabilities required a more efficient commitment of assets. Between 1995 and 1996, therefore, commercial banks were building up their forex liabilities. In the first quarter of 1997, these outweighed the banks' forex assets (see Fig. 1.4).

Moreover, at the close of the first quarter of 1998, the forex liabilities of commercial banks had more than doubled to \$19.2 billion from \$9.5 billion, reaching \$20.5 billion on 1 July 1998. Their leapfrogging was in consequence of a precipitous growth of contracted loans against relatively sedate current forex accounts and deposits (see Fig. 1.5).

Forex assets had expanded to about \$12.1 billion during that period, primarily as a result of expanded lending (see Fig. 1.6). This structure of the banking system balance (apart from its financial feebleness induced by the government's protectionism toward most major banks) was the obvious reason for its extreme vulnerability to national currency devaluation. Furthermore, massive foreign loans were collateralized by securities, which plunged in price as the financial crisis was raging, calling for extra funds to beef up the deposit accounts and kicking off a banking crisis.

1.3. The Economic and Political Fallout of the Financial Crisis

The financial crisis in Russia, which peaked in August 1998, had the following major economic implications:

– Confidence which foreign and domestic investors had placed in the government, the Central Bank, and the Finance Ministry in Russia was shaken, robbing the government of credibility in the eyes of both foreign and domestic lenders and bringing about an exodus of foreign investments and, by implication, dimming the prospects for economic growth.

– With both foreign and domestic sources of financing the fiscal deficit choked off, the country today is faced with the prospect of inflationary budgeting and a return to the old practice of the Russian government being fed out of the Central Bank's hand. And more, this turnabout would spur money supply growth rates and, inevitably, consumer prices, and sap the tough muscle of the monetary policy.

– The crisis of the domestic banking sector due to both financial market losses[6] and the shutdown of the GKO-OFZ market as the principal source of revenues and its interrelated wellsprings would worsen the crisis of arrears.

– The meltdown of the Russian stock market, which reflected the real lure of portfolio investment in the Russian corporate sector (the RTS-1 index fell off by 90 per cent between early October 1997[7] and early September 1998), would further undercut the Russian manufacturers' chances of attracting funds.

– Expectations of a rebound in the oil and gas industry and in other export-oriented sectors of the economy thanks to a twist in the ratio of ruble-denominated costs to foreign currency-

[6] At the time of the default, the Russian banks (minus Sberbank) had about 40 billion rubles in GKO-OFZ bonds among their assets. The losses incurred by Russian banks, which hedged the foreign investors' exchange risks, as a result of the ruble's meltdown range between $15 billion and $22 billion, according to various estimates.

[7] The RTS-1 Index reached its all-time high level of 571.66 on 6 October 1997.

denominated revenue may fail to materialize, as the government, squeezed as it continues to be by a budgetary crisis, may be tempted to scoop up surpluses from the sector by either slapping it with more taxes or by wringing the long-overdue budget arrears out of it. In much the same way, far from all domestic producers can build up production of import-substituting output, availing themselves of the long fall of the real ruble rate and the consequent decline in the competitiveness of imports. The outlook hangs on the rate of the forthcoming inflation as well.

The socio-political aftermath of the August 17th devaluation is too much in evidence to warrant detailed comments here. Its more prominent aspects are as follows:

First, the inflation explosion intensified social discontent. The worst hit segments and groups of the population were those who had supported the existing socioeconomic and political system – the new middle class (the employees of the fast-growing service industry), small business, and residents of large cities in general.

Second, the President's political standing was critically damaged. By insisting on Kiriyenko's approval as premier, President Yeltsin actually took the blame for the performance of the new cabinet. The devaluation and default dealt a heavy blow at the President, while the dismissal of the cabinet and the merging of the political crisis with the financial meltdown left a further dent in public confidence in Yeltsin and reinforced the political positions of those who had been calling for a change of the constitutional system and election of a new president. In all fairness, these developments strengthened the hand of the legislature. Finally, the appointment of Yevgeny Primakov, with unqualified Duma backing, to lead the cabinet made the new prime minister a powerful legitimate political player.

Third, there was a conspicuous jockeying for power and shifting of influence wielded by different interest groups. Above all, the political clout of the "oligarchs," particularly those with ties to the banking and energy business, was severely curtailed by the virtual bankruptcy of many a large bank and the waning of the financial might of the energy exporters. The military-industrial complex has regained political weight, but at the moment there is uncertainty about the relationships between its export-oriented industries and noncompetitive partners. The chances of the agrarian lobby have gone up.

1.3.1. The Crisis: Economic and Political Alternatives

The cataclysmic economic and political changes in August and September 1998 opened a new page in Russia's recent history. The current definitions of the developments that followed are largely similar – they spelled the end of the Yeltsin Era, an era of liberal reforms, and, now and then, even forewarned of the restoration of communist rule. All the definitions have their reasons and can be logically or historically motivated. All these interpretations, most of them rooted in political science ideas, are generally divorced from an analysis of economic processes which always and everywhere, and particularly in the current Russian context, set the mold for the possible and the necessary, guide, to a large extent, the governments' hand, and offer a yardstick to gauge the decisions taken and a crystal ball to peer into the medium term.

The Primakov government formed in September 1998 made no bones about its intention to veer decisively off the economic course the country had been steering. No executive had been making similar statements, at least since late 1992. And now, in September 1998, a "change of tack" was discussed in public. What else could be expected under the circumstances?

First, the Primakov government was formed with an active support and close involvement of the left political forces and their respective political factions – the Communists and Agrarians, in the first place. True enough, Communists and Agrarians were a frequent sight in the previous governments, in secondary roles, though. Now, it was their day. The familiar leftist heavyweights plonked into key cabinet chairs from where they could pull the strings. Most of them wore two hats – membership in or affinity with the Communist Party and affiliation with the traditional Soviet economic establishment, which has been a strong lobbying force in the last few decades. This two-hatter type is exemplified in the new government by Yury Maslyukov, Vadim Gustov, Victor Gerashchenko, and Gennady Kulik. Unlike the left and right, which are actually converging on common grounds in most West European countries, the leftist views on the economics and politics in present-day Russia differ cardinally from the conceptions and backgrounds of non-communist politicians.

Second, the need for a resolute change of tack was dictated by the scale and depth of the economic crisis. The meltdown in August 1998 was not just a financial collapse, without a disastrous domino effect on the country's social and political fabric. The price spike and loss of savings by the population, the multiplying unemployment figures, especially among the population groups with the greatest stakes in the market economy, the consumer market crisis, contraction of demand, and deterioration of the business environment pounced upon the country without warning, it seemed. Everybody was demanding change, even though different socio-political forces put totally different meanings into the term.

For all the turmoil, no one bothers to answer the question: how is the change to occur and what will the current policy be abandoned for? It is not difficult to work out that the real options open to the government are scarce and obvious enough. They logically flow from the hand-on experience in economic politicking in the post-communist period, particularly in 1995 through 1998.

Back to our subject, the Primakov government was, from day one, confronted with a tough political choice, which it could not skirt or reduce to a compromise between the alternatives. One alternative was a return to the practices of 1992-1994, which combined a soft monetary and an equally soft budgetary policy. Another was to hang on to a rigid monetary policy and work toward exchange rate stabilization, with radical budgetary reforms added for good measure, so the treasury revenues and expenditures could be put in balance, that is, seek compatibility and coordination between the Finance Ministry and the Central Bank. The choice between these two alternatives had an unmistakably political color.

The first alternative clearly leans toward inflation. The money supply in the economy is built up, sparking price hikes and devaluation of the national currency. The trick is expected to dispose of the heaping social problems, wipe out stagnant arrears, flush businesses with working capital, and jack up demand for domestically produced consumables, giving a boost to domestic consumer industries. This scenario was acted out in Russia in 1992-1994, when a spell of short-lived stabilization of production (that held for two or three months) was followed by a spurt of inflation and ruble tumbling. Given the stronger communist pull on the government, the most likely response to the price scramble would be attempts to freeze prices and introduce a mandatory dollar exchange rate. These attempts could have fully predictable consequences: a blooming black market and snowballing commodity shortages. Given our current circumstances, however, prices would wriggle out of effective control so we would end up with both an inflation and consumer shortages.

The second alternative aims at stabilization (keeping a lid on inflation). It seeks to achieve a rigid budget equilibrium and macroeconomic stabilization, which lie at the base of economic recovery. These aims are to be attained by determined measures to push the government budget into surplus, pursue a restrictive monetary policy (even introducing the currency board regime, if necessary), and continue measured economic liberalization. The structural and budgetary reform next in the pipeline are to brace up businesses for competition and readiness to find a market niche.

Both alternatives were made public literally within days and weeks following the outbreak of the full-scale financial crisis in mid-August. Most of the Economics Division staff of the Russian Academy of Sciences (RAS), led by D. Lvov, was consistently pushing for inflationary and dirigiste government policies, giving full voice to its preferences in a published open letter to the government, which spelled out their views and proposals. On the other extreme, a policy of rigid stabilization was formulated in a program put forward by liberal economists rallied around Yegor Gaidar.[8]

Making the choice between inflationism and a rigid stabilization policy is largely a political one. At the time, the choice of policy, of course, depended not on the choice of government, or the government's ideological, political, and social preferences alone; it also was influenced by the logic of events and obtaining circumstances. In particular, as domestic and outside finance sources were gone with the resignation of the Kiriyenko government, the country was being nudged toward the inflationary option. This option had not, however, been made inevitable by the previous developments; it had to be written by the government on a clean slate.

The chief political problem of choosing between the inflationary and stabilization alternatives was picking the social segments and groups who were to pay most of the bill for either economic policy the government opted for. These two models differed essentially in social context and payoffs.

The inflationary option benefits the banks, above all. Russia's banking sector owes its affluence to the 1992-1994 inflation, and now that many banks are floundering they can be thrown the life belt by the Central Bank in the form of cheap loans, "cheap money." It would knock down enterprises that have jumped on the market bandwagon, whether exporters or producers of manufactures competitive on the domestic market. The lack of monetary stability is eroding their operating base and holds back their investment plans and growth prospects.

Inflation is at its worst in large cities and industrial centers, because, first, it hurts the local enterprises, which have adapted to the market environment. Second, the urban population (particularly,

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[8] *See:* "Open Letter from Economists of the RAS Economics Division to the President, the Federal Assembly and the Government of the Russian Federation," *Ekonomika i Zhizn*, No. 37, 1998; and Yegor Gaidar et al., "Anti-Crisis Action Program," *Vremia*, 1 October 1998.

the residents of Russia's capital city) depend more heavily on stable commodity flows than the country dwellers or inhabitants of small towns. As money depreciates provisions cease flowing from farming regions which tend to impose restrictions on supplies going out, while foreign imports thin out to a trickle. By contrast, people in the hinterlands, in some ways maintaining their links to farming, can adapt to food ups and downs more easily. The aftermath of August 17th is a vivid demonstration of the high vulnerability of large cities (primarily Moscow) to prices running amok and commodity flows thrown into disarray.

The situation is different under a rigid monetary policy scenario. It closely integrates efforts to speed along the structural reorganization of Russia's economy and allow inefficient businesses – both manufacturers and bankers – to go bankrupt or change hands. This policy endeavors to retain the country's vibrant ties with world goods and capital markets, encourage competition, and restrict government intervention in economics.

Understandably, this policy benefits efficient businesses and large cities. With exchange rates holding steady, businesses are afforded favorable opportunities to implement investment programs. City dwellers, in their turn, are offered a wider choice of jobs or enterprise. The numerous labor market options ease the pain of unemployment, the inevitable companion of economy restructuring, for urban agglomerations. The banks and inefficient businesses, however, are confronted by the stark choice of reorganization, not infrequently a very painful surgery. Unemployment is poised to deliver its blow, which would fall more heavily on the hinterlands, where job opportunities are much fewer than in large cities.

The two options dealt with above share some common and politically unpleasant, yet practically inescapable, upshots. In both options, the government's commitments, including social covenants, are lowered. Under a tight financial policy this occurs directly, with budget expenditures cut to the size of budget revenues. Inflation produces the same result, causing a devaluation of budget expenditures. Both options are painful, the second one being unjust to boot, with rising prices hitting the poorest segments of the population first.

1.3.2. Development of an Economic Program

Certainly, the Primakov government was not politically neutral from the outset, nor did it make a “clean choice” between the two economic policy alternatives. As it was hammered together, the government was expected to opt for inflationism and populism, the likelihood of which was suggested by the dominating presence of proxies of the agrarian and communist forces in the cabinet and the countless statements from politicians and economists supporting the government. The premier promised to pay off arrears to public sector employees and pensioners within months, if not weeks, cut the knot of interenterprise arrears, stabilize the ruble, and clean up the national house in general. Utterances about the need to begin a measured and controlled money issue, nationalize selected sectors of the economy, and introduce a mandatory exchange rate, if not ban foreign exchange possession, and much in the same vein could be heard almost daily from, among other big guns, top-caliber politicians.

The inflation option certainly had firm roots which could not easily be explained by the leftist (communist) visage of the new cabinet. The vast fiscal deficit and the conspicuous absence of external sources to close it nudged the government forcefully toward the printing press. Of course, another alternative was sharply reducing government spending, but it was unacceptable to the government, however, for political reasons, at least in the short term.

The printing press overtures were bolstered by ungainly institutionalist ideas which, too, raised serious apprehensions about the authenticity of the interpretation which the emerging cabinet was putting on the situation in the country and the possible moves by the authorities.[9]

Had the new government acted exactly like it was expected to, it would not be difficult to guess what came next. Actually, the model peddled to the government by advisors from the Duma and the Academy of Sciences was nothing new, having been tested over the post-World War II decades in dozens of countries, with the most spectacular results registered in Latin America. The model is called the "economics of populism" in specialist literature, and is well familiar to every economist.[10]

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[9] Typical in this respect were the suggestions made by Gennady Seleznyov regarding measures ostensibly needed to be put into effect in economic policy within a matter of days, literally. These ideas, actually planks of a program, were put forward almost immediately after Primakov's appointment. Seleznyov, the Duma Chairman, threw his full weight behind the appointee: "It is important to suspend the operations of the currency exchange and have the Central Bank issue a directive fixing the ruble exchange rate to the dollar at a ratio of seven to one.... Talks are to be held with financial interests in the West with a request to suspend the use of plastic forex credit cards to prevent the flight of foreign exchange out of the country.... A temporary ban is to be imposed on currency exchange offices to sell forex to the population. All they are to do is buy dollars.... The foreign exchange in the hands of commercial banks is to be used exclusively to purchase foodstuffs, daily necessities, and medicines." (Quoted in *Kommersant*, 11 September 1998, p. 2). Add to this proposals from the new government's brass to denationalize the loss-making enterprises of the military-industrial complex, which hardly went well with the simple logic of government action in the heat of the financial crisis. (Significantly, these ideas of the cabinet's doctrine implied nationalization of loss-making sluggards rather than prosperous export-oriented dynamos.)

[10] The economic policy of populism, when it is applied in practice, comprises four stages recurring, with due regard to local modifications, from country to country. These stages are:

At the first stage, the government concerned tries to speed up industrial growth by pumping funds from export-oriented industries into "national pride" industries (commonly engineering) and simultaneously expanding money supply. The economy responds to these measures by picking up, and public well-being begins to improve. The impression is that the government is scoring major points, about to turn the country into yet another economic miracle. The government is rapidly gaining in popularity.

At the second stage, the economy begins to show signs of getting out of balance. It turns out that the growing production and improving standards of living are attended by a worsening of some macroeconomic factors – growth of the trade and balance of payments deficits, contraction of forex reserves, and swelling of foreign debt. These adverse sidelights are, for a while, only apparent to professional economists (or only some of them, given the country's protracted detachment from real market economics). The budget

Sometime later, Primakov himself told foreign business people meeting for a Davos Forum session in Moscow about the kind of expectations that were encouraged in this country and overseas by the birth of the new government in Russia: “Not very long ago, we were hearing warnings that nationalization was the trunk road for the government – this hasn’t happened; that we were to go back on privatization..., that we would fix the ruble exchange rate – we haven’t, we are not going to fix it, let the ruble float. We were also warned of an uncontrolled money issue – this hasn’t happened; we were feared to ban dollar circulation in the country – we haven’t; to plug up imports – the imports are flowing in;... were we feared to support domestic producers to the disadvantage of foreign investors – no go again; we were rumored to stop paying off debts – we haven’t.” This is not an exaggeration, for such apprehensions really existed, fed by the mentality of the traditional Soviet establishment that was coming to power together with Primakov, rhetoric, and the communist tradition in post-communist Russia.

Faced with the stark reality, the Primakov government stepped more cautiously than it was expected. The fact that such expectations had been associated with it at all could hardly go unnoticed or put the cabinet in a more difficult position, awkward as it already was. Indeed, the inflation apprehensions could prove a “self-fulfilling prognosis,” infecting the moods and behavior of the business community. Moreover, these expectations (apprehensions)

is sputtering, but no attention is given to these “trifles” as long as manufacturing continues to chug along.

Way into the third stage, commodity shortages are building up in the public sector and free prices are inflating. Attempts to rein in the prices make commodity shortages even worse, and the inevitable devaluation of the national currency explodes into violent inflation. Tax collection slips and the budget collapses. Whatever the government is doing, living standards begin to drop and production falls off.

At the fourth stage, the government falls, and the new authorities (not infrequently military or emergency powers) adopt radical measures to calm the socioeconomic turmoil. (See: R. Dornbusch, S. Edwards (Eds.), *The Macroeconomics of Populism in Latin America*, University of Chicago Press, Chicago and London,1991, pp. 7-13.)

stood on firm ground, being an integral part of the draft schemes pondered by the government as it sat down to draw up its economic program.

The Primakov cabinet's program-making efforts and the premier's own economic ideas have undergone significant modification in the time the cabinet has been in office. Initially, its policy documents were shot with undisguised inflationist and dirigiste ideas, extremely to the point, as long you could call a spade a spade and talking about money printing did not make you blush. Later on, the documents were swamped with technicalities and fine specifics, with no room left deliberately for money issue or fiscal deficit.

The government started out on the ideas supplied by the RAS Economics Division. The no-nonsense approach to the program is evidenced by the fact that its authors, of all people, were lined up in the government's first group set up to develop its economic program, and that Yury Maslyukov sought regular counsel from the titled academics as group members for about a month after the birth of the new cabinet.

The program inspired by the "academics" was a document espousing the imaginably most consistent and rigid (if not extremist) breed of the ideas of populism, inflationism, and dirigisme. In form, it was a fairly integral and harmonious system of measures that could easily be formalized in legislation. According to the program fathers, the crisis was wholly rooted in the economic policy pursued since late 1991, first and foremost, in the liberalism of the economic policy, failure to make the best use of the government establishment's broad administrative powers, and exaggeration of the role of macroeconomic regulation in comparison with institutional reforms. Two closely affiliated ideas – jacking up consumer demand and getting the idling industries to work again – form the mainstay of the constructive planks of the program.

The program aimed at considerable cash injections to resolve social problems, stimulate demand as a way to end the slump, expand the payment system, and put the banking crisis under control. It even suggested to "automatically" activate the printing press to avoid arrears (any kind, not just the shortchange in the budget revenues) in the future. It viewed the printing press, therefore, as a cure-all to deal with the country's myriad economic problems, no less. It also called for rigid monetary controls, including suppression of the population's yen for foreign exchange.

Immediately as it was out, the program was flogged heartily in the public, not so much for its theoretical opportunism (manifest inflationism), as for its glaring detachment from the real economic processes of the day. Many of the measures it marshaled opened up a hitherto unprecedented scope for abuse on the part of both the government agencies (allocation of easy loans) and businesses. The idea of feeding loans to businesses developing arrears implied that virtually any entrepreneur could glut himself on "easy money." The blanket guarantee for the population's deposits could lead the banker to lure funds at fantastic interest rates – and file for bankruptcy. Examples of this kind abound.

By early October, the government had spawned its own economic program. Deprived of official endorsement, the document was produced at the Economics Ministry and circulated to the people concerned in the cabinet in early September. The public, including the mass media, were outraged, compelling Primakov to disown it. The program merits close scrutiny, though, for – unlike its later modifications – it is streamlined and specific.

In form and substance, it is a sibling of the "academic" program. It, too, relies heavily on the printing press to heal economic and social problems in record time, more obtrusive government intervention in the economy, including proscription of the dollar for hoarding and saving purposes. It also projects sweeping government regulation of prices and tariffs ("on the output of core manufacturing industries, food and non-food necessities", etc.), protectionism, and government tutelage for import-substituting industries.

All is not old wine in new bottles, though. As a very practical document, the program names agencies responsible for carrying the plans into effect. Unlike the “academic” version, it nearly misses the Central Bank among the “responsible agents,” loading the full burden of responsibility for jacking up demand on the Finance Ministry. The document loses the virgin innocence of the “academic” program.

The cabinet bosses were clearly frightened by their own inflationist moods and the general anticipations of inflation. The Central Bank, too, was dragging its feet over the money issue. It had learned its lessons well, and its realization of a direct link between money issue and inflation was vivid enough to translate talk about the bracing effect of more money sloshing around immediately into printing press activation. Central Bank chief Gerashchenko himself was evidently loath to assume responsibility for fueling a wild inflation and was pressuring the Duma into legislative action on the monetary policy.

By downsizing its profile on the money issue, the government was plainly trying to exploit its administrative powers. The ideas of tough exchange controls are set in bold type here. As the program appeared unofficially in the press, Eduard Rossel came out for banning the use of the dollar in Russia, a proposal that, he claimed, had the backing of the President. Much is to be read into this coincidence, although it was hardly deliberate. The simple reason is that these moods were at the time pervasive among that segment of the political elite which had close ties to the government. Faith in the Central Bank, exchange controls, and other forms of government intervention were coming on the heels of the ideas of unrestrained inflationism, overlapping them, it seemed.

Not surprisingly, a strong government is among the most popular catchwords today. Its zealots, however, are habitually wrong in tracing the reasons for weak government in post-communist Russia. It is held that weak government is a byproduct of the liberal ideology that sought to put the government beyond the economic framework, depriving the country of an effective tool to implement the economic policy and correct the “market flaws.” To restore the nation’s economic and political might, it is essential, therefore, to brand the previous doctrine as a mistake and to start working to consolidate the government and, particularly, to allow it to expand its influence on the country’s economy.

The reality is at great odds with this perception of the situation. It is not to be blamed on liberalism, for the liberal ideology upholds strong government acting within the rigid confines of the law. The absence of such government is exactly the hurdle that stands in the way of a liberal economic policy. Weak government is the hallmark of present-day Russia, brought about by the array of forces at work in its brief post-communist history. The first sign of weak government is its inability to collect taxes or put merciless budgetary constraints on businesses. Another sign of government weakness is crime – corruption in the civil service, on one hand, and the omnipresence of powerful criminal cartels usurping many government functions (arbitration, contract enforcement, protection of property), on the other. Deeper intervention by government officials in the economy under these conditions would further corruption and bureaucratic abuse, rather than work toward stronger government.

Beginning in late October, the program has been growing even more moderate and less specific. More exactly, it has been taking in a host of unrelated plans in the social and manufacturing spheres, tax policy, and interbudgetary relations. As previously, however, it betrays reluctance to give solid substance to the economic policy. Analysts poking around for the reasons of the crisis were now talking less about the fallacious policy of yesteryear and more about the implications of the budgetary crisis and ways to pull out of it. Maslyukov, you won’t believe it, went on record (in a statement to the delegates of the Davos Forum meeting in Moscow on December 4th) that the new government was going to accomplish what its predecessors wanted, but were unable to.

The core idea suddenly vanished from the program. No hopes were now placed on money issue. Rather, it exudes realization of the dangers haunting the economy awash with banknotes, as is evidenced by the recognition of "the critical gap between the necessity of a larger money supply and the possibility of inflation-free money printing," and the acknowledgement of "the danger of hyperinflation." Hopes for strong and wise government have eventually been reduced to a ritualistic chant about the need to "fortify the nationhood concept as a major source of improved economic performance." Ultimately, the Program was renamed, on the premier's cue, to a document with an elusive title "Apropos of Measures, etc.", as though to emphasize that the measures it contains have a loose, if any, relation to one another.

The microeconomic growth conception built into all the programs surveyed here is a very specific thing. In the first place, it gives negligible attention to the protection of private property, which is accorded only scant attention in most of the documents. It is symptomatic that, for example, the program version unveiled on August 27 totally avoids the concepts of "private property" and "private," while 13 of the 14 instances where mention is made of property reference is made to public property, in its various forms. "Privatization" did not merit attention at all. Here's a government that tends to parade its preference for direct over portfolio investments.

It would be unfair to reduce the government's program-mongering to a hodgepodge of finished or draft program products. Another two documents, the tax reform conception and the draft 1999 federal budget, certainly did and do play a *bona fide* program-setting role. They warrant a brief summary, which comes a few passages below.

The bottom line at the end of 1998 was that the government had, after months of program-mongering and pondering over the problems confronting the country and ways to resolve them, maneuvered itself into a corner. It had recognized the perils of the prescriptions borrowed from the cookbooks of the "economic policy of populism," yet it failed to come up with a worthy replacement for the initial (populist, print press reliant) action program. The cabinet was reluctant, and the premier lacked the will, to accept the unpalatable fact of only two alternatives – either rigid inflationism or rigid stabilization – open to them and, therefore, the inevitability of a choice to be made out of these two options.

The unwillingness to clinch the choice has driven Primakov to opt for evading critical decisions, putting them off for a better time. The political mandate conferred on the premier and the backing he got from the lawmakers and a large segment of the public justified his tactic. The speeding economic processes were leaving him ever less room for dodging movements. The government's practical moves, no matter how earthly and ideologically barren, was not politically neutral, by any measure, and were pushing it to the edge of the cliff, where it was to take the plunge.

1.3.3. Practical Economic Policy in Outline

The government's day-to-day policy consists of practical moves in economics and a stream of enactments churned out by the government. Accordingly, the cabinet members' assorted actions can be arranged into two groups. One group gathers measures, hand-me-downs from the Soviet economic establishment, to strike a compromise between the leading Soviet-era groups of interests, the agrarian and engineering lobbies. The other group unites moves to dismantle the brickwork put up by the preceding cabinets, particularly, the Kiriyenko government, mostly in taxes and budget management and attempts to steer financial flows. The government rescinded legislation that ran against the policy of balancing the main lobbies against one another, and embraced whatever did them a favor. The powerful lobbies were coddled by endorsement of previous cabinet decisions to cut taxes, allow output to be sold below cost, and a series of other steps that were certainly portrayed as measures to support the real economic sector.

Budgetary Policy

An analysis of the government's budgetary policy spotlights two essentially different approaches and, therefore, two groups of decisions that had entirely different effects on the prospects of the country's economic development. First, decisions that eroded the revenue base of the budget, above all, those affecting the tax policy. And second, preparation of the 1999 budget based on the principles of minimum money issue to finance the deficit. The conflict between these two approaches is largely explained by the evolution of the cabinet's macroeconomic views from inflationism in September and October to a realization of the need to stiffen the budgetary policy, in November and December. The conflict has a self-evident practical basis – the cabinet's desire, and the premier's private yearning, to avoid awkward moves and secure, as a reward, a maximum possible political backing for their decisions, however unpopular. Indeed, political support is critical for Primakov as a key factor behind the decisions he makes in economics.

The government's decisions and actions, therefore, fall into two groups and, accordingly, into two phases in his actual practices. First, the populist decisions of the first three months. And second, preparation of a cautious budget for 1999, the publication and adoption of which is, in fact, a stand-alone factor in the evolution of the economic situation. It is expected that a third phase, if and when it comes, will demonstrate the government's guts to translate their budgetary ideas into life.

The budgetary policy decisions rolling out in October through December were hitting the federal revenues, in the first place. The revenues were dissipating for three principal reasons. First, the budgetary take was undercut by government decision. Second, warning signals were sounded about the government's intentions, which dampened businesses' enthusiasm about paying taxes. Finally, third, decisions lopping off the tax base of the federal budget were made. Clearly, the first two reasons were most in evidence during the first few months of the Primakov government – much more time is needed to change the tax system, as the government was to seek approval of its decisions by the legislators.

In its early months, the government made a series of unorthodox decisions that exposed it to the lobbying crowd and showed its readiness to sacrifice federal revenues to please some interests. Typically, most of the government's moves aimed to rewrite the decisions of the previous governments, which had discovered from their own experience the efficiency of netting-out operations, custom-made tax payment schemes, indulgence of financial carelessness of big businesses, etc.

In its search for political support, the government went as far as signing separate covenants with giant taxpayers over when and how they were going to meet their obligations to the budget. The first covenant was signed with Gazprom, which was followed by a declaration of intent to keep up this practice. And more, according to Federal Tax Service officials, Gazprom was allowed to tie its tax payments to the arrears due to that gas giant from public sector entities.

Simultaneously, decisions were taken to permit wholesale setoffs among enterprises and budgets at all levels, quite in the spirit of the new government's program products. The experience of 1996 and 1997 conclusively showed that a mere mention of legitimacy being given to netting-out operations provokes a steep reduction of government revenues. Revenue denting was fated to happen when the government notorious for its kid-gloved magnanimous attitude toward real sector businesses, regardless of their financial standing, opted for setoffs.

Significantly, as the government gave the green light to setoffs it abandoned vigorous efforts to take persistent tax dodgers to court. Summary bankruptcy proceedings were, in effect, outlawed. The annulment of the bankruptcy proceedings against UralAZ (with Maslyukov as the power behind it) is little less than a meaningful signal to other tax evaders. The frequent statements of the government's intention to announce a tax amnesty worked to the same end. The government's readiness to collect some taxes in kind was a further step to widen the revenue drain hole.

Taking the ax to the tax tree, the government chopped down the ruling for VAT to be paid on an accruals basis[11] and reverted to the voluminous catalog of goods slapped with VAT at a rate of 10 per cent.[12] Although deeper changes in the tax system were tied to budget approval for next year, the deliberations on the proposed tax relaxation that started in the fall of 1998 were an early signal that, for the lawmakers, keeping businesses busy was more important than collecting taxes, even if than meant collecting few taxes.

In an effort to stabilize the ruble, the Central Bank directed on September 11 a return to the previous requirement for exporters to sell 50 per cent of their forex proceeds on the home market. This measure yielded a beneficial result in the short run. Over a longer term, it creates an irresistible lure to understate the forex earnings remittable to Russia.

The government's decisions on agribusiness and food provision for the nation were contradictory in essence, yet equally damaging to the budget.

Ostensibly, these steps were aimed to ease the situation of farmers and farm produce processing industries. In the good old communist tradition of four decades' standing, the government restructured, at the cost of 5 per cent p.a. for the beneficiaries (practically for nothing), the farmers' arrears to the budget. Tax dodgers took it for a hint that tax evasion was to be tolerated and economically sound, while the law-abiding taxpayers had to swallow the shortchange again.

To show its liberal side, however, the government hastened to bring down import duties raised, months before, by the Kiriyenko government to broaden the revenue base of the federal budget. Impatient to get the official endorsement of the "action program," it reduced customs duties on a long list of foodstuffs, above all meat and dairy products.[13] The government's haste could be attributed to

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[11] See Ruling by the Federal Supreme Court GKPI No. 98-448 of 2 October 1998.
[12] See Resolution of the Government of the Russian Federation No. 1203 of 25 October 1998.
[13] Resolution of the Federal Government No. 1226 of 21 October 1998.

the fear, which haunted Soviet economy bosses, of food shortages (which normally arrive in the train of their economic policies), the blunting of imports' competitive edge as a result of the ruble devaluation, the pressure put to bear upon it by the interests linked to food imports, and the difficulties of maintaining the high tariffs against the rest of the customs union (particularly with Belarus). Whatever point we look from, the decision works in a twofold way against the budget, throttling the revenues, and the domestic producer, whose competitive positions have been undercut. Obviously, the two decision packages have not been motivated by ideological considerations, but were squeezed out by lobby pressures from interests with many ties to the corrupt elements in the civil service,

A factor to be reckoned with was the need to pay political bills. The new policy outlines suggested a closer union with Belarus. On his first official visit to the republic's capital, Minsk, Primakov spoke about his desire to apply that country's positive experience in running Russian affairs. The looming prospect of integration with Belarus demanded that the Russian government forsake some of its economic interests for the benefit of its ally. This can be achieved by doing Belarus at least two favors. First, the government decided to accept manufactured goods, farming products in the first place, from Belarus as payment of its debts to Russia, a measure as costly as the renunciation of some tax revenues from Gazprom. Second, it was to close its eyes to the gaping "customs hole" on Russia's border with Belarus, whose government was not prone to coordinate its customs policy with Russia. Clearly, the Russian government was going to pay its political bills.

Among the government's other decisions, largely symbolic gestures, the most important were a move to reinstate a system of government guarantees to individual businesses[14] (coupled with an

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[14] The decision was truly unique. Actually, it was the first example in recent economic history of a decision to *resurrect* legislative acts buried two or three years before. It was not merely an economic move, but a political wink as well. Rather than saying he was introducing government guarantees, Primakov went for an unprecedented reinstatement of

ardent request to Western governments for humanitarian food aid) and cancelation of Kiriyenko's decision to transfer the bank accounts of cultural institutions to the Treasury. The above, and some of the unnamed decisions, have much in common. First, they all remove most of the obstacles to continued corruption in the civil service and shadow business. Second, they are an amiable bow to the lobbies. Finally, far from reinforcing government, they undermine it, while at the same time giving more scope to bureaucratic abuse in the interests of individuals and small groups.

It is only natural to expect the real budget revenues to dry up, the cash component of the revenues to ebb, and, therefore, the non-monetary sources to finance spending to shrink.

The performance of the 1998 budget may tentatively be broken down into three periods – from January to March, March to September, and September to year-end. The year opened with a seasonal slack in revenue flow to the federal budget and a buildup of a large deficit (4.7 per cent of GDP in January). This alarming deficit had been caused by high federal spending, which (in particular, the Credit Less Repayment section) recorded Rb4.3 billion in revenues that had not been credited to the Central Bank. In February, this spending item was not present in the budget, bringing the deficit down to a sound 1.8 per cent of GDP.

Table 1.4

Federal budget execution in 1998 (per cent of GDP)

MONTH	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
REVENUE												
1.Profit tax	0,9	0,9	1,2	1,4	1,4	1,3	1,3	1,3	1,2	1,2	1,2	1,3
2.Value added tax	4,4	4,2	4,1	4,2	4,1	4,0	4,0	3,8	3,6	3,6	3,6	4,0
3. Excises on excisable goods and selected mineral raw materials produced on RF territory	2,0	1,9	2,0	1,8	1,8	1,9	1,9	1,9	1,8	1,8	1,8	2,0
4.Taxes on foreign trade and foreign economic operations	1,0	1,1	1,2	1,2	1,4	1,4	1,3	1,3	1,2	1,2	1,2	1,4

repealed acts in an unabashedly demonstrative move. As with the Duma's resolution to restore the monument to Dzerzhinsky in downtown Moscow, the government publicly displayed its filial attachment to the ideology and practices promoting the revival of Soviet and neo-Soviet ways.

MONTH	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
5.Other taxes	0,2	0,4	0,3	0,3	0,3	0,3	0,3	0,3	0,4	0,3	0,4	0,2
TOTAL TAXES AND PAYMENTS	8,5	8,5	8,8	8,9	9,0	8,9	8,8	8,6	8,2	8,1	8,2	8,9
NONTAX REVENUE	1,7	1,8	1,9	1,8	1,9	1,9	1,9	2,0	2,0	1,9	1,9	2,5
TOTAL REVENUE	10,2	10,3	10,7	10,8	10,9	10,8	10,7	10,6	10,2	10,1	10,0	11,3
EXPENDITURE												
1.Government administration	0,3	0,3	0,3	0,4	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,4
2.National defense	2,0	2,0	1,9	1,9	1,8	1,9	1,8	1,7	1,8	1,8	1,9	2,1
3.International activities	0,1	-0,2	0,0	0,0	0,0	-0,1	-0,1	-0,1	-0,1	0,0	0,0	0,3
4. Justice	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
5.Law enforcement and security	1,1	1,2	1,2	1,2	1,2	1,1	1,1	1,1	1,0	1,0	1,0	1,2
6.Basic research and promotion of scientific and technological progress	0,2	0,2	0,3	0,3	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
7. Government services to the economy, of which:	0,4	0,7	0,6	0,7	0,7	0,8	0,8	0,8	0,8	0,8	0,8	0,9
8. Social services, o/w:	1,6	1,8	2,0	2,0	1,9	1,9	2,0	1,8	1,7	1,9	1,9	2,2
8.1.Education	0,2	0,4	0,4	0,5	0,4	0,4	0,5	0,4	0,4	0,4	0,4	0,5
8.2.Culture and arts	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
8.3.Mass media	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
8.4.Health and physical fitness	0,1	0,1	0,1	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
8.5.Social policy	1,3	1,3	1,3	1,3	1,3	1,2	1,2	1,2	1,1	1,2	1,3	1,4
9.Government debt service	2,7	3,3	5,0	4,9	5,3	5,2	5,4	5,1	4,5	4,1	4,0	4,0
10.Financial aid to other levels of government	1,5	1,4	1,4	1,6	1,5	1,6	1,4	1,3	1,2	1,2	1,2	1,6
11.Other expenditure	0,6	1	1,1	1	1,1	1,3	1,2	1,3	1,2	1	1,2	1,1
TOTAL EXPENDITURE	10,5	11,8	13,9	14,1	14,1	14,3	14,2	13,6	12,7	12,4	12,6	14,3
CREDIT LESS REPAYMENT	4,4	0,4	0,4	0,4	0,4	0,4	0,4	0,5	0,6	0,7	0,6	0,4
TOTAL EXPENDITURE AND CREDIT LESS REPAYMENT	14,9	12,1	14,3	14,4	14,5	14,7	14,7	14,0	13,2	13,1	13,2	14,7
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-4,7	-1,8	-3,5	-3,7	-3,6	-3,9	-3,9	-3,5	-3,0	-3,1	-3,2	-3,3
TOTAL FINANCING	4,7	1,8	3,5	3,7	3,6	3,9	3,9	3,5	3,0	3,1	3,2	3,3
DOMESTIC FINANCING	1,2	0,1	2,5	2,7	2,6	1,0	-0,6	-0,8	-0,8	-0,6	-0,3	-0,1
1.1.Change in bank acccount balances of budget funds, in rubles	-0,3	-1,6	-0,8	-0,7	-0,5	-1,3	-0,1	-0,1	-0,6	-0,5	-0,6	-1,2
1.2.Short-term government debt	1,5	1,9	2,9	0,8	0,6	-0,5	-3,4	-3,4	-3,0	-2,6	-2,3	-2,2
1.3.Federal floating rate bonds	0,0	0,0	0,0	-0,3	-0,2	-0,3	-0,3	-0,3	-0,3	-0,2	-0,2	-0,2
1.4.Non-marketable government bonds	-0,3	-0,4	-0,3	-0,2	0,0	0,2	0,2	0,2	0,1	0,1	0,0	0,0
1.5.Federal fixed rate bonds	0,0	0,0	0,9	3,3	2,9	3,0	3,2	3,1	3,0	2,8	2,9	3,4
1.6.Government savings bonds	0,3	0,1	0,3	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
1.7.Other domestic borrowing	0,0	0,1	-0,5	-0,4	-0,3	-0,3	-0,2	-0,3	-0,3	-0,2	-0,2	-0,2
EXTERNAL FINANCING	3,5	1,7	1,0	1,0	1,0	2,9	4,5	4,3	3,9	3,6	3,5	3,4
2.1.Loans from international	3,2	1,7	1,2	0,9	0,7	1,0	0,7	1,1	1,0	0,7	0,5	0,5

MONTH	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
financial institutions												
2.2.Foreign government loans to RF	0,3	0,0	-0,2	-0,2	0,0	0,0	0,1	0,1	0,1	0,2	0,0	-0,2
2.3.Loans from foreign commercail banks and companies to RF	0,0	0,0	0,0	0,3	0,3	1,9	3,6	3,1	2,7	2,8	2,9	3,2

The second period, from March to September, registered a higher level of takes (an average 0.5 per cent of GDP) than the start of the year, and a higher rate of federal spending (around 14 per cent of GDP). The spending went up mostly as a result of larger allocations to service government debt (about 5 per cent of GDP). Tax receipts in this period occasionally (in May) rose to 9 per cent of GDP.

Beginning in September, federal budget revenues sagged (to just over 10 per cent of GDP), and spending slid further by almost 1 per cent of GDP, little or no allocations being made to service the government debts in this period. The healthy growth of revenues and prodigal spending of federal money in December were precipitated by the clearance of arrears, on one hand, and repayment of debt to public sector dependents (target financing), on the other hand, as well as so-called bottom line evening (balancing of revenues against expenditures in the first week of January and somewhat later).

To qualify, an analysis of month by month performance of the budget as percentage of monthly GDP reveals a more noticeable uptrend in both the revenues and spending in March from the year beginning (revenues in March ran at 11.5 per cent of monthly GDP, of which taxes were coming in at 9.5 per cent of GDP, and spending surged to 18.3 per cent of GDP, as compared to 10.2 per cent of GDP in January for the revenues, with taxes accounting for 8.5 per cent of GDP, and 14.9 per cent of monthly GDP for spending), and a plunging downtrend for both the revenues and spending in September through November from mid-year (the revenues in September to November were a depressed 10 per cent of monthly GDP, with tax takes averaging a modest 6.5 per cent of GDP, against spending at 14 per cent of monthly GDP). From October 1998 on, Goskomstat (the Russian Statistics Committee) ceased publishing monthly GDP figures, so our figures are just guestimates. Which means that a likely overhaul of monthly GDP levels by Goskomstat may cripple the numbers arrived at specifically through an analysis of the performance curve as a percentage of monthly GDP more seriously than by an appraisal of the cumulative figures.

A month by month look at the federal budget revenues suggests that both the receipts in general and individual taxes, leaving aside the inspired hikes in December, peaked at mid-year. To illustrate, the profit tax high point of 1.4 per cent of GDP (in 1997, the profit tax take of 2.9 per cent of GDP occurred in August and May) was registered in April and May, VAT crested in April at 4.2 per cent of GDP (4.7 per cent in April 1997), and, finally, customs duties and fees topped at 1.4 per cent of GDP in May and June (1.7 per cent of GDP in April and May 1997). Excise duties are a thing apart, to an extent, being spread out evenly over the year, more or less. The spike in non-tax revenues in December is set down to the sale of the government's shareholding in Gazprom, which was unloaded for Rb13.8 billion.

A structural analysis of the federal budget revenues shows VAT (with 3.9 per cent of GDP) to be the biggest earner for the 1998 federal budget. It was trailed by excise duties (1.8 per cent of GDP), customs duties and fees (1.4 per cent of GDP), and profit tax (1.3 per cent of GDP). Together, these four tax categories accounted for nearly 90 per cent of all tax flows into the budget. In 1997, the situation was a trifle different, with 80 per cent of all revenues contributed by these sources.

Taxes contributing the remaining 10 per cent of the tax receipts included the earnings of the target budgetary funds and nature management taxes. Non-tax proceeds (1.6 per cent of GDP) consisted of gains from the sale of public property (0.6 per cent of GDP) and foreign trade receipts (0.6 per cent of GDP). Overall, the federal budget revenues were equivalent to 11.3 per cent of GDP in 1998, significantly lower than the year before, when they came to 12.4 per cent of GDP.

Another notable set of figures. According to Finance Ministry data, cash inflows to the federal budget in 1998 amounted to 10.2 per cent of GDP, of which 7.7 per cent of GDP was contributed by taxes. This compared favorably with 1997, when cash receipts ended up at around 7.0 per cent of GDP. To our mind, the latest improvement in cash receipts as a percentage of GDP was, in large measure, due to the tough stand taken by the Kiriyenko government which came all out against irresponsible budget performance. The cash taken in to finance government spending under the budget (less target allocations) was put at approximately 90 per cent (9.4 per cent of GDP).

Spending was more rigidly controlled, without major fluctuations under virtually all headings registered over the year. National defense spending was maintained at 1.8 per cent to 1.9 per cent of GDP, topping the average (to 2.0 per cent of GDP) in the period bridging January and February and in December only, to fall off to 1.7 per cent of GDP in August. Social spending held within the 1.8 per cent to 2.0 per cent bracket of GDP. It dipped only twice, to 1.6 per cent of GDP in January and to 1.7 per cent of GDP in September, rebounding to 2.2 per cent of GDP only once, in December. Law enforcement fared similarly (with spending steady at 1.0 per cent to 1.2 per cent of GDP through the year), and matched science (at 0.2 per cent to 0.3 per cent of GDP), and government administration (0.3 per cent to 0.4 per cent of GDP) in stability.

Spending to service government debt and support regional authorities behaved differently in 1998.

Government debt servicing plunged to a yearly minimum of 2.7 per cent of GDP in January, peaking to 5.4 per cent of GDP in July, exactly double the minimum showing. Between March and September, interest expenditures by the federal budget remained steadily at or above 5 per cent of GDP, while in September through December they went down to around 4 per cent of GDP. In percentages of monthly GDP, government debt service costs were the highest in March (8.3 per cent of monthly GDP) and the lowest in September and October, at 1 per cent of monthly GDP. In the second sample, variations were appreciably narrower, even if quite significant, between 1.2 per cent and 1.6 per cent of GDP.

In general, government debt servicing (4 per cent of GDP), defense (2.1 per cent of GDP), and social spending (2.1 per cent of GDP) were the largest expenditure items of the 1998 budget. In the social expenditure bracket, the biggest sums went to education (0.5 per cent of GDP) and social policy (1.5 per cent of GDP). Allocations to different industries (0.9 per cent of GDP), with manufacturing claiming 0.4 per cent of GDP, were the largest spending items of the remaining federal budget. In 1998, total federal budget expenditure worked out at 14.5 per cent of GDP (18.4 per cent of GDP in

1997), and the deficit bottomed out at 3.3 per cent of GDP (3.9 per cent of GDP in 1997).

Save February, the federal fiscal deficit never slipped below 3.0 per cent of GDP, registering a maximum (3.9 per cent of GDP) in June and July. The deficit financing structure was altered at mid-year 1998, after the government actually renounced, in May 1998, domestic borrowing, except for refinancing domestic government debt, abandoning domestic borrowing from mid-August fully in favor of external sources, which had come first beginning in June.

Wage arrears to the federal budget were paid in late 1998 and early 1999. According to estimates by Finance Ministry experts, they had reached Rb13.3 billion by early December, or 5 per cent of the November GDP. The federal budget arrears to the Pension Fund ran at 1.6 per cent of GDP in early 1999, having grown by only 30 per cent of this amount over 1998.

Table 1.5

Execution of 1998 consolidated budget (per cent of GDP)

MONTH	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
REVENUE												
1.Profit tax	2,3	2,5	3,0	3,6	3,7	3,7	3,5	3,5	3,4	3,3	3,3	3,6
2.Personal income tax	2,3	2,5	2,5	2,5	2,5	2,5	2,6	2,5	2,4	2,4	2,4	2,7
3.Value added tax	5,9	5,9	5,9	6,0	5,9	5,8	5,8	5,5	5,3	5,3	5,3	5,9
4.Excises	2,4	2,4	2,5	2,3	2,3	2,4	2,4	2,4	2,4	2,3	2,4	2,6
5.Property tax	0,5	0,6	0,8	1,3	1,6	1,6	1,6	1,7	1,7	1,6	1,6	1,8
6.Taxes on foreign trade and foreign economic operations	1,0	1,1	1,2	1,2	1,4	1,4	1,3	1,3	1,2	1,2	1,2	1,4
7.Other taxes	2,3	3,0	3,0	3,7	3,9	4,0	4,2	4,2	4,1	4,0	4,0	4,2
TOTAL TAXES AND PAYMENTS	16,2	17,4	18,1	19,3	19,7	19,8	19,8	19,4	18,8	18,5	18,6	20,5
TOTAL NONTAX REVENUE	2,6	2,7	3,2	3,1	3,2	3,4	3,4	3,4	3,5	3,5	3,4	4,3
TOTAL REVENUE	18,8	20,1	21,2	22,4	23,0	23,2	23,2	22,9	22,3	22,0	22,0	24,8
1.Government administration	0,9	1,0	1,0	1,1	1,1	1,1	1,1	1,1	1,0	1,0	1,0	1,1
2.National defense	2,0	2,0	1,9	1,9	1,8	1,9	1,8	1,7	1,8	1,8	1,9	2,1
3.International activities	0,1	-0,2	0,0	0,0	0,0	-0,1	-0,1	-0,1	-0,1	0,0	0,0	0,3
4. Justice	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
5.Law enforcement and security	1,4	1,5	1,6	1,6	1,6	1,5	1,5	1,5	1,4	1,4	1,4	1,6
6.Basic research and promotion of scientific and technological progress	0,2	0,2	0,3	0,3	0,3	0,3	0,2	0,2	0,2	0,2	0,2	0,2
7. Government services to the national economy.	3,4	4,5	4,6	5,0	5,2	5,5	5,5	5,4	5,3	5,2	5,3	6,2
8. Social services, of which:	6,7	7,2	7,7	8,4	8,4	8,8	8,7	8,4	8,0	8,0	8,1	9,0

MONTH	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
8.1.Education	2,6	2,8	3,0	3,4	3,4	3,7	3,7	3,6	3,4	3,3	3,3	3,7
8.2.Culture and arts	0,2	0,3	0,3	0,3	0,3	0,4	0,4	0,4	0,3	0,3	0,3	0,4
8.3.Mass media	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
8.4.Health and physical fitness	1,7	1,8	2,0	2,2	2,2	2,3	2,2	2,2	2,1	2,1	2,1	2,4
8.5.Social policy	2,2	2,2	2,3	2,3	2,3	2,3	2,3	2,2	2,1	2,2	2,2	2,4
9.Government debt service	2,7	3,3	5,0	4,9	5,3	5,2	5,4	5,1	4,5	4,1	4,0	4,0
10.Other expenditure	2,0	2,3	2,8	2,8	2,7	2,9	3,0	2,9	2,9	2,8	2,8	3,0
TOTAL EXPENDITURE	19,4	21,9	25,0	26,1	26,5	27,2	27,2	26,3	25,1	24,6	24,8	27,9
CREDIT LESS REPAYMENT	4,7	0,6	0,6	0,6	0,7	0,8	0,8	0,8	0,9	1,0	0,9	0,5
TOTAL EXPENDITURE AND CREDIT LESS REPAYMENT	24,1	22,5	25,6	26,7	27,2	28,0	28,0	27,1	26,0	25,5	25,6	28,4
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-5,3	-2,4	-4,3	-4,3	-4,2	-4,8	-4,8	-4,3	-3,7	-3,6	-3,6	-3,6
TOTAL FINANCING	5,3	2,4	4,3	4,3	4,2	4,8	4,8	4,3	3,7	3,6	3,6	3,6
DOMESTIC FINANCING	1,8	0,7	3,3	3,3	3,3	2,0	0,3	0,0	-0,2	-0,1	0,1	0,2
1.1.Change in bank acccount balances of budget funds, in rubles	-0,2	-1,5	-0,6	-0,7	-0,6	-1,1	0,0	0,0	-0,5	-0,6	-0,7	-1,1
1.2.Short-term government debt	1,5	1,9	2,9	0,8	0,6	-0,5	-3,4	-3,4	-3,0	-2,6	-2,3	-2,2
1.3.Federal floating rate bonds	0,0	0,0	0,0	-0,3	-0,2	-0,3	-0,3	-0,3	-0,3	-0,2	-0,2	-0,2
1.4.Non-marketable government bonds	-0,3	-0,4	-0,3	-0,2	0,0	0,2	0,2	0,2	0,1	0,1	0,0	0,0
1.5.Government (municipal) securities	-0,1	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,0	0,0	0,0	0,0
1.6.Federal fixed rate bonds	0,0	0,0	0,9	3,3	2,9	3,0	3,2	3,1	3,0	2,8	2,9	3,4
1.7.Budgetary loans from other-level budgets	0,0	0,0	0,1	0,0	0,0	0,0	0,0	0,0	0,0	0,1	0,1	-0,1
1.8.Government savings bonds	0,3	0,1	0,3	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
1.9.Other domestic borrowing	0,4	0,6	0,0	0,1	0,3	0,4	0,4	0,3	0,3	0,2	0,2	0,3
TOTAL EXTERNAL FINANCING	3,5	1,7	1,0	1,0	1,0	2,9	4,5	4,3	3,9	3,6	3,5	3,4
2.1.Loans from international financial institutions	3,2	1,7	1,2	0,9	0,7	1,0	0,7	1,1	1,0	0,7	0,5	0,5
2.2.Foreign government loans to RF	0,3	0,0	-0,2	-0,2	0,0	0,0	0,1	0,1	0,1	0,2	0,0	-0,2
2.3.Loans from foreign commercail banks and companies to RF	0,0	0,0	0,0	0,3	0,3	1,9	3,6	3,1	2,7	2,8	2,9	3,2

Table 1.6

Growth of arrears to the federal budget for 1998

	Deflated growth of arrears to the federal budget (in millions of Rbs)	Deflated monthly tax receipts by the federal budget (in millions of Rbs)
January	8298	15792
February	-4381	15274
March	2219	18467
April	10092	18527
May	8386	18617

June	543	17011
July	7172	17908
August	5051	14625
September	3143	10500
October	4498	12565
November	5589	14991
December	-1256	21415

The consolidated budget performance in 1998 was, in general outline, similar to the execution of the federal budget, yet it does not show the three periods of the latter as distinctly. Budget revenues were coming in at a steadily growing rate from the start of the year, when the budget stood at 18.8 per cent of GDP (with taxes amounting to 16.2 per cent of GDP), to 23.2 per cent of GDP in June and July (with taxes topping at 19.8 per cent of GDP). Toward year-end, the consolidated budget revenues fell to 22 per cent of GDP in November (with taxes declining to 18.6 per cent of GDP). Spending followed a similar pattern, peaking at 28.0 per cent of GDP in June and July, from a much lower level, 24.1 per cent of GDP, and slumping to 24.8 per cent of GDP in November.

An analysis of real monthly growth rates in tax arrears to the federal budget (see Table 1.6) shows arrears to be steadily on the upgrade through most of 1998, February and December being the exception, largely due to netting-out operations (target financing).

Table 1.7

Tax arrears to the federal budget for 1998

	Deflated arrears to the federal budget (in millions of Rbs)	Growth rate of deflated arrears	Arrears in per cent of monthly GDP
January	81566		60%
February	77644	-4,8	59%
March	78798	1,5	55%
April	85844	8,9	59%
May	91617	6,7	62%
June	91922	0,3	62%
July	96969	5,5	64%
August	97463	0,5	63%

September	72714	-25,4	57%
October	72863	0,2	58%
November	74136	1,7	58%
December	65515	-11,6	51%

Taxes due to the federal budget were much deeper in arrears than the year before – while they were 4 per cent of annual GDP in 1997, the figure at year-end 1998 was as high as 6 per cent of GDP.

A scrutiny of tax revenues as at the start of 1999 is revealing enough – they had shrunk, in comparable prices, from January and February 1998, outperforming September 1998 alone.

Little can be learned from a review of federal budget tax arrears as they are captured as stock numbers, and not flows. Some meaningful interpretation can be put on the situation, however. In particular, the ratio of accumulated arrears to monthly GDP came out at 64 per cent at mid-year (in July), a tad above the 60 per cent registered at the start of the year, in January, and way above the 51 per cent at year-end, in December. The decline of real arrears between August and September was not attributable to improved tax collection, but was engineered by a spurt of runaway inflation that month, with heavy consequences for the federal budget in the first place: when and if arrears are paid their real value would be far different from what it was when arrears had first emerged.

Accumulated tax arrears to the consolidated budget stood at 9.6 per cent of GDP as at 1 January 1999.

Table 1.8

Execution of the enlarged government budget (including extrabudgetary funds) for 1998 (per cent of GDP)

	Federal budget		Local budgets		Extrabudgetary funds*		Enlarged government budget		
	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	% of budget
REVENUE									
1.Income tax, profit tax	34974,4	1,3	132628,9	4,9			167603,3	6,2	17,8
1.1.Profit tax	34883,9	1,3	61495,0	2,3			96378,9	3,6	10,2
1.2.Personal income tax	90,5	0,0	71134,0	2,7			71224,4	2,7	7,6
2. Taxes on goods and services. License and registration fees	158455,4	5,9	72271,8	2,7			230727,3	8,6	24,5

	Federal budget		Local budgets		Extrabudgetary funds*		Enlarged government budget		
	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	% of budget
2.1.Value added tax	104749,0	3,9	51763,1	1,9			156512,1	5,8	16,6
2.2.Excises on excisable goods and selected mineral raw materials produced on RF territory	48272,0	1,8	15317,9	0,6			63589,9	2,4	6,8
Excises on oil, including gas condensate	7373,4	0,3					7373,4	0,3	0,8
2.2. Excises on excisable goods and selected mineral raw materials imported to RF territory	4181,5	0,2					4181,5	0,2	0,4
2.4.License and registration fees	428,0	0,0	3859,9	0,1			4288,0	0,2	0,5
2.5. Tax on purchase of foreign banknotes and foreign currency-denominated payment documents	824,9	0,0	575,7	0,0			1400,6	0,1	0,1
2.6. Sales tax			755,3	0,0			755,3	0,0	0,1
3. Aggregate income tax	313,0	0,0	1024,9				1337,9	0,0	0,1
4. Property tax	364,8	0,0	46529,1	1,7			46893,9	1,7	5,0
5.Fees for use of natural resources	3230,5	0,1	19044,5	0,7			22275,1	0,8	2,4
5.1.Royalty (fees for use of the subsoil)	1868,4	0,1	11231,6	0,4			13100,0	0,5	1,4
5.2.Fees for use of the continental shelf	0,1	0,0	36,7	0,0			36,8	0,0	0,0
5.3.Fees for use of forest stock			945,5	0,0			945,5	0,0	0,1
5.4.Fees for use of water bodies	5,3	0,0	382,7	0,0			388,0	0,0	0,0
5.5.Fees for statutory and excess emission and discharge of harmful substances and dumping	260,7	0,0					260,7	0,0	0,0
5.6.Land tax	1070,9	0,0	6143,0	0,2			7214,0	0,3	0,8
5.7.Fees for the right to use wildlife sites and water biological resources	0,9	0,0	3,1	0,0			3,9	0,0	0,0
5.8.Other fees for use of natural resources	24,3	0,0	302,0	0,0			326,3	0,0	0,0
6.Taxes on foreign trade and foreign economic operations	36544,4	1,4	0,1	0,0			36544,4	1,4	3,9
6.1.Customs duty	27404,8	1,0					27404,8	1,0	2,9
6.2. Customs fees							0,0	0,0	0,0
6.3.Other taxes and duties charged in respect of foreign economic operations	9139,6	0,3	0,1	0,0			9139,7	0,3	1,0
7.Other taxes, fees and duties	2101,5	0,1	36622,0	1,4			38723,5	1,4	4,1
7.1.Stamp duty	602,7	0,0	1067,9	0,0			1670,6	0,1	0,2
7.2.Other taxes	1498,8	0,1	35554,1	1,3			37052,9	1,4	3,9
8. Extrabudgetary fund receipts					258364,5	9,6	258364,5	9,6	27,5
8.1. Extrabudgetary social insurance fund receipts					206543,2	7,7	206543,2	7,7	22,0
8.1.1. Employees (Pension					5111,7	0,2	5111,7	0,2	0,5

	Federal budget		Local budgets		Extrabudgetary funds*		Enlarged government budget		
	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	% of budget
Fund)									
8.2.1. Employers					201431,5	7,5	201431,5	7,5	21,4
Pension Fund					143126,9	5,3	143126,9	5,3	15,2
Social Insurance Fund					31164,6	1,2	31164,6	1,2	3,3
Employment Fund					7823,2	0,3	7823,2	0,3	0,8
Compulsory Medical Insurance Fund (CMIF) and territorial CMIFs					19316,7	0,7	19316,7	0,7	2,1
8.2. Contributions to territorial road funds					51821,3	1,9	51821,3	1,9	5,5
9. Other extrabudgetary funds					819,5	0,0	819,5	0,0	0,1
10.Revenue of target budgetary funds	23734,9	0,9	17603,5	0,7			41338,5	1,5	4,4
TOTAL TAXES AND PAYMENTS	259718,9	9,7	325724,9	12,1	259183,9	9,7	844627,7	31,5	89,8
NONTAX REVENUE									
1.Revenue friom government property or activity	4065,0	0,2	9209,7	0,3			13274,7	0,5	1,4
2.Proceeds from the sale of government property	15239,5	0,6	2293,2	0,1			17532,7	0,7	1,9
3.Proceeds from the sale of national stockpile	3537,8	0,1					3537,8	0,1	0,4
4.Proceeds from the sale of land and intangible assets	12,5	0,0	265,6	0,0			278,1	0,0	0,0
5. Administrative charges	111,1	0,0	835,0	0,0			946,1	0,0	0,1
6.Penalties and indemnity	251,6	0,0	1062,3	0,0	4543,9	0,2	5857,8	0,2	0,6
7.Revenue from foreign economic operations	15435,2	0,6	45,3	0,0			15480,6	0,6	1,6
8.Other nontax revenue	1014,7	0,0	8522,0	0,3			9536,7	0,4	1,0
9.Transfers from other levels of government			43046,5	1,6			x	x	x
9.1. Subsidies			2743,5	0,1			x	x	x
9.2. Subventions			563,5	0,0			x	x	x
9.3.Remittances from netting-out operations			9680,9	0,4			x	x	x
9.4.Transfers			26731,1	1,0			x	x	x
9.5. VAT refund transfers			3327,5	0,1			x	x	x
10. Other grants			261,8	0,0			261,8	0,0	0,0
11. Receipts from government extrabudgetary funds			5222,7	0,2			5222,7	0,2	0,6
12.Revenue from government institutions	3000,2	0,1	1254,2	0,0			4254,4	0,2	0,5
13. Other government extrabudgetary fund income					19548,7	0,7	19548,7	0,7	2,1
14. Resources transferred to extrabudgetary funds					13935,1	0,5	x	x	x
14.1. Federal budget funds					8175,3	0,3	x	x	x
14.2. Local budget funds					5759,8	0,2	x	x	x
TOTAL NONTAX REVENUE	42667,6	1,6	72018,5	2,7	38027,6	1,4	95732,1	3,6	10,2

	Federal budget		Local budgets		Extrabudgetary funds*		Enlarged government budget		
	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	% of budget
TOTAL REVENUE	302386,5	11,3	397743,3	14,8	297211,6	11,1	940359,8	35,0	100,0
EXPENDITURES									
1.Government administration	9703,5	0,4	20291,4	0,8			29995,0	1,1	2,8
2.National defense	56704,1	2,1					56704,1	2,1	5,4
2.International activities	8533,8	0,3					8533,8	0,3	0,8
4.Justice	3291,8	0,1					3291,8	0,1	0,3
5.Law enforcement and security	30701,9	1,1	11885,8	0,4			42587,8	1,6	4,0
6.Basic research and promotion of scientific and technological progress	5172,4	0,2	507,3	0,0	14,2	0,0	5693,9	0,2	0,5
7. Government services to the national economy, of which:	23943,7	0,9	141464,7	5,3	33477,0	1,2	198885,5	7,4	18,9
7.1.Industry, power engineering and construction	11328,2	0,4	10877,3	0,4			22205,5	0,8	2,1
7.2.Agriculture and fisheries	3256,3	0,1	16192,7	0,6			19449,0	0,7	1,8
7.3 Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	2052,5	0,1	1211,8	0,0			3264,3	0,1	0,3
7.4. Transportation, road maintenance, communications and information technology	1005,7	0,0	17452,4	0,7			18458,2	0,7	1,8
7.5. Market infrastructure development			531,7	0,0			531,7	0,0	0,1
7.6. Housing and utilities			94419,4	3,5			94419,4	3,5	9,0
7.7.Preventing and/or eliminating the effects of emergencies and natural disasters	6301,0	0,2	779,4	0,0			7080,4	0,3	0,7
7.8. Expenditure by territorial road funds					33477,0	1,2	33477,0	1,2	3,2
8. Social services	57161,1	2,1	181710,2	6,8	220569,3	8,2	445505,5	16,6	42,9
8.1.Education	12928,1	0,5	84095,7	3,1	448,8	0,0	97472,5	3,6	9,3
8.2.Culture and arts	1035,1	0,0	9099,9	0,3			10134,9	0,4	1,0
8.3.Mass media	1087,9	0,0	1749,4	0,1			2837,3	0,1	0,3
8.4.Health and physical fitness	5660,1	0,2	58725,2	2,2	36894,1	1,4	101279,3	3,8	9,6
8.5.Social policy	36450,0	1,4	28040,0	1,0	183226,5	6,8	233781,4	8,7	22,5
of which: resources transferred to extrabudgetary funds	8175,3	0,3	5759,8	0,2			x	x	x
9. Government debt service	106571,4	4,0					106571,4	4,0	10,1
10. Expenditure by target budgetary funds	23617,7	0,9	16021,9	0,6			39639,6	1,5	3,8
11.Other expenditure	54034,5	2,0	31336,7	1,2	46310,8	1,7	88635,5	3,3	8,4
11.1.Financial aid to other levels of government	43046,5	1,6					x	x	x
- Subsidies	2743,5	0,1					x	x	x
- Subventions	563,5	0,0					x	x	x
- Transfers	26731,1	1,0					x	x	x
- VAT refund transfers	3327,5	0,1					x	x	x
- Remittances from netting-out	9680,9	0,4					x	x	x

	Federal budget		Local budgets		Extrabudgetary funds*		Enlarged government budget		
	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	in blns of Rbs	% of GDP	% of budget
operations									
11.2.Other expenditure unat-tributable to other subitems	10988,0	0,4	31336,7	1,2	46310,8	1,7	88635,5	3,3	8,4
TOTAL EXPENDITURE	379435,9	14,1	403218,1	15,0	300371,3	11,2	1026043,8	38,2	98,7
CREDIT MINUS REPAYMENT	9490,7	0,4	3910,6	0,1			13276,7	0,5	1,3
1.Budgetary loans	-1316,0	0,0	3910,6	0,1			2470,0	0,1	0,2
2.Government loans to CIS countries	-163,1	0,0					-163,1	0,0	0,0
3.Government loans to foreign governments	-8981,8	-0,3					-8981,8	-0,3	-0,9
4.Foreign credit resources disbursed to enterprises and organizations	20035,5	0,7					20035,5	0,7	1,9
5. Defense conversion credit	-40,9	0,0					-40,9	0,0	0,0
6. Investment credit	-43,0	0,0					-43,0	0,0	0,0
TOTAL EXPENDITURE AND CREDIT LESS REPAYMENT	388926,6	14,5	407128,7	15,2	300371,3	11,2	1039320,5	38,7	100,0
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-86540,1	-3,2	-9385,4	-0,3	-3159,8	-0,1	-98960,6	-3,7	
TOTAL FINANCING	86540,1	3,2	9385,4	0,3	3159,8	0,1	100246,2	3,7	
DOMESTIC FINANCING	-3647,0	-0,1	9385,4	0,3	3159,8	0,1	10059,0	0,4	
1.1.Change in bank acccount balances of budget funds, in rubles	-30758,3	-1,1	413,4	0,0	3899,4	0,1	-26445,5	-1,0	
1.2.Short-term government debt	-57012,7	-2,1	0,0				-57012,7	-2,1	
1.3.Federal floating rate bonds	-4762,6	-0,2	0,0				-4762,6	-0,2	
1.4.Non-marketable government bonds	867,7	0,0	0,0				867,7	0,0	
1.5.Government (municipal) securities			-364,2	0,0			-364,2	0,0	
1.6.Other government securities	23,9	0,0	0,0				23,9	0,0	
1.7.Federal fixed rate bonds	90614,6	3,4	0,0				90614,6	3,4	
1.8.Budgetary loans from other-level budgets			-2434,7	-0,1			x	x	
1.9.Government savings bonds	1533,0	0,1	0,0				1533,0	0,1	
1.10.Other domestic borrowing	-4152,7	-0,2	11770,9	0,4			6344,3	0,2	
1.11. Credits and loans to extrabudgetary funds					-739,5	0,0	-739,5	0,0	
2.1.Loans from international financial institutions	12164,5	0,5					12164,5	0,5	
2.2.Foreign government loans to RF	-5429,4	-0,2					-5429,4	-0,2	
2.3.Loans from foreign commercail banks and companies to RF	83452,1	3,1					83452,1	3,1	
EXTERNAL FINANCING	90187,2	3,4	0,0	0,0	0,0	0,0	90187,2	3,4	

* Estimate

Table 1.8 illustrates the performance of the consolidated budget of the enlarged government, including, in addition to the federal budget, the consolidated budgets of the RF constituent members and non-budgetary funds.

As regards the revenue structure of the aggregate consolidated budgets of the RF constituent members in 1998, one can identify revenues from profit tax (2.3 per cent of GDP), VAT (1.9 per cent), property tax (1.7 per cent of GDP), and income tax (2.7 per cent of GDP). Total budget revenues amounted to 12.1 per cent of GDP. The bulk of non-tax revenues (2.7 per cent of GDP) was accounted for by nonrefundable transfers from the federal budget (1.6 per cent of GDP). In 1998, the revenues of the RF constituent members' consolidated budgets reached 14.8 per cent of GDP, which exceeds the 1997 share (15.0 per cent of GDP) by 1.1 p.p. Practically the entire expenditure side of the RF constituent members' consolidated budgets consisted of social (6.8 per cent of GDP) and industry expenditure (5.3 per cent of GDP), with the largest share (3.5 per cent of GDP) falling to housing and utilities, that is, essentially quasi-social expenditures. In 1998, total expenditure amounted to 15.2 per cent of GDP (in 1997, 17.2 per cent of GDP).

In 1998, the estimated expenditure of extrabudgetary funds was 11.1 per cent of GDP (in 1997, 11 per cent), which is only 0.2 p.p. of GDP higher than the federal budget revenues. The receipts of the largest extrabudgetary fund, the Pension Fund, were 5.5 per cent of GDP, and the revenues from taxes and receipts of the Federal Road Service and the territorial road funds reached 1.9 per cent of GDP. Over 70 per cent of extrabudgetary funds' expenditure (11.2 per cent of GDP in 1998 and 10.8 per cent of GDP in 1997) was accounted for by social expenditure (8.2 per cent of GDP), with the various payments to the population amounting to 6.8 per cent and health care expenditure, to 1.4 per cent of GDP. In 1998, the expenditure of the Road funds was 1.2 per cent of GDP.

All in all, in 1998 the enlarged government budget revenues amounted to 35 per cent of GDP (in 1997, 36.4 per cent of GDP); slightly under 70 per cent fall to the budget of all levels, with the federal budget accounting for 32 per cent. Tax revenues equaled 31.5 per cent of GDP, with the RF constituent members' consolidated budgets receiving 40 per cent of the taxes and the federal budget, 30 per cent.

The highest share of tax revenues to the budgets of all levels was, in 1998, contributed by VAT, which reached 5.8 per cent of GDP (in 1997, 6.6 per cent); the federal budget received 67 per cent of VAT, which is significantly lower than the share envisaged under the law. The share of profit tax was 3.6 per cent of GDP (in 1997, 3.9 per cent), with 30 per cent going to the federal budget; income tax, 2.7 per cent of GDP (in 1997, 2.9 per cent); and excises, 2.6 per cent of GDP (in 1997, 2.4 per cent).

In 1998, the enlarged government budget expenditure side, which constituted 38.2 per cent of GDP (in 1997, 43.1 per cent), with the federal budget accounting for 37 per cent and the regional and local budgets, for 39 per cent, was 43 per cent social expenditure (16.6 per cent of GDP in 1998 and 17.9 per cent in 1997). The bulk of social expenditure (approximately one-half) fell to extrabudgetary funds and about 40 per cent, to regional and municipal budgets. If the so-called quasi-social expenditure - subsidies for transportation, housing and utilities - were added to the social expenditure on the various line items, it would turn out that more than half of the enlarged government's budget revenues (approximately the level of the previous year) was spent on the various social services to the population.

The other expenditure items: national defense (2.1 per cent of GDP in 1998 and 3.1 per cent in 1997), law enforcement (1.6 per cent of GDP in 1998 and 2.2 per cent in 1997), and industry (7.4 per cent of GDP in 1998 and 9.6 per cent in 1997) amounted to slightly under 30 per cent of the enlarged government's consolidated budget expenditure. A significant expenditure item in 1998 was the servicing of the government debt, namely, 4.0 per cent (in 1997, 4.5 per cent), which constitutes about 10 per cent of total expenditure.

Table 1.9

Domestic government debt structure

	1 January 1998		1 January 1999	
	in blns of Rbs	per cent of GDP	in millions of Rbs	per cent of GDP
1. Debt on securities, of which:	518799	20,06	480175	17,89
1992 government loan	105	0,00	125	0,00
1991 domestic government loan	80	0,00	80	0,00
GKOs	272612	10,54	14640**	0,55
OFZs	163352	6,32	448057**	16,69
Government savings loan	13082	0,51	14637	0,55
Non-marketable bonds	1768	0,07	2635	0,10
Debt on foreign-currency denominated domestic bonds (OVVZs)*	67800	2,62	229649	8,56
2. Arrears to banks (government guarantees)	4917	0,19	882	0,03
3. Ex-USSR arrears on commodity debt, of which:	4237	0,16	4875	0,18
1990 directed loan	2037	0,08	1910	0,07
Target deposits, car vouchers, wage arrears to agro-industry workers	2200	0,09	2965	0,11
4. Arrears to agro-industry converted into treasury bills	3920	0,15	3360	0,13
5. Arrears on centralized loans and accrued interest of agro-industry organizations in charge of northern winter supplies	25000	0,97	22002	0,82
6. Interest arrears of Ivanovo Oblast textile industry	560	0,02	490	0,02
7. Arrears on financing reserve stock costs	1994	0,08	1755	0,07
8. Other items, of which:	8233	0,32	7368	0,27
RF Central Bank’s domestic debt inherited from former USSR	191	0,01	191	0,01
Arrears on Central Bank’s technical loans to CIS countries	2408	0,09	2408	0,09
Arrears to the fuel and energy complex and other industries	5000	0,19	4181	0,16
Chelyabinsk Oblast agro-industry arrears on centralized loans and interest	94	0,00	94	0,00
Agroprombank guaranteed *veksels*	540	0,02	494	0,02
Total domestic government debt	500959	21,99	750556	27,96
Memorandum item: GDP (in trillions of Rbs)	2586000		2684000	

* Ministry of Finance statistics have referred to foreign-currency denominated domestic bonds as domestic debt since 1998. Data as at 1 January 1998 are based on total negotiable OVVZs valued at $11.3 billion.
** Includes bottom line evening. If bottom line evening is excluded, GKO arrears amount to Rb215 billion and OFZ arrears, Rb258 billion.

In 1998, the enlarged government's fiscal deficit was 3.7 per cent of GDP, which is 3 p.p. lower than in 1997.

As at 1 January 1999, the domestic government debt was Rb751 billion, which amounts to approximately 28 per cent of GDP and is almost 8 p.p. higher than the figure recorded on 1 January 1998. The structure of the government debt has changed. While in 1997, the debt on floated securities were 90 per cent of the government debt, in 1998 this figure rose to 95 per cent. The highest share was accounted for by GKO-OFZ arrears (62 per cent of the debt on securities, or 17.5 per cent of GDP) and OVVZs (32 per cent of the debt on securities, or 8.6 per cent of GDP). To compare, the 1997 arrears in GKOs-OFZs were 16.8 per cent of GDP, and of OVVZ, 2.62 per cent of GDP.

Among the other domestic debt items, it is worth mentioning the arrears on centralized loans and accrued interest of agro-businesses in charge of the so-called Northern winter deliveries, which were 0.8 per cent of GDP or 3 per cent of the domestic debt as at 1 January 1999 (1 per cent of GDP or 4.4 per cent of the domestic debt as at 1 January 1998). The rest of the domestic debt, apart from arrears on securities and Northern deliveries, amounted to less than 3 per cent of the overall domestic debt, or under 1 per cent of GDP.

During 1998, the domestic debt increased by 7 per cent of annual GDP.

The draft law on the 1999 federal budget was submitted by the government to parliament (the State Duma) on 11 December 1998 (see Table 1.10). It was passed in a first reading on 24 December 1998 without amendments as regards the size of expenditure, revenue and deficit, whereupon the State Duma debated amendments to some items of expenditure and revenue of the federal budget, most of which were not approved.

The adopted amendments changed the structure of budget revenues. Profit tax revenues were increased while VAT revenues were cut down by the same amount, Rb1,450 million. The latter was done because of the redistribution of overall VAT revenues in favor of the RF constituent members' budgets: according to the approved amendment, the regions' consolidated budgets are to get 15 per cent of VAT revenue (under the draft law on the budget, all VAT revenues were to go to the federal budget). It was proposed to increase the planned volume of tax revenues by Rb500 million at the expense of other taxes. Simultaneously, planned nontax receipts were lowered by Rb640 million.

Table 1.10

Draft law and Law on the 1999 Federal Budget

	Draft Law on the Federal Budget	per cent of GDP	Law on the Federal Budget	per cent of GDP
Income tax	25230,8	0,63	25230,8	0,63
Profit tax	34585,8	0,86	36033,4	0,90
VAT	145170,0	3,63	143722,8	3,59
Excises	87141,1	2,18	87141,1	2,18
Tax on foreign trade	91251,2	2,28	91251,3	2,28
Other taxes	15628,5	0,39	16120,3	0,40
Total tax revenue	399007,4	9,98	399499,7	9,99
Nontax revenue	74668,7	1,87	74176,4	1,85
Total revenue	473676,1	11,84	473676,1	11,84
Government administration	15556,9	0,39	13747,3	0,34
Law enforcement and justice	55549,5	1,39	56172,1	1,40
Defense	92202,5	2,31	93702,5	2,34
Science	11434,5	0,29	11634,5	0,29
Services to the national economy	33997,6	0,85	35017,6	0,88
Social expenditure	76734,5	1,92	78124,2	1,95

	Draft Law on the Federal Budget	per cent of GDP	Law on the Federal Budget	per cent of GDP
Government debt service	166844,4	4,17	166844,4	4,17
Domestic debt	66918,5	1,67	66918,5	1,67
External debt	99925,9	2,50	99925,9	2,50
Other expenditure, of which:	122726,7	3,07	119804,0	3,00
Financial aid to Russian regions	39944,4	1,00	43444,4	1,09
Total expenditure	575046,6	14,38	575046,6	14,38
Deficit	-101370,5	-2,53	-101370,5	-2,53
Domestic financing	55470,5	1,39	55470,5	1,39
External financing	45900,0	1,15	45900,0	1,15
GDP	4000000			

As for budget expenditure, most amendments that increased its size applied to: social expenditure (by Rb1,400 million), industry expenditure (by Rb1,100 million), expenditure on law enforcement (by Rb800 million), and expenditure on financial support for the regions (Rb3,500 million). Redistribution was done at the expense of expenditure on government administration (cut down by Rb1800 million) and some other items (by Rb6,600 million).

The draft law was passed by the State Duma in its fourth reading on 9 February 1999, approved by the Council of the Federation on 17 February 1999, and signed by the President on 22 February 1999.

The execution of the federal budget in January 1999 shows that in real terms, tax revenues dropped by 20 per cent from January 1998, with income tax revenues declining the most (by 80 per cent), and VAT and other indirect tax revenues the least (16 per cent). The latter can be explained by the fact that indirect tax revenues drop the least as a result of inflation, being adjusted automatically as prices go up.

Overall federal budget expenditure (in real terms) almost halved from January 1998 and declined by 60 per cent as compared to the top figure recorded in March 1998. As for individual items of federal budget expenditure, only expenditure on the servicing of the government debt remained, in real terms, at the 1998 level, while social expenditure dropped by 45 per cent, industry expenditure 92 per cent, and defense expenditure 70 per cent. Unlike in January 1998, a surplus of 1.5 per cent of federal budget expenditure was recorded this year.

Monetary policy

Developments in the sphere of monetary policy after August 1998 can be divided into three phases. The rapid rise in prices and the fall of the ruble exchange rate in September gave the fiscal authorities an opportunity to increase money supply without inflationary consequences and contributed to a perceptible decrease of the foreign currency exchange rate. This made it possible to use September and October to increase the RF Central Bank's foreign exchange reserves without a serious devaluation of the ruble and immediate acceleration of inflation. That was the case up to the end of October. A turnabout occurred between October 10 and November 10: the forex reserves first stabilized and then began to decline. Three weeks later, the inflation rate and the decline of the nominal ruble rate both accelerated. However, the RF Central Bank's tight monetary policy and intervention on the foreign exchange market made it possible to slow down the inflation rate in January-February 1999. At the same time, the depletion of gold and forex reserves continued. Let us examine these phases in more detail.

In September 1998, the economic and financial crisis related to the ruble devaluation and declined confidence in the Russian national currency continued to exacerbate. The over 60 per cent ruble devaluation and the sharp increase of the velocity of money caused a rapid rise of consumer prices. In the first week of September alone, the consumer price index rose by 35.7 per cent (see Fig. 1.7). Later, however, the inflation rate slowed down along with the declining US dollar exchange rate.

As has already been noted, the deceleration of the inflation rate in mid-September 1998 can be largely explained by the absence of growth in money supply in August 1998 (see Fig. 1.8 and Table 1.11).

In September, the Central Bank stepped up money-printing aimed at maintaining the banking system's liquidity and ensuring payments to the clients. In September-October, Rb26.1 billion was printed, which corresponds to a 16.45 per cent increase of money supply from the end of August 1998. The beginning of currency issue did not, however, accelerate the growth in prices. In October 1998, the consumer price index rose by 4.5 per cent, and in November, by 5.7 per cent, which amounts, respectively, to 69.6 per cent and 94.5 per cent in annual terms. This can be explained by a variety of reasons, including lower inflationary expectations,[15] technical lags between the outset of currency issue and its effect upon the inflation rate, and the lower money multiplier that emerged in the course of the banking crisis.

By the end of 1998, inflationary processes in the Russian economy began to gradually accelerate (see Fig. 1.7). After a significant price leap in September, which ensured price stability over the following month or two, in December 1998 consumer prices rose by 11.6 per cent. This means that in 1998, inflation in Russia was 84.3 per cent, or an average of 5.2 per cent a month. But the price growth throughout the year was uneven: while in the first seven months the consumer price index rose by only 4 per cent (an average of 0.56 per cent a month), between August and

[15] After an inflation leap in late August-early September 1999, the new price equilibrium was not adequate to the volume of money in circulation. However, due to a rigid price level, which in this case implies economic agents' (producers and go-betweens') reluctance to significantly reduce the already increased prices, no adequate deflation took place (see Fig. 7). As a result, the currency issue that followed (loans to the government and commercial banks) was largely used to support the price proportions established after the inflation leap (the real money stock rose). An important factor behind the lower inflationary expectations and increased real money supply was the exchange rate stability and the gradual rise of the RF Central Bank's gold and forex reserves that gradually occurred during that period.

December the prices increased by 77.2 per cent, or 12.1 per cent a month.

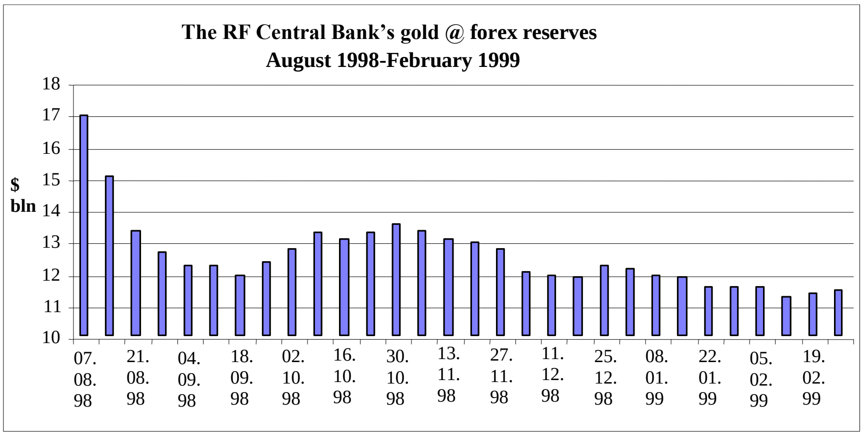
Table 1.11

	Base money (in blns of Rbs)	Rate of change in base money (%)	Gold and forex reserves (in blns of USD)	Rate of change in gold and forex reserves (%)
10-16.8.98	160,7		15,1	
17-23.8.98	161,8	0,68%	13,4	-11,26%
24-30.8.98	158,7	-1,92%	12,7	-5,22%
31.8-6.9.98	162,8	2,58%	12,3	-3,15%
7-13.9.98	167,3	2,76%	12,3	0,00%
14-20.9.98	170,3	1,79%	12,0	-2,44%
21-27.9.98	171,2	0,53%	12,4	3,33%
28.9-4.10.98	174,8	2,10%	12,8	3,23%
5-11.10.98	183,9	5,21%	13,3	3,91%
12-18.9.98	185,9	1,09%	13,1	-1,50%
19-25.10.98	184,8	-0,59%	13,3	1,53%
26.10-1.11.98	185,3	0,27%	13,6	2,26%
2-8.11.98	191,5	3,35%	13,4	-1,47%
9-15.11.98	192,3	0,42%	13,1	-2,24%
16-22.11.98	192,9	0,31%	13,0	-0,76%
23-29.11.98	191,9	-0,52%	12,8	-1,54%
30.11-6.12.98	193,3	0,73%	12,1	-5,47%
7-13.12.98	194,0	0,36%	12,0	-0,83%
14-20.12.98	192,5	-0,77%	11,9	-0,83%
21-27.12.98	199,0	3,38%	12,3	3,36%
28.12.98-3.1.99	207,3	4,17%	12,2	-0,08%
4-10.1.99	203,0	-2,07%	12,0	-1,64%
11-17.1.99	205,4	1,18%	11,9	-0,83%
18-24.1.99	202,2	-1,56%	11,6	-2,52%
25-31.1.99	201,1	-0,54%	11,6	0,00%
1-7.2.99	204,7	1,79%	11,6	0,00%
8-14.2.99	207,1	1,17%	11,3	-2,59%
15-21.2.99	205,8	-0,63%	11,4	0,88%
22-28.2.99	205,2	-0,29%	11,5	0,88%

Source: RF Central Bank

The situation began to change back in November 1998. The dynamic of the RF Central Bank gold and foreign exchange reserves changed direction (see Fig. 1.9 and Table 1.11). Throughout November, these reserves went down from $13.6 to $12.8 billion, that is, by $800 million. In November 1998, the RF Finance Ministry used the Central Bank money to make the payments on foreign debts. On November 27, the Finance Ministry made payments on the first tranche of five-year Eurobonds to the amount of $46.3 million, and on December 2, paid $216 million on IAN bonds. During the preceding month or two, the Central Bank had done its best to smooth out the dollar rate vacillations, but by end-November-early December, the ruble rate fell from 18 rubles to 20-21 rubles to the dollar. In December, the RF Central Bank's gold and forex reserves continued to dwindle. In the first three weeks of that month alone, they diminished by $900 million. In late December, the RF Government made payments on Eurobond coupons to the amount of approximately $330 million.

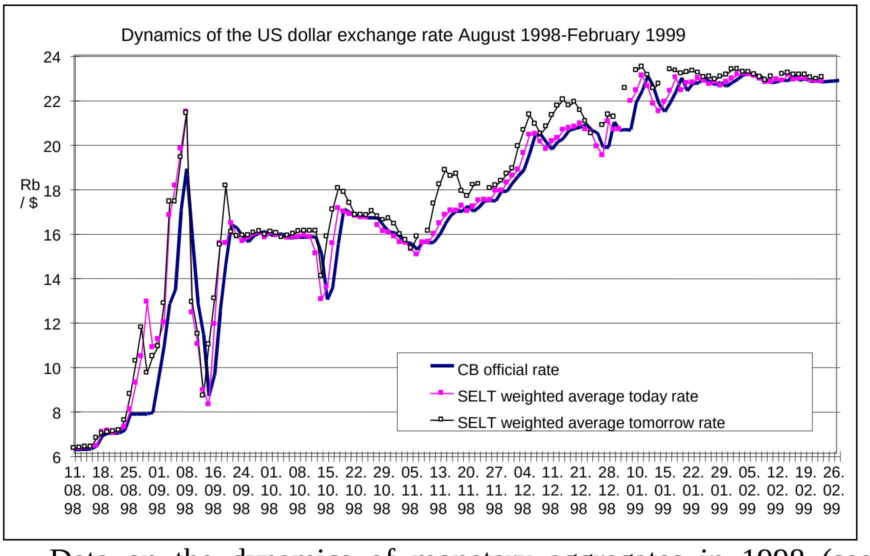
Fig. 1.9



Source: RF Central Bank

During 1998, the RF Central Bank gold and foreign exchange reserves decreased by a total of approximately $5.5 billion (from $17.784 billion to $12.223 billion, that is, by 31.3 per cent). The share of gold in the reserves rose from 27.5 per cent to 36.2 per cent.

Fig. 1.10



Data on the dynamics of monetary aggregates in 1998 (see Table 1.12) demonstrate that by and large, base money rose by 26 per cent (28.5 per cent from 1 August). In that year, the money stock M_2 increased by 21.0 per cent (25.7 per cent from 1 August), and the amount of broad money (including dollar deposits), by 36.3 per cent (43.9 per cent from August 1). The amount of currency in circulation went up by 44.0 per cent (45.2 per cent from 1 August). This means that the share of cash in M_2 rose from 34.86 per cent to 41.5 per cent. The withdrawal of bank deposits and the stricter rationing of loans owing to the overall crisis of the banking system caused the money multiplier to drop from 2.4 in January to 2.02 in October. In November-December it rose to 2.18. Overall, throughout the year, real money supply M_2 diminished 34.4 per cent. At the same time, as the GDP deflator lagged behind the growth rate of consumer prices and the rate of decline in real GDP, the monetization of the economy increased from 14.4 per cent (in 1997) to 16.85 per cent.

In January-February 1999, consumer prices' growth rates gradually slowed down (see Fig. 1.7). In January, inflation was 8.5 per cent (166 per cent p.a.) and in February, 4.1 per cent (62 per cent p.a.). This means that the CPI growth rate was the lowest since August 1998.

In February 1999, the RF Central Bank gold and foreign exchange reserves continued to decline (see Fig. 1.9 and Table 1.11). Since no planned payments on the Russian Federation's foreign debts were made during that period, the Central Bank most probably intervened on the foreign currency market with a view to stabilizing the ruble exchange rate. By February 12, the gold and foreign exchange reserves dropped to \$11.3 billion but rose by \$200 million by the end of the month.

The monetary policy pursued by the RF Central Bank in January and February 1999 was restrained enough (see Fig. 1.8 and Table 1.11). Overall, during January base money decreased by 6.2 billion (3 per cent) from the end of December 1998. In the first half of February 1999, a trend towards higher money supply appeared. Although by 15 February, the volume of base money practically reached the previous maximum value, by the end of the month it declined to Rb205.2 billion; nevertheless, the monthly growth was 2.04 per cent. With account of the Central Bank's sale of foreign exchange, gross currency issue in January was about Rb7 billion[16] and in February, about Rb6.4 billion.

Panic buying of foreign exchange between late August and October 1998 caused sharp fluctuations in the US dollar exchange rate (see Fig. 1.16).

[16] Gross currency issue is calculated as the sum of the change in base money and the volume of the issue sterilized by the Central Bank's sale of foreign exchange.

Key indicators of Russia's

	CPI, % per month	M_2, in blns of Rbs	M_2 growth rate, % per month	M_0, in blns of Rbs	M_0 growth rate, % per month	Base money, in blns of Rbs	Base money growth rate, % per month
Jan 97	2,3%	289900	0,75%	96300	-7,23%	123900	-5,35%
Feb 97	1,5%	299500	3,43%	102000	5,92%	130200	5,08%
Mar 97	1,4%	305800	2,41%	105200	3,14%	136300	4,69%
Apr 97	1,0%	317800	4,25%	115200	9,51%	145700	6,90%
May 97	0,9%	328400	3,35%	120400	4,51%	148200	1,72%
June 97	1,1%	352000	7,19%	136900	13,70%	167000	12,69%
July 97	0,9%	363000	3,22%	140400	2,56%	171400	2,63%
Aug 97	-0,1%	364600	0,59%	141600	0,85%	174700	1,93%
Sept 97	-0,3%	363000	-0,40%	134900	-4,73%	169800	-2,80%
Oct 97	0,2%	368800	1,62%	135800	0,67%	170600	0,47%
Nov 97	0,6%	357400	-2,93%	128800	-5,15%	163800	-3,99%
Dec 97	1,0%	374100	4,67%	130400	1,24%	164500	0,43%
Jan 98	1,4%	361200	-3,45%	116700	-10,51%	150500	-8,51%
Feb 98	0,9%	362900	0,47%	120400	3,17%	152400	1,26%
Mar 98	0,6%	360400	-0,69%	119100	-1,08%	152900	0,33%
Apr 98	0,4%	368000	2,11%	128600	7,98%	161200	5,43%
May 98	0,5%	370000	0,54%	129900	1,01%	163200	1,24%
June 98	0,1%	368600	-0,38%	129800	-0,08%	163200	0,00%
July 98	0,2%	360000	-2,33%	129300	-0,39%	161300	-1,16%
Aug 98	3,7%	343600	-4,56%	133400	3,17%	161700	0,25%
Sept 98	38,4%	365800	6,46%	154200	15,59%	175200	8,35%
Oct 98	4,5%	377600	3,23%	166400	7,91%	187200	6,85%
Nov 98	5,7%	396900	5,11%	167300	0,54%	191300	2,19%
Dec 98	11,6%	-	-	-	-	207300	8,36%

Note: CPI – Consumer Price Index, NDA - net domestic assets, NIR - net international reserves, GFR - gold and forex reserves.
Sources: RF Goskomstat, RF Central Bank

Table 1.12

monetary policy in 1997-1998

NDA, in blns of Rbs	NIR, in blns of Rbs	GFR, in blns of USD	Forex reserves, in blns of USD	Gold, in blns of USD	GDP, in blns of Rbs	
120700	3100	13993	9929,5	4063,5	172000	Jan 97
123600	6600	15207,7	11126,9	4080,8	175000	Feb 97
125000	11300	16508,7	12428,8	4079,9	194000	Mar 97
122200	23500	18184,3	14067,8	4116,6	202000	Apr 97
116900	31300	20016,1	15884,1	4132	205000	May 97
106100	60900	24548,9	20395,7	4153,2	213000	June 97
109300	62100	24456	20186,1	4269,9	222000	July 97
113800	60900	23920,2	19603,9	4316,2	241000	Aug 97
117100	52700	23105	18737	4368	252000	Sept 97
119200	51200	22915,5	18447,7	4467,8	242000	Oct 97
146000	17800	16809,9	12201,4	4608,5	226000	Nov 97
141200	23300	17784	12895	4889	258000	Dec 97
141100	9400	15375	10480	4895	187000	Jan 98
149200	3200	15034	10212	4822	184000	Feb 98
138800	14100	16859	11910	4948	198000	Mar 98
152800	8400	15953	10957	4996	205000	Apr 98
163400	-200	14627	9625	5002	206000	May 98
154500	8700	16169	11161	5008	207000	June 98
166000	-4700	18409	13805	4604	214000	July 98
202300	-40600	12459	8198	4262	226000	Aug 98
215300	-40100	12709	8840	3869	257000	Sept 98
221000	-33800	13572	9656	3916	-	Oct 98
229500	-38200	12480	8175	4306	-	Nov 98
-	-	12223	7801	4422	-	Dec 98

Weekly dynamics of Russia's financial

Week	Inflation, % per week	MICEX ruble rate, Rbs/$	$ exchange rate growth, % per week	Index RTS-1, by end of week	Rate of change in RTS-1index, % per week
4-10.8.97	0,00%	5813	0,14%	569,23	11,57%
11-17.8.97	-0,10%	5813	0,00%	563,14	-1,07%
18-24.8.97	0,00%	5825	0,21%	525,25	-6,73%
25-31.8.97	0,00%	5839,5	0,25%	474,80	-9,60%
1-7.9.97	-0,10%	5839,2	-0,01%	488,46	2,88%
8-14.9.97	0,00%	5850	0,18%	483,75	-0,97%
15-21.9.97	0,00%	5862	0,21%	497,94	2,93%
22-28.9.97	-0,20%	5861	-0,02%	491,42	-1,31%
29.9-5.10.97	0,00%	5877	0,27%	552,14	12,36%
6-12.10.97	0,00%	5869,9	-0,12%	527,78	-4,41%
13-19.10.97	0,10%	5868	-0,03%	532,90	0,97%
20-26.10.97	0,10%	5873	0,09%	518,29	-2,74%
27.10-2.11.97	0,10%	5900	0,46%	422,26	-18,53%
3-9.11.97	0,20%	5902	0,03%	438,34	3,81%
10-16.11.97	0,20%	5909	0,12%	342,07	-21,96%
17-23.11.97	0,20%	5917	0,14%	382,59	11,84%
24-30.11.97	0,00%	5928	0,19%	328,49	-14,14%
1-7.12.97	0,40%	5943	0,25%	382,42	16,42%
8-14.12.97	0,20%	5922	-0,35%	339,25	-11,29%
15-21.12.97	0,30%	5923	0,02%	354,41	4,47%
22-28.12.97	0,20%	5955	0,54%	380,11	7,25%
29.12-4.1.98	0,40%	5998	0,72%	396,86	4,41%
5-11.1.98	0,30%	5,999	0,02%	372,46	-6,15%
12-18.1.98	0,40%	6,0255	0,44%	334,54	-10,18%
19-25.1.98	0,40%	6,048	0,37%	294,71	-11,90%
26.1-1.2.98	0,20%	6,04	-0,13%	284,35	-3,52%
2-8.2.98	0,20%	6,0475	0,12%	304,04	6,93%
9-15.2.98	0,30%	6,0525	0,08%	302,24	-0,59%

Table 1.13

market indicators August 1997 to December 1998

GKO-OFZ weighted average yield, % per annum	GKO/OFZ secondary market trade, in blns of Rbs	GKOs/OFZs in circulation by end of week, in blns of Rbs	GKO-OFZ auction rate, % per annum	GKO-OFZ market portfolio duration, by end of week, days	Week
20,12%	11885,204	312050,128	20,54%	214,93	4-10.8.97
21,47%	15453,983	313550,869	19,06%	216,39	11-17.8.97
19,23%	10617,683	315627,115	18,71%	217,77	18-24.8.97
19,50%	11257,131	317008,224	18,67%	222,10	25-31.8.97
19,58%	13120,967	318825,768	18,60%	226,24	1-7.9.97
18,81%	17435,253	320200,645	18,10%	233,44	8-14.9.97
20,54%	17966,633	322433,781	19,01%	235,12	15-21.9.97
19,18%	13594,635	323131,221	18,44%	236,81	22-28.9.97
22,75%	15488,706	327095,416	18,36%	245,50	29.9-5.10.97
20,34%	16119,549	334440,996	17,88%	242,99	6-12.10.97
21,65%	14862,621	329211,683	18,28%	248,77	13-19.10.97
21,94%	13021,797	330361,880	17,59%	251,85	20-26.10.97
28,30%	28180,178	332547,925	19,55%	256,38	27.10-2.11.97
24,69%	23179,448	333707,460	19,74%	257,90	3-9.11.97
29,24%	28938,773	334658,444	26,61%	255,79	10-16.11.97
30,44%	18069,85	335483,064	26,27%	251,75	17-23.11.97
40,48%	21694,138	337586,469	28,00%	248,17	24-30.11.97
40,77%	15573,864	338125,669	41,34%	244,74	1-7.12.97
36,64%	10805,339	339148,335	34,52%	241,17	8-14.12.97
33,82%	11719,2782	341291,113	32,57%	236,40	15-21.12.97
33,37%	9977,415	343077,919	33,66%	235,21	22-28.12.97
27,36%	4411,860	343077,919	0,00%	231,21	29.12-4.1.98
41,70%	5676,557	344398,774	32,83%	223,81	5-11.1.98
37,02%	9793,106	346574,460	34,71%	221,98	12-18.1.98
33,29%	12471,412	348418,880	32,14%	221,36	19-25.1.98
39,37%	14792,133	349193,781	41,38%	219,64	26.1-1.2.98
36,41%	21309,455	351434,161	44,47%	220,49	2-8.2.98
30,24%	16361,676	355411,408	34,68%	222,85	9-15.2.98

Week	Inflation, % per week	MICEX ruble rate, Rbs/$	$ exchange rate growth, % per week	RTS-1 index, by end of week	Rate of change in RTS-1 index, % per week
16-22.2.98	0,20%	6,046	-0,11%	305,81	1,18%
23.2-1.3.98	0,20%	6,045	-0,02%	309,56	1,23%
2-8.3.98	0,10%	6,065	0,33%	339,66	9,73%
9-15.3.98	0,20%	6,066	0,02%	350,20	3,10%
16-22.3.98	0,10%	6,0815	0,26%	335,78	-4,12%
23-29.3.98	0,10%	6,092	0,17%	341,48	1,70%
30.3-5.4.98	0,10%	6,092	0,00%	313,48	-8,20%
6-12.4.98	0,10%	6,134	0,69%	308,96	-1,44%
13-19.4.98	0,10%	6,1415	0,12%	312,69	1,20%
20-26.4.98	0,10%	6,139	-0,04%	326,16	4,31%
27.4-3.5.98	0,00%	6,1095	-0,48%	312,37	-4,23%
4-10.5.98	0,10%	6,128	0,30%	302,82	-3,06%
11-17.5.98	0,10%	6,1525	0,40%	258,10	-14,77%
18-24.5.98	0,10%	6,154	0,02%	225,41	-12,67%
25-31.5.98	0,10%	6,13	-0,39%	191,29	-15,14%
1-7.6.98	0,00%	6,178	0,78%	207,65	8,55%
8-14.6.98	0,10%	6,21	0,52%	178,13	-14,22%
15-21.6.98	0,00%	6,216	0,10%	174,65	-1,95%
22-28.6.98	0,00%	6,225	0,14%	163,99	-6,11%
29.6-5.7.98	0,00%	6,215	-0,16%	151,33	-7,72%
6-12.7.98	0,10%	6,231	0,26%	144,02	-4,83%
13-19.7.98	0,10%	6,209	-0,35%	193,35	34,26%
20-26.7.98	0,00%	6,27	0,98%	157,74	-18,42%
27.7-2.8.98	0,10%	6,272	0,03%	149,65	-5,13%
3-9.8.98	0,20%	6,285	0,21%	132,86	-11,22%
10-16.8.98	0,20%	6,31	0,40%	115,00	-13,44%
17-23.8.98	2,90%	7,005	11,01%	81,76	-28,90%
24-30.8.98	10,90%	7,86	12,21%	66,77	-18,33%
31.8-6.9.98	35,70%	16,99	116,16%	63,13	-5,45%
7-13.9.98	5,60%	12,87	-24,22%	62,31	-1,30%

Table 1.13 continued

GKO-OFZ weighted average yield, % per annum	GKO/OFZ secondary market trade, in blns of Rbs	GKOs/OFZs in circulation by end of week, in blns of Rbs	GKO-OFZ auction rate, % per annum	GKO-OFZ market portfolio duration by end of week, days	Week
29,65%	14511,897	358865,780	35,32%	226,70	16-22.2.98
28,84%	13239,447	362202,605	32,31%	226,96	23.2-1.3.98
26,83%	17329,613	367470,807	28,53%	232,97	2-8.3.98
26,45%	14168,811	371091,590	29,05%	239,18	9-15.3.98
26,79%	16826,720	373767,032	27,86%	242,85	16-22.3.98
27,82%	22150,965	378813,702	25,98%	247,21	23-29.3.98
28,42%	15934,378	380320,665	28,57%	248,11	30.3-5.4.98
28,71%	15249,230	382804,428	34,23%	252,89	6-12.4.98
28,86%	13326,875	387165,160	33,81%	260,43	13-19.4.98
30,54%	15544,843	389134,692	34,93%	264,39	20-26.4.98
29,40%	11727,225	393345,432	31,84%	268,96	27.4-3.5.98
27,94%	11566,586	397651,534	34,16%	271,69	4-10.5.98
33,11%	10767,486	398084,164	34,16%	272,95	11-17.5.98
45,77%	19094,463	398577,325	45,16%	270,28	18-24.5.98
64,96%	24610,293	399281,413	61,07%	266,63	25-31.5.98
51,45%	20938,528	399016,673	53,15%	265,60	1-7.6.98
46,55%	13799,083	400853,454	48,04%	269,68	8-14.6.98
54,29%	19576,525	395901,065	49,31%	284,61	15-21.6.98
52,72%	12827,391	394435,777	51,19%	287,41	22-28.6.98
72,44%	15457,959	391975,482	63,11%	291,62	29.6-5.7.98
125,77%	15045,254	387523,792	107,23%	288,08	6-12.7.98
52,94%	34163,636	383185,563	0,00%	302,44	13-19.7.98
45,11%	18323,277	382555,058	48,96%	315,77	20-26.7.98
56,41%	19155,219	347498,481	0,00%	337,39	27.7-2.8.98
54,66%	14305,244	343554,332	0,00%	334,38	3-9.8.98
95,58%	12488,508	340326,857	0,00%	330,59	10-16.8.98
-	-	-	-	-	17-23.8.98
-	-	-	-	-	24-30.8.98
-	-	-	-	-	31.8-6.9.98

GKO-OFZ weighted average yield, % per annum	GKO/OFZ secondary market trade, in blns of Rbs	GKOs/OFZs in circulation by end of week, in blns of Rbs	GKO-OFZ auction rate, % per annum	GKO-OFZ market portfolio duration by end of week, days	Week
-	-	-	-	-	7-13.9.98

Week	Inflation, % per week	MICEX ruble rate, Rbs/$	$ exchange rate growth, % per week	RTS-1 index, by end of week	Rate of change in RTS-1 index, % per week
14-20.9.98	1,50%	14,60	13,40%	50,12	-19,56%
21-27.9.98	-4,80%	15,61	6,92%	47,08	-6,07%
28.9-4.10.98	0,60%	15,99	2,43%	38,81	-17,57%
5-11.10.98	0,40%	15,82	-1,06%	42,55	9,64%
12-18.10.98	0,30%	13,56	-14,29%	55,32	30,01%
19-25.10.98	2,10%	16,76	23,60%	60,42	9,22%
26.10-1.11.98	1,20%	16,01	-4,47%	57,54	-4,77%
2-8.11.98	0,80%	15,01	-6,25%	61,13	6,24%
9-15.11.98	1,00%	16,41	9,33%	59,32	-2,96%
16-22.11.98	1,70%	16,96	3,35%	63,36	6,81%
23-29.11.98	2,00%	17,88	5,42%	71,57	12,96%
30.11-6.12.98	2,60%	19,57	9,45%	64,00	-10,58%
7-13.12.98	2,20%	20,10	2,71%	58,67	-8,33%
14-20.12.98	1,80%	20,75	3,23%	59,24	0,97%
21-27.12.98	3,50%	19,48	-6,12%	59,94	1,19%
28.12.98-3.01.99	2,00%	20,65	6,01%	58,93	-1,69%

Sources: RF Central Bank, RF Goskomstat, Finmarket Information Agency, RTS, Institute for the Economy in Transition

To protect the national currency against speculative onslaughts in the situation of a floating exchange rate, in September 1998-January 1999 the Central Bank took a number of administrative steps to restrict demand for foreign exchange:

(1) It was decided to oblige exporters to sell 50 per cent (from September) and 75 per cent (from 1 January 1999) of their foreign

exchange earnings on the interbank currency exchanges which hold Central Bank licenses.

Table 1.13 continued

GKO-OFZ weighted average yield, % per annum	GKO/OFZ secondary market trade, in blns of Rbs	GKOs/OFZs in circulation by end of week, in blns of Rbs	GKO-OFZ auction rate, % per annum	GKO-OFZ market portfolio duration by end of week, days	Week
-	-	-	-	-	14-20.9.98
-	-	-	-	-	21-27.9.98
-	-	-	-	-	28.9-4.10.98
-	-	-	-	-	5-11.10.98
-	-	-	-	-	12-18.10.98
-	-	-	-	-	19-25.10.98
-	-	-	-	-	26.10-1.11.98
-	-	-	-	-	2-8.11.98
-	-	-	-	-	9-15.11.98
-	-	-	-	-	16-22.11.98
-	-	-	-	-	23-29.11.98
-	-	-	-	-	30.11-6.12.98
-	-	-	-	-	7-13.12.98
-	-	-	-	-	14-20.12.98
-	-	-	-	-	21-27.12.98
-	-	-	-	-	28.12.98-3.01.99

(2) A new sales procedure which envisages the separation of trading sessions was introduced. At the morning special session, the mandatory sale of foreign currency by exporters and the purchase of foreign currency against import contracts are held, with the transactions implying immediate delivery. Based on the special session, the Central Bank announces the official exchange rate for the following day. At the afternoon session, foreign currency transactions are conducted by commercial banks for their own needs and for clients. Delivery takes place on the following day.

(3) Commercial banks are obliged to submit to the Central Bank daily reports on their foreign currency transactions; failure to

comply with the Central Bank's instructions may entail banishment from the trading.

(4) As from November 1, a seven-day limit was imposed on how long foreign currency bought against import contracts could be kept on bank accounts. Upon the expiry of this term, the foreign currency not used for the specified purpose is to be surrendered for sale.

(5) It was prohibited to purchase foreign currency at special sessions to pay for the import of services, works and products of intellectual activity.

(6) Resale by resident legal entities of foreign currency purchased on the domestic market and deposited on special transit forex accounts may take place only at special morning sessions.

Also, the rules of managing C accounts for nonresidents were revised. A government resolution on innovation in respect of government securities aimed at reducing the export of capital envisaged a special procedure for nonresidents' use of cash received by them on innovation terms.

In our view, although these steps cannot be regarded as compatible with market principles, they are justified in the current economic situation. It is indicative that there is practically no spread between the official exchange rate, the SELT dollar rate and the selling and buying rates at the bureaus de change. This belies the assumption that the official ruble rate is a non-market one.

In February 1999, the ruble/dollar exchange rate stabilized. Having made payments on foreign debts in January, the Central Bank's interventions effectively fixed the exchange rate at slightly less than 23 rubles to the dollar (see Fig. 1.10).

Production dynamics and social stability

According to the Center for the Study of Economic Trends,[17] the end of the panic on the consumer market added to the ruble devaluation stepped up import-substitution, as a result of which the industrial production recession in October and November had a smaller scale than had been predicted from an inertial assessment of production dynamics.

In November through January, a number of industries showed growth not only from the previous month but from the same periods of 1997-1998. In January 1999 as compared to January 1998, engineering output rose by 2.3 per cent, timber and woodworking by 5.8 per cent, industrial building materials 2 per cent, glass, china and earthenware 2.6 per cent, and microbiology output by 0.4 per cent. Of course,. this is not much, but let us not forget that a year ago the Russian economy had already begun to show signs of growth, so that the reference point in this comparison is not the deepest low of the post-communist crisis.

One has to wonder about the reasons for these positive developments. In late 1998, the government managed, for the most part, to ensure macroeconomic stability (first of all, to prevent inflation from skyrocketing) and to more or less normalize the system of payments and settlements.

Generally speaking, there are two principal groups of factors that determined the production growth trend.

On the one hand, the ruble devaluation, which sharply undermined the competitive capacity of many imported products, generated a rapid rise in the efficiency of a number of domestic producers. This factor will continue to operate provided the real ruble rate is maintained, i.e., provided the inflation rate coincides

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[17] Center for the Study of Economic Trends (CSET). *Industrial Production Intensity Indices (January 1990-October 1998),* Moscow, November 1998; CSET. *Business Activity of Russia's Basic Industrial Enterprises in November 1998*, Moscow, 1998; *Industrial Production Rates of Dynamics. Preliminary Results for 1998. Estimate of the Situation for 1999 (based on reports for January-November 1998),* Moscow, December 1998.

with the rate of decline of the exchange rate. High inflation would by itself cancel the growth potential. Inflation would be curbed (using a fixed or quasi-fixed rate) when the real ruble value rises and the "devaluation" source of the competitive capacity of domestic production has been exhausted.

Table 1.14

Dynamics of industrial output for 1998, per cent of previous month

	01.98	02.98	03.98	04.98	05.98	06.98	07.98	08.98	09.98	10.98	11.98	12.98
Total industry	93,2	101,2	100,4	95,8	93,2	100,9	94,5	99,3	96,9	110,1	100	110,1
Electrical power engineering	96,8	91,4	92,7	84,4	76	86	98	98,2	110,5	131,3	126,4	110,3
Fuel	99,4	93	106,1		98,9	97	103	98,9	96,8	107,4	97	104,9
Ferrous metals	104,5	95,1	107,3	98,3	102	89,5	100,1	97,8	96,8	104,2	94,6	117,1
Nonferrous metals	116,9	97,2	106,5	92,1	106,5	113,2	111,5	99,2	92,8	95,1	92,1	103,2
Chemical and petrochemical industry	99,5	98,5	113,1	102,5	93	88,2	98,1	96,2	100	114,1	99,4	104,5
Machine building and metal working	103,5	108,4	112,1	98,5	78,5	115,4	87,2	95,7	93,4	118,2	93,3	111,4
Timber, wood working and pulp and paper industries	96,1	111,3	113,1	88,1	74,8	120,6	100,3	95	92,9	100,5	92,6	140,1
Building materials industry	87,9	100,1	115,9	112,6	99,5	110,2	98,8	98,7	98,1	100,2	86,7	101,3
Light industry	109,5	109,5	102,3	98,3	71,8	102	81,1	105	107,9	7	95,7	107,1
Food processing	93,2	113	117,2	98,2	98,8	97,7	98,6	95,2	98,1	112,1	91,6	102

Source: RF Goskomstat

On the other hand, the growth of the past few months is associated with the economy's entry into a high inflation cycle. The experience of many countries makes it quite clear that the expansion of monetary financing of the economy initially (during several months) stimulates economic growth thanks to the emergence of a "monetary illusion", that is, money injected into the economy creates an illusion of expanding demand. Households have the money to buy goods. Companies perceive the market's signals as an increase of demand and begin to expand production.

The demand for intermediary goods (ones used for production purpose) grows. The real level of non-payments in the economy goes down. This factor is strictly short-term and is soon followed by a new recession.

Table 1.15

Dynamics of the strike movement in 1998

Month	Number of enterprises and organizations where strikes occurred	Number of strikers, in thousands of persons
January	246	19,6
February	78	8,1
March	70	9,7
April	946	52,3
May	362	25,4
June	92	13,9
July	31	5,4
August	47	2,1
September	2394	78,5
October	4229	196,1
November	2135	65,5
December	5305	134,3

Source: RF Goskomstat

We see that by early 1999, the Russian economy had two mechanisms for stimulating growth, which, although compatible in the short term, are bound to diverge in mid-term (over six months). The stability of the December-January favorable trends would depend, above all, on the government's economic policy. Adequate macroeconomic and institutional decisions on the part of the government are essential for maintaining the favorable trends that came into being in late 1998-early 1999.

In the short term, the operation of these factors was predominantly favorable. As demand expanded, the share of enterprises that increased the volume of output has increased several times. Last autumn witnessed production growth in engineering, the chemical and petrochemical industry, ferrous and nonferrous metallurgy, oil production and oil refining (from September 1997 through August 1998, that is, in the period of macroeconomic stabilization, this indicator was going down).

It was also important that the Duma's support for the government made it possible to pass a law on production sharing, which had been blocked for several years. This sent positive signals to investors, especially foreign ones.

Steps were taken to tighten controls over pricing by the natural monopolies. Many tariffs were frozen, and some were even reduced (e.g., for railroad transportation of some necessities, including foodstuffs).

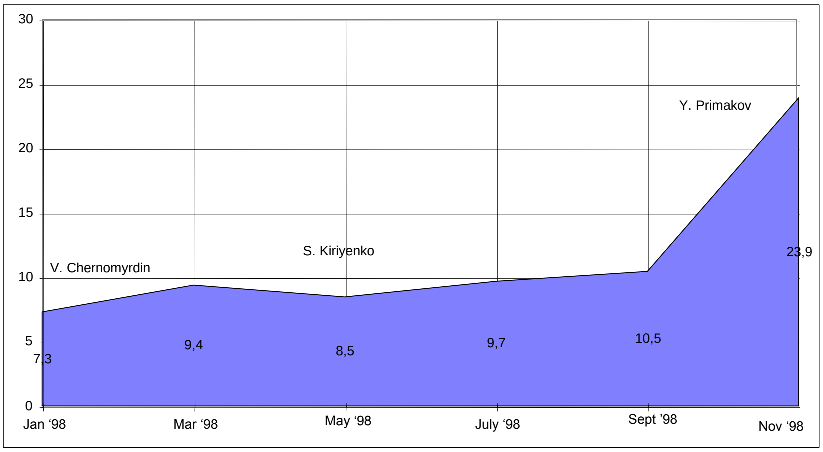
Statistics and sociological data also testify to stabilization and an improved position of enterprises. After a rapid production decline in September output stabilized, demand began to rise, and the share of idle production capacities decreased, especially in the fuel and energy complex and the consumer goods and food-processing industries.

Favorable changes also occurred in the social sphere. The government managed to use monetary sources to deal with some of the accumulated wage and pension arrears. Despite the fact that the value of the ruble decreased several times, the public mood was rather in favor of the current authorities. The duality of the economic situation was also reflected in the strike dynamics. In September, the number of striking enterprises increased more than 50 times and the number of strikers rose 40 times, and in October both figures doubled again. Although in November, the strike movement began to wane and fell to the September level (with 97 per cent of the strikes falling to educational establishments), in December it began growing again.

Nevertheless, according to findings of sociological surveys, in November 1998, 53.2 per cent of the respondents would not have supported protest action demanding that the government should resign. Yevgeny Primakov's personal popularity was also on the rise: during public opinion polls, he was given a place among the five most probable candidates for presidency (see Fig. 1.11).

Fig. 1.11

The Premier as the most trusted political figure (percentage of those who singled out the Prime Minister in a political credibility poll)



Source: VTSIOM monitoring data

We see that the actual course of events closely resembles the logic of economic populism described above. Monetary financing, even if kept within modest limits, exerts a positive short-term effect upon production and the government's popularity. But it is the monetary indicators (together with the balance of payments) that send early warning signals while the indicators of real production continue to demonstrate a positive dynamic.

1.3.4. Russia's social and economic development prospects

The real economic development prospects for 1999 will be determined by the operation of, above all, two factors: first, the impact of the decisions (above all, in the taxation and structural spheres) adopted by the government in the first 100 days of its work and, second, the authorities' ability to implement the approved budget thus achieving a stable and responsible fiscal policy. Of course, there will also be other factors that will make an impact, but at the moment they are difficult to forecast.

One can identify three main problems facing the Primakov Cabinet which are critical to achieving macroeconomic stability. First, there is the problem of external financing, primarily reaching agreements with international financial organizations. Second, inflation must not be allowed to run amok. Third, the political field must be cleared for the government's own political activity.

Negotiations with the IMF and other lenders have been extremely hard. In principle, one may say that the West has a political desire to assist Russia in debt restructuring and, in future, even to write off some of the debt. The World Bank is obviously ready to extend some loans, especially for investment projects. But there are problems that would not be easy to resolve.

First of all, the IMF is afraid to make another mistake and give money just before yet another crisis. This is why they are trying to prolong the observation of developments in Russia and give the money at the last moment, when the payments deadline has arrived, if another crash does not happen by that time. Other things being equal, the deal may be signed by May. By that time, the government will have to demonstrate the stability of the approved budget as best they can.

Meanwhile, it will not be easy to support the stabilization trends that manifested themselves in early 1999. In spring, the government always encounters a rise of lobbying aimed at getting more budget money. The main demands are for money (easy-term loans) for the sowing campaign and for the "Northern deliveries". Agrarian lobbying is one of the strongest not only in this country but everywhere in the world. "Northern deliveries" often imply not only (and at times not so much) the interests of that region's residents but also the interests of banks desireing to be put in charge of these deliveries (and get cheap government loans). In the past, few Cabinets were able to stand up to such pressure. In addition, we are approaching elections, which are another factor of political pressure operating towards financial destabilization.

To consolidate his political position, Primakov took a number of unorthodox steps. First of all, he initiated a treaty on public accord; its main (if not the only) meaningful provision obliged the parties to refrain from attempts to fire the government. (Obviously, this created guarantees for the Prime Minister alone, because the resignation of other government members occurs as a matter of routine.) Despite his sharply negative initial response to the letter which formulated this initiative, in late February Boris Yeltsin declared his intention to complete his term in office with Primakov as the Prime Minister. (True, similar declarations made about other government members in the past were rarely acted upon.)

It is not easy to ensure popularity for a prime minister when real government expenditure (and, consequently, commitments) have practically halved, causing the government to refuse to index the budget-paid wages and pensions although prices have doubled. In this environment, a battle against corruption is an effective way of distracting public attention, at least for a few months. With this end in view, the Prime Minister is promising large-scale arrests on corruption charges and is making unabashedly populist statements about private property.[18]

Primakov also supported the governors' desire to control federal property, having proposed a compromise solution: to transfer part of federal property in trust to the regional authorities. The available experience of the government's trust agreements in industry shows that as a result, the trust-holder in fact becomes a full-blooded (albeit a temporary) owner of the property in question.

Primakov openly proposed that the top leaders of the RF constituent members and of local governments be appointed by the relevant higher-ranking executive authorities and not elected. The

[18] Take, for instance, the following declaration made by Primakov before the Federation Council: "We had written off Purneftegaz. Now we have it back. The next in line are other enterprises which had been taken out of the budget, maybe lawfully but against all logic and common sense." (*Interfax*, Febr. 17).

governors were offered an opportunity to appoint heads of municipalities in exchange for agreeing not to be publicly elected. This deal may be attractive to most governors. They have long fought for total control over the municipalities (especially towns), and this would give them a much broader opportunity to control regional financial flows. Defending their position in the corridors of power is, for many of them, a much more attractive proposition than taking part in election campaigns.

The government is also taking important steps to consolidate its political position in the fuel and energy industry. Following the establishment of a corporation of coal companies in the Kuzbas, the government expressed its readiness to merge state-owned oil companies (Rosneft, Slavneft, ONACO). And, although the commercial sense of such projects is doubtful, at a certain point they may be used as funding sources for election campaigns.

And, finally, the Prime Minister is managing to neutralize his potential political rivals and even turn them into reluctant allies. In February, it became known that Viktor Chernomyrdin may be appointed chairman of the board of directors of Gazprom. The federal center came to the aid of Alexander Lebed in a struggle for influence on financial flows in the Krasnoyarsk Krai. There is the simultaneous consolidation of finances that could be used, if need be, for political purposes. In other words, Primakov now has only one serious rival, namely, Yuri Luzhkov.

A special effect upon the economic and political situation will be exerted by the practical implementation of a federal budget whose passage through the State Duma was the government's triumph.

Macroeconomic prospects and fiscal policy

The key budget parameters for 1999 and the parameters of the 1997 and 1998 budgets (for comparison) are presented in Table 1.16.

Table 1.16

Key federal budget parameters for 1997 to 1999

	1997 (per cent of GDP)	1998 (per cent of GDP)	1999 (per cent of GDP)
Income tax	0,1	0,0	0,6
Profit tax	1,4	1,2	0,9
VAT	4,5	3,6	3,6
Excises	1,9	1,6	2,2
Tax on foreign trade	1,1	1,2	2,3
Other taxes	0,4	0,5	0,4
Total tax revenue	9,4	8,1	10,0
Nontax revenue	3,1	1,9	1,9
Total revenue	12,5	10,1	11,8
Government administration	0,4	0,3	0,3
Law enforcement and justice	1,7	1,1	1,4
Defense	3,1	1,8	2,3
Science	0,4	0,2	0,3
Services to the national economy	2,0	0,8	0,9
Social expenditures	1,9	1,9	2,0
Government debt service	1,6	4,1	4,2
Other expenditure	4,8	3,1	3,0
TOTAL EXPENDITURE	15,8	13,1	14,4
Deficit	-3,3	-3,1	-2,5
Domestic financing	1,3	-0,6	1,4
External financing	2,1	3,6	1,1

Sources: RF Ministry of Finance, estimates by the book's authors

The current Law on the Budget is based on unrealistic premises. First, the budget estimates proceed from an extremely low forecast inflation rate. Given the scope of domestic financing through Central Bank loans as envisaged by the law, implementation of the declared steps to restructure the banking system, and the price growth rates observed in November-February 1998-1999, it is obvious that the inflation rate in 1999 will be higher than the estimated 30 per cent.

Second, tax revenues as a share of GDP (about 10 per cent) envisaged in the federal budget appear significantly overestimated. As was mentioned above, 1999 tax revenues will plunge because of the reduced rates on profit tax and VAT, higher investment privileges in respect of profit tax (amendments that will probably be enforced as from the second half of 1999), and the further slackening of financial discipline caused, above all, by the numerous signals on tax privileges sent by the government. An important contribution could be made by the worsening financial position of enterprises as a result of the general economic and financial crisis. The amount of tax revenues will also be reduced by the rising rate of growth of enterprises' arrears due to the continued banking crisis, the rise of inflationary expectations, and the lower level of monetization of the economy. In our estimate, these factors could cause the revenues of the federal budget (which does not feel the impact of the lower tax rates) to fall between 1.0 and 1.5 per cent of GDP in 1999 from 1997-the first half of 1998 (9.0-9.5 per cent of GDP). As a result, after tax reform, the federal budget's tax revenues will hardly exceed 8.0-8.5 per cent of GDP.

In this context, given higher inflation rates than are allowed by the draft budget, the government will manage, in nominal terms, to collect the planned amount of taxes; in real terms, however, tax revenue will be 15-20 per cent lower. As a result, in the absence of non-monetary sources of financing the fiscal deficit, real budget expenditure would go down at a commensurate rate. We see that the Law on the Budget rests on an attempt to implement it in nominal terms (having redistributed the actually collected money from the constituent members of the Federation in favor of central government) by understating the inflation rate, which means a reduction of the real volume of financing on all the budget items.

During the worsening financial crisis, this budget maneuver could be regarded as justified only on the condition of simultaneous structural reforms and reforms aimed at lightening the budget load and raising the efficiency of budget expenditure. But the Cabinet's program of action does not provide for such steps. What is more, the government is hoping for a chance to reduce the real expenditures of extrabudgetary funds without a reform of pensions and social security and without compensating the extrabudgetary funds' losses from the federal budget. An outcome of such policy could only be lower real incomes of a large part of the households, first of all, the people whose wages are paid from the budget, and pensioners. Implementation of the budget is bound to produce many undesirable social consequences.

To assess the implementation of the 1999 federal budget in quantitative terms, we estimated the performance of the key macroeconomic indicators for 1999 under two scenarios. We assumed that the volume of expenditure and the sources of financing the fiscal deficit and repayment of the RF government debt were based on numbers set by the Law on the RF Federal Budget for 1999.

The first, baseline scenario estimates the issue of money in March-December 1999 at Rb110 billion, with this sum coming from the following sources: (1) the RF Central Bank's loans to the government envisaged by the Law on the Budget to the amount of Rb32.6 billion; (2) expenditure on the restructuring and modernization of the banking system (up to Rb35-40 billion, according to the Central Bank leaders' statements, minus the amount of stabilization loans granted in January-February 1999; (3) raising the Central Bank's gold and foreign exchange reserves by about $2 billion (Rb40-50 billion - an estimate based on the minimum needed for foreign debt servicing and repayment with account of net external financing[19]).

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[19] Net external financing envisaged by the budget (approximately $2 billion) is practically equal to the amount of the tied loans. If no such loans are disbursed, this will

In our view, due to a slacker tax discipline and based on the trend for the fourth quarter of 1998, tax revenues for the first half of 1999 will go down to 8 per cent of GDP (in 1997, 9.4 per cent of GDP). But if the RF Federal Assembly adopts a package of laws on tax reform accompanied by a redistribution of taxes between different-level budgets and the laws come into force in the second half of the year, tax revenues to the federal budget would rise to 9 per cent of GDP. The volume of non-tax revenues, which the Law on the Budget estimates at 1.875 per cent of GDP, appears realistic.

Our calculations assume that a new restructuring of Russia's debts will take place as regards the servicing and regular repayment of the debts of the former Soviet Union. As regards Russia's domestic and foreign debts proper, the terms of the Law on the 1999 Federal Budget will be observed. In this way, the RF Government would, first, implement the GKO-OFZ restructuring scheme announced on 15 December 1998. Second, foreign debt payments would reach $4.935 billion, including $3.6 billion in principal payments on IMF, World Bank and EBRD loans. It is also assumed that debts to the international financial organizations will be refinanced. At the same time, if Russia fails to receive IMF and World Bank loans to the amount of $4.5 billion, the results of our calculations would remain unchanged because in this case, we assume a default on Russia's debts to the international financial organizations and on untied foreign loans in 1999. The servicing of the country's foreign debt will reach $4.3 billion (2.5 per cent of GDP). This amount will include, among other things, coupon redemption on Eurobonds and OVVZs.

The fact that expenditure on foreign debt servicing and repayment remains a stable percentage of GDP stems from our assumption of a relative stability of inflationary expectations and the US dollar rate, because even under relatively low inflation confidence in the present monetary policy would not strengthen

not affect the volume of currency issue and the results of our calculations, because we assume a corresponding reduction in expenditure.

until after a year of its implementation. The money multiplier would remain at the December 1998 level, that is, 2.15, in the case of high inflation. If the inflation rate remains under 100 per cent per annum, the multiplier is expected to rise to 2.2 by end-1999. Correspondingly, in such a case some increase in money demand would be observed. What is more, we assume that the real ruble rate remains unchanged.[20]

This review is not going to examine the effect of the current fiscal and monetary policy upon the state of the real sector and Russia's balance of payments.[21] Our estimates envisage that in 1999, the real GDP decline will constitute 2 per cent from 1998, with the GDP deflator rising commensurately with the consumer price index.

Our estimates of GDP, budget revenues and the inflation rate[22] show that, given the above-mentioned volume of currency issue and the actual price growth rate for January-February 1999, the inflation rate will be about 66 per cent, not the 30 per cent as envisaged by the budget. Correspondingly, a higher nominal volume of GDP would offer an opportunity to collect higher nominal revenues than the Rb400 billion planned by the government. However, due to the lower tax revenues than

[20] The experience of countries where inflation is high shows that the national currency exchange rate usually declines faster than prices rise. Between 1992 and the first half of 1998, Russia witnessed a reverse situation determined by a significant initial inflation of the dollar rate in the early 1990s, and by the fact that the RF Government and Central Bank’s stabilization policy envisaged the use of the ruble nominal rate as the "nominal peg". At present, these factors are absent. In 1999, the rate of the ruble devaluation will probably match the price growth rate, which would secure the stability of the effective rate.

[21] According to the balance of payments forecast made by an RF Finance Ministry expert team headed by Arkady Dvorkovich, in 1999 the Russian Federation will have a $31 billion surplus on its current account; foreign debt restructuring to the amount of $13 billion will take place; foreign tied loans worth up to $2 billion will be obtained. These sources will be used to finance the deficit of Russia’s capital and financial account ($45 billion) and to increase its official gold and forex reserves ($2 billion). Hence our assumptions do not go against the above estimate of the balance of payments situation.

[22] To model inflation, we used the autoregression monetary model of price index performance estimated for a period of high inflation, 1992 through early 1995 (see *The Russian Economy in January through September 1998. Trends and Prospects, Issue 19*).

the Law on the Budget envisages this opportunity would remain untapped.

If this scenario is enacted, real non-interest expenditure would stay at the 1998 level, that is, 9.0-9.2 per cent of GDP. The dynamic of the principal macroeconomic indicators is presented in Table 1.18.

It should be noted, however, that the 1998 level of expenditure is that of a crisis period and cannot be maintained for a long time without provoking social and political upheavals. In 1999, real non-interest expenditure of the federal budget will go down by 33 per cent from 1997. Provided the indexation envisaged by the Law on the Budget is enacted, by year-end budget-supported wages and pensions will decrease by 20-25 per cent in real terms as compared to December 1998, and by 55-60 per cent as compared to July 1998. According to our estimates, the minimal level of the federal budget non-interest expenditure that would not raise the debt to the recipients of budget money at the current level of budget obligations is at least 10-11 per cent of GDP (in 1997, non-interest expenditures constituted 13.9 per cent of GDP).

When assessing social consequences, one should also take into account the reduction of the regional budgets' revenues and, consequently, expenditures. Despite the amendment in the Law on the Budget regarding the distribution of revenues between the Center and the regions at the ratio of 49.5 to 50.5, as a result of tax reform the regional budgets will lose about 1.6 per cent of GDP as compared to 1997. We believe, therefore, that in the second quarter of 1999, the federal budget expenditure on support for the regions may already increase; this support may be essential for dealing with the most pressing social problems. What is more, it will be necessary to increase federal budget expenditure on making up for delinquent receipts of the Pension Fund.

Table 1.17

Key parameters of fiscal policy for 1999[23]

	Law on the Budget	Scenario 1	Scenario 2
1. Tax revenue (per cent of GDP)	10,0%	8,5%	8,5%
2. Nontax revenue (per cent of GDP)	1,8%	1,9%	1,9%
3. Total revenue (per cent of GDP) (=1+2)	11,8%	10,4%	10,4%
4. Non-interest expenditure (per cent of GDP)	10,2%	9,3%	11,1%
5. Primary deficit (per cent of GDP) (=3-4)	-1,6%	-1,1%	0,7%
6. Domestic debt service (per cent of GDP)	1,7%	1,5%	1,5%
7. External debt service (per cent of GDP)	2,5%	2,5%	2,5%
8. Total expenditure (per cent of GDP) (=4+6+7)	14,4%	13,3%	15,1%
9. Overall fiscal deficit (per cent of GDP) (=8-3)	2,6%	2,9%	4,7%
10. Fiscal deficit less expenditures financed by tied loans (per cent of GDP)	1,5%	1,9%	3,7%
11. External debt repayment (per cent of GDP)	2,5%	2,5%	2,5%
12. Quasi-budget expenditure on recapitalization of the banking system (per cent of GDP)	1,25%	1,1%	1,1%
13. Shortfall of funds for fiscal deficit financing, external debt repayment and quasi-budget expenditure on recapitalization of the banking system (per cent of GDP) (=9+11+12)	6,35%	6,5%	8,3%
Sources of finance:			
14. Untied external loans (per cent of GDP)	2,8%	2,8%	2,8%
15. Tied external loans (per cent of GDP)	1,0%	1,0%	1,0%
16. Domestic nonmonetary financing (per cent of GDP)	0,4%	0,4%	0,35%
14. Volume of currency issue (per cent of GDP)[24] (=13-14-15-16+currency issue to replenish gold and forex reserves)	3,1%	2,5%	4,6%

[23] Here we assume that the debt of the former USSR will be restructured while Russia will only pay off and service government loans and its debt to international financial institutions if new loans are granted in 1999. Otherwise a default will be announced with respect to these debts.

[24] The volume of currency issue is determined by the minimum amount necessary for financing federal budget expenditure, quasi-budget expenditure on recapitalization of the

Table 1.18[25].

	1998	1999
Scenario 1		
Inflation (%)	84,4%	66%
GDP (in blns of Rbs)	2685	4337
Growth rate of base money(%)	26,0%	53,4%
Growth rate of M_2 (%)	20,96%	54,7%
US dollar exchange rate (Rbs/$)	20,65	33,0
Real money stock M_2 (per cent of GDP, period end)	13,8%	13,0%
Scenario 2		
Inflation (per cent)	84,4%	81%
GDP (in blns of Rbs)	2685	4476
Growth rate of base money(per cent)	26,0%	99,8%
Growth rate of M_2 (per cent)	20,96%	96,8%
US dollar exchange rate (Rbs/$)	20,65	40,0
Real money stock M_2 (per cent of GDP, period end)	13,8%	12,9%

The second scenario implies that as from May 1999, there will be a rise in expenditure on financial support for the regions totaling 1.0 per cent of the yearly GDP as envisaged by the Law on the Budget, that is, by about 40 billion. The losses of the Pension Fund will require another 1.4 per cent of annual GDP, or about Rb56 billion. These expenditures can be financed by printing money; in this case, the overall volume of money issue during the year would be approximately Rb205 billion (doubling of base money). The other assumptions of this scenario coincide with the first one.

The figures presented in Table 18 show that real non-interest budget expenditure was reduced without account of increased

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banking system and stockbuilding of the RF Central Bank's gold and forex reserves with account taken of nonmonetary sources of finance as stipulated in the budget.

[25] According to the monetary policy guidelines for 1999 set by the RF Central Bank, the growth of the money stock M_2 for the year should be in the range of 18 per cent to 26 per cent.

expenditures on financial support for the regions and Pension Fund receipts (an attempt to raise expenditure by 2.4 per cent of GDP in 1999 caused its real growth by 1.8 per cent of GDP[26]). Prices rose 1.8 times. The real incomes of persons whose wages are paid from the budget will fall by 25-30 per cent over the year (by 60 per cent as compared to July 1998).

Figures describing the volume of financing of the principal federal budget items in conformity with the law and the first two scenarios for 1999, as well as the actual execution of the budget in 1997, the first half of 1998 and 1998 can be found in Table 19. Table 20 shows the change of the level of the federal budget expenditure in 1999 under the Law on the Budget, the first and the second scenarios as compared to 1997, the first half of 1998 and 1998. The need for several comparison bases is determined by the distinctions in the economic and political situation over those periods. The 1997 budget was being executed in a situation of relative economic and political stability, and 1998 can be divided into pre- and post-crisis periods.

As shown by Tables 1.19 and 1.20, the most considerable reduction of federal budget expenditure in real terms is revealed by a comparison with 1997, and the least considerable, with 1998. The execution of the federal budget under the second scenario leads to a more significant reduction of expenditure as compared to the first scenario on all line items with the exception of social expenditure. The latter's significant rise under the first scenario as compared to all the base periods is determined by their incorporating the subsidies to the Pension Fund (Rb56 billion or 1.3 per cent of GDP). Overall, it is due to the growth of social expenditure that the second scenario envisages a lower reduction of expenditure than the first.

It should be noted that the federal budget expenditure on financial support for the regions, which includes the Fund for the

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[26] Needless to say, after the issue of money necessitated by these expenditures has caused a corresponding price rise, real government expenditure will go down further (see below).

Regions' Financial Support, would go down under practically all scenarios and in comparison with all periods. The greatest reduction in expenditure for this purpose would occur if the situation evolved in conformity with the first scenario, under which this expenditure would decline by almost one third (in per cent of GDP) even in comparison with 1997.

We see that in 1999, an aggravation of the social crisis and public discontent are highly likely. In a situation like this, the government may succumb to the temptation to take rash steps, e.g., start the printing press, especially in the year of State Duma elections. In the future, indexation of budget expenditure, a higher volume of money issue, further reduction of budget revenues and payments in real terms, and more monetary financing become unavoidable.

To show what can happen if an attempt is made to solve the problem of reducing real expenditure by using the printing press, we quote the results of our estimates for one of the versions of such policy. It should be noted that the results presented below are not another prognostic scenario but are only an illustration which confirms the obvious fact that currency issue cannot solve real economic problems.

Let us assume that as in the second scenario, additional support for the regions and transfers to the Pension Fund (all in all, 2.4 per cent of GDP) will take place. Also, as from May 1999, the budget's expenditure side will be indexed on a quarterly basis. In our calculations, indexation to the 1997 level (13.9 per cent of GDP) is based on the inflation indices for the past two months of the preceding quarter. The increased fiscal deficit is financed by direct loans from the Central Bank (overall volume of issue will reach Rb430 billion).

In doing this, we assume that a higher inflation rate and a high volume of money issue would increase inflationary expectations and a rapid rise in money velocity, which, in turn, would accelerate the price growth and the decline of the nominal and effective ruble rates (the latter implies a growth of expenditure on RF foreign debt servicing as a share of GDP). High inflation rates also lead to a reduction in tax revenues in real terms because of their inflationary devaluation in the period between tax assessment and tax receipts by the budget.

Table 1.19

Key expenditure items of the federal budget (per cent of GDP)

	1997	First half of 1998	1998	Law on the 1999 Budget	Scenario 1	Scenario 2
Government administration	0,4	0,3	0,4	0,3	0,3	0,3
Law enforcement and justice	1,7	1,2	1,3	1,4	1,3	1,3
Defense	3,1	1,8	2,1	2,3	2,2	2,1
Science	0,4	0,2	0,2	0,3	0,3	0,3
Services to the national economy	2,0	0,8	0,9	0,9	0,8	0,8
Social expenditure	1,9	2,0	2,1	2,0	1,8	3,0
Government debt service	4,5	5,4	4,0	4,2	4,0	4,0
Domestic debt		11,7		1,7	1,5	1,5
External debt				2,5	2,5	2,5
Other expenditure, of which:	4,6	2,9	3,6	3,0	2,6	3,4
Financial aid to Russian regions, of which:	1,9	1,6	1,6	1,1	1,0	1,8
Federal Restructuring Fund	1,3	1,4	1,1	0,8	0,8	1,6
TOTAL EXPENDITURE	18,4	14,7	14,5	14,4	13,3	15,1

Source: RF Ministry of Finance, estimates by the book's authors.

In this case, by the end of 1999, we would have extremely high inflation rates. In November-December prices would grow by over 25 per cent a month. For the year as a whole, the consumer price index would reach 3.52, and money supply would increase 2.7 times. By December 199, the economy's level of monetization would fall to 11 per cent of GDP.

Table 1.20

Change in key expenditure items of the federal budget

	Law on the Budget			Scenario 1			Scenario 2		
	1997	First half of 1998	1998	1997	First half of 1998	1998	1997	First half of 1998	1998
Government administration	-8%	5%	-5%	-15%	-4%	-12%	-18%	-7%	-15%
Law enforcement and justice	-17%	15%	11%	-23%	6%	2%	-26%	3%	-1%
Defense	-24%	33%	11%	-30%	22%	2%	-32%	19%	-1%
Science	-21%	26%	51%	-27%	16%	39%	-30%	12%	35%
Services to the national economy	-57%	6%	-2%	-60%	-2%	-9%	-61%	-5%	-12%
Social expenditures	4%	-1%	-8%	-4%	-8%	-15%	60%	52%	41%
Government debt service	-8%	-23%	5%	-11%	-25%	2%	-12%	-26%	1%
Financial aid to Russian regions	-34%	2%	-16%	-44%	-13%	-28%	-26%	15%	-5%
Other expenditure	-44%	-31%	-32%	-48%	-37%	-38%	-7%	13%	11%
TOTAL EXPENDITURE	-22%	-2%	-1%	-28%	-10%	-8%	-18%	3%	4%

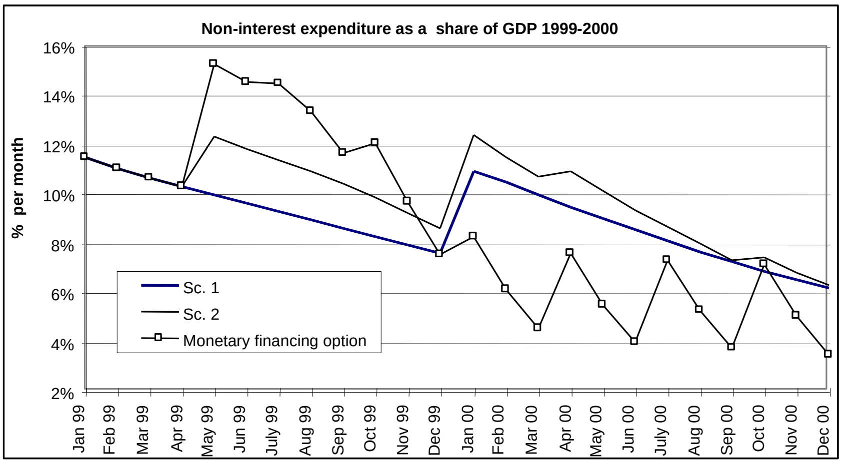
Sources: RF Ministry of Finance, estimates by the book’s authors.

Despite attempts to increase the federal budget's real expenditure to 16.3 per cent of GDP, in actual fact real budget expenditure would be 11.3 per cent of GDP over the year. Some increase of real expenditure financed through seigniorage would be observed only immediately after the rise of the rate of money issue. An estimate of the federal budget’s real expenditure for a longer term (1999-2000)[27] shows that in December 1999, it will already be lower than under the first two scenarios (see Fig. 1.12). By

[27] The forecast for 2000 is made similarly to the forecast for 1999. Under both scenarios and for the case currently under consideration, the 2000 federal budget parameters were determined by indexing the corresponding parameters of the 1999 federal budget under the consumer price index for 1999. A leap of expenditure in January 2000 under both scenarios can be explained by the fact that the volume of expenditure each month was estimated as one-twelfth of nominal expenditure envisaged for the current year.

December 2000, real budget expenditure would fall below 4 per cent of GDP.

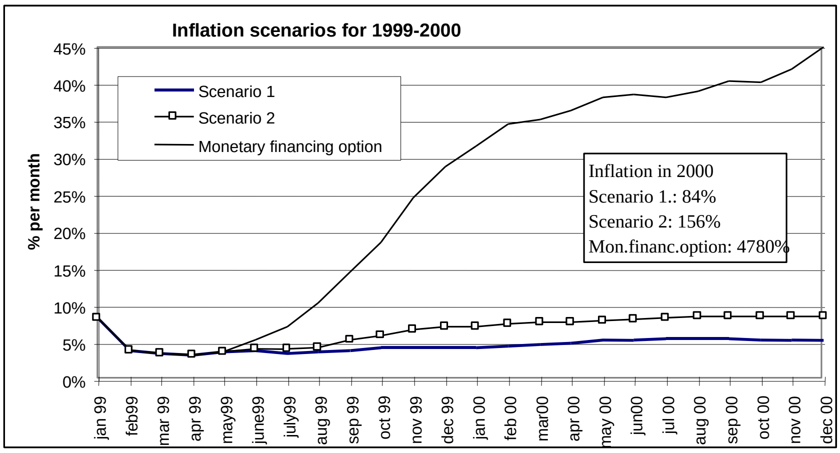
Fig. 1.12



It should also be noted that while in 1999, the second scenario shows a higher level of real expenditure (including the additional expenditure on support for the regions and transfers to the Pension Fund) than the first, by the end of 2000 these figures become practically the same. Obviously, if such policy continues, in 2001 real expenditure would already reach a higher level. This means that a rise of real budge expenditure not backed by regular revenues through monetary financing is feasible only in the short term. With time, the inevitable rise of the rate of inflation would invalidate all such attempts.

The forecast inflation rate for 1999-2000 is determined by a range of values close to the trajectories of the first and second scenarios (see Fig. 1.13) and would in fact depend on the scale of indexation attempts. The harder the government would try to deal with socioeconomic problems through monetary financing and not budgetary reforms aimed at raising the efficiency of government expenditure and sensible tax reforms, the more rapid the fall of real budget expenditure and the deeper the social problems would become, and the inflation rate would tend toward figures consistent with the monetary-financing option of fiscal policy.

Fig. 1.13



1.4. The Primakov government's performance: early results

In early 1999, after six months in office, the government was still trying to formulate its economic and political course. Its desire to implement a tight budget conflicts with the chosen tax reform orientation and is not supported by measures aimed at raising the efficiency of government expenditure, while declarations about keeping inflation at 30 per cent in 1999 go hand in hand with a soft monetary policy.

The chief economic implications of this course are as follows:

- lower real revenues for the enlarged government budget due to an incompetent tax reform. Significant reductions in the enlarged government's real expenditure and, in consequence, a new level of budget equilibrium with tax exemptions of about 27-28 per cent of GDP (in 1997, 32.6 per cent of GDP) and government expenditure standing at 32-33 per cent of GDP (from approximately 43 per cent in 1997[28]);

- accelerated inflation in 1999 and the danger of extremely high inflation rates;
- a further deterioration of the standard of living of employees in the budget-supported sector and of pensioners, a higher share of those with incomes below the subsistence minimum, a wider income gap;
- demonetization of GDP as a factor behind continued production decline.

There are also some serious political problems. There is a threat of state power significantly weakening despite the Prime Minister's repeated statements regarding his commitment to the ideology of etatism and consolidation of the State as a priority of his work as Cabinet head. The main factors behind the weakening of the state, which are likely to grow stronger, are as follows:

- limited opportunity to influence developments in this country and deal with economic, political, and defense issues due to reduced federal budget revenues;
- loss of control over government expenditure both at federal and regional levels. Due to a rapid rise of lobbying inside the Cabinet, the latter's failure to function as an integral political team, it becomes impossible to pursue a consistent policy;
- as central authority weakens, the governors' position will consolidate. The rise of inflation would inevitably weaken the regional authorities' dependence upon the Center. The regions will begin inventing their own ways of combating inflation, which would most probably be incompatible with the provisions of the relevant federal laws. A special danger would be presented by price-regulation attempts because the shortages that would begin as a result would supply the regions with a weighty motive for

[28] In 1997, the enlarged government budget revenues, including non-taxes, amounted to 36.4 per cent of GDP and the fiscal deficit and the volume of its financing, to 6.7 per cent of GDP.

restricting the flows of goods, which would undermine the integrity of the country's economic space.

The most general conclusion prompted by analysis of the earliest results of the Primakov government's work shows that the country is steadily and inexorably approaching another stage in its social and economic crisis. This stage is likely to be far more damaging than that of mid-1998. Its features will include high inflation, a steady fall of the ruble, and overall macroeconomic and social confusion. What is more, for a number of socio-psychological and political reasons, this crisis may prove much more painful than at the outset of market reforms.

The government and the Prime Minister personally seem to be aware of these dangers. After a period of indecision and open determination to avoid drastic steps, Primakov showed an awareness of the fact that the heart of the crisis lies in the monetary and fiscal, that is, macroeconomic field. The draft budget demonstrates a desire to coordinate monetary and fiscal policy not by weakening the former but by tightening the latter, that is, a refusal to succumb to ‘economic populism’.

However, there are at least three problems here. First, a number of serious mistakes have already been made, especially as regards taxation, which cannot but have an adverse effect on the budget situation. Second, the proposed budget parameters, which are not backed by structural reforms, would be difficult to observe. Third, a certain danger lies in the Prime Minister's predilection for political compromise, which, although desirable, is not always possible without fundamental losses for economic policy. Naturally enough, Primakov does not want to lose the government's accumulated political capital - relative popularity in society and the State Duma's support. But the problem is that failure to take resolute steps may cause a gradual deterioration of the economic and then the social environment so that the effects may prove far more serious.

The Prime Minister's diplomatic talents are well-known and may be useful. But economic policy requires an ability to make the right choice. Unlike modern foreign policy based on compromise and a balance of interests, economic policy has no room for compromise between lower budget revenues and higher expenditure, between the printing press and a healthy national currency. The economic policy course will have to be clearly defined.

Circumstances are bound to confront the government with an increasingly pressing need to choose between a tough stabilization course and a populist economic policy. It is a choice that cannot be avoided. Reluctance to make it would only lead to a decision imposed by the logic of economic circumstances. It would be a choice of both policy and the social forces that would have to bear the costs of its implementation.

1.5. Subfederal and municipal borrowing

The structure of local authorities' borrowing

In 1997-1998, the performance of the regional debt market was largely shaped by the financial market situation and the instability of investors' expectations regarding the magnitude of Russia's country credit risks. Failure to contract long-term financing made the system of subfederal borrowing akin to that of the GKO market. Bank loans and loan bonds were backed, in real terms, not so much by the regions' budget revenues and still less by the property of the oblast administrations as by a capacity to obtain new loans to refinance the accumulated arrears.

Investors' optimistic expectations enabled the regions to increase their borrowing by financing the growing primary fiscal deficit, which in 1997 reached 1.25 per cent of GDP. And it was not until the RF Finance Ministry tightened its policy on granting demand loans to the regions in early 1998 that the consolidated fiscal deficits of the RF constituent members finally went down to 0.81 per cent of GDP (as at end-August).

While in 1997, loans from the Center covered more than 53 per cent of the local budgets' deficit, at the moment of the August financial crisis only 6 per cent was financed by the Finance Ministry loans. But, despite the steady rise of interest rates on the financial markets in the first half of 1998, the local budgets' deficit was financed from private sources at approximately the same level as in 1997, reaching 0.67 per cent of GDP by August 1998 (Table 1.21).

Table 1.21

Consolidated budget deficit financing in RF constituent members, per cent of GDP

Year	1995	1996	1997	August 1998*	1998
Deficit financing	0,38	0,90	1,25	0,81	0,34
Demand loans from federal budget	0,07	0,23	0,66	0,05	-0,09
Subfederal (municipal) bonds	н.д.	0,16	0,22	0,08	-0,01
Other borrowing	0,31	0,48	0,55	0,58	0,43
Decrease in fiscal account balance	…	0,03	-0,18	0,09**	0,02
Deficit financing less demand loans from higher-level budget	0,31	0,67	0,57	0,76	0,43
Deficit financing less demand loans from higher-level budget and change in balance of budget funds on bank deposits	0,31	0,64	0,75	0,67	0,41

*Estimates by the Institute for the Economy in Transition based on RF Ministry of Finance data
**January-August 1998

Over the first eight months of 1998, the share of loans received from higher-ranking budget in the overall volume of the borrowing used to finance the local fiscal deficits fell 6.5 times (from 46.2 per cent to 7 per cent), and the share of net revenues from the issue of regional and municipal bonds decreased by one-quarter (from 15.2 to 11.8 per cent). The share of "other borrowing" (mainly bank loans) in deficit financing almost doubled, rising from 38.6 per cent to 81.3 per cent. Commercial banks became the principal lenders for regional and local administrations (Table 1.22).

Table 1.22

The borrowing structure of consolidated budgets of RF constituent members

	1995		1996		1997		1998		1998	
	January-December		January-December		January-December		January-August		January-December	
	in blns of Rbs	per cent of total	in blns of Rbs	per cent of total	in blns of Rbs	per cent of total	in millions of Rbs	per cent of total	in millions of Rbs	per cent of total
1.Subfederal and municipal securities	н.д.	н.д.	3564,4	18,5	5602,3	15,2	1 371,6	11,8	-364,2	-4,1
2.Budgetary loans received from higher-level budget	1058,5	17,8	5154,9	26,8	17 016,8	46,2	808,7	7,0	-2434,7	-27,1
3.Other domestic borrowing	4894,2	82,2	10544,2	54,7	14 208,6	38,6	9 449,8	81,3	11770,9	131,2
4.Total	5952,7	100,0	19263,5	100,0	36 827,7	100,0	11 630,1	100,0	8971,9	100,0

Source: Estimates by the Institute for the Economy in Transition based on RF Ministry of Finance data

Between January 1997 and August 1998, the debt of the RF constituent members and local authorities to commercial banks rose, in real terms, more than 6.6 times (from Rb2.8 billion to Rb24.5 billion in current prices).

Table 1.23

Financing of regional and local authorities by commercial banks (in millions of Rbs)

Date	Commercial bank claims on local authorities*	Commercial bank deposits by local authorities	Balance of claims and deposits
01.01.97	2 790,4	4 210,6	-1 420,2
01.04.97	3 232,6	6 602,9	-3 370,3
01.07.97	4 876,0	10 790,4	-5 914,4
01.09.97	9 594,9	12 491,8	-2 896,9
01.12.97	12 073,8	12 765,2	-691,4
01.01.98	12 514,5	8 467,1	4 047,4
01.02.98	20 086,4	11 010,0	9 076,4
01.04.98	23 039,6	10 015,8	13 023,8
01.07.98	24 002,0	9 401,8	14 600,2
01.09.98	24 506,0	8 459,7	16 046,3
01.10.98	25 225,2	8 987,9	16 237,3
01.11.98.	23 799,5	10 641,7	13 151,8
01.12.98.	24 603,4	11 647,7	12 955,7
01.01.99.	24 172,4	10 145,9	14 026,5

*The government authorities of the RF constituent members and local governments

Source: Estimates by the Institute for the Economy in Transition based on RF Central Bank data

While in January through November 1997, the ratio of deposits held by municipal and regional authorities at commercial banks, on the one hand, to the volume of borrowing from the banking system, on the other, was consistently positive, beginning in December 1997, commercial banks were already net lenders to local authorities. By early September 1998, commercial banks' claims on regional and municipal authorities exceeded the value of deposits by Rb16.0 billion (Table 1.23).

Due to the tighter budget restrictions caused by the collapse of investor confidence in the solvency of most local authorities and the inflationary growth of incomes after the August crisis, for the first time since mid-1995 the local budgets were executed with a primary surplus, which in September-December reached Rb3.699 billion.

Table 1.24

Financing of consolidated budget deficits of RF constituent members in 1998 (in millions of Rbs)

	January-August Ст.1	January-December Ст.2	Ст.2-Ст.1
Deficit (surplus)	13 084,4	9 385,4	-3 699
1.Change in bank acccount balances of budget funds (by January)	1 454,4	413,4	-1 041
2.Subfederal and municipal securities	1 371,6	-364,2	-17 35,8
- borrowing	8 970,6	12 581,6	3611
- payment of principal	7 599,1	12 945,8	5 346,7
3.Budgetary loans received from higher-level budget	808,7	-2 434,7	-3 243,4
- loan receipt	1 097,8	2 484,5	1 386,7
- loan repayment	289,1	4 919,2	4 630,1
4.Other domestic borrowing	9 449,8	11 770,9	2 321,1
- loans	24 197,5	35 930,0	11 732,5
- payment of principal	14 747,6	24 159,1	9 411,5
Total financing	13 084,4	9 385,4	-3 699

Source: estimates by the Institute for the Economy in Transition based on RF Finance Ministry data

The principal amount of the debt on municipal bonds was reduced by Rb1.7 billion and the debt on loans received from a higher-level budget, by Rb3.2 billion. The local budgets' balances at commercial banks rose by Rb1.04 billion. But the principal amount of the debt on commercial bank loans increased by Rb2.3 billion, mainly due to the conversion of interest arrears into the principal and the use of bank loans to make the payments of loan bonds. Even when the local budget showed a surplus, commercial banks found themselves obliged to increase their lending to it (Table 1.24).

It should be noted that the use of loans to finance extrabudgetary funds is not usually captured in budgetary statistics. This is why the growth of bank lending to territorial budgets while the overall volume of commercial banks' claims on local authorities remained practically the same indicates a reduction of loan-based financing of the regions' extrabudgetary programs.

The issue of loan bonds

The year 1998 witnessed the registration of issue prospectuses for domestic bonds of 23 RF constituent members to the amount of Rb12.6 billion and nine municipal entities to the amount of Rb417.24 million, as well as four foreign bonds of two RF constituent members to the amount of $800 million, DM500 million, and ITL750 billion.

The crash of demand for Russian securities as a result of the financial crisis sharply reduced the volume of issue: in September, there were no new issues, in October, loan bonds were issued in the Khabarovsk Krai (to the amount of Rb277.84 million); in November, in Yaroslavl (Rb18.285 million); and in December, in the Rostov Oblast (Rb190 million). As compared to the pre-crisis period, the overall volume of new issues in the fourth quarter of 1998 dropped to almost one ninth, this not counting inflation.

One can identify four basic types of subfederal loans issued during 1997-1998: external Eurobond loans, agrobonds and energy bonds, bonds circulating on the exchange market, and securities unlisted on stock markets.

Foreign regional loans. In 1997, on the crest of a "favorable wave" more than 20 Russian regions were getting ready to enter the Eurobond market. A number of them were given an international credit rating by Moody's, Standard & Poor's, and IBCA Fitch at RF level. The Finance Ministry registered issue prospectuses for four RF constituent members: Moscow, St. Petersburg, the Nizhny Novgorod Oblast and the Moscow Oblast (Table 1.25). By June 1998, the RF President's decrees gave permission to issue foreign loan bonds to 12 constituent members of the Federation, including the Republic of Komi, Tatarstan, the Krasnoyarsk Krai, and the Leningrad, Orel, Samara, Sverdlovsk and Chelyabinsk oblasts.

Table 1.25

Subfederal external bond issues registered with the RF Ministry of Finance

Issuer	Size of negotiable issue	Maturity	Date	Lead manager
Moscow	$500 million	3 yrs	31.05.97	CS First Boston, Nomura Int.
St. Petersburg	$300 million	5 yrs	18.06.97	Salomon Brothers
Nizhny Novgorod Oblast	$100 million	5 yrs	03.10.97	ING Barings
Moscow	DM500 million	3 yrs	02.04.98	CS First Boston
Moscow[1]	ITL750 billion	3 yrs	03.05.98	Chase Manhattan International
Moscow Oblast	$300 million	5 yrs	07.05.98	Swiss Bank, Goldman Sachs
Moscow[2]	$500 million	20 yrs	23.06.98	CS First Boston, ING Barings

[1] A ITL400 billion portion has been floated

[2] Not floated

Source: RF Ministry of Finance data.

An intention to issue Eurobonds was announced by at least 10 other constituent members of the Federation, which had not by that time been authorized to do so, including the republics of Sakha-Yakutia and Bashkortostan, the Khanty-Mansi and Yamal-Nenets okrugs, and the Astrakhan and Perm oblasts. The planned overall volume of regional Eurobond loans in 1998 was to reach at least $4 billion.

However, by May 1998, due to the foreign investors' undermined confidence the floating of regional Eurobonds was in fact frozen. The $500 million Moscow loan denominated in US dollars proved impossible to float.

Failing to float three-five year foreign loans and extremely high nominal interest rates on domestic borrowing, a number of Russian regions, including the Republic of Sakha (Yakutia), Tatarstan, the Yamal-Nenets Okrug and the Leningrad Oblast resorted to foreign short-term bank loans. It should be noted that unlike the issue of Eurobonds, such loans do not require authorization from the federal authorities.

The credit rating of Russian regions was going down simultaneously with that of the country generally, and as at September 16 it did not rise above the CCC- level on the Standard & Poor's scale, which effectively banned their access to the market for untied private loans. Despite the Russian regions' timely servicing of foreign bonds, the 1998 yields on subfederal Eurobonds (maturing in 2000-2002) on the secondary market were over 100 per cent per annum in US dollars, exceeding by several dozen percentage points the yields on federal securities with the same maturity.

The financial crisis entailed a default on foreign bank loans in a number of regions, including the republics of Tatarstan and Sakha (Yakutia). However, no Russian region was in arrears on Eurobond redemption.

Agrobonds and energy bonds. Agrobonds and energy bonds were issued by RF constituent members to restructure their debts to the federal budget on the 1996 loans granted against goods to enterprises of the agro-industrial complex, and 1993-1995 loans given to energy and electricity producers. The RF constituent members' authorities guaranteed repayment to the federal budget, which acted as the lender. A specific feature of the agrobonds is their unified issue: they are floated in equal tranches for a term of one, two or three years; they are issue in paperless form; their coupon yields amount to 10 per cent per annum. The floating of agro- and energy bonds was (for some tranches, still is) done by auctioning at a discount.

The floating and circulation of these bonds on the secondary market takes place within the trading system of the Moscow Interbank Currency Exchange. It is worth noting the extremely low liquidity of the secondary market for this type of bonds due to the relatively small size of each individual tranche.

The year 1997 saw the registration of 193 agrobond issue prospectuses for the total amount of Rb6.6372 trillion, and eight energy bond prospectuses for the amount of Rb795.18 billion. In the first half of 1998, the overall volume of the 18 registered issues of agrobonds and energy bonds was 722.61 million redenominated rubles.

The long maturity of the agrobonds, thanks to which under the Russian law nonresidents can count on repatriation of the expected revenues, promoted their floating among foreign investors in the favorable situation of 1997. The Federal Commission for the Securities Market estimates that nonresidents purchased over 70 per cent to 75 per cent of individual issues of agrobonds with a two- or three-year maturity issued by Russian regions with a view to restructuring their debts to the federal government.

Since agrobonds were not issued on the initiative of regional administrations but under pressure from the RF Finance Ministry, they were floated among outside investors (registered outside the given region's territory), and some issues were not floated but remained at the disposal of the Finance Ministry. Many issuers do not regard the redemption of these securities as a priority task. however. The regions have to repay the loans to the agro-industrial complex which they guaranteed and which used to be written off and, consequently, were usually employed inefficiently.

After the federal government declared a default on domestic bonds, the overwhelming majority of regions refused to make timely payments on agrobonds.

By end-1998, only 10 (out of more than 60) regions that had issued agro- and energy bonds managed to meet their obligations on these securities on time: Karelia, the Krasnodar Krai, the Leningrad Oblast, Orenburg Oblast, Sakha (Yakutia), the Tomsk Oblast, Rostov Oblast, Khakassia and Chuvashia.

Investors won several court cases involving regions' failure to service "agrobonds". However, the execution of judicial decisions is often impossible due to crises in the execution of regional budgets. Since in most regions noncash tax revenues (through netting-out operations) constitute more than 50 per cent of the budgets' own revenues, administrations of the RF constituent members are negotiating the possibility to meet their "agrobond" obligations through deliveries of goods manufactured by taxpayer enterprises.

The market for subfederal securities. As at the beginning of July 1998, apart from the relatively non-liquid agro- and energy bonds, securities issued by 17 RF constituent members were circulating on the Russian securities market (Table 1.26).

The largest issuers of bonds floated on the securities market were Moscow, St. Petersburg, the Republic of Sakha (Yakutia), the Omsk and Sverdlovsk oblasts, and Tatarstan. Trade in subfederal securities was concentrated mainly on three exchanges: the St. Petersburg Interbank Currency Exchange, the Moscow Interbank Currency Exchange, and the Moscow Stock Market.

Table 1.26

Issue of subfederal domestic securities 1997 to 1998[1]

Issuer	Size of issue		Exchange
	1997 in blns of Rbs	1998 in millions of Rbs	
RF constituent members			
Moscow	4 600	2 800	SPCEX, MICEX, MSE, MCSE
St. Petersburg	1 250	2 840	SPCEX, St. Petersburg SE

Issuer	Size of issue		Exchange
	1997 in blns of Rbs	1998 in millions of Rbs	
Sakha (Yakutia)[2]	1 270	1 300	SPCEX
Orenburg Oblast	2 000	- -	SPCEX, St. Petersburg SE
Omsk Oblast	350	1 000	SPCEX, St. Petersburg SE
Leningrad Oblast	500	- -	SPCEX
Sverdlovsk Oblast	300	1 000	YSE, SPCEX
Irkutsk Oblast	855	600	MSE
Rostov Oblast	290	190	MSE
Novosibirsk Oblast	200	200	CMCEX
Chelyabinsk Oblast	150	200	SUSE
Tatarstan[3]	800 700	560 - -	KSTBE MICEX
Moscow Oblast	1 000	- -	MICEX
Kursk Oblast	400	- -	MICEX
Lipetsk Oblast	100	75	MICEX
Novgorod Oblast	- -	30	MICEX
Altai Krai	- -	300	- -
Belgorod Oblast	- -	100	- -
Ivanovo Oblast	25	20	- -
Primorsky Krai	- -	200	- -
Tomsk Oblast	- -	100	- -
Republic of Chuvashia	- -	140	- -
Yaroslavl Oblast	- -	300	- -
Amur Oblast	5,4	- -	- -
Buryatia	50	- -	- -

Issuer	Size of issue		Exchange
	1997 in blns of Rbs	1998 in millions of Rbs	
Volgograd Oblast	540	- -	- -
Kabardino-Balkaria	0,15	- -	- -
Komi Republic	150	- -	- -
Perm Oblast	120	- -	- -
Samara Oblast	300	- -	- -
Yamalo-Nenets Autonomous Okrug	280	- -	- -
Municipalities			
Chelyabinsk	150	150	SUSE
Novosibirsk	- -	140	CMCEX
Nizhnevartovsk	20	40	- -
Volgograd	10	25	- -
Yaroslavl	30,2	18,28	- -
Chapayevsk	2	4	- -
Nizhnekamsk	- -	20	- -
Volzhsky	- -	15	- -
Zhukovsky	- -	4,95	- -
Bryansk	10	- -	- -
Dubna	10	- -	- -
Kaliningrad	20	- -	- -
Langepas	20	- -	- -
Lobnya	3	- -	- -
Novokuibyshevsk	7,784	- -	- -
Novocheboksarsk	20	- -	- -

Issuer	Size of issue		Exchange
	1997 in blns of Rbs	1998 in millions of Rbs	
Petrozavodsk	16	- -	- -
Saratov	2,586	- -	- -
Cheborsary	100	- -	- -
Lensky District (Sakha-Yakutia)	10	- -	- -

1. Other than agrobonds and energy bonds.
2. Some of the bond issues registered in 1997 have only been floated on the over-the-counter market. Official market trading in issuers' bonds began in 1998.
3. Various issues of the Tatarstan Republic’s bonds have been floated separately on the MICEX and the Kazan Stock Trading Board Exchange (KSTBE). Before they were transferred to the KSTBE Tatarstan’s RKO auctions had been held at the Volga-Kama Exchange.
Source: RF Ministry of Finance and Prime-TASS Agency data.

Leadership in subfederal bond sales is held by the St. Petersburg Currency Exchange. Thanks to its efficient infrastructure which came into being while servicing St. Petersburg bonds, the city's exchange managed to build a relatively liquid market for subfederal securities. The liquidity of the securities was maintained by market-makers who acted as general managers for subfederal loans - AVK and Sberbank-kapital investment companies. As a result, by the end of the first half of 1998, the St. Petersburg Interbank Currency Exchange dealt in the bonds of the seven largest issuers of subfederal securities, and managed to outrun the Moscow trading sites even in the volume of trade in bonds issued by the Government of Moscow. The liquidity of most bonds bought and sold on the Moscow Interbank Currency Exchange and the Moscow Stock Exchange is not high, only single transactions for each series of bonds are held within their trading systems.

Up to the second half of August, there existed regional exchange systems servicing just the trade in subfederal securities issued by the administrations of the regions where they were located: the Siberian Interbank Currency Exchange, the South Urals

Stock Exchange, the Yekaterinburg Stock Exchange, the Kazan Trading Board Stock Exchange.

While before the end of October 1997, yields on most subfederal bonds lay within the annual range of 21 per cent to 28 per cent, by February-March they rose to 24 per cent to 39 per cent per annum.

In May-June, investor confidence in the solvency of Russian borrowers was seriously undermined, and this promptly caused a further rise of interest rates to 80-100 per cent per annum. However, the need to refinance their obligations prevented most issuers from halting the issue of new bonds.

Most lenders were beginning to realize that the regions could not possibly service such a fast-growing domestic debt, and this made the panic even worse. The secondary trade turnover began to go down: it was more and more difficult to find buyers for bonds which were rapidly losing their value. Unwilling to record considerable losses, some investors continued to count on the redemption of the bonds on hand before the expected crash of the debt pyramid (Table 1.27).

Between April and June, the trade turnover in subfederal bonds decreased by 33 per cent to 50 per cent. In the first half of August, interest rates were already much higher than 100 per cent p.a., the investors switched over to the exchange market, and most of the subfederal issuers halted their bond auctions.

Table 1.27

Secondary market trade in subfederal securities for the first half of 1997 and 1998 (in millions of Rbs)

Issuer	1997	1998						
		Q1-2	Jan	Feb	Mar	Apr	May	June
St. Petersburg	12 810	3 708,3	578,7	898,5	706,5	765,2	421,1	338,3
Orenburg Oblast	1 716	1 449,1	191,4	323,6	275,3	331,0	167,8	170,0
Moscow	1 017	572,5	46,5	60,0	224,5	159,8	80,7	99,1

Omsk Oblast[1]	- - -	- - -	239,0	7,8	80,0	73,3	28,6	49,3

[1] Trading started in February 1998.
Source: Prime-TASS data.

The declaration of default on GKOs obliged Tatarstan (as from August 19) and the Novosibirsk Oblast (as from August 25) to pass a decision on mandatory restructuring of their bonds held by legal entities. Then, during September and October, default was announced on the bonds issued by the Republic of Sakha (Yakutia), the Sverdlovsk, Orenburg, Lipetsk, Irkutsk, Novgorod and Omsk oblasts and the bonds of the City of Chelyabinsk, the only municipal entity that had built a relatively liquid exchange for its own securities.

In mid-October, having failed to redeem its own bonds on time, the Leningrad Oblast bought them off their holders within two subsequent weeks at a large discount on a voluntary basis.

In November, Moscow managed to get its bonds redeemed, but with the investors' voluntary consent up to 40 per cent of the next issue was redeemed in noncash form, exchanged for tax benefits, housing certificates and newly issued municipal bonds.

The immediate cause of the defaults was that the issuers had exhausted their capacity for refinancing their liabilities by new borrowing due to the crisis on the financial market. As for the in-depth cause, it was the reduction of the overall volume of budget revenues: the lower tax collection level and delays in the receipt of federal transfers made it impossible to redeem the bonds using own means. In a number of cases, a significant share of the means obtained by floating regional bonds was used by the authorized investment companies to deal in transactions involving GKOs, which after the federal default could not but undermine the stability of the loan bonds' financial schemes.

By early February 1999, out of the 11 issuers who had established large and relatively liquid markets of their bonds only Moscow, St. Petersburg and the Chelyabinsk Oblast managed to avoid defaulting. The Irkutsk Oblast also managed to combat the difficulties and redeem the investors. The other major subfederal borrowers are having a hard time implementing debt restructuring programs.

Off-board bonds. Even now, Russia does not have a developed infrastructure for over-the-counter trade in bonds, which covers bonds not figuring on the RTS lists.

The main reasons why an issuer of subfederal or municipal (local) securities does not have them listed on an exchange are usually as follows:

(a) a relatively low volume of issue, which makes the formation of a market of this type of securities pointless;

(b) targeted issue of bonds that provides for their noncash redemption (housing loans) or bonds intended mainly for households (savings loans);

(c) protectionist character of loans designed to maintain a high yield for a relatively narrow circle of privileged investors;

(d) absence of exchanges in the given region.

Legislative regulation of the debt market

The Law "On the Issue and Circulation of Government and Municipal Securities" signed by the RF President on 27 July 1998 gave the constituent members of the Federation a right to issue government securities leading to the formation of an external debt, provided that:

- information about the revenues, expenditures, size of the fiscal deficit and the sources of its financing over the last three years before the issue is provided during the government registration of an issue prospectus for government securities;
- their budgets are executed in conformity with the fiscal and tax law of the Russian Federation;
- permission for foreign exchange transactions involving the movement of capital has been obtained;
- a credit rating has been given in accordance with the international credit rating standard by at least two leading international rating agencies;

- the standards set to the amount of borrowing and the volume of expenditure on the redemption and servicing of all debt liabilities are observed/met.

Under the law, "the RF constituent members shall issue loan bonds with account of the priority of the state foreign borrowing of the Russian Federation".

On 31 July 1998, the President approved the Budget Code of the Russian Federation, under which the maximum amount of the government debt of the RF constituent members and the debt of a municipal entity may not exceed the revenues of the relevant budget without account of the financial support from higher-ranking budgets. It also sets the ceiling on the maximum time of the borrowing, 30 years for the RF constituent members and 10 years for the municipal entities.

If a constituent member of the Federation fails to ensure the servicing and repayment of its debt liabilities and the servicing of the debt exceed 15 per cent of its budget revenues, or the maximum amount of the borrowing set by the law, "the authorized federal authority body" may initiate a revision of this member's budget and place the execution of this budget under the control of the RF Finance Ministry.

Similar steps are envisaged for the municipal entities, the only difference being that control is to be executed at the level of the RF constituent member.

The Budget Code envisages the establishment of a Government Debt Book, which would contain information about the amount of debt liabilities of the Russian Federation, constituent members of the Federation, and municipal entities on the securities issued, the date of these securities' issue, the use of these liabilities in full or in part, and other information deemed necessary by the person in charge of keeping the Government Debt Book of the Russian Federation.

Development prospects for the subfederal and municipal debt market

After a sharp drop of the credit rating of all domestic subfederal and municipal issuers, we should expect the transition from the so-called general bonds typical of Russia to bonds secured not only by budget guarantees but also the revenues from the funded project in question, that is, to "double-backed" securities.

It appears the most promising line to use borrowed money to finance the reconstruction of infrastructure facilities in housing and utilities: the demand for their services shows low elasticity due to the local monopoly status. Apart from sufficiently high rate of returns, the implementation of such projects would make it possible to reduce the budget load imposed by the need to subsidize housing and utilities: in 1998, 3.44 per cent of GDP or 23.7 per cent of the local budget revenues was spent for this purpose. The funding of infrastructure projects is usually a priority as regards the international financial organizations, which under certain terms grant long-term loans even in the presence of high risks.

Cases of mass-scale default on municipal and regional debt markets have revealed the principal problems that need to be solved before these markets can make some headway. Apart from the political and country risks, the main obstacle to the attraction of financial resources is **the absence of institutional mechanisms protecting the rights of the lenders** who finance the RF constituent members and local government bodies.[29] Securitization mechanisms for municipal borrowing are also nonexistent.

First, should a region refuse to repay a loan, it proves impossible to execute court decisions passed in favor of the lender. Judicial practice connected with agrobonds shows that the available legal framework is unable to ensure the observance of investor rights in cases where the authorities of RF constituent members fail to honor their obligations. The seizure, on judicial decisions, of

[29] See A. Shadrin, "New Municipal Bonds for City Infrastructure", *Rynok tsennykh bumag*, No.1, 1999, pp. 63-67.

individual bank accounts held by administrations is ineffective, while the seizure of all the budgetary accounts of a region is impossible. Under default, a procedure for the exercise of lenders' rights is absent.

To deal with the issue of protecting lenders' right would take more advanced legislation in the sphere of debt restructuring procedure by the RF constituent members and the municipalities. In view of the experience of other countries, it may be sensible to pass a special law on the bankruptcy of municipal entities.

Second, there are no mechanisms for protecting lenders' rights as regards control over the appropriate use of borrowed money and management of the means of the loans' reserve funds, which causes their inefficient and/or illegitimate use. Neither is there a developed system of monitoring the implementation of investment projects and evaluating the credit risks they involve (trustee banks, rating agencies).

The system of control over the appropriate use of borrowed money by municipalities and regions and the need to represent the interests of many small bondholders who would find it difficult to protect their rights individually makes it necessary to introduce the institution of trustee banks, whose functions could, in principle, be assumed by specialized depositories (in accordance with current RF legislation).[30]

The main functions of trustee banks are to ensure the transparency of the issues, control over the latter's conduct, and protection of end investors if the issuer fails to honor its obligations. Trustee banks control (monitor) the issuer's current financial status and the management of its reserve funds and collateral fir the loan. If the issuer fails to meet its obligations on the bonds, the relevant trustee bank presents claims to the issuer on using the reserve funds to repay the investors and represents the

[30] *The Development of the Russian Financial Market and New Instruments for Attracting Investment*, Institute for the Economy in Transition, Moscow, 1998, pp. 262-263 (in Russian).

interests of bondholders as a collective lender in court after a bankruptcy suit has been brought in.

Third, there are no mechanisms for securitizing loans, that is, uniting small-scale loans into a pool that could provide security for an issue of potentially liquid bonds into which non-bank investors could invest. As a result, it is practically impossible to set up a secondary market for municipal debt.

The formation of a system for municipal debt securitization requires a debt market backed by either a pool of bank loans or a pool of small bond issues, that is, a market for asset-backed securities (ABSs). This raises the question of the need to guarantee or insure the issues of such bonds and maintain their liquidity on the secondary market. While in late 1997, these functions could still be claimed by the largest Russian banks, at present potential candidates from among private financial institutions include only nonresidents.[31]

An alternative way to secure municipal borrowing could be developed using a model for the organization of a secondary market for mortgage loans that envisages setting up a specialized federal agency for lending to municipalities (along the lines of the Russian Federal Agency for Mortgage Lending and the US-based Fanny Mae, Ginnie Mae and Freddie Mac).[32]

Such an agency could independently undertake large issues of potentially liquid bonds (maybe guaranteed by a third party) backed by a pool of municipal debt on infrastructure projects bought back on the secondary market.

At the same time, the status of the Russian financial market as of the spring of 1999 makes it impossible to expect that any at all significant projects can be implemented in this sphere even in the medium term.

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[31] See: A. Shadrin, "Asset Security and the Development of an Asset-Based Securities Market", *Finansist*, Nos. 9-10, 1998, pp. 12-15.

[32] See: A. Shadrin, "The Market of Mortgage Securities. A Russian Perspective of US Experience", *Rynok tsennykh bumag*, No.7, 1998, pp. 62-64, No. 8, pp. 73-76.

Section 2

Real Sector of economy

2.1. Main Trends in Real Sector of Economy

Production of GDP: Factors and Trends

In the first half of 1998, the trends formed in 1997 continued their positive effects on the situation in the real sector of economy. During the first quarter of 1998, the positive dynamic of the GDP and industrial production remained effective. However, already this period has seen the gradual growth of the negative effect of the world commodities market situation. In 1997, the export reduction reached 2.7% compared with 1996. This was due to both the changes of the world prices on the main export commodities (including the sharp drop, in November 1997, of the world prices on the fuel and energy resources) and the lowered demand for the feedstock resources resulting from the worsened world economic conjuncture.

From the beginning of 1998, the export has been reducing not only from the money but also in the physical viewpoint (in 1998, the export reduced by more than 17.0%). The loss of the incomes from the external trade had the negative effect on both the financial situation of the export-oriented industries and the macro-economic situation.

In these conditions, the trends to the decrease of the real volume of the GDP have renewed; the dynamic of the industrial and agrarian production has worsened; the volume of the contract works in the construction has diminished; and the volumes of the transport freight turnover have decreased, as well.

Table 2.1

Dynamic of main macro-economic indexes
(% the relevant period of the preceding year)

	1997	1998	By quarters of year			
			1	2	3	4
Gross domestic product	100.4	95.4	100.9	99.9	96.8	89.9
Industry	101.9	94.8	101.3	98.7	96.1	91.8
extractive	103.0	97.0	101.6	99.3	98.7	94.7
manufacturing	101.8	92.8	101.0	97.7	94.5	90.2
consumer goods	102.1	91.0	101.4	99.1	96.3	91.4
Agrarian economy	100.1	87.7	99.2	100.7	78.0	85.6
Investments	94.5	93.3	94.4	93.6	94.1	91.6
Freight turnover of transport entities	96.4	96.5	96.0	96.4	96.6	96.9
Communications services	123.6	101.5				
Retail trade	101.4	95.5	99.6	98.4	99.8	85.6
Paid services	103.7	97.6	99.7	101.0	97.6	93.6
External trade turnover	101.5	82.4	99.0	96.3	78.8	60.8
Export	97.3	83.6	87.6	91.1	82.8	75.0
Import	107.4	80.9	115.6	102.4	74.1	44.4
Balance						
Real disposable money incomes	103.5	81.8	90.6	87.2	81.3	72.2
Unemployed. officially registered	79.4	82.1	77.6	74.4	82.1	94.4
Price indexes:*						
consumer	111.0	184.4	103.1	101.0	143.8	123.3

	1997	1998	By quarters of year			
			1	2	3	4
food	109.1	196.0	104.1	100.9	142.7	130.9
non-food	108.1	199.5	101.0	100.2	165.4	119.1
paid services to population	122.5	118.3	104.0	102.6	105.9	104.7
industry						
finished products:	107.4	123.2	101.3	99.2	105.3	116.5
purchased resources	106.8	115.1	100.9	100.0	100.6	113.8
capital construction	105.0	112.1	102.6	99.8	103.6	105.6
cargo transport	100.9	116.7	101.3	88.8	125.0	103.8
communications services	104.2	106.2	103.9	99.5	101.9	100.9
Official exchange rate of US$*	107.6	341.9				

*- end of the period to end of the preceding period
Source: Russian State Committee for statistics (Goskomstat).

In 1998, the gross domestic product was Rbl. 2,684.5 billion; it decreased by 4.6% compared with the relevant level of the preceding year. While in the first quarter of year the situation was stable enough, the April began the deepening of the GDP production decrease. Up to the third quarter of 1998, the low inflation rate remained. The limited effective demand required from the producers a moderate pricing policy and this attenuated the rates of production decrease in the industries of the real sector. During January trough July 1998, the consumer prices grew by 8.1% while the producers' prices reduced by 1.5% at the US Dollar exchange rate having grown, in January through July, by 4.7%.

The new wave of the world financial crisis aggravated the situation in the Russian economy. The significant change of the situation of the monetary and stock markets of Russia resulted, in the end, in the collapse of the banking sector. The Ruble was devaluated and, from August 1998, the Russian economy has been functioning in the conditions of permanent growth of prices. In August through December 1998, the consumer prices grew

1.7-fold, the producers' prices grew 1.25-fold, and the US Dollar exchange rate grew 2.6-fold.

In the structure of the produced GDP, the specific share of almost all the commodities manufacturing industries reduced. The growth of the services production notwithstanding the reduction of the demand for this sphere of activities reflected, first of all, the decline of the business activities in the other fields. For the other hand, the growth of the services share was conditioned by the positive structural shifts in this sector of economy. In particular, the shares of the communication, trade, real estate, money, insurance, and other services of the market character grew up.

Table 2.2

Structure of production of GDP (% of balance)

	1995	1996	1997	1998
Gross Domestic Product	100.0	100.0	100.0	100.0
incl.:				
Production of goods	48.0	46.3	44.1	42.7
incl.:				
industry	30.7	29.9	28.6	28.1
rural economy	7.6	7.3	7.1	6.5
construction	8.8	8.2	7.8	7.1
Production of goods	52.0	53.7	55.9	57.3
Incl. market	39.5	40.3	41.7	45.3
Incl.				
Transport and	11.1	13.3	12.2	11.9
Trade	18.5	15.9	16.6	19.3
Non-market services	12.5	13.4	14.2	12.0

Source: Russian State Committee for statistics (Goskomstat).

The commercial freight turnover in the transport field reduced by 3.5% compared with 1997, including the 7.3% for the rail transport (the latter supports over one third of the cargo transport and freight turnover of Russia). In 1998, the rhythm of the rail transport operation was sharply broken. The growing social tension resulted in more strikes and periodical blockades of the railroads having paralyzed the operation of whole regions and industries. The volumes of transportation and loading reduced for practically all the kinds of industrial products and material and technical resources. Thus, in the rail transport, the volumes of loading reduced, in 1998, by 5.8%. It should be noted that the export-oriented productions tried to stabilize their positions due to the growth of the export of their products.

In the second half of 1998, the volumes of transport of the imported cargoes decayed sharply; the collapse of the freight turnover by the automobile and sea transport was observed. In 1998, the commercial turnovers reduced by 26% for the automobile transport and by 30% for the sea transport.

In the sea transport fleet, the situation was aggravated by the technical state of the vessels. In 1998, the number of units of the transport fleet reduced by 22% due both to their purring out of operation resulting from the wear and tear and from the transfer of the other part for repair to the other companies to the subsidiaries registered outside Russia to obtain the credits. Besides, the reduction of the profitability of the vessels use in the Russian market and the growth of the operating expenses resulted in the sale of some of the vessels.

To the end of 1998, the remainder of the export cargoes in the main Russian seaports intended for the marine transport grew by 2.7% compared with December 1997. The hard currency income of the Russian shipping companies from the external market activities and from the export-import transport reduced in 1998 by 16.6% compared with 1997.

The communications remain the most dynamically developing sector of the Russian economy. In 1995, the average number of employed in this sector was 0.6% of the total employed in the economy; in 1998, the share of the employed in the communications exceeded 1.5%.

The stable growth of the share of the communications in the GDP has been observed during the last five years. In 1998, the volume of the communications services grew by 1.6%; as of today, it was Rbl. 64.4 billion in the current prices. The implementation of the state-of-the-art equipment has been changing the structure of the services: the shares of the telepnony, radio, TV, and satellite communications have been growing while the shares of the mail and wire broadcasting have been declining.

In 1998, the volume of retail trade decreased by 4.5% compared with 1997. After the rush of the consumer demand in August 1998, the following growth of prices and reduction of the money incomes of the population, the conditions of the trade functioning worsened significantly. In January to November 1998, almost a half of the trade enterprises suffered losses; the number of shops was declining; in the structure of the retail trade the role of the unorganized turnover grew. In the fourth quarter of 1998, the retail commodities turnover was 85.6% of the same period of 1997. In the fourth quarter of 1998, the share of the import in the volume of commodities resources dropped down to 37% against the 48% in the first half of the year. The saturation of the retail market was supported by the domestic products and stocks of trade that, as of 1 January 1999, were by 34.7% lesser than as of 1 January 1998.

It should be emphasized that the growth of the share of the services in the GDP structure was due, first of all, to the change of the volume and structure of the paid services to the population. While the year 1997 had been characterized — for the first time during the years of the reforms — by the growth of the volume of the paid services to the population (by 3.3%), in 1998, the reduction by 2.4% took place. During the first half of 1998, the dynamic of the paid services to the population was forming under the effects of such factors as the irregular payments of the labor remuneration and pensions to the population. The August financial crisis added to this the factor of the reduced solvent demand of the population for the services. In this situation, the dynamic of the prices and tariffs on the paid services remained within the limits of the average monthly rates of inflation of the January through July period. This was restraining the reduction of the demand. However, the main thing was that the features of their specific forms also determined the dynamic of the volumes of the paid services to the population.

During the last two years, the structure of the paid services to the population has acquired a stable enough character. By more than a half, it is formed by the mandatory payments for the communal services, services of transport and communications. Almost 20% of the volume of the paid services to the population fall on the repair of the living premises, home appliances, servicing and maintenance of automobiles, medical services, and educational services. This very underdeveloped structure of the demand of the population for the paid services was holding back the reduction of their volume in the fourth quarter of 1998.

The dynamic of the production of the goods was determined by the processes of the gradual deepening of the crisis in all the sectors. After a certain enlivening of the activities in the industry in 1997, both the extracting and manufacturing industries saw the depression trends again. In whole, in 1998, the recession of the industrial production was by 5.2%; it was observed in all the branches of industry.

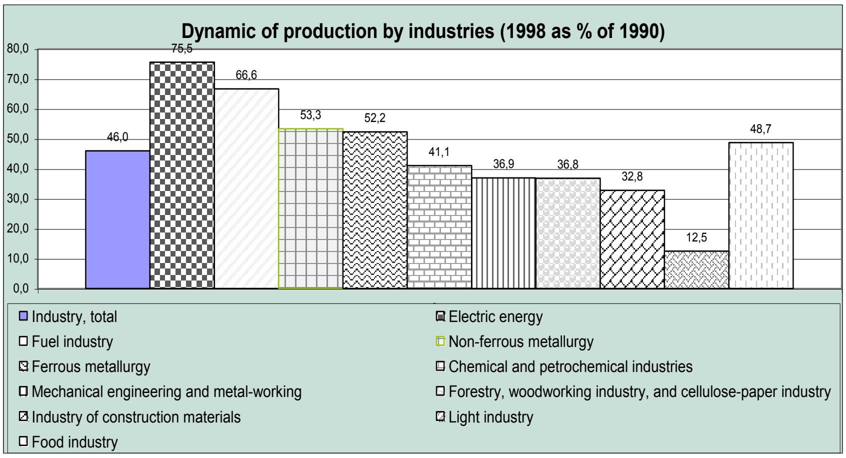
Table 2.3

Dynamic of physical volume of the industrial production in 1991-1998, 5 of the preceding year

	1991	1992	1993	1994	1995	1996	1997	1998
Industry, total	92	82	85.9	79.1	96.7	96.0	102.0	94.8
Electric energy	100.3	95.3	95.3	91.2	96.8	98.4	98	97.5
Fuel industry	94	93	88.4	89.8	99.2	98.5	100.3	97.5
Non-ferrous metallurgy	93	83.6	83.4	82.7	109.6	97.5	101	91.9
Ferrous metallurgy	91	74.6	85.9	91.1	102.8	96.4	105	95.0
Chemical and petrochemical industries	94	78.3	78.5	75.5	107.6	92.9	102	92.5
Mechanical engineering and metal-working	90	85.1	84.4	69.2	90.9	95.4	104	92.5
Forestry, woodworking industry, and cellulose-paper industry	91	85.4	81.3	69.5	99.3	82.5	101	99.6
Industry of construction materials	98	79.6	84	72.7	92	82.7	96	94.2
Light industry	91	70	77	54	69.8	77.5	98	88.5
Food industry	91	83.6	91	82.5	91.8	95.8	99	98.1

Source: Russian State Committee for statistics (Goskomstat).

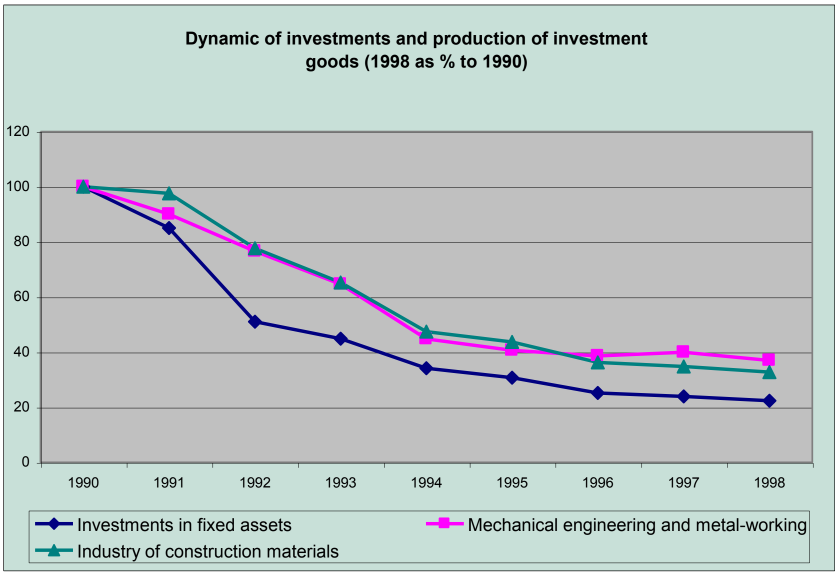
Fig. 2.1



Before the market reforms, the Russian economy was characterized by the disfigured system of the interaction between the financial sphere and the real sector of economy. Regretfully, the extremely slow rates of restructuring of the economy and the absence of the efficient governmental investment and industrial policy have not allowed to solve this problem of the balanced development of the financial and real sectors of the economy up to today. The strict limiting financial policy has led to the large-scale practical use of the system of the non-money settlements between enterprises. Due to these circumstances, the financial crisis did not have a visible effect on the dynamic of the industrial production at the first stages of its development. In January thtough June 1998, every second region of the Russian Federation observed the growth of the industrial production, compared with the relevant period of the preceding year. However, this trend was unstable, and, in the first half-year, the industry showed the indications of the gradual slowdown of the growth rates. From the beginning of 1998, the enterprises began feeling the growing effect of the demand limitations. The situation in the industry was worsening also due to the changes of the conjuncture of the world markets of the energy media and metals.

In 1997, for the first time from the beginning of the reforms, the industry saw the positive dynamic in the sector of the investment and consumer goods. In 1998, the decline in the investment complex renewed; hence, the reduction of production in the industry of construction materials and in the mechanical engineering.

Fig. 2.2



The share of the construction in the GDP reduced by 0.7 percentage points, compared with the preceding year. The volume of the construction works was 92.5% of the level of the preceding year; with this, the main wave of curtail was seen in the fourth quarter of 1998. The reduction of the scales of works was accompanied by the decline of the demand for the construction materials. It is interesting to note that the recession in the industry was seen on the background of the production restructuring. The drop of the demand for the precast concrete articles and articles for the industrial construction was compensated by the growth of the demand for the wall materials and cement; the latter was due to the implementation of the new construction processes. As in 1997, the demand for the ceramic articles, roofing materials, and articles of polymeric raw materials continued growing. The state-of-the-art high quality construction materials were manufactured by more than 30 new production entities. The fact that certain enterprises had began participating in the different structures of the corporate type with participation of the banking and foreign capital had a certain positive effect on the normalization of the situations of such entities.

The dynamic and structure of the production in the mechanical engineering accumulate the effect of the factors determining the situations of the financial, real, and consumer sectors of economy. The mechanical engineering reacted on the financial crisis by the marked reduction of production in all the sub-branches. In 1998, the volume of production in the mechanical engineering reduced by 7.5%, while the 1997 growth was 3.5%.

The positive dynamic in the mechanical engineering complex stayed effective only during the first four months of 1998. In May, the recession began that initiated the reduction of both the domestic demand and export. The volume of the mechanical engineering export reduced by 11.2% compared with 1997, due to the continuing financial crisis in the countries importing the Russian mechanical engineering products. The export to the outside CIS reduced 2.7-fold for the forging equipment, by 30% for the road construction equipment, and by 3% for the metal cutting machinery. The export of the Russian mechanical engineering products to the CIS countries dropped by 36.3%.

While in 1997 the revival of the industrial production had been connected with the restitution of the positive dynamic in the automobile construction, in 1998, the situation differed: the production of the automobile construction reduced by 11.5% compared with 1997. The industry faced the problem of sale and growth of the overproduction crisis. The automobiles manufacture forms almost a third of the gross production of the mechanical engineering, and, of course, the new situation has a destabilizing effect on the trends of evolution of the mechanical engineering complex and industry in whole.

In 1998, after the drop of the production profitability down to 5.7% (against the 6.96% in 1997), the share of the profitless mechanical engineering enterprises grew. It reached 47.9% (against the 44.6% in 1997). As of 1 December 1998, the accounts payable exceeded the accounts receivable almost 2-fold; the delayed payments to the budget and the state non-budget funds grew, as well.

The production facilities of the industry were used within the limits 18% to 21%, except for the automobiles manufacture where the levels of use of the facilities were 60% for the buses and 85% for the passenger cars. The elimination of the facilities continued, mainly in the large-batch production (metal-cutting equipment, electric motors, and cranes) due to writing off the worn and torn equipment. The shortage of the money led to the lack of renewal of the fixed assets, the implementation of the energy and resources saving processes did not go on.

In the first half of 1998, the production of the defense industry grew by 3.9% compared with the relevant period of the preceding year. However, in the third quarter-year, the decline began; in whole, in 1998, the manufacture of the civil purpose articles in the defense industry complex was 92.4% of the level of the preceding year, while its specific share in the overall production of the complex reduced to 56.5% compared with the 59.4% of 1997.

Due to the low solvent demand of the customers, lack of the own circulating assets, limited possibilities of mobilization of the credit resources, badly developed leasing relationships, and shortage of the budget financing of the conversion programs, the financial and economic situation of the defense industry entities remained difficult. The accounts payable exceeded the accounts receivable more than 2-fold. This situation resulted in the insolvency of about 400 enterprises (as of 1 January 1999) and larger use of the barter; these worsen the situation with the non-payments of the labor remuneration and aggravate the social tension.

In 1998, the defense complex conserved the trend (formed in 1997) to the growth of the production volumes of the entities whose civil products are competitive and have the demand. Thus, in 1997, the production volumes of the medical equipment grew by 20%. The growth of the medical equipment manufacture was due to the high quality of the equipment and the prices significantly lower than the ones on the similar imported articles.

In the aviation industry, the production grew by 1.3% due to mastering by a series of enterprises of the up-to-date aircraft (airplanes of the TU-204, IL-96 types), growth of their export, and grown volume of repair and maintenance of the earlier manufactured aircraft. In whole, in 1998, 14 large civil airplanes and 42 helicopters were manufactured; of them 7 airplanes and 12 helicopters were intended for export.

The problems with increasing the manufacture of the civil aviation equipment were due, mainly, to the absence in Russia of the leasing supplies system: the deployment of such system requires the significant initial investments. Some of the aircraft constructors when exporting the aircraft solved the problem of the financing using the international financial leasing. Thus, *Sirocco Aerospace* (Egypt) was the first foreign leasing company having ordered the supply of five TU-204-120 passenger planes (from the Ulianovsk Aircraft Industry Complex *Aviastar*) and having made the option for twenty four more aircraft of this type.

In whole for the defense complex, in 1998, the export of the civil products was US$ 810 million (132.6% of the 1997 level). The export supplies were made by 331 enterprise of the defense industry to 80 countries of the world.

In 1998, the production continued to grow in the electrical engineering, instrument making, and communication means industries. Despite the low specific shares of the above industries in the structure of the mechanical engineering complex, they have an active influence on the evolution of the competition in the market of the machinery and equipment.

The manufacture of the production equipment for the enterprises of the light industry and processing branches of the agro-industrial complex reduced by 17.5% and 5.0% respectively compared with the relevant period of the preceding year. The use of the facilities manufacturing the production equipment for the fuel and energy complex was about 40%; its manufacture grew by only 2.7% from the 1997 level. The production of the non-food consumer goods reduced by 21.4% from the level of 1997.

In 1998, the production in the civil shipbuilding reduced by 17.3% from the 1997 level. The further decline of the already low solvency of the customers determined the delays in the vessels manufacture. As of today, the construction of almost 30 ships has been suspended due to the non-payments from the customers.

In 1998, the dynamic of production of the consumer goods was predetermined by the growth of the prices and reduction of the demand in the domestic market. The greatest effect of the crisis was on the production of the long life consumer goods and sophisticated home appliances. According to the preliminary data, in 1998, the overall volume of production of the consumer goods reduced by 9% compared with 1997. The entities manufacturing the goods under the licenses of the foreign companies and using the imported components and materials reduced significantly the production volumes; some even stopped their manufacture.

In the light industry, in 1998, the overall production volume decreased by 11.5% compared with the preceding year. With this, during the year, its dynamic underwent significant changes. In the first half-year, the production remained at the level of the relevant period of 1997. From the beginning of the second half of the year, the decline of the overall production volume was growing from 14.5% in July to 30% in October through December.

The sharp growth of the prices on the imported cotton, wool, and cotton thread was one of the factors of the aggravation of the recession in the textile industry. The 3.3 to 3.5-fold growth of the prices on the imported cotton fiber resulted in the 2.5-fold growth of the prices on the cotton products and the problems with the sale of the finished goods. As a result, certain enterprises oriented to the domestic market stopped. The situation of the enterprises exporting the fabrics was a little better, but their number does not exceed 20% of the total in the cotton industry and they do not determine the overall situation. The growth of the prices of the imported wool and drop of production of the domestic wool feedstock had the negative effect on the wool industry. The unfavorable weather conditions led to the 2-fold reduction, in 1998, of the flax fiber production compared with 1997. As a result, the manufacture of the flax and hemp jute fabrics dropped by almost 34%.

The growth of prices on the natural feedstock resulted in the growth of the demand for the chemical fibers and threads; this made it possible to conserve the production in this branch of the chemical industry practically at the 1997 level.

However, in whole, more than 64% of the light industry enterprises were profitless as of 1 December 1998. Many enterprises had unnecessary equipment and workers resulting in the excessive production expenditures.

The private enterprises and the ones with foreign capital favored the restructuring of the light industry and its gradual adaptation to the market situation. From the middle of 1998, the clothing industry saw the revival remaining effective up to today. Occupying a certain niche in the consumer market, the products of the clothing industry began competing with success with the similar imported articles. This ensures the work places in the clothing industry and the associated branches of the light and chemical industries.

In 1998, the positive trends that had appeared in 1997 in the chemical and petrochemical industries could not be intensified. From March 1998, the reduction of the monthly production began; it was the most intensive in June to September. The production of most of the most important products of the chemical industry reduced. The production of the mineral fertilizers reduced by 2.5% compared with 1997. Their export exceeded 80% of the total production volume and exceeded by almost 3% the export of 1997. The production of the synthetic rubber reduced by 11.8% compared with 1997 due to the reduction of the export supplies of certain kinds of the rubber resulting from the non-competitiveness of the latter. In addition, the situation with the feedstock supply aggravated because the long pause in the reproduction of the fixed capital in the associated branches had resulted in the shifts of the in- and inter-branch proportions.

With the reducing demand in the domestic market for most of the domestic chemical industry products, the export holds back the production drop in the industry and gives the hard currency income required to purchase the feedstock and materials. Almost a third of the chemical industry products is exported. At the same time, the drop of the world feedstock prices, the anti-dumping sanctions by the Western countries, and the growth of the export potential in China and Middle-East countries pushing the Russian chemical products exporters away from the traditional markets, the export supplies of the nitrogen fertilizers, methanol, ammonium, and synthetic rubber reduced. As a result, the estimated volume of the hard currency income was about 91% of the level of 1997.

Due to the growth of the exchange rate of the US Dollar, the import of the household chemical products, plastic articles, paints, and other materials reduced. This favored the growth of the demand for the domestic products and a certain revival of the relevant production. However, this also resulted in the worsening of the situations of the entities whose production processes require the imported feedstock.

The financial situation in the chemical industry remained very complicated. As of 1 December 1998, 49.7% of the enterprises were profitless. The accounts payable exceeded the accounts receivable almost 2-fold; the coverage factor characterizing the solvency of the entities reduced, during 1998, from 92.3% to 83.3%.

The production profitability level of the chemical industry enterprises stayed low: it was minus 0.6% in the first quarter-year, 1% in the second quarter-year, and 4.1% in the third quarter-year. As a result, the estimated annual profitability was 2% to 2.5% compared with the 4.6% in 1997.

In the forestry and woodworking complex, the total production volume of 1998 was close to that of 1997. Under the reduction of the solvent demand of the domestic market, the production became more dependent upon the foreign market situation. The export volume of the wood and paper products (round timber, veneer, paper, commercial cellulose, and packing cardboard) somehow grew. In the structure of the export, the raw timber (31%) and sawn timber (18%) prevailed still. In the overall export volume of the wood and paper products, the specific share of the deep treatment one was 38% (26% for the paper and cardboard and 12% for the commercial cellulose). In 1998, there were the cases of suspension of the export supplies due to the suspensions of the payments, growth of the expenditures on the feedstock and transport, and drop of the prices on the export products. As a result, the total hard currency income decreased, according to the estimates, by 5% compared with 1997.

The intensification of the decay in the extracting sector of the economy resulted from the drop of demand in the domestic market. In 1998, as compared with the preceding year, the sales for the production and operation needs reduced by 7.5% for the crude oil, by 2.5% for the natural gas, and by 0.7% for the coal. With the reduction of the domestic market demand from the basic mechanical engineering, the sale of the metallurgical products reduced.

The drops of the production by 8.1% in the ferrous metallurgy and by 5% in the non-ferrous metallurgy, compared with the preceding year, were due, mainly, to the decrease of the export supplies of certain products. Besides, the solvent demand from the mechanical engineering, fuel and energy, and investment complexes reduced. During the year, the domestic market sales reduced by 4% for the finished roll of the ferrous metals and by 20% for the steel pipes. In 1998, the demand of the domestic market for the main non-ferrous metals remained, practically, at the level of the preceding year.

In 1998, the export stayed the main direction of sale of the most important non-ferrous metals. Its share in the production of the industry exceeded 80%.

The drop of the Ruble exchange rate resulted in the temporary improvement of the financial situations of the export-oriented enterprises of the metallurgical complex, growth of the financial profitability of their products, and replenishment of their circulating capital; however, in whole, the situation remained unsatisfactory.

As of 1 December 1998, the losses of the ferrous metallurgy enterprises reached Rbl. 3.5 billion; the accounts payable exceeded the accounts receivable 1.9-fold. In the non-ferrous metallurgy, the losses were Rbl. 3.1 billion; over 60% of the enterprises were profitless.

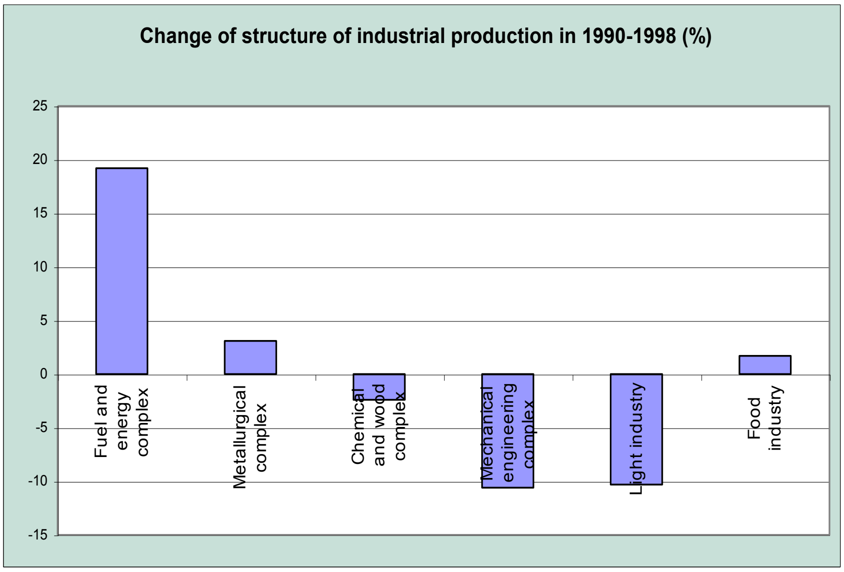
The production and financial results of the industry were affected by such internal factors as the growth of the interest rates and expenditures on the rail transportation of the export cargoes. The financial and economic crisis resulted in the slowdown of the settlements between enterprises, worsened circulation of the capital, and strengthening of the barter (the latter has reached 70% of the sold products). All these had the negative effect on the production.

The metallurgical enterprises did not have the money to update and reconstruct their facilities, to implement the state-of-the-art production processes. At most enterprises, the wear and tear of the fixed assets exceeded 50% to 70%, resulting from the worsened competitivenes of the products and irreparable damage to the environment.

When evaluating the outlooks of the evolution of the metallurgical complex, the feedstock base issues have been gaining priority. The low rates of increase of the prospected reserves and the fact that the putting into operation of the facilities extracting the non-ferrous ores has remained behind their removal from operation may result in the sharp decline of production in this branch in the nearest years. The aluminum manufacturers were provided with the domestic feedstock at 35% to 40%, and the remaining feedstock, mainly alumina, was purchased in the foreign market.

The share of the fuel and feedstock production in the industrial production structure has continued growing.

Fig. 2.3



Source: Calculated based on the data of the Russian State Committee for statistics (Goskomstat).

According to the pre-estimates, in 1998, the extraction and production of the primary fuel and energy resources grew by 0.7% compared with the preceding year, due to the growth of the extraction of the natural gas and production of the electric energy by the hydro-electric power plants.

The demand of the domestic market for the fuel and energy resources was fully satisfied; with all this, over 45% of the extracted crude oil, 33% of the extracted natural gas, and 28% of the petroleum products were exported.

In 1998, for the first time during the years of the reforms, the growth of the prices on the most important energy resources stopped and they began significantly decreasing. Thus, in December 1998, as compared with the relevant period of 1997, the prices of the producers reduced: by 9.8% for the crude oil, by 5.9% for the electric energy, and by 8.1% for the coking coal. The average price of the gas, including the cost of its transportation, stayed the same, while that of the energy coal grew by 2.2%.

Up to August 1998, the prices of the main oil processing products were significantly reducing, as well. However, the inflation processes, having become more severe due to the financial crisis, resulted, to the end of the year, in the growth of the prices by 29.5% on the automobile gasoline, by 7.8% on the diesel fuel, and by 3.4% on the fuel oil.

In 1998, the production of the electric energy was 826 billion kWh which was close to the 1997 level. The index of physical production volume in the sector, including the heat energy production, reduced by 2.5%.

(The main tendencies of the oil and gas complex and food industry evolution will be discussed below).

Formation of GDP by Incomes

The decline of the business activity in the national economy has resulted in the decrease of the real mass of the profit received by the large and medium enterprises and the growing differentiation of the branches by the financial and economic indexes. In 1998, the level of production profitability in the industries and production infrastructure continued reducing. In the first half of 1998, the financial balance of the large and medium enterprises and organizations was Rbl. 55.1 billion, or 70.9% of the level of the preceding year.

In the second half of 1998, the indexes of financial activity worsened in all the branches of the real sector. As of the results of the first eleven months of 1998, the profit of the large and medium enterprises was Rbl. 209 billion. As compared with 1997, the share of the profitless enterprises grew up to 48.3% (50% in the industry) and their losses reached Rbl. 187.5 billion. In January through November 1998, the balance profit of the large and medium enterprises reduced by 84.6% compared with the relevant period of 1997, including by 84.9% in the industry, by 46.3% in the construction, and by 9.9% in the transport. All the branches of the industry, except the fuel and energy complex, medical industry, and polygraphy, were profitless. In the wood industry complex, light industry, non-ferrous metallurgy, microbiological industry, industry of construction materials, and fuel industry, the specific share of the profitless enterprises exceeds the average one.

The certain revival of the production noted in October through November 1998 was due to the partial restoration of the solvency of the banks, reduced amplitude of the variations of the exchange rate of the Ruble, and reduction of its real exchange rate. In November 1998, for the first time since the August crisis, the large and medium enterprises and organizations of all the branches of economy (not taking into account the agrarian economy, crediting, and insurance organizations) received the balance profit (profit minus losses) of Rbl. 14.6 billion, including the Rbl. 6.3 billion in the industry. The positive financial result of the industrial enterprises is partially explained by the slowdown of the recession rates and redirection of the consumer demand to the domestic goods due to the significant reduction of the supplies of and growth of the prices on the imported goods.

The 1998 financial situations of different industries differed. In the second half of 1998, compared with the second half of 1997, the profits grew in the food industry and in the exporting industries, i.e., oil and gas extraction, metallurgical, and chemical industries. The devaluation of the national currency resulted in a certain growth of profitability of the export because the decrease of the Ruble exchange rate was larger than the reduction of the world prices on the main feedstock products. At the same time, the devaluation of the Ruble resulted in the growth of the expenditures on the imported feedstock and materials and on the transportation.

The communications observed the growth of the profit in the first half of 1998, compared with the first half of 1997, by almost 2.6%. However, after the crisis, the profitability sharply dropped, and for the first eleven months, the balance result was 55.9% of the level of the preceding year.

The collapse of the retail turnover in the fourth quarter of 1998 and the growth of the number of the profitless entities worsened the financial results. The year in the trade ended with the losses exceeding Rbl. 14.4 billion.

The total estimated balance profit of 1998 of the large and medium enterprises and organizations of all the branches of economy (not taking into account the rural economy, crediting, and insurance organizations) was Rbl. 60 billion, or 73% of the level of the preceding year.

During 1998, the financial situation of most of the enterprises worsened, the disproportions in the structure of their financial resources were growing. With the reduction of the production profitability and of the profit, the own assets of the enterprises decreased and the mobilized assets saw the growing share of the non-payments and bill crediting.

In January through November 1998, 46.4% of the circulating assets were formed by the debts for the dispatched products and performed works and services, while only 3.2% were formed by the balance of the money assets on the accounts of the enterprises and organizations. With the sharp deficit of the liquid assets, the breaches of the discipline of the payments and settlements intensified.

The limitation of the circulating assets galvanized the growth of the barter settlements whose use distorted the real picture of the financial situation of the enterprises and let them withdraw significant sums from under taxation. Besides, the real sector of economy had the especially painful reaction on the growth of the cost of the crediting resources. First of all, this showed itself in the intensified tendency to the growth of the non-payments.

As of the beginning of 1998, the aggregate indebtedness on the liabilities (accounts payable, debts on the bank credits and loans) of the industry, construction, rural economy, and transport was Rbl. 1,453.0 billion, including Rbl. 782.2 overdue.

In January through November 1998, the average overdue accounts payable were growing monthly by 3.3%. In the fourth quarter of the year, as a result of the measures taken by the RF Government regulating the settlements between enterprises and organizations, the growth rates of the overdue accounts payable reduced to 2.1% in October and 1.1% in November.

During 1998, the overdue accounts payable grew more than 1.5-fold. As of 1 December 1998, the aggregate indebtedness on the liabilities of the industry, construction, rural economy, and transport reached Rbl. 2,751.9 billion, of them Rbl. 1,307.1 billion overdue. The main debts (56.5% of the aggregate and 65.2% of the overdue accounts payable) fell on the industrial enterprises.

During 1998, the structure of the overdue accounts payable was changing insignificantly: the debts to the suppliers stayed within the limits 46% to 47% and the debts to the budgets of all the levels stayed within the limits 19% to 20%.

As of the end of 1998, the overdue accounts payable were about 46% of the GDP while the accounts receivable were about 29% of the GDP, i.e., in whole, the enterprises were net debtors and the sum of the net debt was systematically growing.

As of the beginning of December 1998, the aggregate accounts payable in Russia were Rbl. 1,547.9 billion, of them Rbl. 776.2 billion overdue. In the structure of the overdue accounts payable, 84.2% fell on the indebtedness of the purchasers, including 5.4% of the payments for the performed works and services under the state orders.

The trend to the growth of the debt on the labor remuneration intensified, as well. As of 1 January 1999, the aggregate debts on the labor remuneration was Rbl. 77 billion, it had grown 1.4-fold compared with the beginning of 1998, including, respectively, by Rbl. 55.7 billion and 1.2-fold in the production branches and by Rbl. 21.3 billion and 2.6-fold in the social sphere. The aggregate debt exceeded 3.7-fold the monthly labor remuneration fund at the enterprises having the debts on the labor remuneration. Almost 75% of the aggregate debt is due to the absence at the enterprises and organizations of the own money to pay the wages and salaries. The debt due to the absence of the direct financing from the budgets of all the levels, mainly regional, was, as of 1 January 1999, Rbl. 19.7 billion.

The aggravation of the financial situation of the enterprises, the growth of the non-payments in the economy and of the labor remuneration debts determined the peculiarities of formation of the GDP by incomes.

Table 2.4

Structure of formation of GDP by incomes (% of balance)

	1995	1996	1997	1998
Gross domestic product, total	100	100	100	100
including: Labor remuneration of hired workers and employees, including hidden	43.9	46.9	46.9	48.2
Net taxes on production and import	11.8	12.6	13.8	13.4
Gross profit, including net entrepreneurial income	44.3	40.5	39.3	38.4

Source: Russian State Committee for statistics (Goskomstat).

Since 1996, the growth of the difference was seen between the indexes of the labor remuneration determined on the calculation basis and the estimates of the real cash flows in the economy. The gap between the calculated and really paid labor remuneration grew from 2% of the GDP in 1997 up to 3.1% of the GDP in 1998. The share of the labor remuneration of the hired workers and employees, including the hidden one, grew in 1998 up to 48.2% against the 46.9% of 1997. The estimated labor remuneration without the hidden one gave 37.5% of the GDP.

The structure of the GDP formation by incomes saw the reduction of the shares of the gross profit and gross mixed income: as compared with 1997, it made 0.9 percentage points.

Use of the Gross Domestic Product

The main factors influencing the dynamic and structure of the use of the gross domestic product in 1998 were both the reduction of the end use and the high rates of reduction of the demand for investments.

Table 2.5

Dynamic of use of the GDP in 1997-1998, as % of the preceding year

	1997	1998*)
Gross domestic product	100.9	96.0
Expenditures on end use:	101.8	97.5
households	102.4	97.3
state entities	100.5	98.0
Gross accumulation	100.6	89.4
Net export of goods and services	87.5	108.8

*) Estimate of Ministry of economy of Russia
Source: Russian State Committee for statistics (Goskomstat).

The trend to the reduction of the end use was observed since the beginning of 1998; it had been conditioned by the reduction of the real incomes of the population. Before this, the almost five-year trend to the reduction of the real incomes of the population, had been overcome in 1997: their increment had made 1.9%. In 1997, the slowdown of the inflation rates had resulted in the growth of the real labor remuneration and, to the end of the year, of the real pensions.

The change of the external economic conjuncture and reduction of the income of both the state and enterprises limited sharply the possibilities to stabilize the social parameters. The tendency to the reduction of the real disposable incomes of the population renewed. During the first half-year, they reduced by 11.2% compared with the first half of 1997. With the remaining tendency to the growth of the real calculated wages and pensions, the reduction of the real consumption of the population was initiated by the growth of the debt of the state and enterprises on the social guarantees and labor remuneration. The conservation of the low inflation environment was the factor attenuating the splashes of the social tension.

The crisis of the financial and crediting system intensified the effect of the negative factors determining the social and economic indexes of the level of life. The devaluation of the Ruble and the unprecedented crisis of the banking system resulted in the critical situation of the consumer sector of the economy.

In the conditions of the rushing growth of the prices, the real disposable incomes of the population began rapidly reducing, and in the second half of the year, the end consumption of the households reduced by 2.7%. The purchasing activity of the population decreased, and the retail turnover reduced, during the year, by 4.5% with the visible worsening of its macrostructure.

In 1997, the expenditures on the current consumption of households were reducing and made 67.9% of all the incomes of the population. With the renewal, in 1998, of the inflation processes, the share of the expenditures on the end consumption of households grew by 0.5 percentage points. From the beginning of 1998, the structure of the expenditures of the population saw the stable growth of the expenditures on purchase of the goods and services, including the communal services, which was connected with both the reduction of the budgetary subsidies and the growth of the prices and tariffs in this sector of economy. The specific share of the expenditures on the purchase of the goods reached its peak in September (92.4%) as the result of the almost 1.5-fold monthly growth of the prices; in whole, during the year, it made 78.5%.

The grown in the second half-year inflation expectations resulted in the significant shifts in the structure of use of the incomes of the population: while in July 1998, the organized savings of the population reached Rbl. 166.1 billion, to December they reduced by Rbl. 25 billion. The outflow of the deposits would have been much higher if the process had not been regulated by the decisions of the governmental and banking structures. To the end of the first half-year, the share of the savings reached 18% of the money incomes of the population; in the fourth quarter-year it dropped down to 12.3%.

The formed situation led to the inefficient for the national economy use of the savings of the population: a significant share of the savings is stored in hard currency. In combination with the reduction of the real incomes of the population, the possibility of the households to invest in the national economy was strongly worsening: the gross savings of the households dropped, in 1998, more than two-fold: from the 15.7% of the GDP in 1997 down to the 9.7% of the GDP in 1998.

Table 2.6

Structure of end use of gross domestic product *(% of balance)*

	1995	1996	1997	1998
Gross domestic product, total	100.0	100.0	100.0	100.0
Expenditures on end consumption	72.8	72.9	76.0	76.5
including households	50.5	50.1	51.6	56.2
Gross accumulation	23.7	23.1	21.1	18.2
Net export of goods and services	3.5	4.0	2.9	6.2

Source: Russian State Committee for statistics (Goskomstat).

The reduction of the gross accumulations in whole and of the investments in the fixed capital was, in 1998, more intensive than for the other components of the aggregate demand. The increment of the discount rate and reserve norms in the first half of 1998 limited the investment demand; the banking crisis in the second half of the year reduced even more the possibilities to mobilize the financial resources in the real sector. The share of the gross accumulation in the GDP dropped by 2.9 percentage points, compared with 1997.

The first half of 1998 saw the growth of the share of accumulation of the material circulating assets in the GDP due to the growth of the remainder of the unsold products; the second half-year saw, at the intensified trend to the production decrease, the reduction of the stocks, finished products, and material and technical resources. With the limited money assets, the enterprises rejected the practice of forming the stocks forestalling the inflation rates.

The reduction of the demand for the capital goods also had the negative effect on the domestic market situation. In 1998, the share of the new investments in the fixed capital was 15% of the GDP against the 15.9% of the GDP in 1997. During 1998, the volume of the new investments in the fixed capital decreased by 6.7%. With the reduced new investments, the structure of the gross accumulation saw the growth of the share of the capital repair at the expense of the one of the net accumulation. The slowdown of the rates of renewal of the fixed capital and the worsening of the characteristics of the age and technique structures of the fixed assets has resulted in the irreversible processes in the capital reproduction. In this situation, determining the efficient, rapidly repaying, segments of the economy and forming the conditions to mobilize the investments in these very sectors has become the most urgent task of the state.

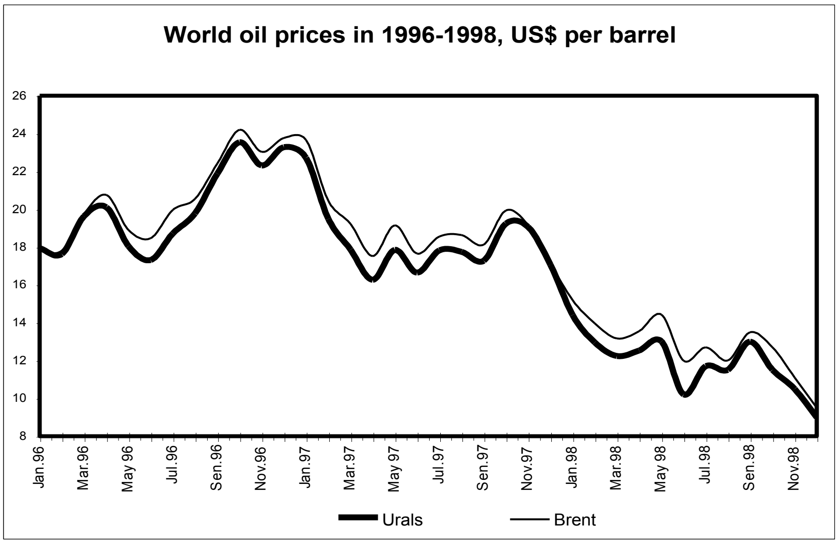
2.2. Oil and gas sector

In 1998, the sharp drop of the world oil prices affected the Russian oil industry. While, in 1997, the average price of the Russian crude oil in the world market was US$ 133.3 per MT (US$ 18.3 per barrel), in 1998 it dropped down to US$ 86.9 per MT (US$ 11.9 per barrel), i.e., by 35% compared with the preceding year (see Fig. 2.2.). As the calculation of the dynamic of the world oil prices in real expression show, this was the lowest level in the last 25 years. The main factor determining the drop of the world prices was the increase of the production and supplies of the crude oil by the OPEC countries that ensure the main share of the world oil export. The rapid increase by the OPEC countries of the crude oil production observed in 1997 was supported by the decision on the ten-percent increase of the export quotas; this growth continued, actually, during the whole first half of 1998. At the same time, the growth of the demand for the crude oil and the petroleum products was negatively affected by the crisis in the South East Asia, slowdown of the economic growth rates in the USA and Western Europe, and the relatively warm winter in the Northern Hemisphere. All these resulted in the overproduction of the oil, imbalance of the world oil market, and collapse of the prices.

The efforts of the OPEC countries to limit the crude oil production volumes made in order to restore the pre-crisis level of prices did not yield any visible positive result. This was due to the continuing growth of the oil production outside the OPEC, accumulation of the excess of the crude oil and petroleum products in the industrial countries, and significant increase of the oil production by Iraq whose export quota for July through November 1998 was increased by the resolution of the UN Security Council from US$ 2 billion to US$ 5.25 billion.

The drop of the world prices resulted in the sharp reduction of the hard currency inflow (see Fig. 2.5), drop of the profitability of the Russian oil export, and loss by the oil companies of the greater share of their profit (according to our estimates, before the crisis of the world prices, the sale of the oil in the foreign market ensured almost three fourths of all the profit from its sale).

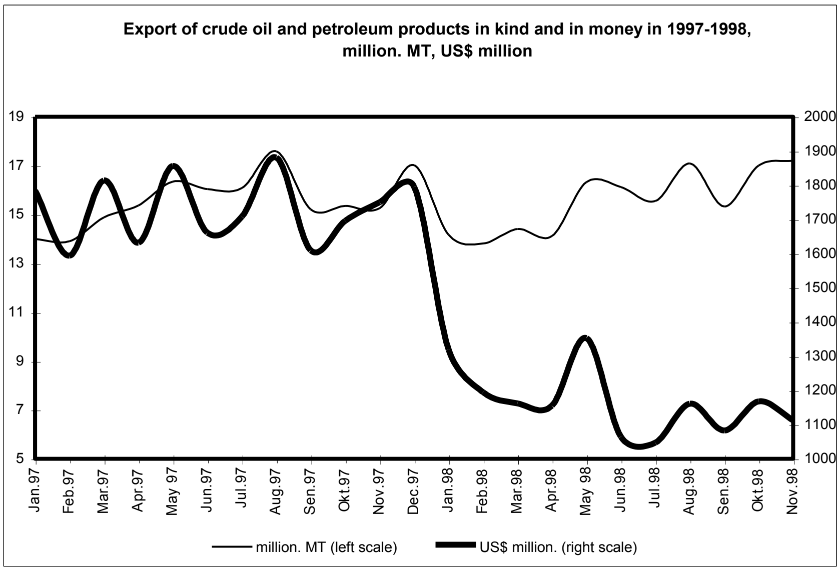
Fig. 2.4



Source: US Department of Energy

Fig. 2.5

Export of crude oil and petroleum products in kind and in money in 1997-1998, million. MT, US$ million



Source: Calculated on the basis of the data of the Russian State Committee on statistics (Goskomstat)

Table 2.7

Production in and export from Russia of energy resources in 1991-1998 (crude oil and petroleum products: million. MT; natural gas: billion. cub. m)

	1991	1992	1993	1994	1995	1996	1997	1998
Production of oil	462.3	399.3	353.9	317.8	306.8	301.3	305.6	303.0
Export of oil, total	173.9	137.7	122.6	129.8	122.3	126.0	126.9	137.1
Export of oil outside CIS	56.5	66.2	79.9	91.7	96.2	105.4	109.8	117.9
Export of oil in CIS countries	117.4	71.5	42.7	38.1	26.1	20.6	17.1	19.2
Export of petroleum products, total	46.1	43.0	47.4	47.3	47.0	57.0	60.6	53.8

	1991	1992	1993	1994	1995	1996	1997	1998
Net export of oil and petroleum products	196.1	167.9	157.4	166.4	156.4	171.6	175.6	181.4
Net export of oil and petroleum products in % of oil production	42.4	42.0	44.5	52.4	51.0	56.9	57.5	59.9
Production of gas	643.4	641.0	618.4	607.2	595.4	601.1	571.1	591.0
Export of gas, total	246.8	194.4	174.4	184.3	192.2	198.5	200.9	200.6
Export of gas outside CIS	91.0	87.9	95.9	109.3	121.9	128.0	120.9	125.0
Export of gas in CIS countries	155.8	106.5	78.5	75.0	70.3	70.5	80.0	75.6
Net export of gas in % of gas production	27.6	29.2	27.2	29.7	31.6	32.3	34.4	33.9

Note: The data on the geographic distribution of the export in 1991 include the export outside the FSU and in the former constituent republics of the USSR.

Source: Russian State Committee on statistics; State Customs Committee of RF; International Energy Agency (IEA); calculations by author.

The visible reduction of the production and the renewal of the recession in the oil industry were the reaction on the worsening of the external conditions (see Table 2.7). In 1998, the extraction of oil, including the gas condensate, was 303 million MT, i.e., it reduced by 0.9% compared with the preceding year; the oil processing dropped down to 164 million MT, i.e., by 7.5% (in 1997, the oil production grew by 1.4% and its processing grew by 1%). The curtailment of the production facilities accelerated: the operating fund of the oil wells reduced from 138,800 at the end of 1997 to 133,000 to the end of 1998; the number of the operating ones decreased from 102,100 to 98,000. The investments in production also saw a sharp drop: in 1998 compared with 1997, the volume of the development drilling for oil reduced by 38.4%; the starts up of the new wells reduced by 20.6%. According to the date of the Russian Ministry of economy, the aggregate investments in the oil industry in the comparable prices reduced by 26.1%.

The extremely low world prices faced the producers with the necessity to reduce considerably all the kinds of expenditures. To support the positive profitability of the export, the oil companies had to pointedly reduce the depreciation deductions (on the basis of the decreasing factor used at re-evaluation of the fixed assets), the labor remuneration, and the number of employed. The comparison of the dynamic of the wells operating fund and volumes of the oil extraction also evidenced the formation of the trend to the concentration of the oil production at the most productive fields. The reduction of the general level of expenditures was also favored by the governmental measures aimed at reducing the cost of transport of the oil by the system of the state-controlled pipelines, namely, the reduction of the hard currency component of the transport tariff on the oil export and roll-back of the excise tax on its transport. The hard currency component of the transport tariff was reduced from US$ 3.00 per MT in the first quarter-year to US$ 1.50 per MT in the second quarter-year and to US$ 0.50 per MT in the third quarter-year. In the fourth quarter-year, it was increased to US$ 1.50 per MT due to the drop of the Ruble to hard currency exchange rate.

Table 2.8

Domestic prices on crude oil and petroleum products expressed in US Dollars (average wholesale producer's prices, US$/MT)

	1996 December	1997 December	1998 June	1998, September	1998 December
Crude oil	63.9	63.1	46.1	17.0	17.0
Automobile gasoline	164.0	169.6	162.6	69.7	63.4
Diesel fuel	153.8	170.0	147.3	58.1	52.9
Fuel oil	71.2	73.8	68.3	25.7	22.0
Domestic price of oil as % of export price	49.0	57.5	68.6	22.9	28.3

Source: Calculated after the data from the Russian State Committee on statistics (Goskomstat)

The reduction of the production expenses resulted in the significant decrease of the domestic prices on the oil. The average producer's price, expressed in the US Dollars dropped from US$ 63.10 per MT in December 1997 down to US$ 43.70 per MT in July 1998, i.e., by 31% (see Table 2.8). It should be. however, noted that this effect was due not only to the real reduction of expenditures, but also to the forced reduction of the norm of profit of the producers because of the aggravation of the sales problems in both the foreign and domestic markets.

Supporting the high enough level of extraction under the conditions of the reduced domestic demand and limited export facilities resulted in a certain overproduction of the oil inside Russia. The wish to support the reached volumes of the oil extraction was connected, first of all, with that the access of the oil companies to the export facilities was, in fact, linked with the volume of the oil they extract. Besides, cutting down the extraction leads, as a rule, to the drop of the final yield at a field under development and loss of the maximal possible volume of extraction. The social factors also favor the support of the production even at the extremely low efficiency fields: the curtailment of production in the regions totally dependent upon the oil industry is inevitably connected with the negative social consequences. A certain influence comes from the yet accepted management psychology (traditional orientation to the maximal production volumes).

For the other hand, the renewal of the economic recession and significant reduction of the export due to its inefficiency conditioned the significant decrease of the demand for oil in the domestic market. According to our estimates, in 1998 compared with 1997, the sale of the petroleum products in the domestic market reduced by 1.6% while their export reduced by 12.3%. The resulting excessive offer of the oil had the important lowering effect on the domestic prices leading to their reduction not only in the US Dollar but also in the Ruble expression (the average oil price decreased from Rbl. 376.00 per MT in December 1997 to Rbl. 249.00 per MT in August 1998, i.e., by 33.8%).

The conclusion on the domestic overproduction of the oil is confirmed by the analysis of the dynamic of its stored reserves.

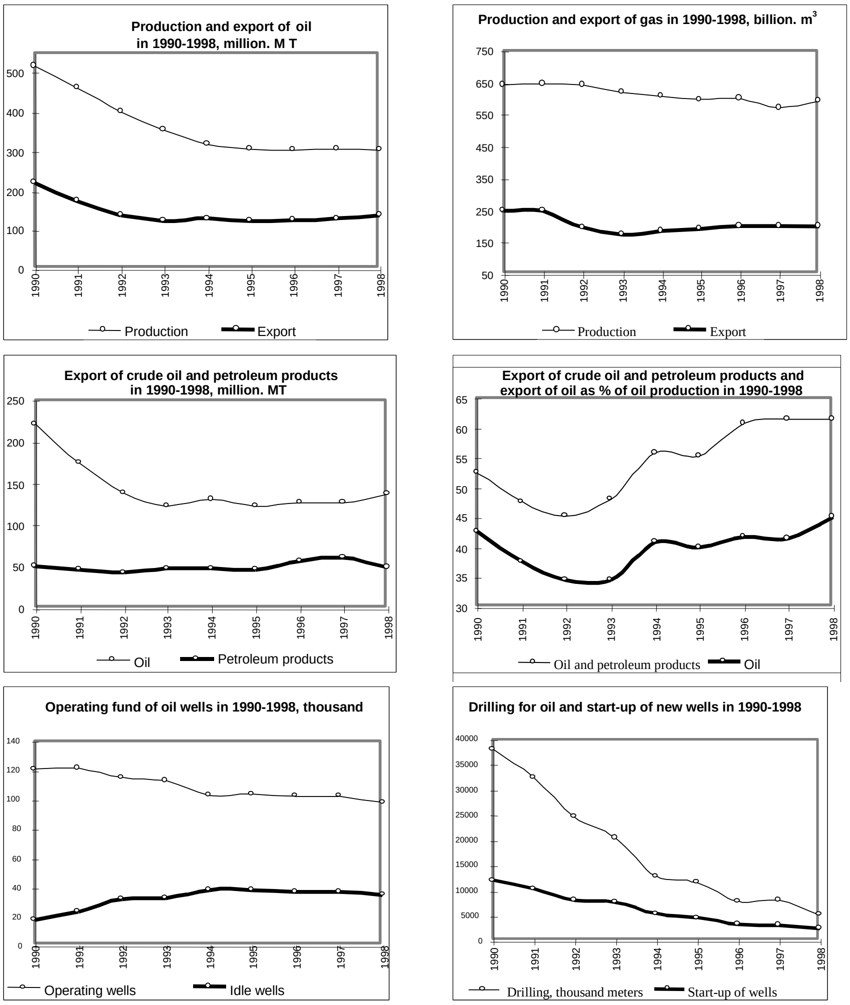
While the growth of these reserves was insignificant (from 31.5 million MT in 1997 up to 31.6 million MT in 1998, or by 0.3%), if they are reduced to the comparable form taking into account the reduction of the domestic consumption of oil, i.e., counted in the days of consumption, the sharp growth can be seen: from 64.5 up to 70.4 days, or by 9.1%.

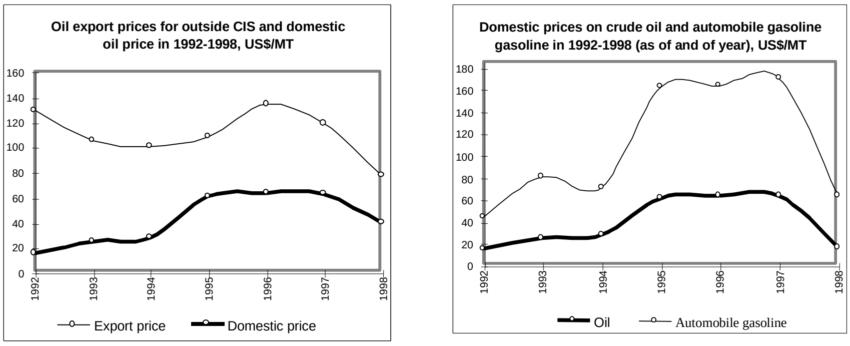
In the conditions of the drop of the world prices, the oil companies tried to compensate their financial losses by increasing the physical volumes of export. The aggregate export of the crude oil and petroleum products grew from 187.5 million MT in 1997 up to 190.9 million MT in 1998, i.e., by 1.8%. With this, the export of the crude oil increased significantly (by 8.1%) while the export of the petroleum products dropped sharply (by 12.3%); the profitability of the latter stayed negative up to September 1998. As a result, the specific share of the crude oil in the export of the liquid hydrocarbons grew from 67.7% up to 71.8%. The ratio of the net (minus import) export of the crude oil and petroleum products to the crude oil production volume reached, according to our calculations, 59.9%. At the same time, the absolute volumes of the oil export have remained, up to today, significantly lower than before the reforms.

The visible growth of the oil and petroleum products export to the CIS countries in 1998 should be noted. With this, the growth of the oil export to the FSU was observed for the first time in the last ten years. The CIS markets remain, however, narrow enough from the viewpoint of the sale of the Russian oil. In 1998, they formed only 14.0% of the export of the crude oil and 4.8% of the export of the petroleum products.

The changes of the main indexes characterizing the evolution of the oil and gas sector of the economy are shown at Figures 2.6 and 2.7.

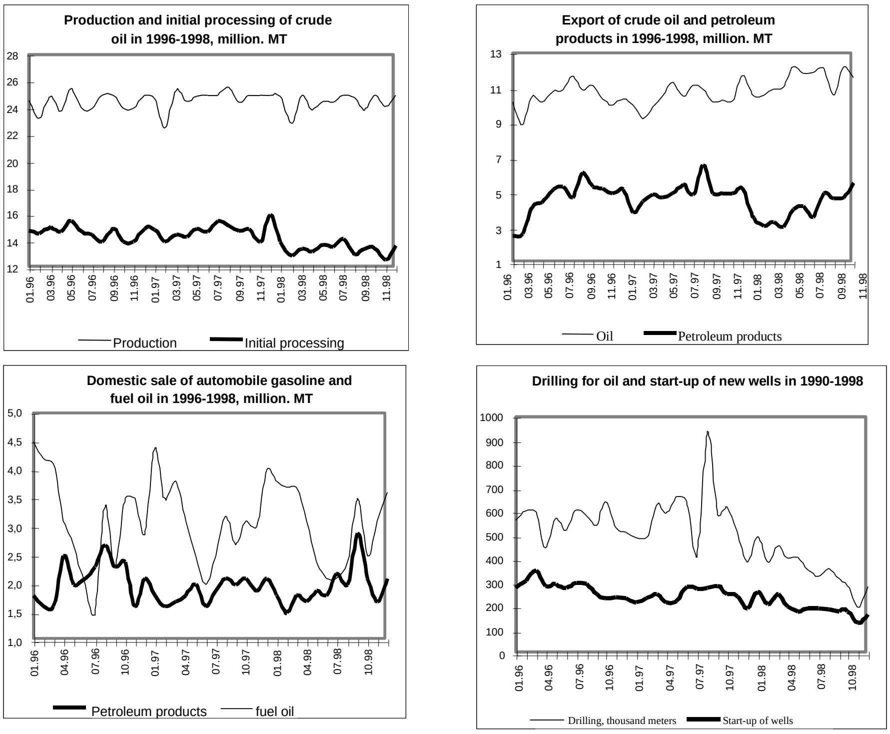
Fig. 2.6

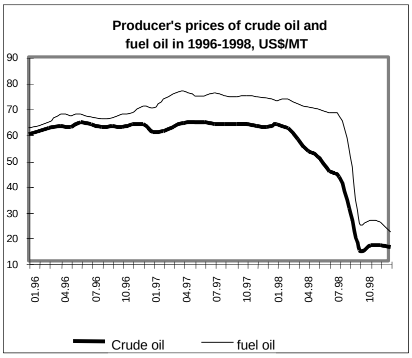

Production and export of oil in 1990-1998, million. M T
Production
Export
Production and export of gas in 1990-1998, billion. m3
Production
Export
Export of crude oil and petroleum products in 1990-1998, million. MT
Oil
Petroleum products
Export of crude oil and petroleum products and export of oil as % of oil production in 1990-1998
Oil and petroleum products
Oil
Operating fund of oil wells in 1990-1998, thousand
Operating wells
Idle wells
Drilling for oil and start-up of new wells in 1990-1998
Drilling, thousand meters
Start-up of wells

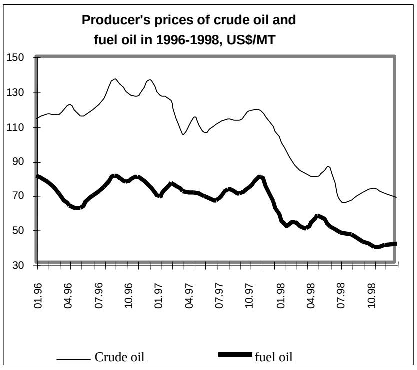


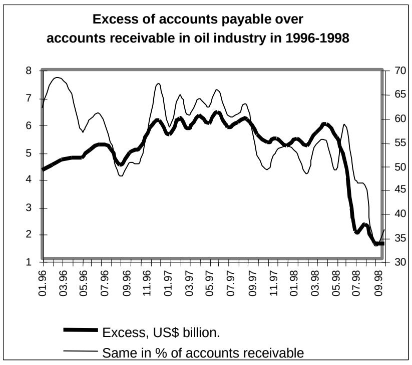
Source: Russian State Committee on statistics (Goskomstat), calculations by the author

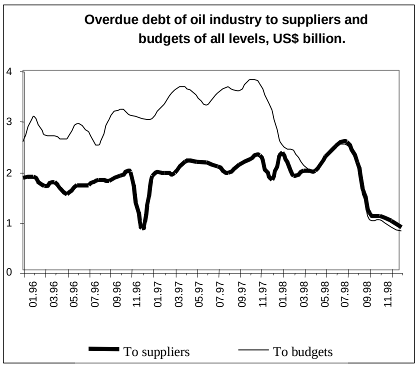
Fig. 2.7











Source: Russian State Committee on statistics (Goskomstat), calculations by the author

As the above analysis shows, in contrast to the period of 1990-1996 when the crisis of the oil industry was conditioned, mainly, by the reduction of the demand for the oil in the domestic and foreign markets, the production decrease of 1998 was due, first of all, to the worsened economic conditions of the industry's activity having resulted from the sharp drop of the world prices having brought about the decrease of the petroleum products production and export. The change of the world market situation in the conditions of the high expenditures on the production resulted in the decrease of the production, profit, and investments in the Russian oil industry. The latter means, in fact, the accumulation of the potential for the additional recession in the oil industry. The positive effects of the crisis are the intense activation of the Russian oil companies in the field of reduction of the expenditures and restructuring of the production.

The devaluation of the Ruble allowed to improve significantly the financial situations of the oil companies due to the strong growth of the gap between the expenditures on production and the income from the products sale in the foreign market. According to our estimates, in September 1998, the profit from the Russian oil export outside the CIS reached US$ 45.80 per MT. To the end of 1998, under the effect of the world prices drop, this index reduced to US$ 31.10 per MT (see Table 2.9, Fig. 2.8). Thus, in September 1998, the net profit from the oil export was US$ 29.80 per MT and to December it dropped down to US$ 20.20 per MT. At the same time, the large liabilities of most of the oil companies for service the debts in foreign currencies (according to the Russian Ministry of fuel and energy, as of September 1998, the sum of the foreign credits to the Russian oil companies was US$ 4.5 billion) actually neutralized the effect of the devaluation. According to the estimates of the World Bank, even after the devaluation, the current liabilities of the oil companies for service of the foreign debt per ton of extracted oil exceeded significantly their net profit.

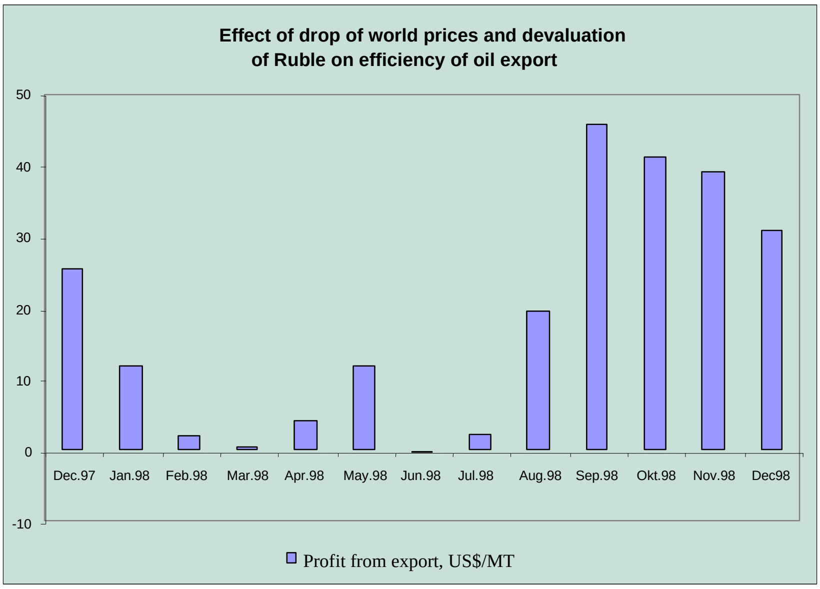
Table 2.9

Estimate of influence of devaluation of Ruble on efficiency of oil export, USS$/MT

	1998 July	1998 August	1998 Sep.	1998 Oct.	1998 Nov.	1998 Dec.
Outside CIS oil export prices	66.7	72.3	75.3	72.0	69.7	59.9
Expenditures: cost price, excise tax, export expenditures (including transport)	64.3	52.6	29.5	30.8	30.7	28.8
Profit from export	2.4	19.7	45.8	41.2	39.0	31.1
Net profit	1.6	12.8	29.8	26.8	25.4	20.2
For reference: Ruble/US$ exchange rate (average monthly)	6.22	6.75	14.61	15.93	16.42	19.99

Source: Calculations by the author based on the date of the Russian State Committee on statistics (Goskomstat) and Russian Ministry of fuel and energy.

Fig. 2.8



Source: Calculations by the author.

In these conditions, at the forecast remaining low level of prices in the world oil market, the financial situation of the Russian producers will depend, in the nearest future, on the repayment of their external debt and dynamic of the real exchange rate of the ruble. Otherwise, the gradual loss of the effect of devaluation and gradual approach of the situation in the oil sector to the pre-devaluation one should be expected.

2.3. Agrarian and food sector

In 1998, the evolution of the agrarian and food sector was influenced by the very contradictory and differently directed factors. First, the agrarian production strongly suffered from the weather: even by the most optimistic estimates, the grain crop in Russia was very low. For the other crops, the effect of the weather factor was not so important.

Second, the budget crisis having been intensifying during the whole year led to the sharp cutback of the expenditures on the agrarian sector. Though the efficiency of the agrarian and food complex was very low, however, in the conditions of poor crop and crisis, such support could have had a certain stabilizing effect.

The permanent political crisis and, hence, the absence of the concerted agrarian and food policy formed one more negative factor in the evolution of the agrarian and food complex.

Just as in the former years, the regionalization of the agrarian and food policy in the country, especially aggravated in the post-crisis period, had a negative influence. The trade barriers between the regions led only to the growth of the food prices for the importing regions and to the too low sale prices for the agrarian producers in the exporting regions. At the same time, the corruption in the power bodies was growing.

For the other hand, the adaptation processes having begun revealing themselves in the agrarian sector, it began to react adequately to the situation of the market, to adapt itself to the realities of the economy. In particular, the tendencies revealed themselves to the production growth in the poultry keeping and swine-breeding, the sub-branches capable of the fastest growth. The positive shifts showed themselves in the food industry, as well; moreover, this was based on the growth of the investments in this sector of economy.

Paradoxical as it was, the economic and financial crisis had a positive effect on the agrarian and food economy. The devaluation of the Ruble became a natural barrier for the import thus having freed the market niches for the domestic producers. The latter had, already, been to a certain extent made ready for this by all the previous years of the reforms, all the accrued experience, and formed infrastructure. Moreover, the financial problems connected with the crisis had almost no effect on the sector that had for already long worked in the conditions of the exchange in kind.

The crisis has led to the reanimation of the tendency to the growth of production on the farms of the population, and, to all appearances, in 1999, this sector will see the evident growth. This is due, first of all, to the decrease of the real incomes of the population and the intensifying instability in the society.

In 1998, the agrarian and food policy underwent substantial changes, not in the last instance because of the burst out economic and political crisis. Although the agrarian policy of the Primakov's cabinet stays, yet, unclear, the trend to the strengthening of the distributive methods of the regulation of the sector has begun to show itself. Here, it should be acknowledged that the Government has become aware of the chance of growth for the national agrarian and food sector and has begun trying to help put it into life.

The gross produce of the agrarian sector reduced by 12.3% (in 1997, the growth was 1.3%), but mainly in the plant growing. The animal breeding was characterized, last year, by the recession extremely low for the latest years: less than 1% (5.3% in 1977).

Agrarian production

Plant growing

The total area under the crop of 1998 in economies of all categories reduced by about 6% compared with 1997 or by almost 20% since 1992 (see Table 2.10). The areas under the fodder crops, flax, and sugar beet continue diminishing. After the two-year recession, the areas under sunflower grew significantly (by 16%) again. According to the statistics, the area under the grain crops reduced, as well. However, the experts of the grain market think that large areas under the grain crops in the main grain regions were hidden.

As a result, the certain shifts took place in the structure of the areas under crops (see Fig. 2). The share of the areas under the sunflower and wheat grew visibly. At the same time, the share of the areas under the fodder crops and sugar beet reduced.

According to the RF State Committee on statistics (Goskomstat), in 1998, the gross grain harvest was 47.8 million MT in the weight after treatment. However, the independent experts speak of the 10 million to 50 million MT of grain not accounted for in the official statistics The reduction of the grain harvest was conditioned, mainly, by the summer destruction of the grain crops in large areas and decrease of the productivity by

43.0%. Last year, the gross harvest of the sunflower seeds increased by 5.9%. This was due only to the expansion of the areas under this crop, because the productivity of the sunflower was diminishing.

Table 2.10

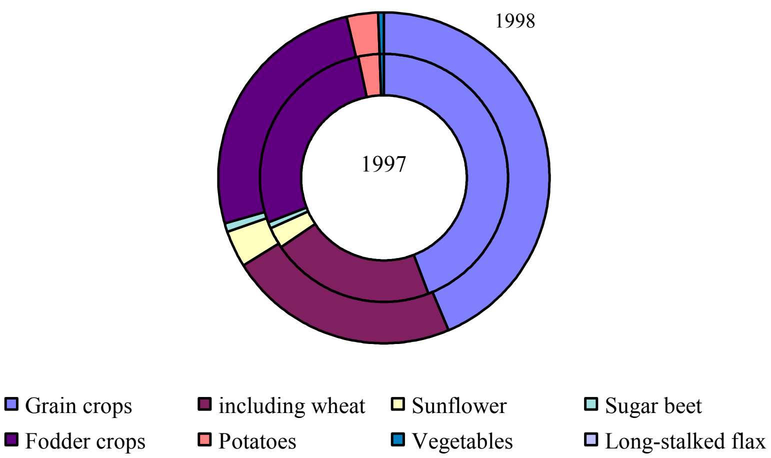
Areas under main crops in Russia, thousand hectares

	1992	1995	1996	1997	1998	1998, % of 1997	1998, % of 1992
Total area under crops	114.6	102.5	99.6	96.6	91.6	94.8	79.9
Grain crops	61.9	54.7	53.4	53.6	50.7	94.6	81.9
Including wheat	24.3	23.9	25.7	26.1	26.0	99.6	107.0
Sunflower	2.9	4.1	3.9	3.6	4.2	116.7	144.8
Sugar beet	1.4	1.1	1.1	0.9	0.8	88.9	57.1
Long-stalked flax	0.3	0.2	0.2	0.1	0.1	100.0	33.3
Potatoes	3.4	3.4	3.4	3.4	3.3	97.1	97.1
Vegetables	0.7	0.8	0.7	0.7	0.7	100.0	100.0
Fodder crops	42.5	37.1	35.6	33.3	30.1	90.4	70.8

Source: Russian State Committee on statistics (Goskomstat).

Fig. 2.9

Structure of areas under crops in Russia, %



Source: Areas under crops in Russian Federation in 1988, Russian State Committee on statistics (Goskomstat).

Table 2.11

Gross harvest of main crops in Russia, million. MT

	1992	1995	1996	1997	1998
Grain (weight after treatment	106.9	63.4	69.3	88.6	47.8
Sugar beet (factory)	25.5	19.1	16.2	13.9	10.8
Sunflower	3.1	4.2	2.8	2.8	3.0
Potatoes	38.3	39.9	38.7	37	31.3
Vegetables	10.0	11.3	10.7	11.1	10.5

Source: Russian State Committee on statistics (Goskomstat).

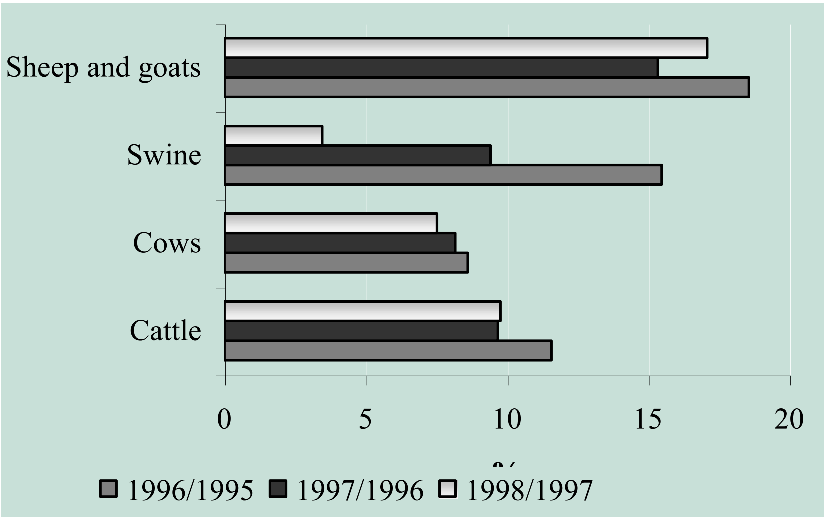
In 1998, the production of the potatoes reduced by 15% compared with 1997; it was on the level a little higher than that of 1990. As this culture is produced almost exclusively by the private farms, the serious underestimate is possible. Besides, the private sector ensures the higher level of storage of the potatoes than the former state structures; hence, the 1990 level covers quite well the needs of the country in this produce.

Animals breeding

Last year, the total number of almost all the livestock continued reducing. (see Table 2.12). The causes remained the same: the producers lack the circulating assets, the expenditures on keeping the livestock are high, and the purchase prices remain low. Nevertheless, the meat production reduction rates somehow lowered: they were 5% against the 9.3% of 1997. However, while, during the last years, the meat production had been showing the steady tendency to decline, the production of the milk began growing, at the beginning of 1998, due to the higher yields. This was the result of the better provision of the animals with fodder during the winter of 1997-1998. However, already to the end of the year, the situation with the fodder base worsened. This resulted in the lower milk yields, and, hence, the drop of the milk production volumes.

Fig. 2.10

Rates of reduction of livestock



Source: Russian State Committee on statistics (Goskomstat).

Table 2.13

Production of main animal breeding produce, million MT

	1996	1997	1998
Meat (cattle and poultry for slaughter, slaughter mass)	5.3	4,9	4,6
Milk	35,7	34,1	33,2
Eggs	31,9	32,2	32,6

Source: RF Ministry of agriculture and food

In 1998, the agrarian entities saw the tendency to the growth of productivity: by 8% for the milk yield per cow, by 1% for the eggs yield per hen, by 3% for the yield of the calves, and by 10% for the yield of the piglets; the loss of cattle reduced.

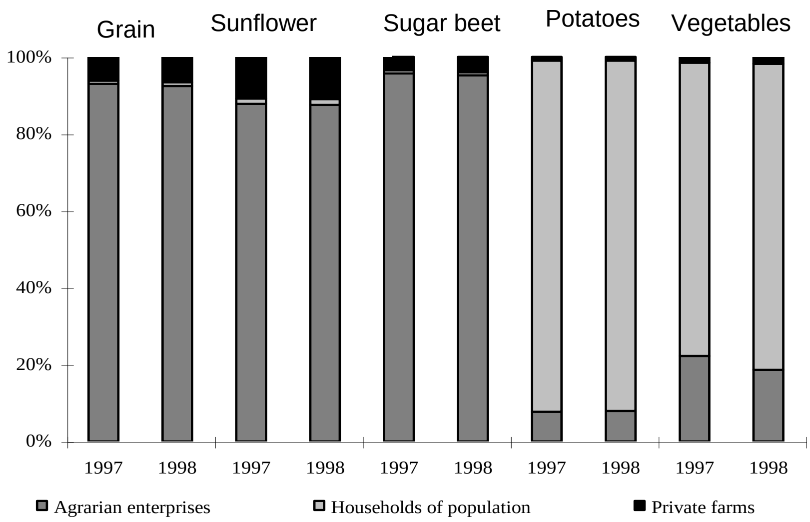
The growth in the poultry breeding attracts attention: it was ensured, mainly, by the growth of production in the large economies.

Structure of agrarian production

Just as in the previous years, the agrarian enterprises remain the main producers of the grain and industrial crops. They produce the main shares of the grain, sugar beet (factory one), and sunflower (see Fig. 2.11).

Fig. 2.11

Structure of production of main produce of plant growing by categories of economies



Source: Russian State Committee on statistics (Goskomstat).

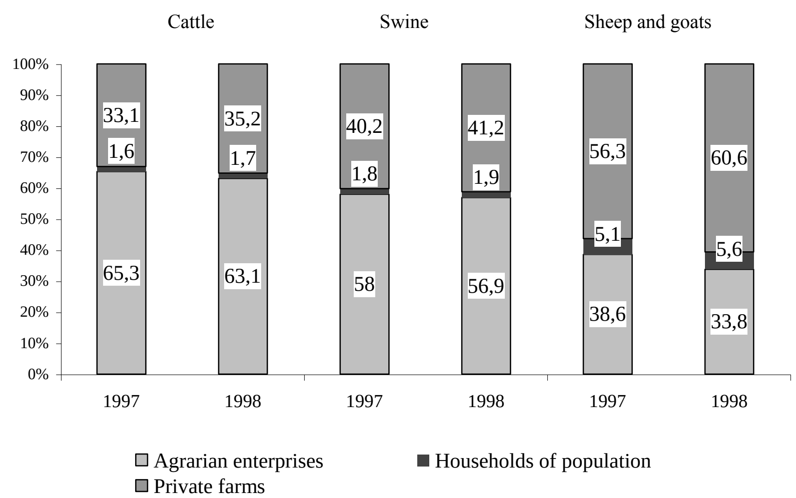
However, in the grain production, the share of the private farms grew somehow; the share of the private households grew in a lesser extent. A similar, not very serious, redistribution of production occurred for the sunflower and sugar beet.

In the production of the potatoes, the private households continue ensuring over 90% of the produce, though in 1998 the share of the agrarian enterprises grew a little.

Analyzing the structure of the livestock, one can notice that the slower reduction of it in the households of population compared with the agrarian enterprises during several years resulted in the grown share of the livestock in the households of population in the total number of livestock.

Fig. 2.12

Distribution of livestock by categories of economies



Source: Russian State Committee on statistics (Goskomstat).

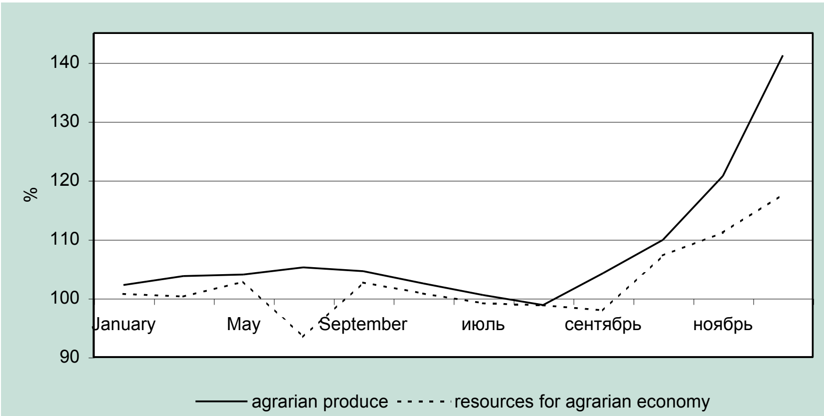
Financial situation of agrarian producers

According to the official data, in 1998, the share of the profitless economies grew up to 89% (82% as of the end of 1997). Of the main agrarian produce, only the sale of the sunflower, potatoes, vegetables, and eggs stays profitable. For the first time, the production of the grain crops became profitless. The latter seems suspicious: at such a poor crop and on the background of the visible growth of prices on the other crops, the grain prices remain stable enough. All this supports the expressed above suspicions in the significant concealment of the real production of the grain and the absence of the competent monitoring of the real grain prices.

In the previous review of the IET, we have supposed the improvement of the price ratio for the agrarian economy under the effect of the crisis. The 1998 data fully confirmed this supposal: after August, the growth rate of the prices on the resources for the agrarian economy began slowing down compared with the growth rate of the purchase prices on the agrarian produce (see Fig. 2.13). The better conditions of exchange for the agrarian sector mean the better financial conditions of the production. In these conditions, the accumulated accounts payable will animate the secret and barter deals in the agrarian economy and the propagation of the settlement arrangements by-passing the bank accounts. Already in 1998, not more than 10% to 20% of the settlements passed by the bank accounts of the agrarian enterprises.

Fig. 2.13

Parity of prices on agrarian produce and resources for agrarian economy (price indexes, December 1997 = 100%)



Source: RF Ministry of agriculture and food

Production of means of production

The decline in the industries producing the resources for the agrarian production has been continuing.

In the first and third quarters of 1998, compared with 1997, the growth of production of the mineral fertilizers was observed. However, during the year in whole, the insignificant decrease of production took place (see Table 2.14).

In the tractor and agrarian equipment manufacture, the reduction of manufacture of most products continued. At the same time, the manufacture of the machines designed to fertilize the soil with the mineral fertilizers grew by 27% compared with 1997; this may be explained by the feeble tendency to the growth of use of the mineral fertilizers. The manufacture of the small-size equipment, e.g., cultivators, has been growing as well: this evidences the certain growth of the purchasing capacity of the agrarian producers.

Table 2.14

Dynamic of volume of manufacture of means of production for agrarian economy

	1998 as % of 1997
Mineral fertilizers, thousand MT	97.5
Tractor and agrarian equipment manufacture	70.7
tractors, thousand	79.0
grain harvesters	44.9
equipment for applying mineral fertilizers	128.0
tractor cultivators	109.4

Source: Russian State Committee on statistics (Goskomstat).

Food industry

In 1998, the inflow of investments in the food industry continued: during the first half of the year, the investments in this sector grew by 45% having exceeded this index over all the other sectors of economy. Most likely, the greater share of the investments was directed to the secondary processing which is less dependent upon the agricultural feedstock.

The financial and economic crisis entailed the reduction of the import supplies and sharp growth of the Ruble prices on the imported products. This situation favored the import substitution tendency in the food industry. Table 2.15 shows by month the rates of change in production of the main foods. It is easy to see that, in whole, these form the two groups: the ones whose production grew after August and the ones whose production began reducing even more rapidly. The second group of the products includes the sugar, meat, and sausages. These are the ones whose production used the imported feedstock. After the devaluation of the Ruble, the feedstock import became problematic and the purchasing capacity of the population dropped for these very groups (especially for the meat products).

Table 2.15

Rates of growth of production of main foods in 1998 (monthly and yearly indexes as % of the relevant period of 1997)

	July	August	September	October	November	December	Year
sugar	107	69.4	86.1	114.3	44.7	13.3	125.1
meat	95.3	91.4	90.3	89.6	81.9	71.1	86.5
sausage	85.2	83.3	73.7	75.9	83.5	80.8	86.7
bread and bakery	92	92.2	95.7	98.7	97.1	98	94.8
macaroni	99.6	92.5	178.6	159.2	156.5	158.4	121.4
margarine products	116.8	72	86.7	139.7	171.4	185.1	106.8
whole milk products	100.7	100.9	104.8	103.5	101	90.7	102.9
butter	92.4	90.6	93.5	82.8	82.3	85.6	93.7
cow and sheep milk cheese	96.6	101.4	105.4	113.5	102.3	85.2	103
flour	94.9	85.4	102.1	100.1	100.4	103.2	95.9
cereals	97.7	78.5	105.7	114	104	112.9	103.2
vegetable oil	110.1	133.6	178.4	144	106.6	109	112.1

Source: Data of the Russian State Committee on statistics (Goskomstat) for the relevant period.

The recession in the bakery production was not stopped but slowed down. This may serve the indirect index characterizing the dynamic of the incomes of the population: at the other equal conditions, the decrease of the real incomes of the population is accompanied by the growth of consumption of the bread. Since August, the recession in the whole group slowed down; the most probable is that the production of bread was growing on the background of cutback of the bakery production.

Such groups as the macaroni, margarine products, whole milk products, cheese, and cereals directly illustrate the import substitution trend after the beginning of the crisis. The share of the imported products in this group had been high enough, and the devaluation of the Ruble improved the domestic competitiveness of the domestic producers.

The vegetable oil production dynamic has a more complex nature; the sharp growth of production in August and September may have been due to the rush demand. The further evolution of the industry will depend on the efficiency of the policy of the sunflower seeds export limitation introduced at the beginning of this year.

General characteristic of situation in the Russian agrarian markets in 1998

In 1998, the evolution of the agrarian and food market was influenced by both the remaining in the country macroeconomic instability and the absence of the clear conception of the governmental regulation of the agrarian and food complex.

The process of formation of the non-traditional for the planned economy market structures and sales channels, dynamical at the beginning of the 1990's, slowed down sharply during the last two years. Under the effect of the macroeconomic instability, the importance of the non-money forms of settlement, direct supplies, and shade turnover grew strongly. This was, to a great extent, favored by the federal and regional policy of the commodity crediting and the remaining effective practice of formation of the regional food funds.

The underdevelopment of the food markets infrastructure stimulated the process of formation of the vertically integrated links in the food supply chains, first of all, between the feedstock producers and processors. In particular, the shortage of the feedstock formed in the meat and milk sub-complexes conditioned the wish of certain enterprises of the processing branches to organize their own feedstock production bases and to make the long-term contracts with the agrarian producers. An example is the *Cherkizovsky APK* having invested in two state farms and a poultry farm in the Moscow region. At the same time, there are numerous examples of the artificial amalgamation of the enterprises of different levels of the food chains; these have gotten, in the last years, the name "financial-industrial groups. Such associations are often created under the aegis of the regional administrations and are the attempts to restore to life, at the regional or micro levels, the centralized management and control system.

In 1998, the reduction of the share of the produce supplies to the traditional purveyors became even more obvious. The especially critical drop of the supplies to the purveyors is observed at the markets of national importance (grain) or of the export oriented (sunflower) produce (see Table 2.16).

Table 2.16

Specific share of supplies to purveyors in aggregate volume of sale by agrarian producers, %

	1992	1993	1994	1995	1996	1997	1998*
Grain	64	63	33	28	26	25	6
Sunflower	76	42	8	19	8	8	6
Potatoes	50	45	34	35	31	28	9
Livestock and poultry (weight before slaughter)	80	80	71	64	55	47	44
Milk	96	96	93	90	84	81	72

* 11 months

Source: Sale of agrarian produce by agrarian enterprises
Russian State Committee on statistics (Goskomstat), 1992-1997 and as of 1 December 1998.

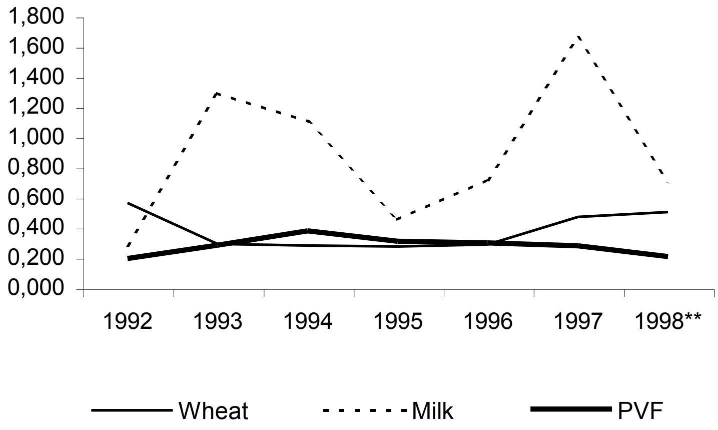
The non-money forms of settlements (barter, "give and take", mutual settlements, commodity credit, etc.) have become the important characteristics of the today's structural changes in the food markets. The difficulties with sale, lack of cash, and burden of the non-payment of the taxes have given birth to the most varied, multiple-step forms of barter, "give and take", mutual settlements, commodity credit, etc. For example, Orlovskaya Niva, the regional food corporation of the Orel region, pays the "meat subsidies" to the agrarian producers in grain; sometimes, the agrarian producers pay the taxes in kind. In many regions, the "luboil - butter" type multi-stage pattern of settlements has become usual. In accordance with it, the agrarian producers are supplied the fuel and lubricants and pay for them in, for example, butter that the suppliers of the fuel and lubricants themselves take from the dairies to which the agrarian producers supply the milk.

The distinctive characteristic the agrarian markets is the strongly grown volume of the shade turnover. In certain regions, the whole volume of the produce, except the share supplied to the regional funds or under the commodity credit, is sold, practically in whole, for cash. This is always fraught with the concealment of the really received incomes.

The isolation of the regional food markets continues. The growth of the barriers between regions is explained by both the underdevelopment of the market infrastructure, which often increases significantly the transactional costs, and by the high administrative barriers. In many regions with the excessive offer, the regional power bodies are more and more often using the direct bans on the food export as the instrument to regulate the local market. The still remaining (and in certain events strengthening) variation of the prices by regions (see Fig. 2.14) may serve the quantitative indicator of the interregional disintegration processes.

Fig. 2.14

Regional variations of sale prices in agrarian markets (price variation factor)



* January to December 1998.

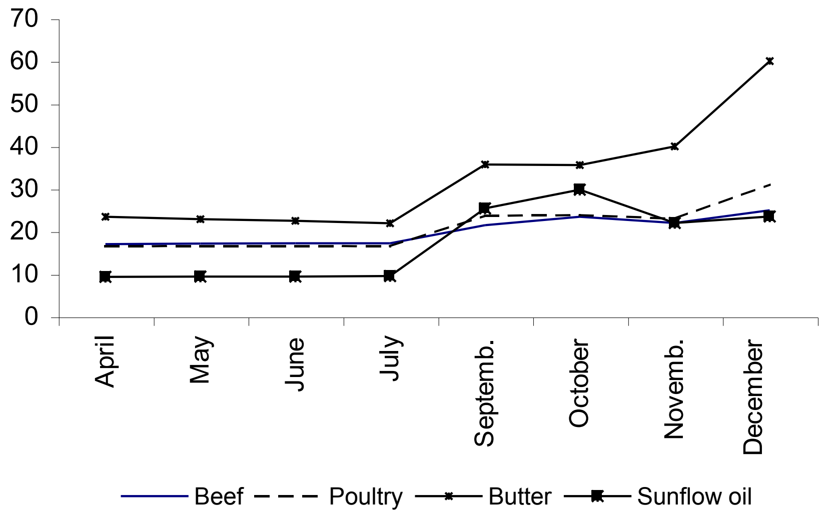
The important regional variation of the prices on milk by regions makes it clear that it is, mainly, the produce of the local market (there is no regional specialization in the milk market). The main volumes of the milk are produced and sold within the regions, the interregional flows are unimportant, hence, the milk prices do not level between regions with time. As for the grain market, the alleviation of the price dispersion evidences that this product belongs to the national market: the barriers between regions were being gradually overcome. However, since 1997, the strengthening of the export ban practice and the growth of the barriers between regions again resulted in the growth of the price gaps between regions. In the beef market, the attenuation of the dispersion between regions rather seems the evidence of that the main sale of this produce has shifted in the individual private sector whose situation is determinant when forming the prices.

Effect of financial crisis on food market

The consumer market was the first to react on the crisis. the sharp growth of the retail prices was conditioned by the devaluation of the Ruble, high share of the imported food in the retail turnover, and the rush demand incited by the crisis.

Fig. 2.15

Dynamic of retail prices on certain foods (before and after crisis), Rbl./kg



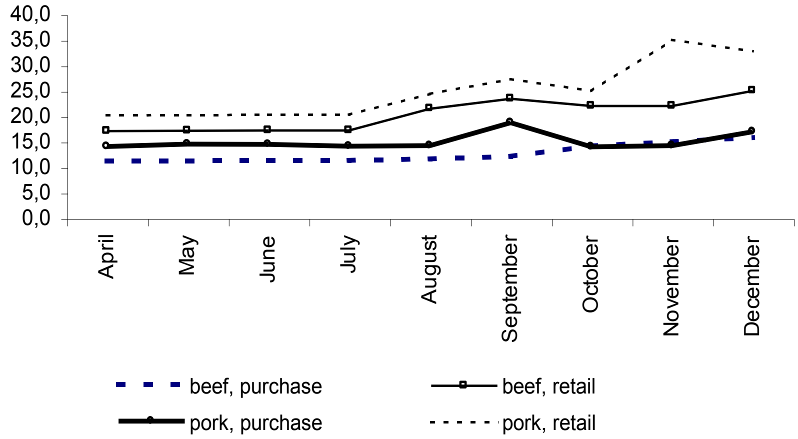
Source: RF Ministry of agriculture and food

To November, after the cutback of the rush demand, the prices whose growth had been conditioned by the inflation expectations of the population stocking up the long storage foods began going down. In the middle of December, the food prices leaped up again because of the continuing growth of the US Dollar and growing demand of both the seasonal character and brought on by the depletion of the food stored after the rush purchase.

The August crisis affected the prices of all the levels of the food vertical, though to different extents and at different rates. Here the reaction of the meat segment of the food market is interesting because it is strongly dependent on the feedstock import. For example, in the beef market, the reaction of the initial demand prices (retail prices on food) was high in the short term, while the derivative demand prices (purchase prices) grew insignificantly, and their growth went on with a certain lag: it became sensible only to September (see Fig. 2.16). At the same time, in the pork market, not only the retail but also the purchase prices reacted on the change of the situation in the short term.

Fig. 2.16

Dynamic of purchase and retail prices on beef and pork, Rbl./kg



Source: RF Ministry of agriculture and food

The summer crisis abruptly changed the imported to domestic produce prices ratio: the latter got the sensible advantage. The consumer demand shifted towards the similar produce of the domestic production.

Moscow, being the subject of Federation with the greatest financial potential and concentration of various means, strongly expanded under the crisis the purchase of the food inside the country, even from the regions not characteristic for such purchases in the last years. The Moscow purveyors contracting the food purchases at the conditions of prepayment and often in cash found themselves beyond the competition with the local purveyors. For the one hand, the expansion of the Moscow consumer in the domestic market indicates the growth of demand for the national agrarian and food sector. However, for the other hand, the massive outflow of the foods from the regions has become the factor having, in the crisis condition, motivated numerous regional power bodies to impose the bans on the export of the local food in order to keep the integrity of the local food provision systems. However, the practice has conclusively proven the impossibility of the efficient implementation of such bans in the today's conditions in the country, and one region after another are today lifting such bans.

External trade in food in 1998

In the first half of 1998, just as during the previous years, the various limiting methods of regulation of the external trade in the agrarian produce and food failed to bring up any important changes in the dynamic and structure of the Russian trade in the agrarian produce and food. Hence, in January through June 1998, the trend of 1997, expressed in the growth of the import and cutback of the Russian export remained.

The financial and economic crisis has also led to the alteration of the geographical structure of the trade flows. While the preceding years had observed the constant growth of the food import from abroad, in the third quarter of 1998, under the effect of the crisis, the import supplies lessened from both outside the FSU and from the CIS countries. The import transactions with the partners from outside the FSU reduced, first of all, due to the growth of the prices on the imported products in the national currency. The food import from the CIS reduced less (by 23% in the third quarter-year compared with the second quarter-year) than from outside the FSU (by 38%). As a result, the share of the countries outside the FSU in the aggregate food trade turnover reduced from 86.6% as of the beginning of 1998 to 82.5% as of July to September 1998, while the share of the FSU countries grew from 13.4% to 17.5%.

In the first half of 1998, the cost of the food import grew, in comparison with the relevant period of 1997, by 17%, while the export reduced by 9%. The negative trade balance in the agrarian produce and food sector had always been characteristic for Russia; in January to June 1998, this index grew even more.

In the second half of 1998, the external trade relations of Russia evolved under the effect of the effect of the financial and economic crisis. Already in the third quarter of 1998, the sharp reduction of the import of numerous goods was observed. Compared with the third quarter of 1997, the import of the food in the cost expression reduced by 36% (see Table 2.18). The especially critical drop of the import was observed in August and September, just after the financial and banking crisis (see Table 2.17). Lots of Russian companies lost the possibility to receive the bank loans on purchase of the agrarian produce and food; meanwhile, they lacked their own assets for the import on the basis of prepayment. The uncertain situation with the currency exchange rate suspended the food already imported at the bondage stores. Besides, the substantial price gap formed between the domestic and foreign manufacture goods; this gap will stay for a long time.

Table 2.17

Change of import of certain agrarian produce and foods

	January-July 1998, % of January-July 1997	January-October 1998, % of January-October 1997
Fresh meat	101.7	80.6
Poultry meat	112.5	81.6
Butter	51.5	51.2
Citruses	126.6	110.0
Tea	146	120.7
Grain	52.8	44.6
Vegetable oil	162.8	119.9
Canned meat	84.9	56.9
Sugar	187.9	122.5

Source: Russian State Committee on statistics and RF State Committee for customs.

Under the effect of the financial crisis, the import of all the groups of commodities reduced. Hence, despite the radical changes in the dynamic of the external trade flows, in January to September 1998, the share of the agrarian and food import did not change compared with the relevant period of 1997 and made 27%. The share of the agrarian produce and food in the aggregate volume of the Russian export also remained at the same level, 1.6%.

Table 2.18

Results of external trade of Russia in agrarian produce and food in the first to third quarters-year 1998 (without unorganized trade)*

	1st quarter-year		2nd quarter-year		3rd quarter-year	
		% of 1st quarter-year 1997		% of 2nd quarter-year 1997		% of 3rd quarter-year 1997
Export, US$ million	266.8	93.8	232.5	83.1	263.5	78.3
incl. CIS, US$ million.	93.4	124.7	77.2	68.1	64.9	79.3
%	35.0		33.2		24.6	
Outside FSU, US$ million.	173.4	82.7	155.3	93.3	198.6	78.0
%	65.0		66.8		75.4	
Import, US$ million.	3,189.8	125.8	3,412.9	106.3	2,235.9	64.0
incl. CIS, US$ million.	427.1	81.2	510.8	74.4	391.8	54.5
%	13.4		15.0		17.5	
Outside FSU, US$ million.	2,762.7	137.5	2,902.0	114.9	1,844.0	66.4
%	86.6		85.0		82.5	
Balance, US$ million.	–2,923.0		-3,180.4		-1,972.4	
incl. CIS, US$ million.	-333.7		-433.6		-326.9	
Outside FSU, US$ million.	-2,589.3		-2,746.7		-1,645.4	

*- Without data on trade between Russia and Byelorussia.
Source: Customs statistics of RF external trade.

Up to September 1998, the growth of the import purchases was accompanied by the reduction of the average import contract prices. After the financial crisis, the import flows of the agrarian produce and food strongly reduced (see Table 2.19).

Table 2.19.

Dynamic of import of most important agrarian produce and food in first to third quarters of 1998 (without unorganized trade)*

	1st quarter-year		2nd quarter-year		3rd quarter-year	
	million. MT	% of 1st quarter-year 1997	million. MT	% of 2nd quarter-year 1997	million. MT	% of 3rd quarter-year 1997
Beef	127,3	67,0	135,4	88,9	92,2	56,6
Pork	77,2	108,1	98,2	128,8	63,5	83,5
Poultry meat	290,8	196,0	252,4	74,1	181,2	55,1
Vegetable oil	60,9	192,9	75,1	130,0	59,1	46,8
Butter	38,7	55,8	15,0	37,5	12,9	68,0
Wheat	355,5	108,5	377,6	58,8	305,9	49,7
Wheat flour	85,7	105,2	70,8	76,5	41,6	42,2
Raw sugar	1,005,428	652,6	1,711,8	197,1	686,5	58,8
White sugar	156,4	66,3	115,9	31,5	67,9	28,7
Citruses	223,3	126,8	167,0	130,5	41,7	71,7
Coffee	1,9	40,4	1,2	16,2	0,8	10,3
Tea	41,7	112,1	41,3	95,0	32,2	91,6

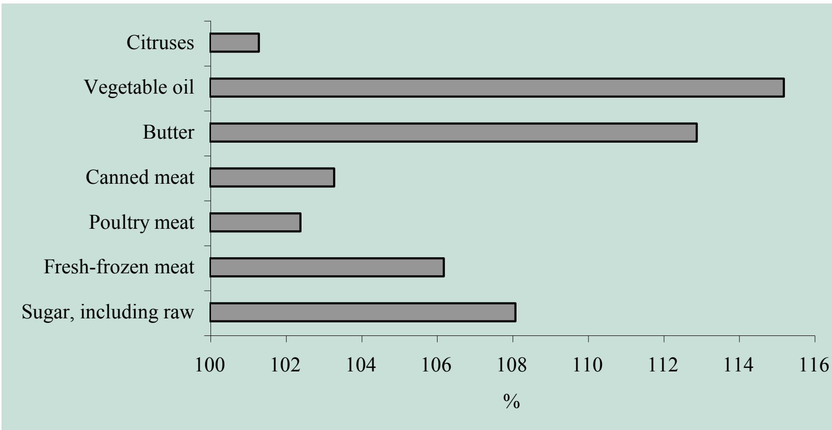
*-. Without data on trade between Russia and Byelorussia.
Source: Customs statistics of RF external trade.

At the same time, the suppliers of the imported food to the Russian market raised their average contract prices in the US$ Dollars, notwithstanding that, even without such increase, only as a result of the devaluation of the national currency, the Ruble prices on the imported goods were high enough for the Russian consumers (see Table 2.17).

This strategy of the companies was explained by their wish to compensate to some extent by increasing the contract prices the losses from the import August-September blockade of import. In the other words, for many suppliers of the foreign produce, the main goal of trade in the Russian market was to earn the short-time profit and not to save a certain niche in this market. However it should be noted that, in the long term, the large trading companies would, most probably, begin selling the produce at the dumping prices in order to save the sales volume. Thus, already at the end of 1998 - beginning of 1999, the drop of the prices on the chicken legs from the USA was observed. The USA holds 70% of the aggregate volume of the import of this product to the Russian market.

Fig. 2.17

Alteration of average import contract prices on certain agrarian produce and food in September 1998 compared with August 1998



Source: Social-economic Situation of Russia. January-October 1998. Moscow, Goskomstat. 1998. P. 144

In the first half of 1998, the aggregate cost of the food export was reducing, though the physical export grew. This was due, first of all, to the decrease of the world market prices. In the third quarter-year compared with the second quarter-year, the export of the agrarian produce and food grew by 13%. Moreover, this resulted from the growth of the export to outside the FSU (by 28%) at the reduction of the export to the CIS (by 16%). This phenomenon may be explained by the growth of the export profitability due to the increase of the currency exchange margin. However, in the third quarter of 1998, the food export of Russia did not, yet, reach the volumes of 1997. No significant growth of the export occurred on the basis of the Ruble devaluation because the range of the Russian agrarian produce and food traditionally exported to other countries is very narrow and the domestic production is limited (see Table 2.20).

Table 2.20.

Dynamic of export of most important agrarian produce and food in first to third quarters of 1998 (without unorganized trade)

	1st quarter-year		2nd quarter-year		3rd quarter-year	
	thous. MT	% of 1st quarter-year 1997	thous. MT	% of 2nd quarter-year 1997	thous. MT	% of 3rd quarter-year 1997
Frozen fish	40.1	354.9	74.0	211.4	106.2	132.9
Wheat	362.3	396.4	280.8	146.4	357.4	338.1
Sunflower seeds	219.0	327.5	90.0	87.4	34.7	93.8
Vodka	46.5	13.3	89.7	23.0	126.1	43.9

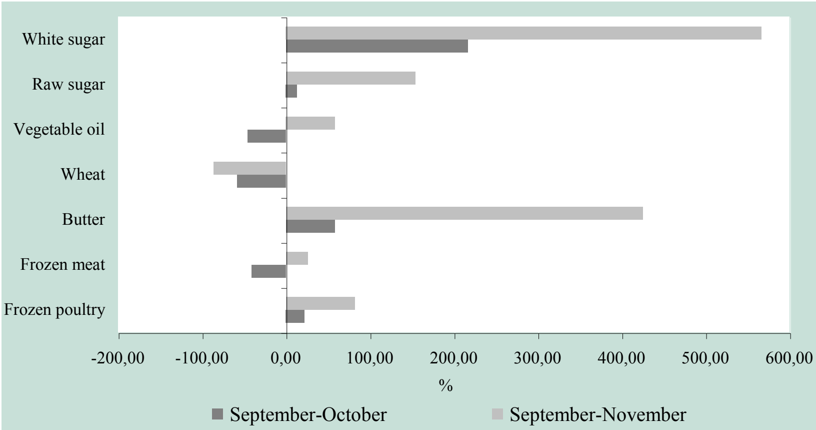
*-. Without data on trade between Russia and Byelorussia.
Source: Customs statistics of RF external trade.

The reduction of the import due to the financial crisis and the growth of prices on the imported food resulted in the reduction of the import share in the food consumption. thus, according to the expert estimate of the State Committee on statistics, in the fourth quarter of 1998, the share of the food import in the retail trade dropped down to 19%, while before the crisis it had been 36%.

The stabilization of the currency exchange rate in October and November 1998 resulted in the growth of the import of numerous foods.

Fig. 2.18

Alteration of import of certain agrarian produce and food in October and November compared with September 1998



Source: RF State Committee on statistics

The supplies of the butter, poultry meat, sugar, and raw sugar grew already in October 1998. In November, the growth of import of the meat and vegetable oil was observed. The largest inflow of the food supplies was from the CIS countries. In October 1998, the CIS countries were the main suppliers of the sugar and butter.

Agrarian produce and food policy in 1998

The agrarian produce and food policy of Russia of 1998 formed to a great extent under the effect of the factors external for the sector. First of all, this was the replacement of the Cabinet of Ministers, having resulted in the replacement of the agrarian and food complex management. At the replacement of the Cabinet of V. Chernomyrdin, the Minister of agriculture and food was replaced as well; this entailed the replacement of a large part of the management of the Ministry of agriculture and food. At the same period, the double-stage system, "Vice Prime-Minister - Minister", of the agrarian and food complex management was annulled, as well. In August, as soon as the new Minister of agriculture and food only declared the strategic goals of his program, the financial and economic crisis broke out, having made an important part of this program obsolete. The political crisis that followed the financial one resulted in the replacement of the Cabinet of Ministers and restoration of the double-stage system of the agrarian and food complex management.

The second condition determining the policy was the significant, much more sharp than in the preceding years, reduction of the budget allotments to the agrarian and food sector.

The absence of the financing on the federal level resulted in that, for the first time during the years of the reforms, the share of the regional budgets in the budget financing of the agrarian and food complex grew so strongly: up to 80% in the aggregate expenditures on the agrarian and food complex in the consolidated budget of Russia.

Due to all the above, the main share of the year was spent on forming any strategy for the agrarian and food complex; for the other hand, the budget limitations made the possible selection of the measures in the agrarian and food policy extremely sparse.

The third important factor conditioning the state policy in the agrarian and food sector was the political inertia that predetermined the safeguard of many programs adopted during the previous years. Thus, the Fund of privileged crediting of the agrarian and food complex continued to exist; attempts were made to quote the so-called agrarian bonds of the subjects of Federation; the programs of subsidies to the agrarian economy continued nominally (because the real financial filling was practically absent). In the other words, neither the absence of the real budget financing on the federal level, nor the impending economic crisis brought to the urgent revision of the agrarian and food policy and to the concentration of the efforts at the most important issues of the sector.

At last, beginning from August 1998, the agrarian and food policy has been determined, first of all, by the conditions imposed by the financial and economic crisis that had made the tactical issues more important than the strategic plans of development of the sector. Practically all the 89 subjects of Federation did not wish to wait the solution of the crisis at the political level and, at the end of August - beginning of September 1998 made the attempts to protect their food markets against the crisis. These attempts were, mostly, the attempts to control, this or that way, the retail prices and build the trade barriers between regions. The federal power became the hostage of these solutions because to the moment when it became capable to undertake any political steps, everything had been solved at the regional level. Everything left to the Federal Government was the sphere of the external trade and tax control, and the Government used this.

As a result of all the above factors, the agrarian and food policy of 1998 is a quite fragmentary picture and does not reflect any integral strategic line of the Federal Government or regional powers. However, the cutback of the federal power role in forming this policy is quite obvious together with the further, but much more expressed, shift of the center of gravity in the agrarian and food policy to the subjects of Federation.

Regulation of agrarian produce and food markets

The main programs of support of the agrarian and food complex are traditionally envisioned by the annual integrated government act distributing by directions the money allotted in the federal budget for this sector of economy. In the middle of April 1998, the Government signed the Act # 392 "On Economic Conditions of Functioning of Agrarian and Food Complex in 1998".

This Act envisioned no new measures from the viewpoint of regulation of the agrarian markets. Just as before, it proposed to set up the "minimal guaranteed purchase prices" on the food to be purchased to the federal funds. Just as before, these prices had nothing in common with the mechanisms of the interventions with which such prices are usually connected; they were supposed to be the calculation parameters for crediting the state contractors for the purchases in the state funds.

In practice, the RF Ministry of economy strongly objected to fixing the guaranteed prices as contradicting the principles of functioning of the market, and despite the negative reaction of the agrarian group of the State Duma, no such prices were fixed for 1998.

The Law "On State Regulation of Agrarian and Food Complex" adopted by the Federal Assembly of Russia in 1997 envisioned the governmental purchase and commodities interventions in the agrarian markets. In order to put into life the clauses of this Law, the Government Act # 392 envisioned the new, compared with the previous years, measure, the purchase interventions. However, the mechanism of such interventions was not stipulated. As the Act speaks of the purchase quotas at the purchase interventions, no full-scale interventions to support the agrarian produce prices at the guaranteed level were proposed; instead, the Act envisioned the right of the producers to sell their produce to the state at the fixed ("guaranteed") prices within the limits of the certain quotas. The greatest doubt was incited by the decision of the Government to make such purchases of the grain and oil-bearing crops, i.e., the ones with the highest and relatively steady profitability. However, the absence of the real mechanism of interventions and, which is the main thing, the budget crisis felt already at the beginning of 1998did not let to take this clause of the Government program seriously. As a result, no intervention transactions were made in the market of the agrarian produce and food.

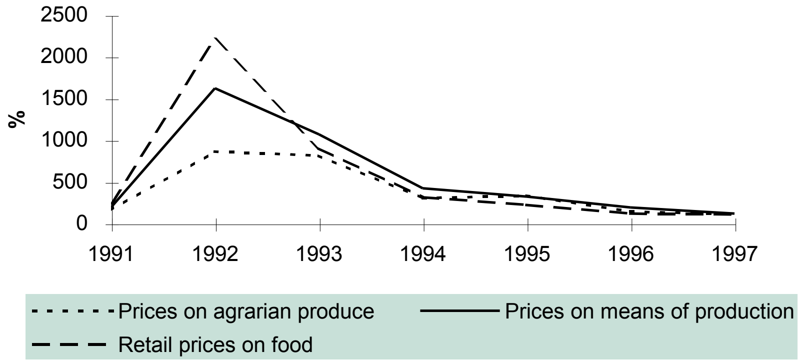
The second step of the Government in the field of regulation of the agrarian markets ensuing from the Law "On State Regulation of Agrarian and Food Complex" was the drafting of the document on raising the parity of the prices on the agrarian produce.

The main idea of the document consists in introducing the certain goal prices to be calculated after the basis prices of 1990 and to be used to validate the level of subsidies for the agrarian produce.

The return to the parity prices of 1990 means the return to the pricing proportions of the Soviet time. It is known that the policy of support of the agrarian economy by subsidizing the agrarian economy itself and the population for the food had led to the proportions between the prices on the means of production and the prices on the agrarian produce mush more preferential for the agrarian sector than in the whole world. The share of the agrarian production in the end prices on the food was also artificially overestimated (due to the mechanism of subsidies, this share exceeded 100% for certain foods). The liberalization of the prices resulted in the violent mutation of the relative prices in the agrarian and food complex. As soon as these relative prices leveled with the world proportions, the dynamic of the prices in the three spheres became parallel (see Fig. 2.19).

Fig. 2.19

Annual indexes of prices on agrarian produce, means of production for agrarian economy, and retail prices on food

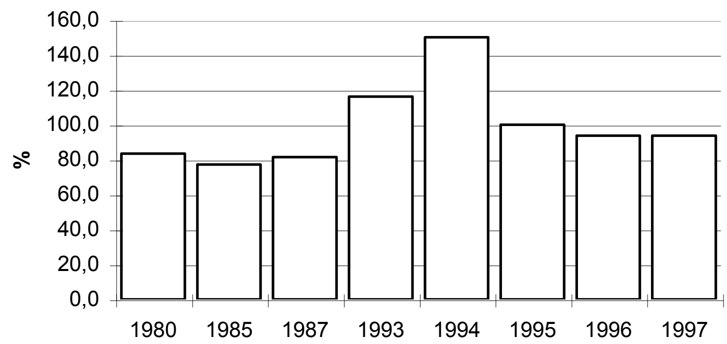


Source: Russian State Committee on statistics (Goskomstat)

The policy of the cheap resources for the agrarian economy led to their extremely wasteful use. It is known that up to 40% of the mineral fertilizers purchased by the farms were lost. Almost all the annually manufactured in Russia tractors (sometimes, even more than 100% of the manufacture: due to the stocks) went to replenish their loss. The fuel consumption was exuberant. The transition to the realistic price proportions (the calculations show that the relative prices in the Russian agrarian economy are more or less in accordance with the world level) resulted in the more cost-saving use of the resources: the purchased fertilizers are applied at 100%, the equipment is used only for its purpose and in the much more rational way (for already several years, it is hard to see the machines abandoned in the fields that had been quite normal in the Soviet times), the decline of the agrarian production is much lesser than the decline of use of the main agrarian production resources (see Fig. 2.20 and 2.21). All this shows the rationalized use of the resources. Meanwhile, the Ministry of agriculture and food proposes to get back to the 1990 situation.

Fig. 2.20

Application of mineral fertilizers, % of supply to agrarian economy

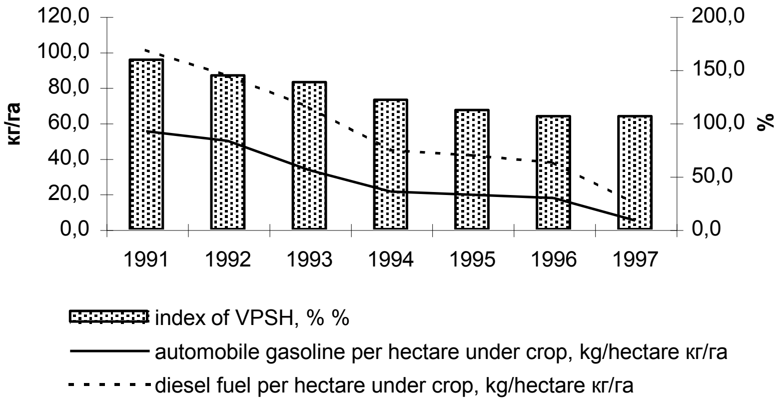


* - 1980-1987: USSR in whole

Source: Russian State Committee on statistics (Goskomstat) and RF Ministry of agriculture and food

Fig. 2.21

Dynamic of change of gross agrarian produce (accumulating after 1991) and consumption of automobile gasoline and diesel fuel per hectare of land under crop



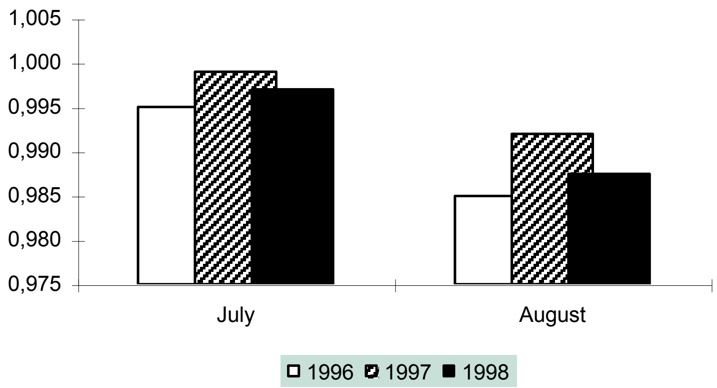
Source: Russian State Committee on statistics (Goskomstat) and RF Ministry of agriculture and food

The Federal Government stopped regulating the food markets in Fall 1993 when the federal subsidies for bread were lifted. The governmental program for 1998 did not suppose such regulation.

The main rationale of the Ministry of agriculture and food for selecting 1990 as the basis year for the calculations of the parity prices consisted in that that year was the one of the highest profitability in the agrarian economy and minimal number of the profitless husbandries. However, the Ministry failed to take into account that in the conditions of the prices fixed by the state, the profitability is the exclusively calculating category. Had, in 1990, in the system of the double prices on the agrarian produce and double tariff on the electric energy, the proportions been more preferential for the agrarian economy, had the purchase prices been raised higher (and they had been raised just before), the profitability could have reached not 37%, but, say, 50%. Under the conditions of the central plan economy, the profitability of the agrarian production was determined, mainly, by the possibilities of the budget and the force of the agrarian lobbying.

Fig. 2.22

Ratio of indexes of prices on food to general index of consumer prices in July and August



Source: Russian State Committee on statistics (Goskomstat)

The Government of S. Kirienko, guided by the mainly fiscal purposes, lifted, in July 1998, the privilege 10% rate of the VAT on most foods. With all this, the growth of the VAT rate did not affect the prices of the food. Fig. 2.22 shows the ratio of indexes of prices on food to general index of consumer prices in July and August of 1996 to 1998. The Figure shows that after lifting the privilege VAT for an important group of foods, the food prices were, in whole, growing slower than the average consumer prices (the comparison with the two previous years allows to eliminate the factor of the seasonal lowering of prices.

After the crisis, the list of the goods to which the privilege 10% rate of the VAT was applied was expanded again. In addition to the foods fixed in August 1998, it was supplemented with the meat and meat products, eggs, vegetable oil, margarine, sugar, cereals, macaroni, fish and sea products, vegetables, and potatoes. This measure is of temporary character and will stay effective till 1 June 1998.

Thus, by virtue of the strict budget limitations, the state policy in the field of regulation of the agrarian and food markets at the federal level had been forcedly liberal. With the beginning of the financial and economic crisis, the situation sharply changed: first the regional, then the federal power bodies made the attempts to regulate the agrarian and food markets in the administrative manner. These measures will be discussed in more detail below.

Policy of subsidies

The Federal Government has practically moved away from subsidizing the agrarian and food complex: while in the previous years of the reforms the share of the federal budget had been about one third of the aggregate budget financing of the agrarian and food complex, in the first half of 1998, this share dropped down to 19%.

Besides, the priorities of the agrarian and food sector in the budget policy of the state had always been expressed by that the percent of fulfillment of the projected expenditures for this sector of economy had been higher than for the other sectors. In 1998, the fulfilled items of the federal budget expenditures on the agrarian economy and fishing were only 12% of the Rbl. 12 billion planned for 1998. The share of the agrarian item in the expenditure side of the consolidated budget reduced from 3.6% in 1997 to 2.3% in 1998. The subsidies to the agrarian sector were financed only at 20%. What is characteristic is that the least efficient subsidies were financed in the largest share: the sheep breeding, the compensation of the energy and fuel expenditures of the greenhouse farms, and the elite seed growing. The subsidies for which the largest growth of the subsidies had been envisioned for 1998 (mineral fertilizers, flax growing, and crop insurance) were financed in the least degree. All this shows the absence of any serious controls of the agrarian sector in the hands of the federal power: the sector is being subsidized in the inertial way, by the least efficient channels.

As it has been already mentioned, the seasonal Government Act "On Economic Conditions of Functioning of Agrarian and Food

Complex in 1998" was adopted only in April. It had never been adopted so late, after having adopted all the production programs in the agrarian and food complex, received (or not received) all the credits, and began the sowing campaign where the late Spring had allowed. This delay has the objective causes. However this is not the matter. The adopted document contained nothing radically new as for the state agrarian policy. The system of measures, even the form of the document, has been repeated every year, only the figures and signatures have varied. Hence, the date of adoption plays no role for the real functioning of the agrarian and food complex.

Financial and crediting policy

In 1998, the 12 banks having won the tender of the end of 1997 distributed the Fund of privileged crediting of the agrarian and food complex. With all this, the 5 banks of the 12 distributed 86% of all the credits granted from the Fund (see Table 2.21).

As a result, there was no competition between the banks distributing the Fund. Almost a third of the territories worked with one bank, about one more third of the territories worked with two banks, and only in the main agrarian regions, such as the Altai, Krasnodar, Stavropol provinces, Rostov region, etc., the competition was supported by the presence of 4-6 banks in the financial market. As not all the selected banks had the networks of branch offices, they often had the correspondent relations with the local banks, thus adding the margin and, hence, making the loans to the agrarian producers more expensive. Thus, the percent of the credits to the so-called exterritorial borrowers (indirect index of that the authorized bank does not work directly with the producers) reached 50% for the MIB and 20% for the UNEXIMBank.; these are the typical examples of the banks having no regional network in the rural regions.

Table 2.21

Distribution of assets from Fund of privileged crediting of the agrarian and food complex by authorized banks, 1998

	Thous. Rbl.	%
Total granted	5,857,926.4	100.00
SBS-Agro	2,619,898.0	44.72
Alphabank	1,024,525.0	17.49
Incombank	584,600.0	9.98
Renaissance Bank	448,735.0	7.66
Menatep	345,580.0	5.90
Mostbank	268,000.0	4.57
Sobinbank	255,298.4	4.36
Imperial	163,980.0	2.80
Rossiyskiy Credit	62,500.0	1.07
MIB	50,810.0	0.87
Uneximbank	25,000.0	0.43
Mosbusinessbank	9,000.0	0.15

Source: data from SBS-Agro

Second, the local banks are, as a rule, dependent on the local administrations. Hence, they are able to strengthen their influence when distributing the credits and again means the bureaucratic mechanism of crediting instead of the bank one. Thus, in the Altai province, the department of agriculture makes up the register, and then the local banks make the contracts in accordance with this register. Here, as before, the egalitarian distribution of the credit resources and the basis for the red-tape corruption are seen. In the Lipetsk region, the former Governor used the crediting mechanisms to nationalize the agrarian enterprises (the new Governor later lifted the relevant resolutions, but the possibility itself of such use of the federal crediting mechanism remains).

As the shares of the authorized banks are not fixed (seemingly attempting in vain to incite a kind of competition in the loans market), the natural wish occurs to conserve the already "owned" (i.e., distributed at the previous stage) sum of the loans.

As the problem of the debts of the agrarian enterprises had not been solved, the banks had to grant the credits not directly to the producers, but to the processors, suppliers of the resources (the best variant), or regional administrations (the worst variant). Thus, the study of some regional branch offices of the SBS-Agro of all the credits granted, only 12% to 30% were granted directly to the agrarian producers (at the exception of Omsk with 44% and Tambov with 63%). Both the theory and already accumulated Russian experience testify that in the conditions of the exchange in kind bargains, the agrarian economy always loses because it does not have the access to the whole set of the market information and its influence in the bargains is lesser.

In certain regions of Siberia and Far East, 50% to 80% of all the credits were granted to the territorial administrations; this actually meant the return to the administrative distribution of the financial resources in the agrarian economy. Thus, the new system of crediting of the agrarian and food complex did not create any competitive environment in the agrarian crediting market, led to the inevitable conflicts between the participating banks and the management of the Fund, strengthened the administrative management of the crediting process at the regional level, and, in some cases, made the credits for the agrarian economy more expensive. And, last but not least, this system was fully dependent upon the accumulated assets allotted to replenish the resources. It does not envision any multiplier of the money (the 10% annual that the borrowers pay cannot ensure any multiplying effect).

The indebtedness that the agrarian producers accumulated to the beginning of the financial year in the agrarian and food complex (to the Spring sowing campaign) did not allow for a normal crediting of the sector: because of the cardfile, the allotted money would have been at once transferred to the budget. Hence, the problem of restructuring of the debts became substantive already at the end of

1997. In April 1998, the Government adopted the Act on restructuring the debts of the legal entities (in whole for the economy) to the Federal Budget. As for the number of the legal entities having debts to the budget, the agrarian sector is, maybe, the first in the economy. At the end of 1997, the management bodies of the agrarian and food complex submitted to the Government the demands to restructure the debts of the agrarian enterprises, but the administration of the President did not support this. As a result, in 1998, the credit to the agrarian economy had the form of the commodity credit (in the events of crediting the I and III spheres of the agrarian and food complex) or of granting to the local administrations the authority to distribute the loans; for the one hand, this strengthened the bureaucratic management, for the other hand, this led to strengthening the barter exchange in the agrarian and food complex.

The Government of Primakov again considered the issue of restructuring the debts to the agrarian sector; the relevant resolution was adopted. In the conditions of the new chance for the Russian agrarian and food sector, the quite doubtful measure of the overall restructuring (meaning writing off) of the debts may have the real stimulating effect if supported by other measures.

Institutional and land reform

The discussion on the draft Land Code in the Federal Assembly has not, yet, yielded any result. The attempt to reach a compromise on the main argued issues was made at the Round Table under the aegis of the RF President at the end of 1997. The results of the discussion by the Government served the basis for drafting and adopting the Federal Program "Development of Land Reform in RF for 1998-2000". The Program is liberal enough and defends the conception of the gradual formation of the controlled land market in Russia. However, its influence on the real processes in the legislative sphere is extremely limited. The State Duma stays aimed at approving its own variant of the Land Code, which in many aspects contradicts the Federal Program. At the same time, the expert poll by the IET in August 1998 showed that the specialists did not expect the adoption of this variant on the Code in the short term.

At the same time, the permanent reorganization in the Government and, in particular, in the bodies managing the land relations, resulted in that the fulfillment of the Decree of the RF President of 7 March 1997 "On Exercise of the Constitutional Rights of Citizens on Land" was, as a matter of fact, suspended: the registration of the contracts on use of the land shares was frozen at the level of the beginning of 1998. As of today, only a little more than 40% of the allotted land shares have been registered.

External trade policy

During these last years, the external trade policy of Russia had the purpose to protect the domestic market against the import. Since 1992, for the one hand, the control over the export of the agrarian produce and food has been being lifted; for the other hand, the system of the import tariffs and other limitations of the food import has been developing.

At the beginning of 1998, the Russian external trade policy was not much different from the one of the previous years. The evolution of the external trade system was determined, first of all, by the regulation of the import, while no measures to support the export were envisioned.

In 1998, the special attention was paid to the import of the alcohol. The austere control over the turnover of the alcohol was due to the growth, during the past years, of the import of the cheap liquors (including smuggled). This and the growth of the illegal production threaten the legal domestic producers of the alcohol. To systematize the import of the alcohol in the RF, from 15 February 1998, the liquors stronger than 28 degrees were added to the list including the vodka and ethyl alcohol whose import is to be licensed. Besides, from 31 December 1998, the excise tax rates on the alcohol and tobacco were raised.

The RF State Committee for customs has made tougher the rules of the import in Russia of the milk products produced in the CIS countries. From 15 June 1998, the custom clearance of the certain milk products imported from the CIS countries became subject to the mandatory submittal of the certificate of origin of the goods.

In 1998, the strict control over the trade in the sugar continued. At the beginning of 1998, the quota of the duty-free import of the sugar was fixed for Ukraine, 600,000 MT. Five Russian companies were licensed for the duty-free import of the sugar within the fixed quota. In accordance with the agreement between Russia and Ukraine, of the 600,000 MT quota, Ukraine was to supply to the Russian market 100,000 MT in the first and fourth quarters-year, and 200,000 MT in the second and third quarters-year. However, in reality, the volume of purchase by the Russian companies licensed to the duty-free import was much smaller. The main reason is the high, from the viewpoint of the world level, prices of the Ukrainian sugar.

In addition, from 1 August to 31 December 1998, in order to protect the Russian sugar beet complex, the temporary special duties were fixed for the refined and raw sugar imported from outside the FSU. The new duties were in excess of the effective custom duty rates (25% on the refined sugar and 1% on the raw sugar) and made 74% of the custom cost but nor less than ECU 0.16 per kilogram for the raw sugar and 20% but not less than ECU 0.055 per kilogram for the refined sugar. However, as the production of the sugar beet reduced, and after fixing the temporary special duties the supplies of the raw sugar dropped, at the beginning of 1999, the temporary special duties were lifted. This gives the ground to suppose that the Russian sugar factories will, soon, again begin processing the imported raw sugar. This and the prolongation of the supplies of the Ukrainian sugar within the limits of the duty-free quota to the end of March 1999, complicate the situation for the Russian producers of the sugar beet.

The other import limitation was the lifting, from 1 August 1998, of the privilege 10% rate of VAT applied to the foods (see above).

On 15 August 1998, the 3% additional import duty was fixed to stay effective till 31 December 1999. This duty was in excess over the effective rates of the duties and on all the goods, including the agrarian produce and food, imported in Russia from other states, except the members of the Customs Union. Obviously, the small sum of the duty was hardly capable to limit the import flows to Russia. This gives the grounds to suppose the purely fiscal character of this measure.

In the second half of 1998, the evolution of the external trade relations of Russia was influenced by the financial and economic crisis. The reduction of the import as a result of the devaluation of the national currency made the Russian Government approach the issues of the external trade regulation from the viewpoint of stabilization of the situation in the food market and support of the domestic processing industry, especially the milk and meat one.

To reinforce the base of the milk and meat industry, from 27 October 1998, the import duties on the meat, milk powder, and cream were reduced. The duties on the foods of social importance, such as butter and vegetable oil, baby food, and soybeans were cut as well. The new duties were adopted for the six-month term with the condition of the possible prolongation.

The reduction of the limitations for the import supplies of the agrarian produce and food was also manifested by the lift of the 3% extra duty made effective in August on certain agrarian produce and foods. The restoration of the privilege rate of the VAT on the wide range of foods has lied within this series of measures.

In the conditions of the economic crisis, the barter relationships between Russia and the former constituent republics of the USSR spread wider. The development of these relations was connected, for the one hand, with the shortage in these states of the sufficient finance and, for the other hand, with the wish of the Russian Government to replenish the food stocks. For example, Russia will exchange the fuel against the food from Lithuania. Byelorussia and Moldavia will repay their debts for the natural gas from Russia with the supplies of the food.

Being aware of the possibility of expansion of the export of the food from Russia after the devaluation of the national currency, the Russian Government imposed, in November 1998, the licensing of the export of the sunflower seeds, rape, and soybeans. Besides, at the beginning of January 1999, for the first time since 1996, the food export duties were renewed. The combined export duties were introduced on the soybeans and rape seeds, 10% of the customs cost but not less than ECU 20 per MT and on the sunflower seeds, 10% of the customs cost but not less than ECU 15 per MT.

The oil-bearing crops are a traditional item of the Russian export, i.e., the only crop in which Russia has been net exporter during all the years of the reforms. Many economies of the south of Russia have survived only due to the high profitability of these crops. The export limitations will result in their financial degradation with the further necessity of the financial support of these producers, as well. Meanwhile the domestic market sees no deficit of the vegetable oil that could validate the reasonability of such measure.

2.4. Investments in real sector of economy

Sources of formation of investment resources

The development of the positive processes in the investment sphere outlined in 1997 was suspended by the crisis in the world and domestic financial markets. The growth of the refinancing rate, interest on the collateral credit, and norms of mandatory reserves worsened the main parameters of the credit and financial market. The reduction of the investment rating of Russia, the growth of the risks, and the sharp worsening of the investment climate initiated the outflow of the assets of the non-residents from the Russian stock market, destabilizing even more the situation in the financial and real sectors of economy. After the devaluation of the Ruble and declaration of the default for the internal debt, the recession of the business and investment activities intensified.

After the relative stabilization of 1997, in 1998, the gross accumulation reduced by 10.5% and the share in the GDP of the investments in the fixed capital was, to the end of the year, 15.0%. The acceleration of the investment recession rate was conditioned by the increased limitations of the financing of the investment expenditures at the expense of both the own and the mobilized resources.

In the conditions when the own assets of the economic activity subjects form over 85% of all the investments in the fixed capital, the sharp reduction of the savings in all the sectors of economy predetermined the depth of the investment crisis. The reduction of the production profitability intensified the tendency to the reduction of the role of the profit as source of financing of the fixed capital reproduction. The share of the profit in the investments in the fixed capital reduced, compared with 1997, by almost 1.7 percentage points making 11.2% in 1998. Though the role of the amortization deductions in the investments is growing, the growth of the prices on the capital goods narrows its functions to the limits of reproduction of the fixed capital.

Table 2.24

Structure of investments in fixed capital by sources of financing, in prices of relevant years

	structure of investments in fixed capital, % of balance			share of investments in fixed capital, % of balance		
	1996	1997	1998	1996	1997	1998
Investments in fixed capital	100.0	100.0	100.0	17.09	15.41	15.0
incl.:						
1. Own and mobilized assets	79.9	79.3	85.1	13.65	12.22	12.76
of them:						
own assets of enterprises	52.3	60.8	52.3	8.94	9.37	7.84
credits of commercial banks	2.7	2.6	3.0	0.45	0.40	0.48
assets of out-budget funds	12.2	4.6	11.7	2.09	0.70	0.58
other	12.7	11.3	14.2	2.17	1.75	2.86
2. Assets of consolidated budget	20.1	20.7	14.9	3.44	3.19	2.23
of them assets of federal budget	9.9	10.2	6.5	1.69	1.66	0.97

Source: Russian State Committee on statistics, preliminary data

The lack of the own financial assets for the investment programs is not compensated by the mobilization of the assets of the others. The share of the bank credits in the structure of the investments in the real sector does not exceed 2.5% to 3%. In the first half of 1997, the reduction of the interest rates on the credits, the low inflation environment, and the reanimation of the production favored a certain growth of the long-term credits to the real sector. This was also, to a high extent, favored by the reduction of the profitability of the transactions with the governmental securities. The growth of the profitability of the transactions in the financial market within the period from October 1997 to June 1998 renewed the process of movement of the resources from the real sector to the stock and currency markets. The cost of the credit resources was growing, which limited even more the already modest possibilities to finance the real sector.

The Russian market of the corporate securities does not, in practice, fulfill the function of transformation of the financial resources into investments. The issuing of the corporate securities finances less than 1% of all the out-budget investments, while in the countries with the developed economy this figure reaches 10% to 40%. In 1998, especially after the crisis, the drop of the rate of the securities forced many enterprises to reject the plans of the further issues and placement of their securities in the market.

In 1998, the investments by the state reduced even more. According to the preliminary data, the share of the assets of the consolidated budget in the investments dropped, as the result of the budget crisis, down to 14.9% (from the 20.7% of 1997). The expenditures of the federal budget on the investment purposes reduced from 9.5% in 1997 to 4.8% in 1998. The governmental investments from the federal budget reduced, in the absolute figures, from Rbl. 30.2 billion in 1997 to Rbl. 14.7 billion in 1998; only 1/4 of them was financed. As a result, their share in the total volume of the investments in the fixed capital reduced from 7.3% in 1997 to the 3.7% in 1998.

In 1997, the governmental financing of the basic industries was Rbl. 0.9 billion, or 21.7% of the annual budget goal-oriented allotments by the production complexes. The investment projects and federal goal-oriented programs were financed as follows (percent of the relevant annual goal-oriented allotments): 10% for the fuel and energy complex and the mechanical engineering one; 11% for the chemical complex; and 30% for the transport and communications complex. The short financing of the "Russian People's Telephone" Federal goal-oriented Program, the reduced volume of the investments in the communications from all the sources of financing, (by 8% from the level of 1997), and the reduction of the foreign investments (by almost 63%) affected significantly the scale of construction of the communication projects and the dynamic of the communications development.

The dynamic of financing for the specific projects of the goal-oriented investment program, namely, the non-governmental non-commercial organizations, was directly dependent on the implementation of the mechanism of financing fixed by the order of allotment of the finance from the federal budget in accordance with the Government Act of 1 June 1998 # 548. Due to the long period of the legalization of the transfer of the shares to the state, practically no commercial entities were financed.

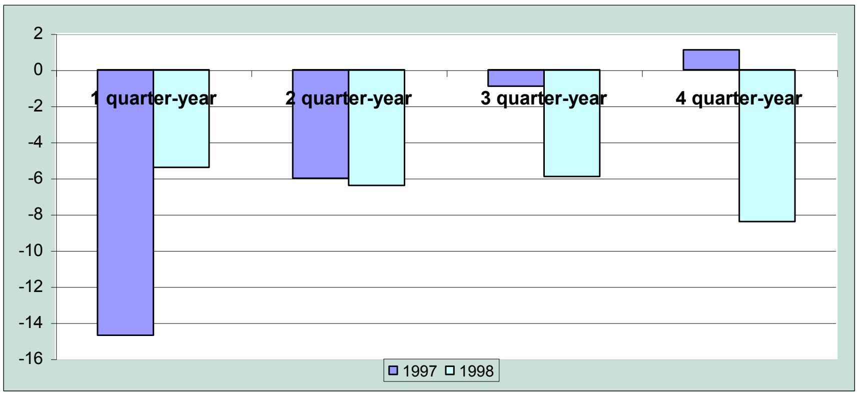
The Federal investment program for 1998 had envisioned the start-up of the 267 most important projects of the production and social sphere; however, only 15 projects were started up, only 10 of them were started up at the full capacity. At most of the start-up projects, the technical readiness was less than 50%. Of the 350 projects having won the investment tenders and supported by the state only 6 were started up in 1998 for the full capacity.

The analysis of the governmental investments shows that the growth of the accounts payable for the works executed exceeded, to the end of 1998, the volume of the governmental investments for 1999. In these conditions, the investment program is limited to the support of the extremely narrow range of directions. Taking into account the acute crisis of the budget and finance system and strict sequestering of the financing of the federal investment programs during these last years, no positive changes are foreseen for this sphere in the nearest future.

The total volume of the investments in the fixed capital from all the sources of financing made, in 1998, Rbl. 402.4 billion, or 93.3% of the 1997 level. In the first half of 1998, the investments in the fixed capital reduced by 6% compared with the relevant period of 1997. From September 1998, the investment recession intensified. In the fourth quarter of 1998, the investments in the fixed capital decreased by 8.4%.

Fig. 2.23

Change of dynamic of investments in fixed capital in 1997-1998 (% of the relevant period of the previous year)



The recession of the investment activity in 1998 affected to the greatest extent the investments in the production sphere. During the last two years, the certain growth of the production construction share was observed; at the end of 1997, even the positive dynamic was restored. With the change of the macroeconomic situation, the investments in production, from all the sources, reduced by 10.5% compared with the 1997 level. The absolute volume of the investments in the construction of the production projects reduced by almost Rbl. 13 billion, down to Rbl. 250.1 billion; meanwhile, the prices of the construction and erection works grew by 9.7% and the prices of the machinery and equipment grew by 20.7%. As for the non-production projects, Rbl. 152.3 billion were invested there;

in 1998, the share of these investments grew up to 37.8% against the 35.5% of 1997.

The investment crisis called forth the process of cutback of the economic activity in practically all the sectors and branches of economy. From the beginning of the reforms, the structural shifts in the economy have been seen on the background of the investment in the sphere of services. Thus, while in 1990, 56.7% of the investment fell on the capital producing the goods, in 1998, the relevant share decreased to 46.7%. However, the last three years have shown a certain growth of the investments in the branches producing goods.

Table 2.22

Structure of investments in fixed capital by sectors and branches of economy, % of balance

	1995	1996	1997	1998
Investments in fixed capital, total	100.0	100.0	100.0	100.0
Incl.:				
Branches producing goods	41.4	42.1	43.3	46.7
Of them				
Industry	34.4	34.8	36.4	39.9
Agrarian economy	3.5	2.9	2.5	3.4
Construction	2.5	4.0	4.2	3.3
Branches rendering services	58.6	57.9	56.7	53.3
Of them:				
Transport	13.2	13.5	15.2	14.4
Communications	1.4	1.8	2.8	3.7
Trade	2.0	2.2	2.2	2.0
Living construction	22.8	20.3	16.7	16.2

Source: Russian State Committee on statistics (Goskomstat)

It should be noted that these last years, the changes of the branches structure have been influenced, for the one hand, by the intensive investments in the fields of the natural monopolies, i.e., fuel industry, energy production, transport, and communications and, for the other hand, the lowering of the business activity in the processing industries and agrarian economy. The share of the investments in the agrarian economy has reduced, during the last eight years, by the 12.5 percentage points, down to 3.4% in 1998. The cutback of the demand for the construction services and shortage of the own financial resources reduce the investments in the construction complex.

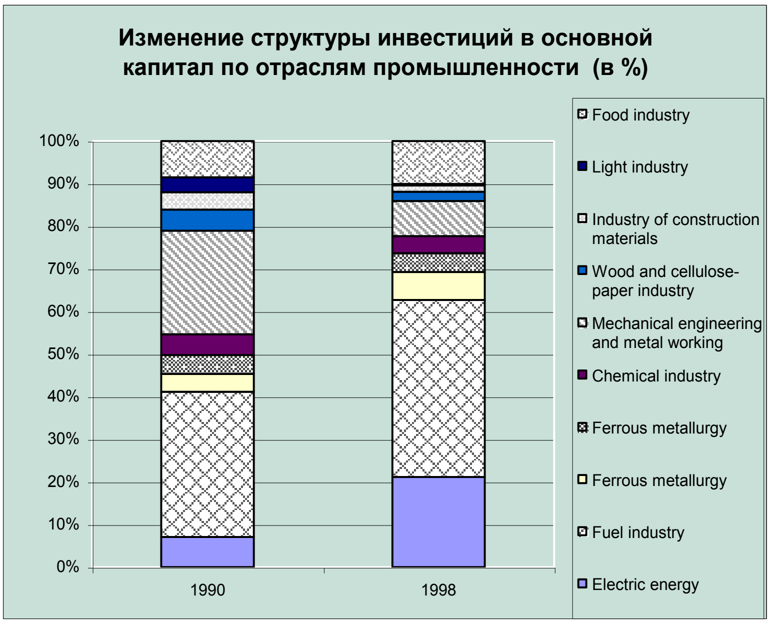
The relatively stable tendency to the growth of the share of the industry in the total volume of investments was supported by the travel of the capital to the extracting, export-oriented, and competitive industries.

In the industry sector, the greatest share of the investments fell on the fuel and energy complex, whose share of 1998 was 61.0% of all the investments in the industry against the 32.4% before the reforms. However, with the worsening of the world conjuncture in the market of the energy resources and reduction of the incomes from the export activities, the volumes of the investments in the fuel industry have been reducing, as well. In 1998, the total volume of investments in the fixed capital of the fuel and energy complex reduced by almost 29% compared with the preceding year.

The investments for support of the oil extraction reduced, compared with 1997, by more than 26%; the extension and development drilling reduced by 39% and 22%, respectively; the start-up of the new wells reduced by 21%; the start-up of the new fields reduced by 37.5%. The program of reconstruction and updating of the operating production facilities of the existing refineries and construction of the new ones was practically frozen, because here the volume of investments reduced by 25% compared with 1997.

Fig. 2.24

Change of structure of investments in fixed capital by industries (%)



Source: Russian State Committee on statistics (Goskomstat).

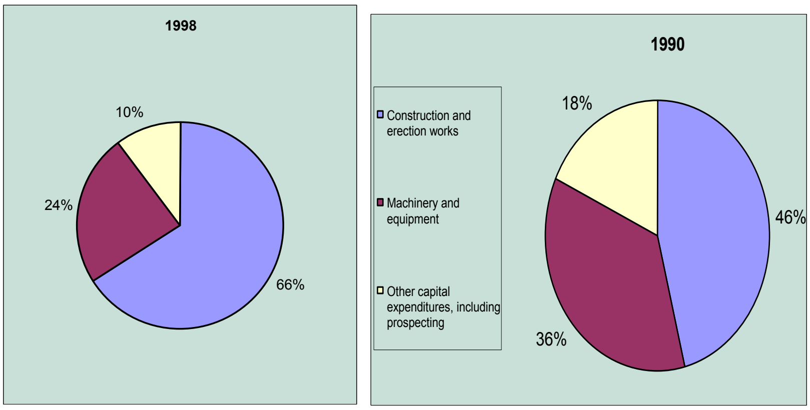
In the gas industry, the volume of the investments in the fixed capital from all the sources of financing was about 60% of the 1997 level. This did not allow to ensure the start-up of the projects needed for the support of the stable level of the gas extraction and reliable supply of it to the consumers. The reduction of the investment resulted in the longer terms of construction and growth of the volumes of the unfinished construction. The negative effect on the investment activity of the industry also came from the reduction of the gas prices in the external market because the hard currency incomes from the export are practically the only source of financing of the investment activity.

In the electric energy production, the tendency to the aging of the production funds remained effective (in 1998, the newly started-up capacities were less than 10% of the technically necessary level of renewal of the fixed capital). One of the main causes of the situation is the strong shortage of the investment resources resulting from the non-payments of the consumers for the consumed electric and heat energy.

The implementation of the program of restructuring of the coal industry allowed freeing over 92,000 employed and raising the labor productivity per worker by 3.5% compared with 1997. The volume of the investments in the fixed capital from all the sources of financing reduced, in 1998 compared with 1997, by over 20%; the start-up of the fixed assets reduced by 17%.

Fig. 2.25

Technological structure of investments in fixed capital



Source: Russian State Committee on statistics (Goskomstat).

The situation and outlooks of the development of the extracting sector of the industry are beginning to be determined, to the greater and greater extent, by the dynamic of the investments in the development of the mineral feedstock base. However, during these last years, the share of the expenditures on the prospecting has been constantly reducing.

According to the preliminary data, the estimate cost of the prospecting performed in 1998 and financed from all the sources was Rbl. 15.6 billion which is, in the comparable prices, by 12%

lower than in 1997. With this, in the first half of 1998, the volume of the works exceeded the level of the relevant period of the previous year by 13% but reduced sharply beginning from the third quarter-year. The reduction of financing in the fourth quarter-year resulted in the complete suspension of drilling of the deep exploration wells for oil and gas.

The main share of the prospecting works (about 70%) was financed from the allotments for reproduction of the mineral feedstock base from the subjects of Federation and the money remaining at the disposal of the mining enterprises. The money from the federal budget was used to finance the prospecting works for Rbl. 1.3 billion, and the debt to the budget for the works executed for the federal needs was Rbl. 354 million. The reduction of the oil prices resulted in the reduction of the allotments on reproduction of the feedstock base; hence, the cutback of the prospecting works. Under the crisis, the practice of the non-purpose use of the assets from the budget fund for reproduction of the mineral feedstock base became wider. Besides, the worsening of the general economic situation in the country resulted in the sharp drop of the foreign investment in the geological prospecting of mineral resources. In this connection, the volume of the deep exploration drilling for oil and gas in 1998 was by 22% smaller than in 1997.

In 1998, the increment of the explored reserve did not, just as before, ensure the compensation of the annual extraction of the most important fuel and energy resources. The reduction of the deep exploration drilling during these last years prevented from revealing the fields of large and medium size reserves. Only the small-size fields with the difficult to extract reserves were involved in the development; this did not even compensate the lowering levels of the oil extraction. The metallurgical enterprises have also begun to feel the shortage of the feedstock base. In the new, potentially promising regions, in particular, East Siberia and Republic Sakha, the prospecting works have been fully suspended.

Reproduction and technological structure of investments

From 1995, the reproduction structure of the investments in the fixed capital has had the stable enough share for the technical re-equipment, reconstruction, and expansion of the operating enterprises: it has been about 58%. With this, the share of the investments in the active part of the fixed assets within the technological structure of the investments in the fixed capital has been steadily reducing. In 1998, the share of the investments in the machinery and equipment was 23.5% against the 36% in 1997. The equipment renewal factor in the industry dropped from 6.0% in 1990 down to 0.7% in 1997.

The start-up of the new equipment does not compensate the natural wear of the equipment fleet. Almost two thirds of the production equipment is older than 15 years, and the wear and tear of the fixed assets exceeds 50%. The average actual life has been constantly growing during the last ten years, and has exceeded the normative life almost 2.5-fold. The ratios of the renewal rates liquidation rates, and average age of the equipment show that the support of the actually formed age of the fleet of machinery and equipment in the industry is possible only at the simultaneous increase of the start-up and removal factor almost three-fold.

The share of the enterprises developing and implementing the technical innovations in the industry did not exceed 5%. The highest share of the innovation expenditures falls on the purchase of the new machines, equipment, and plants required for the technological renewal of the production. The own assets of the enterprises form the main source of financing of the investments. The exceptions are the individual enterprises of the mechanical engineering, gas industry, and glass manufacture, whose innovative activity is supported by the participation of the foreign capital.

The three thirds of the innovation-active enterprises are in the mechanical engineering, metalworking, food industry, chemistry and petrochemistry. Though the most intensive implementation of the new technologies and developments is seen in such branches and the medical, microbiological, printing, flour grinding, cereal, combined fodder, and sewing industries, their aggregate share in the branch structure of the industry is not high. As the expenditures on the innovations do not exceed 3% of the aggregate volume of investments in the production purpose projects, these processes do not influence on the change of the technological structure and indexes of renewal of the active share of the fixed capital. The technical backwardness of the production is the stumbling block of the Russian economy.

Investments in social sphere

In 1998, the volume of the construction works at the social sphere projects was insignificant. In 1998, Rbl. 2.9 billion were allotted for the construction of the social sphere and science objects from the federal budget; this is 2% of the governmental investments approved by the federal budget for 1998, including by branches: 16% for the education; 15% for the public health; 31% subway construction and culture; 29% for the science. The federal goal-oriented program for 1998 for the social complex and science envisioned to invest the federal budget assets for fulfillment of the 51 events of the federal goal-oriented program, including the presidential programs. Twenty of the federal programs were not financed at all, while the financing of all the others was at the extremely low level.

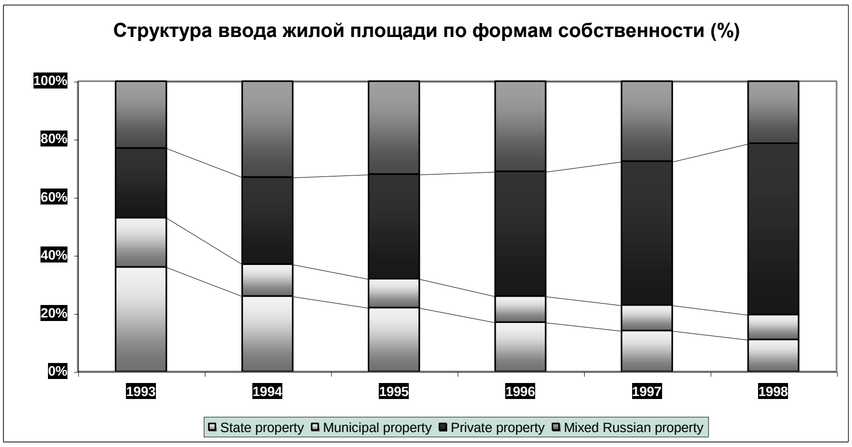
The tendency to reduction of the dwelling construction rates has been observed since 1995. In 1998, the investments in the dwelling construction were about 60% of the 1995 level. At the general tendency to the reduction of the share of the state financing of the federal dwelling construction programs, the share of the assets from the federal budget has been reducing, while the share of the subjects of Federation and local budgets has been increasing. The private capital holds the dominating positions in the dwelling construction.

In 1998, the governmental financing of the dwelling construction was 22% of the annual allotments from the budget. In 1998, the highest importance program of granting the living premises for the military people, "State Dwelling Certificates", was fulfilled at 30%. Of the 42,000 dwelling certificates for purchase of the dwelling premises only 13,000 were issued indeed; only 7,000 of them were financed in fact. The "My Own Home" Federal goal-oriented Program for which the budget had envisioned to allot Rbl. 300 million was not, in practice, financed. The subsidies to the people leaving the regions of the extreme North and equal status regions were Rbl. 557.4 million or 46% of the budget allotments of 1998.

On 16 June 1998, the Federal law "On Real Estate Mortgage" was adopted. This Law is considered one of the basic factors favoring the growth of the investments in the dwelling construction. Certain cities, towns, and regions of Russia have created the agency for the mortgage crediting. However, the lack of the assets for developing this direction of the dwelling construction blocked the practical implementation of the mortgage in 1998.

In certain regions, the dwelling construction was due to the out-budget sources. For example, the Belgorod region and Mordovia used the out-budget funds for the country dwelling construction with the loans to be repaid by the agrarian produce. The Tambov region organized the system of purchase of the homes by installment, using the dwelling accumulation accounts. In the Chuvashiya, Sakha (Yakutiya), Karachayev-Cherkesiya Republics, Archangel and Belgorod regions, the dwelling bonds were issued. In Ekaterinburg, several enterprises of various industries and banks made the agreements on the joint construction of the dwelling premises; the possibility to mobilize the financial resources of the local banks by issuing the bills of exchange on the dwelling facilities under construction is the important element of the agreement.

Fig. 2.26



Source: Russian State Committee on statistics (Goskomstat)

In 1998, the enterprises and organizations of all forms of property put into operation 30.3 million m^2 of the dwelling surface; this makes 92.7% of the relevant figure of 1997.

Due to the fact that the share of the dwelling construction at the expense of the population remains high, the rates of recession in this sector of economy are possible to hold down. While the volumes of putting into operation of the dwelling premises by the state-owned entities decreased by 18.3%, the putting into operation of the dwelling premises at the expense of the population mobilizing the credits grew by 5.2%. The private capital safeguards its positions at the stable demand for the dwelling facilities; in 1998, the putting into operation of the dwelling premises by the private investors grew by 21.7%.

While, from the beginning of the reforms, the dynamic of the offer in the dwelling market formed under the influence of the demand of the people with the high and medium incomes, as of today, its development is limited by the reduction of the demand of the people with the lower income. However, this very circumstance is the factor holding down the dwelling prices. In 1997 and the first half of 1998, the potential purchasers were the people with the average monthly income exceeding Rbl. 7,000; these were less than

7% of the population. After the August crisis, the situation in the real estate market radically changed. This has not, yet, effected the dwelling construction market; however, beginning from June 1998, most of the construction entities have noted the trend to the reduction of the orders.

Construction complex

The evolution of the investment processes closely correlates with the situation and operation of the construction complex. The works performed in 1998 under the construction contracts cost Rbl. 234.0 billion (92% compared with the relevant period of 1997).

The financial crisis of the second half of 1998 resulted in the partial cut of the construction works and growth of the number of the suspended constructions.

During 1998, the normative and legal bases for improving the investment conditions were being formed. The normative and legal basis for the contract tenders (accounting for the foreign and domestic experience) has been, in general, created. In 1998, the governmental customers, holders of the budget assets, made over 60,000 contract tenders. The cost of the contracts made exceeded Rbl. 37 billion or 91% of the offer cost of the governmental customers. However, the statistical data show the unwarrantedly overestimated number of the closed contract tenders: during the first 9 months of 1998, 50% of the tenders were either closed or under the quotation requests.

2.5. Foreign investments in Russian economy

In 1998, the volume of the foreign investments mobilized to Russia grew due to the inflows falling on the share of the investments formed, mainly, by the credits of the indirect investors, e.g., the World Bank, International Monetary Fund, European Bank for Reconstruction and Development, and the assets directed by the investors to purchase the governmental securities, mainly, the GKO-OFZ (Table 2.23 shows them as the "Other investments").

Their share in the aggregate volume of the foreign investments of 1998 was about 70%.

Table 2.23

Structure of foreign investments in Russian economy

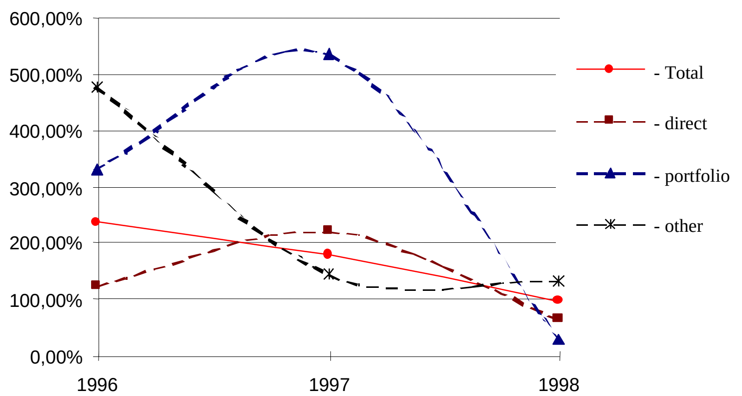
	1995		1996		1997		1998	
	US$ million	share, %	US$ million	share, %	US$ million	share, %	US$ million	share, %
Total	**2,983**	**100**	**6,970**	**100**	**12,295**	**100**	**11,773**	**100**
incl.:								
— direct	2,020	67.72	2,440	35.01	5,333	43.38	3,361	28.55
— portfolio	39	1.31	128	1.84	681	5.54	191	1.62
— other	924	30.98	4,402	63.16	6,281	51.09	8,221	69.83

Source: Russian State Committee on statistics (Goskomstat).

As of the end of 1998, the aggregate volume of the foreign investments was estimated as US$ 11.77 billion; this was 95.8% of the 1997 level. The general unfavorable situation in Russia, the loss of the investment attractiveness, and the growing instability in the world stock markets induced, to the Summer 1998, the foreign investors to depart from the Russian market. The number of the investment companies operating in the Russian market reduced more than 3-fold. In 1998, the market of the corporate securities did not, practically, participate in the processes of transformation of the resources from the financial sphere to the investment one due to the loss of the liquidity by the financial instruments. In 1998, the volume of the mobilized foreign portfolio investments reduced by 72% compared with the relevant level of 1997.

Fig. 2.27

Dynamic of foreign investments in Russian economy, % of the previous year



The analysis of the dynamic of the direct foreign investments shows that, as the political and social instability is growing, the tendency to the reduction of the foreign investments in the Russian economy is strengthening, as well. Thus, as of the balance of the first quarter-year and the first half-year, the direct foreign investments were 86% and 54%, respectively, as compared with the relevant periods of 1997. In whole, in 1998, the aggregate volume of the mobilized foreign investments was US$ 3.36 billion, or 63% of the relevant sum of 1997. The growth of the interest rates on the credit resources, the high investment risk, the shrinkage of the domestic demand, the inefficient payment system of Russia, etc. have strengthened the tendency to the reduction of the investment market.

The branch structure of the foreign investments (see Table 2.24) has also underwent changes in 1998, first of all, due to the significant cutback (5-fold) of the share of the investments in the financial, crediting, and insurance.

Table 2.24

Branch structure of foreign investments

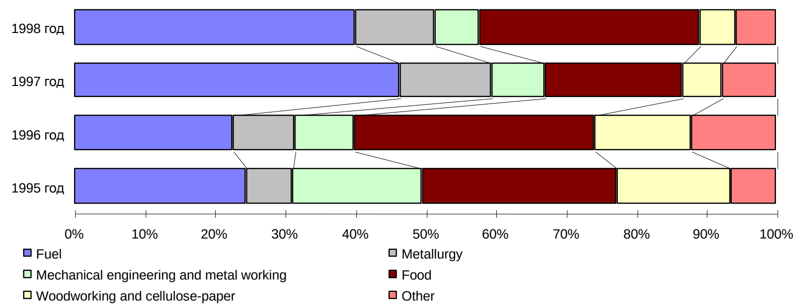
	1995		1996		1997		1998	
	US$ million	share, %	US$ million	share, %	US$ million	share, %	US$ million	share, %
Industry	1291	43,28	2278	32,68	3610	29,36	4698	39,90
Transport and communications	99	3,32	269	3,86	194	1,58	589	5,00
Trade and public catering	507	17,00	375	5,38	733	5,96	1201	10,20
Market servicing commercial activity	145	4,86	1629	23,37	2299	18,70	1426	12,11
Finance, crediting, insurance, pensions	406	13,61	2024	29,04	4763	38,74	900	7,64
Other	535	17,93	395	5,67	696	5,66	2959	25,13

Source: Russian State Committee on statistics (Goskomstat)

As for the production sphere, the greatest investment attractiveness has remained with the branches of the natural monopolies and high monopolization facilities of the processing industries whose products see the high demand in both the domestic and foreign markets. The significant part of the accumulated foreign investments in the industry was received in the form of the credits from the international financial entities. The industries oriented to the domestic market have significantly lower investment attractiveness for the foreign investors. The only exception here is the food industry: in 1998, the investments in it were US$ 1.47 billion, or 12.5% of the total volume of investments.

Fig. 2.28

Structure of foreign investments in industry



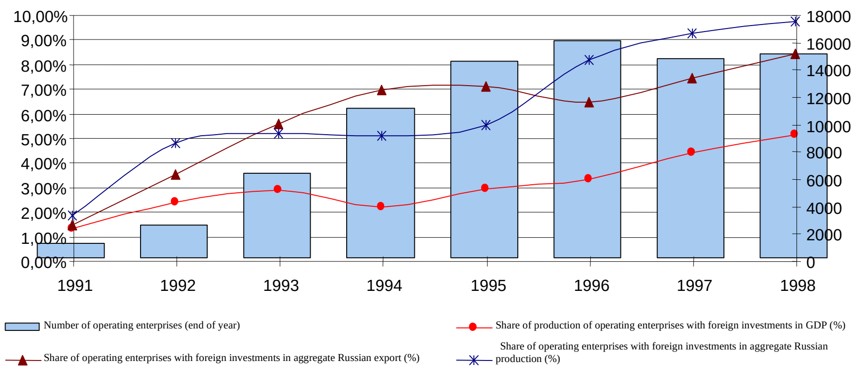
In 1998, the cooperation with the foreign companies under the investment projects went on in the oil extraction, oil processing, aircraft construction, automobile construction, extraction of the diamonds and gold, mechanical engineering, communications, conversion of the defense enterprises, agrarian production complex, and food industry. Notwithstanding the complex situation, the foreign companies are trying to safeguard their positions in the Russian market. The large-scale investment of the production share type in the field of the oil extraction are continuing to be implemented. In 1998, the projects Sakhalin-1 and Sakhalin-2 were invested about US$ 360 million. About US$ 20 million were invested in the development, exploration, and geophysical works and re-equipment of the offshore platform for the Sakhalin-3 project. According to the pre-estimate, the aggregate expenditures on implementation of this project will make about US$ 35 billion for the whole period of implementation.

During the last three years, the number of the enterprises with foreign investments has increased.

Among the enterprises with foreign investments really operating today, 35.2% operate in the trade and public catering, 26.4% operate in the industry, 8.5% operate in the transport, and about 6% act in the general commercial activity of the market servicing. The efficiency of operation of the enterprises with foreign investments calculated as the product manufactured per employed person is twice higher than the average level of the Russian ones.

Fig. 2.29

Number of operating enterprises with foreign investments and main specific indexes of their activity



In 1998, the foreign exchange share of the enterprises with foreign investments in the foreign exchange share continued growing. These last years have been characterized by the growing intensity of the import activities of the enterprises with foreign investments. The greatest activity in the import comes from the enterprises with foreign investments functioning in the trade, public catering, and industry. The share of these enterprises in the aggregate Russian import during the last three years has constantly exceeded the other specific indexes of their activity. In many aspects, this has been due to the stabilization of the economic and political situations in Russia and introduction of the currency corridor during the period from August 1995 to August 1998. Beginning from 1995, the constant growth of the number of the enterprises with foreign investments has been observed; these enterprises have been founded in the infrastructure and food industry and oriented to the domestic market.

The export of the enterprises with foreign investments is, mainly, of the feedstock character: the crude oil, chemical goods, timber, sea products, non-ferrous metals and their scrap prevail. In

1995, the reduction of the export growth rates with the enterprises with foreign investments was, in many aspects, conditioned by the reduction of the activity of the foreign investors in the extracting industries and redistribution of the direct foreign investments between the sectors of economy. The main factors of growth of the cost of export under the aggravating external economic situation and reducing average contract prices were the growth of the physical volumes of the exported feedstock resources.

The growth of the share of the enterprises with foreign investments in the relevant Russian indexes and the growth of their production volumes in the Russian GDP during these last three years have evidenced, first, the deepening of the tendency of inflow of the foreign investors in the industry, and, second, the expansion of the import of the equipment and components for the domestic manufacture.

However, in whole, the influence of the enterprises with foreign investments on the macroeconomic indexes of Russia has not been significant: they have manufactures only about 5% of the Russian GDP.

Naturally, the crisis situation in the Russian economy in the second half of 1998 hag the negative effects on the activities of the enterprises with foreign investments. The consequences of the financial, budget, and currency crisis having affected the enterprises with foreign investments have been the following: the absence of access of the enterprises with foreign investments to their financial assets due to the crisis of the banking system; the losses due to the non-payments; the reduction of the demand on the goods and services; the destruction of the distribution network; and the alteration of the external trade structure. All these have resulted in the delays of the payments to the creditors, reduction of the number of employed and labor remuneration fund; and reduction and suspension of the manufacture. However, the danger of loss of the positions in the large-size and non-mastered Russian market have resulted in that only a small number of the enterprises with foreign investments have suspended their activities there.

During the last three years, the structure of the foreign investments by countries has undergone the significant changes. In 1998, the positions of France and Germany strengthened; as of today, they own the 24.2% (13.4% in 1997) and 13.1% (1.7% in 1997) of the respective foreign investments. The share of the four industrial countries (USA, Germany, France, and UK) has grown 2-fold compared with 1996. In whole, the industrial countries prevail among the foreign investors. Over 90% of the foreign investments fall on them.

Table 2.25

Distribution of foreign investments by countries, US$ million

	Inflow		Including		
	Total	% of balance	direct	portfolio	other
Total investments	**11,773**	**100%**	**3,361**	**191**	**8,221**
of them:					
Germany	2,848	24.2%	328	0.0	2,520
USA	2,238	19.0%	1,170	143	925
France	1,546	13.1%	15	5	1,526
UK	1,591	13.5%	205	11	1,375
Netherlands	877	7.5%	610	2	265
Switzerland	411	3.5%	40	0.4	370

Source: Russian State Committee on statistics (Goskomstat).

As for the regional aspect, in 1998, the main share of the foreign investments fell on the Central region (59% of the aggregate volume or US$ 6.96 billion). The importance of Moscow, St. Petersburg, and Moscow region as the centers of the business activity remains; these attract 50.6% of the aggregate investments in the real sector of the Russian economy. In whole, the 5 economic regions uniting the 43 administrative regions (48.8% of the aggregate number of the Federation subjects) accumulate thew 93% of the aggregate foreign investments.

Fig. 2.30

Distribution of foreign investments by economic regions of RF, % of balance

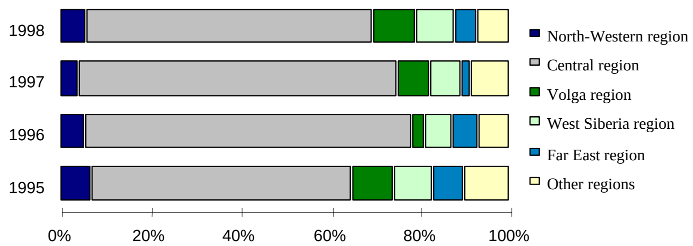


Table 2.26

Grouping the regions by specific shares of inflow of foreign investments

Specific shares of foreign investments inflow in regions in aggregate volume, %	Number of regions			Specific share in aggregate number of regions, %		
	1996	1997	1998	1996	1997	1998
0 — 1	76	78	78	86.36	88.64	88.64
1,1 — 2	5	6	5	5.68	6.82	5.68
2,1 — 50	6	3	4	6.82	3.41	4.55
exceeding 50	1	1	1	1.13	1.13	1.13

Source: Russian State Committee on statistics (Goskomstat).

The practice shows that the low activity of the foreign investors often contradicts the favorable investment climates of certain regions with the high enough investment potential and low investment risk.

Table 2.27

Distribution of administrative regions by 5 economic regions by levels of economic potential and investment risk*

	High			Average (moderate)			Low (insignificant)		
	1996	1997	1998	1996	1997	1998	1996	1997	1998
North-Western region	50 (0)	50 (0)	25 (0)	0 (50)	0 (50)	0 (75)	50 (50)	50 (50)	75 (25)
Central region	53.85 (30.8)	23.07 (23.1)	15.38 (7.7)	38.46 (23.1)	61.55 (23.1)	0 (84.6)	7.69 (46.2)	15.38 (53.8)	84.62 (7.7)
Volga region	50 (0)	50 (0)	0 (12.5)	37.5 (62.5)	37.5 (37.5)	50 (75)	12.5 (37.5)	12.5 (62.5)	50 (12.5)
West Siberia region	44.45 (33.3)	55.56 (44.5)	11.1 (33.3)	33.3 (44.5)	33.33 (33.3)	44.45 (66.7)	22.22 (22.2)	11.11 (22.2)	44.45 (0)
Far East region	11.11 (77.78)	44.45 (33.33)	0 (66.67)	55.56 (22.22)	0 (66.67)	22.22 (33.33)	33.33 (0)	55.56 (0)	77.78 (0)

* — the estimated investment risk is given between the parentheses.

In order to overcome the effect of the negative factors, improve the regional structures of the foreign investments, and taking into account their influence on the development of production, the regional and federal administrations have increased their activities in the spheres of the investment and taxation laws during the last year. Thus, while to May 1997 only 5 regions had the special laws for the foreign investors Novgorod, Ivanovo, and Cheliabinsk regions; Tatarstan and Chuvashiya republics) as of today, the number or the regions having approved the special laws regulating the activities of the foreign investors has reached 45. To incite the inflow of the direct foreign investments, most of the regions grant to the foreign investors the direct fiscal privileges as for the payment of the taxes to go to the regional budgets.

The work of the legislative power at the federal level has become more active. In accordance with the Program of Governmental external loans for 1998, the US$ 1,739 million worth foreign tied credits have been used. The Decree of the President of the Russian Federation of 16 July 1998, # 851, instructed the Government to suspend the granting of the new guarantees for the tied foreign credits. However, as of today, the scheme of guarantees needs to undergo the serious corrections because, after the 17 August 1998, the foreign creditors, taking into account the situation formed in the Russian market refuse granting the credits under the guarantees of the Russian commercial banks and subjects of the Russian Federation.

On 7 January 1999, the Federal Law # 19-FZ "On amendments and Supplements to the Federal Law "On Product Share Agreements"" has been promulgated. The draft Law "On Amendments and Supplements to the Laws of the Russian Federation Deriving from the Federal Law "On Product Share Agreements"" is being actively prepared for discussion by the Council of Federation. The final draft of the Law "On Foreign Investments in Russian Federation" has been prepared; it has accounted for the notes of the President of the Russian Federation.

The Decrees of the President of the Russian Federation "On Measures to Implement the Investment Agreements between the Ministry of economy of the Russian Federation and Foreign Investors", the Act of the Government "On Establishment of Customs Control over the Import of the Foreign Goods in the Customs Territory of the Russian Federation in Accordance with the Agreements between the Ministry of economy of the Russian Federation and Foreign Investors", and the Federal Law "On Amendments and Supplements to the Law of the Russian Federation "On Customs tariff" have been drafted.

2.6. Foreign trade

In 1998, under the effect of the extremely unfavorable for Russia external conditions and the growing home difficulties, for the first time in the five years, the external trade turnover has reduced. The importance of the foreign trade as the stabilizing factor of production and material basis for the further market reforms has declined.

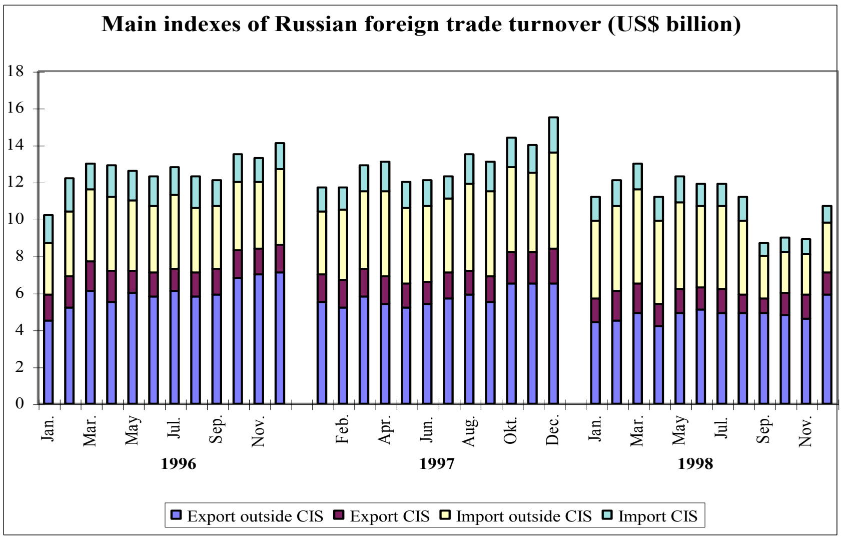
In 1998, **the external trade turnover of Russia** (taking into account the unorganized export and import) has dropped by 17.6%

compared with 1997, down to U$S 133.4 billion, including the US$ 73.9 billion for the export (reduction by 16.4%) and US$ 59.9 billion for the import (reduction by 19.1%).

The reduction of the external trade turnover of Russia has resulted in the deterioration of the situation in the foreign trade. According to the data published by the UNO, the Russian foreign trade turnover holds, as of today, the 18th place in the World. The Russian share in the international trade has dropped from the 2.5% in 1997 down to 1.3% in 1998.

The share of the countries outside the CIS amounts to the 7.5% of the external trade turnover; in 1997, the change has not been significant (77.7% in 1997).

Fig. 2.31

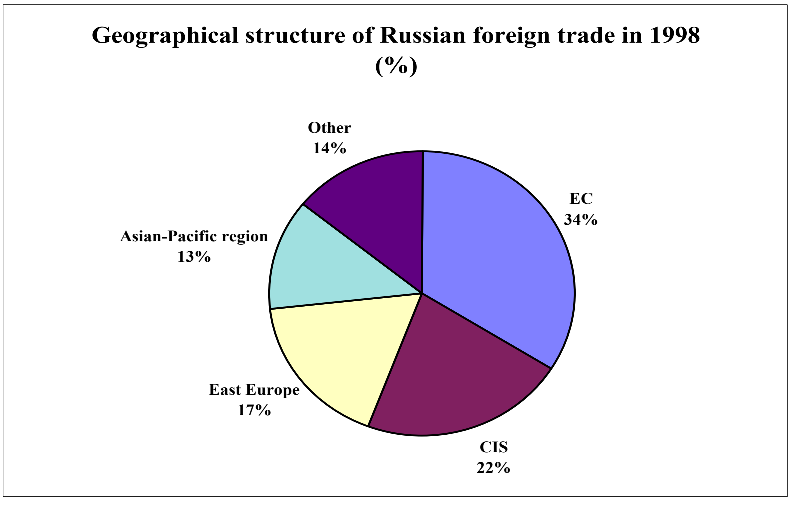


Source: Russian State Committee on statistics (Goskomstat).

In 1998, **the foreign trade turnover of Russia with the countries outside the FSU** (taking into account the unorganized import) dropped by 16.7% down to US$ 108.4 billion.

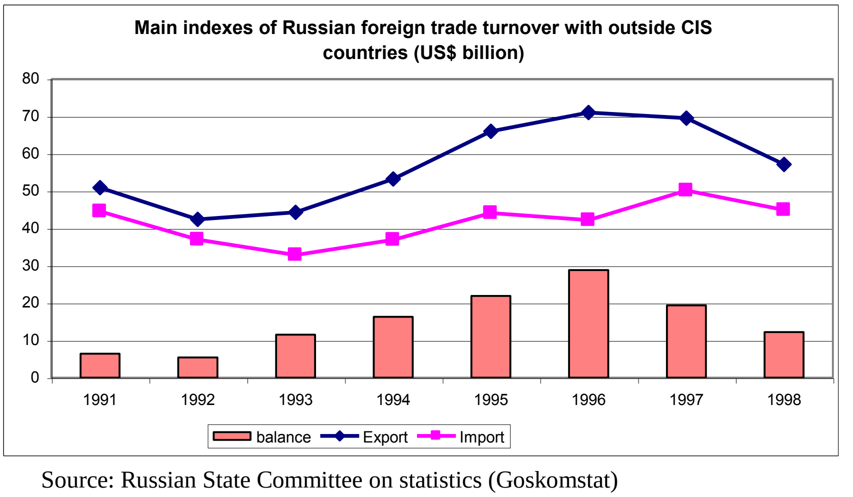
The unfavorable world market situation formed in 1997 for the main goods of the Russian export has continued worsening in 1998, as well. The world prices on the feedstock (energy media, ferrous and non-ferrous metals, chemical products, and timber) have continued growing; hence, the further **reduction of the cost of the Russian export**.

Fig. 2.32



Source: Russian State Committee on statistics (Goskomstat)

Fig. 2.33



Source: Russian State Committee on statistics (Goskomstat)

Table 2.28

Dynamic of world prices on main goods of Russian export (% of the previous year)

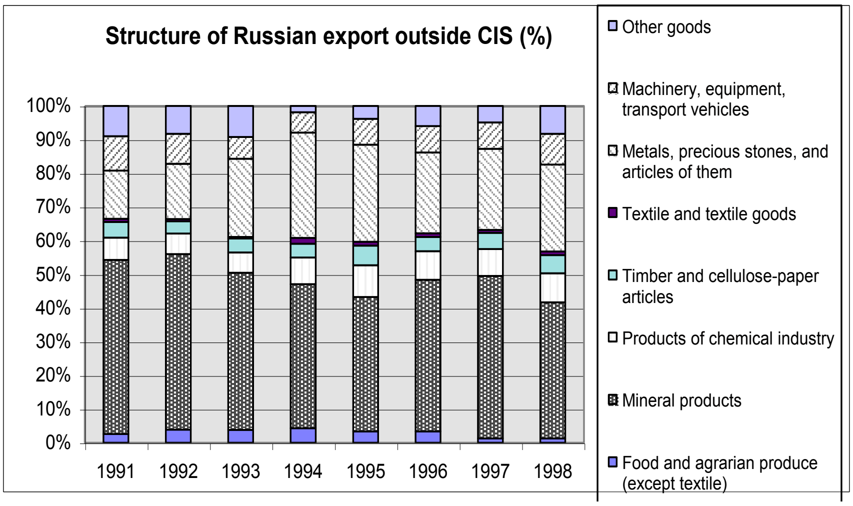
	1994	*1995*	*1996*	*1997*	*1998*
Crude oil	95.0	107.8	118.4	94.6	68.5
Diesel fuel	94.2	106.3	117.1	98.1	70.6
Aluminum	129.4	122.3	83.5	106.1	84.9
Copper	120.4	127.2	78.2	99.2	72.7
Nickel	119.3	129.9	91.2	92.3	66.8
Zinc	103.5	103.3	99.4	128.3	77.9
Wood					
hard	81.3	81.5	98.5	93.9	68.4
soft	92.3	96.3	105.3	90.8	88.3

Source: International Monetary Fund.

According to the data of the Russian State Committee on statistics (Goskomstat), in 1998, Russia exported to the outside FSU the goods worth US$ 59.0 billion; this was by 15.8% less than in 1997.

The structure of the export by commodities has, as before, remained with the high share of the fuel and energy resources and feedstock with the insignificant share of the machinery and equipment.

Fig. 2.34



Source: Russian State Committee on statistics (Goskomstat)

In 1998, the share of the fuel and energy goods formed 37.9% of the aggregate volume of sale to the outside FSU (44.9% in 1997). The volume of supplies to these countries reduced by 29% compared with 1997; this reduction has been due to the drop of the average contract prices: by 36% on the crude oil; by 34% on the petroleum products; and by 20% on the natural gas. The drop of the prices has made the Russian exporters of the mineral fuel lose about US$ 10 billion.

Despite the growth of the oil export in kind by 7.5% during 1997, its cost share in the aggregate volume of the export reduced from 18.6% to 15.6%. The significant changes were seen in the dynamic of the cost and physical volumes of export of the petroleum products. The share of the latter in the cost of the export dropped from 9.7% down to 6.2%; the physical volumes of the petroleum products export reduced from 58.4 million MT to 46.9 million MT. The supplies of the natural gas grew by 3.5%; its share in the export was 15.7% (against the 15.4% in 1997).

Table 2.29

Dynamic of physical volumes of export in countries outside CIS

	1994	1995	1996	1997	1998
Crude oil, million MT	95.4	96.2	105	110	117.9
Petroleum products, million MT	39.1	44	53.4	56.9	51.2
Natural gas, billion m^3	110	122	128	120	125.0
Coal, million MT	17.7	21	20.3	18.9	18.6
Iron ore, million MT	9.8	11.4	7.8	8.2	10.1
Ferrous metals, US$ million	4,371	5,646	6,208	6,018	4,464.1
Aluminum, thous. MT	2,301	2,250	2,616	2,693	2,790.4
Copper, thous. MT	451	467	524	533	550.3
Nickel, thous. MT	124	153	166	220	214.1
Machinery and equipment, thous. MT	32,000	5,314.5	5,554.2	5,598.7	5,760.5
Mineral fertilizers, million MT	13.1	16.2	15.1	14.4	15.9
Round timber, million m^3	13.5	17.9	15.4	17	19.8

Source: Russian State Committee on statistics (Goskomstat)

The specific share of the ferrous and non-ferrous metals in the aggregate volume of the Russian export to outside the FSU amounted to 19.7% (against the 19.6% in 1997). Compared with 1997, the cost of the export of the ferrous and non-ferrous metals reduced by 15%. The average contract prices reduced by 10% (by 13% on the cast iron, by 10% on the ferro-alloys, by 17% on the semi-finished products of the carbon steel, by 22% on the copper, and by 5% on the nickel). The physical volume of the supplies reduced by 5% (by 36% for the semi-finished products of the carbon steel and by 5% for the nickel). The export of the cast iron and rolled metal remained on the level of 1997 and the supplies of the aluminum and copper grew by 3%.

The factors holding down the dynamic of the export of the ferrous metals include the partial loss by the Russian exporters of the world markets for sale of their products and the anti-dumping measures used by the governments of certain countries with the purpose to limit the import of the Russian ferrous metals in their territories. Already 63 limitations are, today, effective against the Russian firms; 43 of these limitations are the anti-dumping ones.

In October 1998, the US International Trade Commission made the decision on the anti-dumping proceeding as of the supplies of the hot-rolled metal from Russia; the proposal to charge the 107% to 199% anti-dumping duties is under discussion. The USA justify this with that Russia exports its steel at the price equal to one third of the manufacture cost, which is against the laws of the international trade.

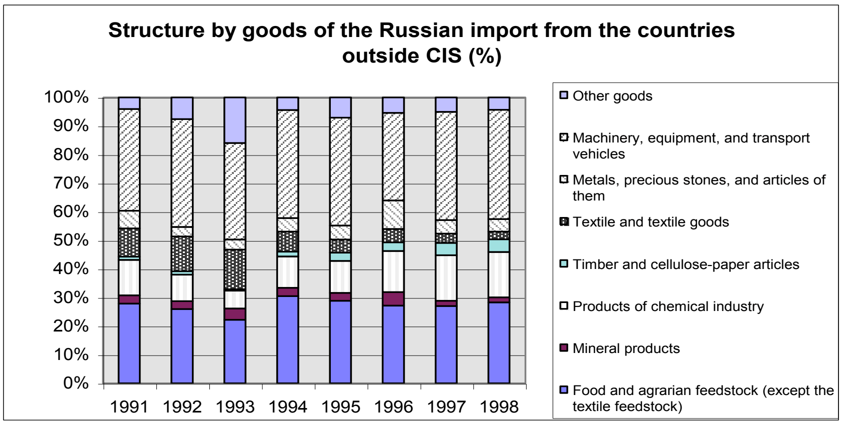
The supplies of the mechanical engineering products increased by 1.7%; their share in the aggregate export grew up to 9.8% against the 8.1% of 1997.

The devaluation of the Ruble could have become a serious incentive for the development of the export. However, the important growth of the physical volumes of the export can hardly be expected because of the limited throughput of the export pipelines, limited external demand under the world financial crisis, anti-dumping measures against the Russian producers, and complications with coming to the market of the goods that are not exported now or whose export is insignificant due to their low competitiveness.

The devaluation of the Ruble after the financial crisis of August 1998 and the cutback of the purchasing capacity of the population due to the growth of the prices, in the second half of 1998, the **import** reduced significantly. According to the Russian State Committee on statistics (Goskomstat), in 1998, the US$ 45.8 billion worth of the goods were imported in the territory of the Russian Federation; this was by 17.9% less than in 1997.

Fig. 2.35

Structure by goods of the Russian import from the countries outside CIS (%)



Source: Russian State Committee on statistics (Goskomstat)

The food and the feedstock for its production, and the machinery and equipment remain the largest items of import from the outside FSU; the respective shares of these groups of goods were about 27% and 38%.

During 1998, the dynamic of the import underwent the significant changes. The positive dynamic of the first half of 1998 of the import from outside the CIS (growth by 15.9% compared with the first half of 1997) was replaced by its cutback in August and painful drop in September 1998 (2.1-fold reduction compared with September 1997 and by 42% compared with September 1997). In October 1998, the import reduced 2.6-fold compared with October 1997 and by 6% compared with September 1998. In November 1998, the import reduced 2.3-fold compared with November 1997 and by 6% compared with October 1998. In December 1998, as compared with December 1997, the import supplies reduced by 59.3%; however, they saw the growth by 22.7% compared with November 1998. The largest cutback in the last months of 1998 was seen in the group of the consumer goods.

Table 2.30

Dynamic of physical volumes of Russian import of main goods

	1994	1995	1996	1997	1998
Pipes, thous. MT	631	367	385	239	154.1
Machinery and equipment, US$ million	10,696	12,804	10,172	13,511	12,789.4
Medicaments, US$ million	1,184	969	1,083	531	1,198.0
Textile and knitted clothes, US$ million	861	511	298	313	211.9
Footwear, million pairs	41.7	26	45.8	15.4	2.9
Fresh frozen meat, thous. MT	358	506	540	694	595.8
Fresh frozen poultry meat, thous. MT	496	824	748	1,117	814.1
Raw sugar, thous. MT	1,081	1,166	1,680	2,511	3,002.9
Refined sugar, thous. MT	369	377	147	367	331.4
Alcohol and soft drinks, US$ million	695	1,017	379	700	390.4
Grain, thous. MT	2,100	193.7	307.3	226.8	103.9

Source: Russian State Committee on statistics (Goskomstat)

The estimated volume of the unorganized trade was US$ 12.9 billion, which was by 21.3% less than in 1997.

The balance of the foreign trade was positive, US$ 13.2 billion (against the US$ 14.1 billion in 1997).

The unfavorable situation in the foreign markets and the reduction of the average contract prices as of the main items of the Russian feedstock export worsened the conditions of trade of Russia (in January to August 1997, the export to import prices change ratio was 1.1; in January to August 1998, it dropped down to 0.95).

In 1999, the situation in the foreign trade will be worsening. It has become impossible to increase the volumes of the export supplies. In certain branches of economy, the export quotas have reached the upper limit and become equal to 50% to 90% of the production volume. The extreme wear of the fixed assets and lack of the investments for their updating hinder the growth of production. The fuel and energy complex has also practically exhausted its capacities for the growth of the supplies to the foreign market due to the critical situation of its production basis; meanwhile, the unfavorable situation of the external markets forecast for the short-term future makes problematic the support of the Russian export at the already reached level.

The import will be reducing under the effect of the consequences of the financial crisis, first of all, the devaluation of the Ruble. Besides, the outlooks of the import will be highly dependent on how Russia will pay for the Eurobonds (in 1999, US$ 4 billion will become due). The RF Government has declared these payments mandatory and payable in full. In the contrary, the foreign counter-agents will request from the Russian companies the pre-payment in cash for all the foreign exchange bargains; this will result in the collapse of the import.

In 1998, the **trade turnover with the CIS countries** was US$ 28.6 billion, which is by 20.6% less than in 1997. The share of the CIS countries in the aggregate commodities turnover with the CIS countries reduced by 0.8% down to 21.5%.

The trade balance was positive, US$ 1.2 billion (against the US$0.7 billion in 1997). The tendency to the growth of the positive balance resulted, in many aspects, from the financial crisis of August 1998. It should be noted that during the several previous years (1995 to 1996) the balance was negative. In addition, for example, the balance of the trade with Byelorussia was negative in 1997, as well: US$ 106.9 billion; in 1998, the positive balance of US$ 67.4 billion formed In whole, even in 1998, Russia maintained the positive trade balance with the CIS countries only up to the beginning of the second quarter-year: beginning from April, the import began exceeding the export, though insignificantly; only after the August events, the situation made the U-turn.

Among the CIS states, Byelorussia, Kazakhstan, Uzbekistan, and Ukraine continue staying the main trade partners of Russia; their aggregate share in the trade between Russia and CIS is 92%.

However, in 1998, the specific share of the Russian trade with Ukraine, the largest trade partner of Russia, reduced by 1.6% down to 35%. During 1997, despite the distancing of Ukraine from most of the integration programs in the framework of the CIS, the trade turnover between Russian and Ukraine showed the tendency to growth. As for the countries within the Customs Union, the contrary trend was observed: the share of these countries in the aggregate turnover between Russia and CIS countries grew by 5%, up to 55%. Probably, in 1999, this index will grow even more when Tajikistan joins the Customs Union.

In 1998, the **export** from Russia was US$ 14.9 billion, which was by 18.7% less than in 1997. The main cause of the reduction of the Russian export cost was the cutback of the export prices for the CIS countries by more than 13%, due, first of all, to the drop of the oil prices. However, the physical volumes of export of certain goods showed the positive dynamic: the Russian export of the crude oil to these countries grew by 12.2%; the growth for the petroleum products was18.3%; the export of the coal grew by 55%; and the export of the iron ore grew by 9.0%.

In 1998, the commodity structure of the Russian export remained stable: its main share fell on the fuel and energy resources and mechanical engineering products (respective 48.9% and 13.9%). However, the export of the machinery and equipment was under the effect of the opposite direction factors: at the beginning of 1998, the export of these products was growing due to the lowering competitiveness of the Russian manufacture products in the world market, their redirection to the neighboring countries, and the low efficiency of the Governmental support of the export to outside the FSU. However, the lack of the budget resources, the illogical economic policy, and the high level of risk for the national markets of the CIS countries have conditioned the extremely low level of demand for the investment type equipment.

The financial crisis in Russia was a high power bomb for the national currencies of the neighboring countries and sharply reduced the inflows of the foreign investments in them. As for the results of the year 1998, the supplies of the machines and equipment reduced by 35.9% compared with 1997.

In 1998, the volume of the import was US$ 13.7 billion, which was by 22.6% less than in 1997.

The structure of the import by commodities showed the predominance of the food, products for the processing enterprises of the agrarian production complex, machinery and equipment, and products of the ferrous metallurgy.

In 1998, the most significant reduction of the Russian import was seen for the following items: by 43.7% for the fresh-frozen meat; by 68.8% for the refined sugar, by 61.1% for the grain, and by 19.6% for the machinery and equipment.

The greater reduction of the import from the CIS countries (in 1998, the import from the outside FSU reduced by 17.9%) was, in many aspects, due to the low quality of the exported goods, their packing, low terms of storage, and higher, compared with the outside FSU, import prices: by 22.9% on the fresh frozen meat; by 40.4% on the fresh frozen poultry meat; 2-fold on the fresh-frozen fish; 1.4-fold on the butter; and 2.0-fold on the raw sugar.

With all these, the import of the foods ensured, mainly, by the supplies of the neighboring countries, reduced, e.g., the import of the refined sugar; hence, the reduction of the share of Ukraine in the aggregate volume of the Russian external trade.

The reduction of the cost of the Russian trade with the CIS countries was also affected by the mutual lowering of the contract prices on the certain important products, including the crude oil, coal, fresh-frozen meat, and butter exported from Russia.

The comparative analysis of the monthly ranges of the average prices on the above produce has shown that the certain growth of the crude oil export prices observed in January and February 1998 (from the US$ 98.00 per MT to US$ 103.00 per MT) was replaced by their gradual reduction to US$ 65.00 per MT to October 1998. The similar tendency was seen, in 1998, with the supplies of the coal and petroleum products to the CIS countries: the respective price drops were from the US$ 33.00 per MT down to 22.00 US$ per MT and from US$ 176.00 down to US$ 111.00 per MT. During

1998, the change of the prices on the natural gas and electric energy was not significant: the variation was, mainly, within the limits of US$ 54.00 per m^3 to US$ 59.00 per m^3 and US$ 25.0 per kWh to US$ 27.00 per kWh.

As for the back supplies from the CIS countries of the fresh-frozen meat and butter, these saw the growth of the respective contract prices, in January to May 1998, up to the US$ 1,934.00 per MT and US$ 2,760.00 per MT; then the respective drops down to the US$ 1,500.00 per MT and US$ 2,100.00 per MT followed.

During the first nine months of 1998, the volume of the barter exchange with the CIS countries was equal to US$ 4.2 billion, or the reduction by 14% compared with the relevant period of 1997. Hence, the export from Russia reduced by US$ 1.8 billion (or by 24%) and the import from Russia reduced by US$ 2.4 billion (or 5%). As for the barter exchange with the CIS countries, the tendency opposite to the one of the general turnover trend has been observed: the import from the CIS countries has exceeded the export by almost US$ 0.6 billion.

As for the barter exchange in the aggregate volume of the barter with all the countries of the world, it was 77% as for the commodity turnover within the framework of the CIS countries, it was 22%.

As for the commodity structure of the export to the CIS countries, the prevailing items are the fuel and energy resources (49%); mechanical engineering products (17%); and chemical industries products (12%). As for the structure of the barter-type import from these countries, the prevailing items are the ferrous and non-ferrous metals (29%); mechanical engineering products (22%); and energy resources.

As of today, the outstanding debts of the CIS countries to the Russian commodity producers only for the energy resources have amounted (as of 1 December 1998) to Rbl. 41.5 billion, including Rbl. 19.4 for Ukraine; Rbl. 8.2 billion for Kazakhstan; and Rbl. 5.3 billion for Byelorussia.

The greatest share of the outstanding debts to Russia falls on the natural gas (64% of the aggregate production volume) and electric energy (28% of the aggregate production volume).

The payment for the cost and transport of the Russian natural gas via the Ukrainian territory has remained crucial, as well. Though, in 1998, Ukraine reduced the tariffs for the transport of the Russian natural gas via its territory; it has declared its readiness to leave its transport at no cost (32 billion m^3 annual) at the account of repayment of its debts for the natural gas, in whole, the problem of the payment for the Russian natural gas has not been settled, yet.

The similar situation is forming with the payments for the supplies of the natural gas to Byelorussia: despite the fact that Byelorussia has signed the Agreement to pay the US$ 225 million till the end of 1998, only 10% of the declared sum have been actually paid.

The influence of the today's crisis in Russia on the evolution of the trade links in the CIS will, seemingly, be of the ambiguous character. For the one hand, the sharp worsening of the situation with the Russian import due to the devaluation of the Ruble should have had the lesser effect on the trade with the FSU countries because the settlements with these countries remain based on the clearing and barter. Hence, one could have supposed that the share of the CIS countries in the Russian trade turnover would somehow grow. Besides, immediately after the beginning of the crisis, it seemed that the foreign currency exchange rate forecast for the following six months could be not only a protection for the Russian producers giving them, at a reasonable pricing policy, the possibility to expand their market niche inside the country, but also the possibility to increase their supplies to the CIS countries, thus improving the positive trade balance.

For the other hand, the crisis has led to the significant weakening of the positions of Russia as the center and motive force of the integration within the framework of the Commonwealth, has reduced the role of the Russian currency in the settlements between the partners within the CIS, etc. Though Russia has been and remains the main or one of the main external trade partners for all the countries of the Commonwealth, and many countries are fully dependent of not only the supplies of the Russian energy media (Byelorussia, Ukraine, Kazakhstan) but are also critically dependent on their export to Russia (Byelorussia, Moldavia), the Russian crisis has only intensified the already existing tendency to the development of the bilateral and multilateral relations between the CIS countries without the participation of Russia.

Even during the pre-crisis period, the neighbor countries had been to a certain extent oriented to the export of the available feedstock resources to the countries outside the FSU or the transit of the Russian energy media via their territories. The situation has aggravated with the drop of the world energy media prices.

The crisis has made the situation with the growth of the negative balance in the trade with Russia practically impossible to settle. The sharp drop of the Russian Ruble rate does not allow anymore to efficiently solve the problems of the negative trade balance by the growth of the export to Russia; this makes the neighbor states to limit their import from there. Thus, in January 1999, for the first time since the creation of the Customs Union, Kazakhstan fixed the limits on the import of the Russian food, including meat, milk, and butter, for the 21 items of goods in total. Though such policy of Kazakhstan does not directly contradict the conditions of the Customs Union on the possibility to limit the import in the event of menace to the national producers, it will, without doubt, worsen the positions of the Russian producers for which conserving the former volumes of the export is one of the not numerous ways to exist under the crisis.

Thus, the attempts of certain countries of the CIS to get out of the crisis situation are, rather, of the centrifugal character. The leaders of the post-Soviet stated are not really aimed at the joint actions to overcome the crisis, which actions require, in particular, the joint economic policy and unification of the external economic laws.

The interest of the countries of the Commonwealth in the economic cooperation with Russia had been, in many aspects, stimulated by the relatively longer way hour country had followed by the way of the reforms. And the deceleration of the economic transformations can make to the integration tendencies such damage that will overweigh all the political declarations on strengthening of the unity and friendship. Already today, the CIS countries are trying to diversify their import and export flows and looking for the ways to the new markets; if the today's tendencies remain the same, this will result in the reductions of the volumes of the mutual trade within the framework of the Commonwealth.

Regulation of external trade

In 1998, the issues of protection of the domestic market were being solved by the methods of the tariff and non-tariff regulation of the external economic activity.

In 1998, the drafting of the new version of the Russian Federation Customs Code was completed; its purpose is to develop the external trade of the country, create the conditions for the support of the domestic manufacturers, and counteract the violations of the customs regulations and smuggling. The amendments have been made to the rates of the import duties on certain goods (medicaments, articles and equipment for medical industry, certain foods, accumulators, and chemical products).

The set of the measures aimed at improving the governmental regulation of the production and turnover of the ethyl alcohol and alcohol containing products; the licensing of the alcohol import and export was implemented. On 13 January 1998, the Law "On the Fees for Issuing of the Licenses on and the Right to Produce the Ethyl Alcohol and Alcohol-Containing Products" was promulgated.

In order to protect the branches of economy and individual subjects of economy against the unfavorable effect of the foreign competition, the Federal Law "On the Measures of Protection of the Economic Interests of the Russian Federation at the Foreign Trade in Goods", of 14 April 1998, # 63-FZ, was promulgated.

The Kaliningrad region had been the only one to which the foreign goods had been imported without the duties and VAT. The Governmental Act of 5 March 1998, # 281, limited the duty-free import to the region of 35 kinds of goods. The quotas on the duty-free import to the Kaliningrad region of the alcohol, cigarettes, gasoline, certain kinds of chemical feedstock, construction materials, furniture, certain kinds of food, and second-hand passenger cars were introduced. For the goods imported over the quotas, the duties shall be levied under the general terms and conditions. It was the regional administration that had made the efforts to obtain the Governmental Act in order to protect the Kaliningrad region enterprises against their foreign competitors.

In order to support the Russian sugar beet complex during the period of production and processing of the sugar from the domestic feedstock, the seasonal rates of the duties on the refined and raw sugar were introduced. The licensing was introduced for the import of the sugar, starch treacle, color TV sets, carpets, textile floor covers, tobacco and its industrial substitutes. The licensing was also introduced for the export of the certain goods lacking for the domestic processing industry. Thus, for example, the Governmental Act of 31 October 1998, # 1267, introduced, from 25 November 1998, the licensing of the export from Russia of the cattle skins, sheepskins, and other untreated skins.

In order to regulate the export from Russian Federation customs territory of the oil-bearing seeds, the Governmental Act of 31 October 1998, # 1268, introduced, from 25 November 1998, the licensing of the export of the sunflower seeds, rapeseeds, and soybeans.

In February 1998, the new version of the Law on Excise Taxes took force and effect. It increased significantly the rates of the excise taxes: the excise tax on the strong wines and liquors were increased 3-fold; the excise tax on the expensive imported automobiles with the engine volume exceeding 2,500 cm^3 was increased 2-fold. The other excise tax rates growth was not so important, i.e., by 10% to 20% in average.

In 1998, the work aimed at improving the access of the Russian goods to the foreign markets and regulating the anti-dumping procedures. From 1 May 1998, all the quantitative limitation on the trade in the textile goods between Russia and EC were lifted. Russia assumed the obligation to issue the licenses on the export of the textile goods and clothing in accordance with the list, in the automatic condition.

In the trade with the USA, the anti-dumping fees on the Russian titanium sponge were lifted from 1 July 1998 (effective since 1968). The decision on lifting the "competitiveness threshold" for the articles of forger titanium and caprolactam articles from Russia was lifted, as well. The 50% threshold on the export to the USA was lifted for such Russian goods as certain fish products, plywood, ferro-tungsten, ferro-silico-tungsten, and spare parts for the rolling mills.

The timely actions managed to prevent the opening of the anti-dumping proceedings for the zinc (Republic Korea) and the spring lock washers (USA) and settle, under the conditions acceptable for Russia, the proceedings on the steel, magnesium, ferro-vanadium, and vanadium nitride in the USA, articles of steel and transformer steel in the EC, I-beam in Republic Korea, reinforcement steel in Egypt. As the result from the efforts of the Russian Trade Mission in Thailand during the anti-dumping investigations of the supplies of the Russian metal products, the Thailand party made the decision to consider Russia a country of the market economy (in such event, the limitations must cover only the products of the relevant suppliers and not the country in whole).

Due to the financial crisis, the Russian Government had to change radically the foreign trade policy.

To regulate the situation in the currency market, the Central Bank, jointly with the State Customs Committee, made the decision to renew the mandatory sale of the 50% of the hard currency income by the exporters, this time, not at the Central Bank rate, but at the currency exchange. However, almost at once, the tendency was seen to the growing failure to delay the inflow of the hard currency income to the accounts of the exporters against the terms declared at the custom clearance of the exported goods. Despite the fact that the normative documents of 1992-1993 regulating the inflow of the hard currency income to Russia have nor been used these last years, they have not been made void, either. Thus, if the exporters fail to place the hard currency at their accounts in the authorized banks in the Russian Federation territory in the fixed terms, they may have to pay the penalty of 100% to 200% of the cost of the goods being the direct objects of the felony.

In order to stabilize the situation in the consumer market and reduce the prices on the food and medicaments sold to the population, the Governmental Act of 15 October 1998 has fixed the list of the main foods for which the rate of the value-added tax is reduced from 20% to 10%. The Act of the Russian Federation Government of 17 July 1998, # 791, "On Introduction of the Additional Import Duty" on the agrarian produce, food, and medicaments was called off, as well. The Government Act of 21 October 1998, # 1226, reduced the rates of the import duties on the meat, milk, cream in powder, butter, sunflower oil, baby food, etc.

The sharp drop of the import resulted in the reduction of the custom duties inflow to the budget. In these conditions, the Government had to return to the practice of levying the duties from the Russian exporters whose incomes began growing after the growth of the US Dollar to Russian Ruble exchange rate.

The Government Act of 4 January 1999, # 17 "On Approval of the Rates of the Export Custom Duties on the Goods Exported from the Territory of Russian Federation" introduced the export custom duties on the waste and scrap of certain non-ferrous metals, including the copper, nickel, aluminum, lead, cobalt, and titanium; the timber of oak, beech, and ash; the soybeans, seeds of rape and sunflower; and untreated skins and leather of skins of the cattle, horses, sheep, and lambs.

The combined export custom duty of 10% of the custom cost has been introduced on the on the waste and scrap of the non-ferrous metals. The lower limits of the duty were fixed on the waste and scrap of the non-ferrous metals: ECU 110 per MT for the copper; ECU 240 for the nickel; ECU 50 for the aluminum; ECU 35 for the lead; ECU 60 for the zinc; ECU 400 for the cobalt; and ECU 75 for the titanium. The export custom duty on the processed and unprocessed timber will also be 10% of the custom cost, at the lower limits ECU 10 to 10 per cubic meter in function of the wood (oak, beech, ash).

In order to increase the incomes of the Federal Budget, the Act of the RF Government of 11 January 1999, # 45, fixed, for the six-month term, the following export duties: 5% on the coke and semi-coke of coal; 5% on the oil and petroleum products excluding the crude oil and petroleum products; Euro 10 per MT on the fuel oil; 5% but not less than Euro 2 per MT of the natural gas; 5% on the copper and articles of it; and 5% on the nickel and articles of it.

The Act of Government of 23 January 1999, # 83, fixed the export custom duty on the crude oil and crude petroleum products, of Euro 2.5 per MT.

The abolition of the export duties in 1996 was considered one of the main achievements of the Russian economic reforms and the important step on the way to the World Trade Organization. However, under the new conditions, the return to the export duties was less painful for the economy than the unsecured issuing of money.

In 1998, just as in the previous years, the mechanism of the control over the external economic activity was inconsistent with the progressive evolutions in the export and import structures. The deep involvement of the Russian export in the feedstock makes it dependent upon the changing conditions of the world market, thus excluding the possibility of its quick and painless adaptation to its conjuncture. Russia covers almost a half or its requirements in the food by the import which creates the real threat to the economic safety of the country. Thus, the necessity to improve the mechanism of regulation of the eternal economic activity remains urgent.

Section 3

Social Sphere

3.1. Household Finances and Consumer Markets

Monetary Income

In 1998 the populace's living standards steadily fell, unfavorable changes were observed on consumer markets.

An average per capita monetary household income did not exceed Rub. 870 (per monthly estimate) in the pre-crisis period (January – July 1998), at the same time, the decrease in real disposable monetary income was over 10 per cent in comparison with the same period of 1997.

In 1998 average per capita household income was Rub. 970 a month (Rub. 1558 in December). The real income in September through December 1998 declined at increasing rates (27 per cent vs. 31 per cent) as compared with the same months in 1997 resulting in the 18 per cent drop in real income by the end of the year. The total nominal income made Rub. 1703 billion in 1998 increasing by 3.6 per cent in comparison with 1997 figures. Evidently in the beginning of 1999 the trend towards a decline in real income will become much more apparent than in previous years, and in the first quarter of 1999 the income will not exceed 55 to 60 per cent of the corresponding period level in 1998.

In 1998 the decline in real incomes was observed across practically all regions; only several territories (Novgorod and Moscow regions, the Nenets Autonomous District, the Khabarovsk Area) experienced only an insignificant decline or a stabilization of real incomes. Differentiation across regions was observed to increase as average per capita household incomes registered in Moscow were by 6 to 9 times higher then corresponding indicators calculated for regions of the Central District (by 5 to 7 times in 1998); the Tumen Region was by 2 to 2.5 times ahead of other regions of the West-Siberia District as concerns this indicator. Thirty five regions experienced a decline not only in real incomes, but in nominal incomes as well[34].

The general decline in the level of real incomes was accompanied by structure shifts first beginning to show already in the first half of 1998, as the share of incomes derived from property, entrepreneurial activities and other sources diminished; in particular this fact may be explained by diminishing amounts of funds placed on deposit accounts, and corresponding interest payments. The share of social transfers slightly fell (mainly, due to an increase in pension and children's allowance arrears). In relative terms an increase in the share of remuneration of labor was especially apparent. (See Table 3.1).

In all economic regions of Russia (including the Central Region without Moscow) average wages and salaries exceeded average per capita incomes; however, in the City of Moscow it made only 48 per cent of the average per capita incomes (41 per cent in 1997). At the same time, the average per capita wages and salaries for Russia at large in the fourth quarter of 1998 were practically equal to the average per capita incomes as «official» current incomes at the end of 1998 increased at a lesser degree than entrepreneurial incomes, incomes derived from property and other incomes originating mainly from the shadow sector of economy (and calculated on the base

[34] As per estimate of the VTsUZh (All-Russian Center for Living Standards) of the Russian Labor Ministry.

of the «add-on» method). While average per capita incomes in December of 1997 exceeded average wages and salaries by about 1.5 per cent, in December of 1998 the excess made 12 per cent. It shall be noted that especially during the crisis and spasmodic fluctuations of the Ruble exchange rates the add-on methods used by the Goskomstat to find out the totals for household income amounts demonstrated its vulnerability. In particular, this may be explained by the fact that the retail turnover index changes with a time lag to changes in current household monetary incomes.

Table 3.1.

Household monetary incomes structure in 1992 –1998 (%).

Year	1992	1993	1994	1995	1996	1997	1998
Total monetary incomes	100	100	100	100	100	100	100
Wages and salaries	69,9	60,5	46,6	40,7	41,9	39,3	42,4
Social transfers	14,0	15,1	15,4	12,4	14,2	14,9	13,3
Property, business and other incomes	16,1	24,4	38,0	46,9	43,9	45,8	44,5

Source: RF Goskomstat

Imputed average monthly wages and salaries made about Rub.1,110 in 1998; in real terms they decreased by 13.8 per cent as compared with 1997 figures. While real wages and salaries in the first six months of 1998 increased by 4.5 per cent as compared with the first half-year of 1997 (the U.S. dollar equivalent was USD 180 a month at the mid-year), in September this index fell by 30 per cent and in December by 40 per cent as compared with the same months of 1997. By the end-1998 average monthly wages and salaries in U.S. dollar terms fell by about 2.5 times as compared with the mid-year figures. The interregional differentiation of average monthly wages and salaries levels diminished slightly as compared with 1997 figures. While in 1997 the average monthly wages and salaries in the leading region – the Yamal-Nenets Autonomous District — exceeded the average index for Russia by 4.3 times, by the end of 1998 this difference made only 3.8 times. As per VtsUZh of the Labor Ministry data[35] the ratio of the total monthly arrears in wages and salaries to the imputed monthly wage and salaries bill increased sharply from 1.11 in the IV quarter of 1997 to 1.82 in October of 1998. This index for the Chukotka and Koryak Autonomous Districts made 5.26 and 6.14 correspondingly. Moscow was in the most favorable situation with the ratio of 26 per cent; however, the situation here also deteriorated as compared with 1997 when the arrears made only 18 per cent of the wages and salaries bill.

The natural gas industry experienced the highest wage growth rates as the average monthly wages (Rub. 5,000) exceeded the average wages for the country at large by 4.65 times, while wages in other industries of the fuel complex, electric power industry, nonferrous metallurgy were significantly over average figures.

1998 saw a significant deterioration of the pensioners' situation, as while average pensions practically did not change in April through December, the average pension, which in April of 1998 exceeded pension payment level in April of 1997 by 16 per cent, by end-year fell by almost 40 per cent with respect to December of 1997. In December the pensions made only 29 per cent of imputed average monthly wages and salaries (it was 38 per cent at mid-1998) and was below subsistence minimum for pensioners by 20 per cent (it was above the minimum by 30 per cent at mid-year).

The ratio between average wages and salaries and the subsistence minimum also experienced a significant deterioration. While in November of 1998 it made only 149.2 per cent (it was 216 per cent in the first half-year), the November index equaled the first half-year levels of 1995.

The first half of 1998 saw an insignificant growth of statistical indices characterizing the degree of populace differentiation in monetary income terms. Gini coefficient increased from 0.37 to 0.375, decile coefficient increased from 12.5 to 12.8.

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[35] Monitoring: Household Incomes and Living Standards, 1998, IV quarter of 1998, pp. 70-71.

The Russian Goskomstat estimates of the average per capita household income distribution in the RF in December of 1998 are listed in Table 3.2.

Table 3.2

Distribution of Average Per Capita Monthly Monetary Household Income (Rub., % of total)

Total population	100
Income below 400,0	8,8
400,1-600	11,4
600,1-800	11,9
800,1-1000	10,8
1000,1-1200	9,3
1200,1-1600	14,2
1600,1-2000,0	9,7
Above 2000,0	23,9

Source: RF Goskomstat

By end year Gini coefficient made 0.379, while the ratio between incomes of the poorest and the richest populace groups (10 per cent each) was 13.4. There was no significant change in income distribution between 20 per cent populace groups. A number of factors affected the income differentiation. First of all, a sharp fall of Ruble exchange rate resulted in a significant advantage for owners of dollar denominated assets and incomes recipients. Under this factor's influence income differentiation increased, but mainly in Moscow and St. Petersburg. Indeed, the decile coefficient of differentiation in Moscow increased from 11.1 in the IV quarter of 1997 to 18.8 in the IV quarter of 1998, while in St. Petersburg it increased from 6.8 to 9.6 respectively. On the other hand, the share of wages and salaries in household incomes rose, while differentiation between employees' groups by wages and salaries decreased. Since the wages and salaries differentiate less than property and business incomes, this factor somewhat lessens the total index of household incomes differentiation at large. It is probable that because of this income differentiation totals for Russia at large remained practically the same as compared with 1997 figures.

In 1998 the subsistence level was increasing steadily (an autumn seasonal drop in prices of vegetables led to a decrease in subsistence levels at that time in previous years). The first half year saw practically no change in the share of populace with incomes below or at subsistence level (22.5 per cent), later it increased up to 29 per cent in September and November, and somewhat dropped in December (27.5 per cent). As per preliminary estimates, the poverty level increased up to 38.2 per cent (i.e. reached the maximum since the start of observation in 1992) in January. It may be expected that if Goskomstat of Russia uses the same calculation methods, the share of poor will make about 35 per cent in the first quarter of 1999.

Monetary Expenditure

A share of household expenditure for goods and services increased significantly in January – July of 1998. It made up to 75.9 per cent of the total household incomes (69 per cent in 1997). A discount rate growth brought about an increase in interest rates of both commercial banks and the Russia's Sberbank alongside with a significant increase in the share of savings in total incomes (from 2 to 2.6 per cent).

As a result of a shopping spree in August through September, a crisis of the banking system and a resulting decrease in savings in 1998 as a whole, the share of consumer spending made 92 per cent of the total monetary incomes in September, and 80 to 82 per cent in October through November. The share of household expenditure for non-food products and services fell significantly (from 24.0 to 20.8 per cent) in the fourth quarter of 1998, while at the same time the share of expenditure for manufactured goods increased from 36 to 40.4 per cent.

At the beginning of 1999 the total amount of bank household deposits in Russia remained practically unchanged as compared with levels of January of 1998 at Rub. 148.5 billion. Deposits in commercial banks fell by about Rub. 11 billion (by 1.5 times) since a majority of them had to default due to the financial crisis. The Sberbank's share in the total household savings made 85 per cent, a majority of them in pension deposits. Sberbank's interest rates (about 40 per cent) were below most probable inflation rate estimates for 1999; therefore it may be expected that in 1999 pensioners will remain the most numerous (mostly due to habit) depositor group, who are accustomed to negative real interest rates in banks. A rather significant increase in amounts of cash on hand, which made 4 per cent of the total household incomes in the fourth quarter of 1998 (in the same period of 1997 and in the first half of 1998 this amount was decreasing, although insignificantly), may be partly explained by an outflow of household deposits from banks. In 1998 due to an increase in consumer expenditure the share of household expenditure for hard currency purchases declined. In the fourth quarter of 1998 it diminished by 2.5 times as compared with the same period in 1997; in 1998 the total drop was by 1.7 times as compared with 1997 (8.7 and 12.7 per cent of the total expenditure).

In 1998 the overwhelming majority of depositors could not withdraw money (or make payments for goods and services with it) from frozen accounts in commercial banks allowing household deposits; the funds transferred to Sberbank could be withdrawn only since the end of November. However, a part of these savings has not been withdrawn until the end of 1998.

In the pre-crisis period (from January through August of 1998) retail turnover in comparable prices rose by 3.6 per cent as compared with the respective period of 1997. The share of foodstuffs made about 50 per cent of the retail turnover. A buying spree was observed in August and September of 1998, as compared with respective period of 1997. In August the turnover increased by 6.8 per cent and in September fell by 3.3 per cent as compared with respective months of 1997. Thus, a shift in demand towards cheaper products brought about a decrease in turnover even in spite of a shopping spree and massive purchases of basic foodstuffs at the end of the third quarter of 1998. A major consequence of the crisis was a shrinking of product range, diminished supply of luxuries and outflow of a number of suppliers and manufacturers from the market. The contraction of demand affected not only consumer market segments offering relatively technology-intensive goods (computers, electronic products, and telecommunications), but also luxury foodstuffs for higher income consumers. A sharp downfall was experienced in trade with juices, non-alcoholic drinks, alcoholic beverages imports.

As inflation expectations somewhat abated and due to lack of available cash resources in households, the trade turnover decreased by 15 per cent (foodstuffs by 7 per cent and non-food goods by 22 per cent) in the fourth quarter of 1998. For the whole 1998 the retail turnover volume totals fell by 4.5 per cent (foodstuffs by 3 per cent and non-food goods by 6 per cent). The volume of paid services to households decreased at least by 2.4 per cent. At the same time a decrease in the volume of paid services will become most apparent in early 1999 when tariffs for paid services will be rising more intensively. The trend towards decline in the total volumes of turnover will dominate the whole first quarter of 1999, in the second quarter it may be expected that decline rates slow down from 22 — 27 per cent to 18 – 22 per cent (as compared to 1997).

3.2. Social and Cultural Indicators

The financial crisis affected the economic situation in social and cultural sphere most dramatically: in 1998 budgetary provisions for these sectors fell by 20 per cent in comparable terms as compared with the previous year. At the same time, the decline in welfare expenditure was traditionally more pronounced than the decrease in the aggregate budgetary expenditure, which made 15 per cent in 1998. Culture and public health were most badly affected (a decrease in budgetary expenditure by 24 and 22 per cent respectively) in 1998. It may be noted, however, that employers' contributions to mandatory medical insurance somewhat rose (less than by 2 per cent) as compared with 1997. (Table 3.3).

Table 3.3

State Expenditure for Social and Cultural Needs (1991 = 100%)

	1991	1992	1993	1994	1995	1996	1997	1998
Public Health, including	100	80	108	98	72	71	81	67
National Budget	100	80	91	81	59	57	65	51
Compulsory insurance contributions of legal persons	-	-	17	17	13	14	16	16
Education*	100	79	79	76	56	58	64	52
Culture, Arts and Mass Media*	100	91	81	87	63	54	60	46

* — national budget expenditure.
Source: calculated on the basis of RF Goskomstat data and GDP deflators.

Table 3.4

State Expenditure for Social and Cultural Needs (in % of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998
Public Health, including	2,9	2,5	3,7	3,9	2,9	3,1	3,4	3,1
National Budget	2,9	2,5	3,1	3,2	2,4	2,5	2,8	2,4
Compulsory insurance contributions of legal persons	-	-	0,6	0,7	0,5	0,6	0,6	0,7
Education*	3,6	3,6	4,1	4,5	3,4	3,7	4,1	3,6
Culture, Arts and Mass Media*	0,5	0,6	0,6	0,8	0,6	0,5	0,6	0,5

* — national budget expenditure.
Source: calculated on the basis of RF Goskomstat data.

National budgetary expenditure for social needs, as had already become customary, were diminished not only in absolute, but also in relative terms as compared with approved budgetary items. The share of federal budgetary expenditures for social and cultural sectors decreased from 6.3 per cent in 1997 to 5.3 per cent in 1998 (see Table 3.5). In 1998 the government reverted to the policy of putting the burden of financing the social sphere on the subjects of the Russian Federation it broke for a short period in 1997. A ratio between respective outlays from the national budget and budgets of the subjects of the Russian Federation changed from 13:87 in 1997 to 12:88 in 1998 (see Table 3.6).

Table 3.5

The Share of Federal Budgetary Expenditure for Social and Cultural Needs бюджета (%)

	Outlays in 1995	Budgeted in 1996	Outlays in 1996	Budgeted in 1997	Outlays in 1997	Budgeted in 1998	Outlays in 1998
Social and Cultural Sectors, total, including	5,4	6,5	4,9	7,4	6,3	6,5	5,3
Public Health	1,3	1,7	1,2	2,2	2,2	1,9	1,5
Education	3,1	3,6	3,2	3,5	3,5	3,5	3,3
Culture and Mass Media	1,0	1,2	0,5	1,7	0,6	0,7	0,6

Source: RF Goskomstat

Table 3.6

Ratio between Expenditures from Federal Budget and from Budgets of Russian Federation Subjects for Social and Cultural Needs (%)

	1992	1993	1994	1995	1996	1997	1998
Federal Budget	27	17	18	14	12	13	12
Budgets of RF subjects	73	83	82	86	88	87	88

Source: RF Goskomstat

The problem of budgetary wage arrears in the social sphere, which had been among the most acute problems in recent years, became even more pronounced in 1998. The amount of these arrears increased from 67 per cent of the total wage budgetary arrears across the economy in the beginning of the year to 83 per cent at its end respectively. While the total annual increase in wage budgetary arrears made 3.2 times, in social sectors it made 4.2 times. At the same time, education was responsible for more than one third of the total budgetary arrears at end-year (see Table 3.7).

Mr. Primakov's government attempted to improve the situation of chronic wage arrears of the RF subjects they had to the social institutions financed from local budgets, especially educational ones. Acting on the government's orders, the Finance Ministry determined 40 RF subjects who would not be able to finance current monthly budgetary wages in full even assigning not less than 40 per cent of local budgetary funds for this purpose. These regions received funds to cover their budget deficits for monthly wages on 26.12.1998.

Besides, the new government announced a principally new approach to the arrears problem. First, it proposed to pay arrears back not all at once, but during the first six months of 1999; second, to carry out current control of wage payments from local budgets on the base of agreements with 84 of 89 RF regions signed in summer of 1997.

Table 3.7

Budgetary Arrears Dynamics in the Social and Cultural Sphere in 1998.

Budgetary wage arrears	on 1.01	on 1.02	on 1.03	On 1.04	on 1.05	on 1.06	on 1.07	on 1.08	on 1.09	on 1.10	on 1.11	on 1.12	на on 1.01.99
Total, Rub. Million	6954	6318	7638	8944	9507	11034	12979	14879	18596	20929	22094	22093	19732
Including:													
Social sectors	4632	3986	5230	6434	6983	8423	10311	12060	15507	17625	18726	18726	16517
Including:													
Education	1382	958	1628	2263	2551	3206	4248	4955	4886	5553	6129	6272	5523

Public health	574	281	611	858	976	1338	1827	2447	2990	3495	3636	3574	2920
Culture and arts	132	80	168	246	289	387	514	660	744	836	895	907	776

Source: RF Goskomstat

At the same time, it should be noted that according to the RF Constitution local governments have the right to independently dispose of the local revenues and federal transfers. Objectively, it accounted for such a widespread practice of spending federal transfers targeted for repayment of budgetary arrears for other purposes. For instance, in December 18 regions experienced an increase and 67 regions a decrease in wage arrears. Due to this, it seems that the general approach to fighting chronic budgetary wage arrears should be the administration of the budget via the Treasury, especially in regions with a high share of federal financing and large wage arrears of budgetary institutions and organizations.

Table 3.8

Strike Movement in Social Sectors in 1998.

	I	II	III	IV	V	VI	VIII	IX	X	XI	XII
Number of organizations taking part in strikes:											
Education	188	46	35	852	319	41	18	2333	4052	2086	1806
Public health	13	-	-	20	-	-	7	22	64	25	13
Number of employees involved, (thousands):											
Education	8,3	2,0	1,3	28,4	13,1	0,8	0,1	72,6	125,2	59,0	50,1
Public health	3,4	-	-	2,0	-	-	0,3	0,6	11,9	2,4	2,5

Source: RF Goskomstat

Strike movement. In 1998 all social sectors experienced social conflicts and tensions due to large wage arrears. As federal, regional, and local authorities failed to create effective mechanisms for payment of current wages and repayment of wage arrears, the strike movement remained at high levels, especially in educational sphere. A majority of strikes took place in April and in September through October of 1998. The most important strike movement event was the All-Russian Protest Action on 27 – 29 January of 1999. According to the Central Committee of Education and Science Employees, 400 thousand teachers participated in the action across 72 regions of Russia. The main demand of the strikers was not only repayment of accumulated arrears, but also governmental guarantees of regular wage payments. However, it seems that until local budgets keep the responsibility to finance institutions for general education under the current legislation, the federal government will hardly be able to radically change the educational workers' budgetary arrears situation without amending the Budgetary Code.

Section 4

The Financial Crisis and Some Institutional Problems of the Russia's Economy

4.1. Privatization in 1998

The financial and political crises of 1998 have put an end to the privatization policy period, which to some degree conventionally is known as the "cash privatization." Like in the period from 1995 to 1997, in 1998 the privatization policy was aimed exclusively at the provision of budgetary revenues.

Table 4.1

Federal Budgetary Revenues from Privatization in 1995 - 1998

	1995*, Rub. trillion	1996, Rub. trillion	1997, Rub. trillion	1998***, Rub. billion
Approved Budget	4.991	12.3	6.525	8.125****
Actual	7.319	1.532	18.654**	14.005*****

* — the approved budget was adjusted in December of 1995, 70.8 per cent of the actual revenue was derived from "loans for shares" auctions.
** — including USD 1.875 billion from "Svyazinvest" stocks sales.
*** - only from property sales.
**** - adjusted to Rub. 15 billion in April of 1998 (at the governmental level).
***** - including Rub. 12.5 billion from the sale of the 2.5 per cent share in "Gazprom."

As concerns other **revenues from state property**, in accordance with the federal budget for 1998 dividends on state owned stocks should have make Rub. 1.09 billion; revenues from federal property lease – Rub. 0.301 billion. Although the government had approved an increase in revenues from these sources up to Rub. 1.35 and 1.6 billion respectively, the 1998 totals were different: dividends made Rub. 1.2 billion (Rub. 540 million from Russia's corporations and USD 76 million from joint ventures with a Russian share in their capital), lease made Rub. 0.54 billion.

An insignificant progress of lease revenue inflows resulted from numerous problems of inventorying the leased space and the conclusion of new agreements on bidding terms. At the same time, an increase in dividend amounts was due to the abolition of respective privileges (the RF President's Decree No. 396 of 16.04.98 «On Abolition of Presidential Decrees Concerning Dividend Withholding Privileges for Stocks in the Federal Ownership»).

Initially, the prognosis list of shares in large enterprises targeted for sale in 1998 included 61 items: «Rosneft,» «Svyazinvest,» «LUKoil,» TNK, «Norsi-Oil,» VNK, «Slavneft,» «Sibur,» Novosibirsk Electrode Factory, «Elektrosvyaz,» etc. However, practically all biggest sales failed due to two generally similar reasons:

— the government initiated cancellations due to Ruble depreciation (initial prices were fixed in national currency before the crisis that leading to a threefold decrease of budgetary revenues in dollar terms in the post-crisis period);

— lack of investors' interest — initial prices even when reduced appeared to be padded against the background of the stock market crisis, or ownership structure had been already relatively fixed (accordingly, both portfolio investors and large shareholders who had already controlled JSCs showed no interest).

The government had the highest expectations for the sale of shares in «Rosneft» (after a long discussion in 1997 through 1998, 75 per cent plus one share were tendered). The first cancellations of tenders (on May 26 and July 17) came as no surprise due to the general situation of falling exchange rates, a significant drop in oil prices, disagreement within the government and problems with the company's management. Already for the second tender price terms were changed (the price of the block of stocks was reduced from USD 2.1 billion to 1.6 billion; i.e. a 30 per cent premium for a qualified controlling interest was removed). The third tender, whose results should have been announced on October 30, 1998, was cancelled on November 4, 1998 because of the lack of investors' interest.

The second block of «Svyazinvest» holding's stocks was to be sold at a commercial tender with investment provision in October of 1998. Tender terms included starting price of the block at USD 1.035 billion (Rub. 6492 million at the CB exchange rate on August 14, 1998) and investment (including license cost of cellular communications) in the amount of USD 516 million. The tender was open for foreign investors on the condition of the state control continuation (until mid-1999, 50 per cent plus 1 share). As in the «Rosneft» case, a most important ground for cancellation was a drop in real terms of starting Ruble price fixed on the tender dates.

As has been mentioned above, the only transaction, which brought significant budgetary revenue, was the sale of «Gazprom» stocks. «Gazprom» offered the government to sell 1 to 3 per cent of stocks as convertible bonds directly to strategic partners. The RF President's Decree No. 887 of 25.07.1998 «On Sale of Shares in the Russian Corporation «Gazprom» had diminished the share of the state in the corporation from 40.87 to 35 per cent; the government was charged with setting privatization method and maximum stocks' block size – up to 5.87 per cent.

Although the governmental interest in this transaction was obvious, «Gazprom» had to avoid a one-time launching of the block of shares exceeding the total number of freely traded stocks on the external market, to take into account ADR holders' interests, and interests of the corporation's management (by estimate, controlling about 7 per cent of stocks), and of the corporation itself (owning about 15 per cent of stocks).

The RF Government's Order No. 1587-r of November 4, 1998, envisaged selling of a single 2.5 per cent lot of stocks, the starting price being USD 651 million. No restrictions were set for non-residents; however, in case of winning a non-resident would have to abide to terms prohibiting re-sale in a 5-year period, or an issue of derivatives. In fact it meant a direct sale to a «Gazprom» strategic partner. Indeed, the tender was won by a German concern «Ruhrgas» who paid USD 660 million (and by this formally increasing the «Gazprom» capitalization up to USD 26.4 billion). Although the concern paid 20 per cent above the current market price, it can not have a representative in the Board of Directors (a minimum 8 per cent share is required) and has no right to sell the stocks, it is probable that «Ruhrgas» will be compensated with an informal option to purchase next 2.5 per cent stocks' block in 1999[36].

Similarly to previous years, **standard privatization transactions** did not provide large budgetary revenues. At the same time, in 1998 the situation was aggravated by the influence of new factors linked to the financial crisis.

First, Ruble depreciation and the general decrease in the Russian stock market capitalization (by 90 per cent in October of 1997 through September of 1998) eliminated price guidelines for even more prospective Russian emitters.

In these circumstances the state as a seller was tempted to play outside of the formal legal field. An example of this was the cancellation of a 15 per cent share purchase in an oil trading company

[36] On January 20, 1999, the State Duma passed draft legislation "On Natural Gas Supply in the RF"in the second reading. In particular, the draft stipulates that the state will own only a blocking (25 per cent plus 1 stock) share in Gazprom, while the share for non-residents is set at 25 per cent minus 1 stock (as compared with 9 per cent stipulated in the RF President's Decree No. 529 of May 28, 1997). This decision certainly favors the corporation, since the less share the state owns, the less control and influence it has in the Board of Directors. Other corporation's shareholders are either affiliated, or controlled, atomized, or are strategic partners. What is more, Article 15 of the draft prohibits the partition of the "single gas supply system," thus in effect making impossible a reform of the corporation as a natural monopoly.

«NAFTA-Moskva,» which was pledged to the company itself and the «Unibest» bank for a loan of USD 20 million in 1995 with an option to sell the shares in the case of default. All formalities were observed (two purchase offers, a pledge, execution of documents, the tender winner NPF «Zabota» representing NK «Surgutneftegaz» offered Rub. 124.511 million, this being above starting price – Rub. 124.5 million); however the tender commission did not recognize the transaction due to a lower price in USD equivalent at that time (although the commission did not change the tender terms fixing the price in Rubles).

It seems that a possibility of a cancellation on these grounds made the actual commissioner («MFK-Renaissance») to retain the USD equivalent when determining the price for 14.84 per cent share in the Novolipetsk Integrated Iron and Steel Works (*Russ. abbr*. NLMK). The government received a loan of ECU 24.2 million at the «loans for shares» auction in 1995; in December of 1998 this block of shares was offered at the start price of ECU 25 million, and was sold for ECU 26.1 million (for USD 30.8 million, while the market price of the block was about USD 8 million at the time of transaction). No doubt, «MFK-Renaissance» was not a philanthropic organization, as per the «loans for shares» agreement the starting price could not be below the amount of the loan. There was another tangible reason for this – a threat that the controlling interest could be purchased by either an old competitor TWG (36 per cent of NLMK shares), or a former ally in the fight against TWG and the NLMK management — Cambridge Capital Management (about 25 per cent of NLMK shares).

Second, the terms of the struggle for ownership redistribution have changed. In the situation of chronic crisis on Russia's financial markets, since October of 1997 the mobilization of available financial resources (both internal and borrowed) to seize control over new entities has become a more problematic task even for largest domestic financial groups. As concerns potential foreign investors, the best evidence of their appraisal of the situation was a massive outflow from the corporate securities market in 1998. As per estimates, foreign investors had considered the Russia's markets as a higher systemic risk zone.

An apparently unfavorable situation for budgetary revenues may, however, facilitate privatization sales in cases when a sharp price downfalls on markets allows to complete processes of corporate control consolidation. Thus, if at the fast market growth stage many shareholders had to limit their activities to exclusively portfolio investment, a blocking, or, at best, a controlling interest, in the crisis situation a further concentration of stock capital becomes a logical course of action.

In the current situation the continuing mass sales of shares may even accelerate. On a whole, as per the RF Ministry of State Property (MSP, *Russ. abbr. MGI*) data there was a possibility of sales of about 2 thousand «unbound» blocks of shares in 1998. The MSP made also a forecast of inevitable sales of shares' blocks less than 25 per cent. As the events of recent years have demonstrated (the more so in the situation of a gravest crisis on financial markets) it may go not about sales, but about handing these packages over to some or other private or institutional shareholders.

As a result, the privatization process reverts back to the stage of spontaneous extra-economic development: on the one hand, because the government is disinterested in organization of standard transactions in the framework of residual privatization, on the other hand, because assets are cheap, and therefore market transaction criteria disappear. At the same time it may result in growing **legal nihilism towards privatization process operators**, thus bringing about further destabilization of ownership rights. Some legal decisions in the sphere of shareholders' rights destabilize the investment climate at large and hinder its improvement.

A most striking example of this was the adoption of Federal Law No. 74-FZ of 07.05.98 «On Specifics in Disposing of Shares in the Russian Joint Stock Company of Power Engineering and Electrification «United Power Grids,» and of State-Owned Shares in Other Joint Stock Companies of Power Engineering.» Article 3 of this law stipulates that foreign states, international organizations, foreign legal entities, and their affiliated Russian legal entities, as well as foreign individuals may own up to 25 per cent of the total shares in the UPG, although at the time the law was approved foreigners already owned about 30 per cent of the UPG shares[37].

As per some estimates, the adoption of this quota, hypothetically meaning a demand to nationalize a certain block of shares, was a key factor in the downfall of the Russian stock market in May of 1998. Revealingly, this factor was essentially a psychological one, since it is practically impossible to bring the share of foreigners down to the level prescribed by the law in a legal way. There is only one legal way to achieve this goal – by additional emission, which would have become possible only by the decision of a shareholders' general meeting (foreigners own a blocking, and the government owns a controlling interest in the company) followed by the registration of this emission in the FCS, who will have good reasons to refuse the registration referring to the RF Civil Code.

In January of 1999 the government basing on a request of the General Prosecutor's Office charged SCM with an inquiry into the legality of the sale of an 8.5 per cent share in the «PGS of Russia» (*Russ. abbr. RAO ES Rossii*) at a special auction in 1996. The buyer, the National Reserve Bank, used this block of shares as collateral on foreign loans and according to the available data transferred 7 per cent of shares to repay the debt. During the auction there were accusations of abuse of insider's information about the price of the block and of getting a Central Bank credit for the purchase; however there were no legal action. At the same time, there were no restrictions for the sale of the block to non-residents. In fact, the cancellation of this transaction would have legalized the retrospective action of this law, and would have resulted in the cancellation of consequent transactions made in good faith; besides, it could have led to repay about USD 300 million from the budgetary funds to the buyer. Obviously, even the formulation of this problem is a major

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[37] As per some data, the share of foreign investors increased up to 33 per cent by February of 1999, as they expected (wrongly, it seems) the abolition of prohibitive quotas and a significant increase in the company's stock prices.

destabilizing factor affecting not only the emitter's image, but also the market recovery at large.

The annual refusal of the State Duma to pass the draft law «On Approval of the State Program of Privatization of the State-Owned Property in the RF» (formally – in 10 days after the approval of the budget) remains a serious destabilizing factor. This document should include a prognosis list of joint-stock companies shares in which are targeted for sale, proposed limitations in the process of their privatization, volumes of shares' blocks for sale and estimates of initial prices. The reason of refusal is that without this «prognosis list» of strategic enterprises (stipulated as such by law) their stocks can not be sold. In 1998 a decision about this matter had to take the President and the government.

In fact, the State Duma adopted, and the Federation Council approved of an alternative law «On Protection of the Russian Federation's Interests while Disposing of Shares in Joint Stock Companies Whose Outputs (Products, Services) is of Strategic Importance for Maintaining the Country's National Security.» Originally the number of such enterprises was 2873; it fell to 737 by the time the list was approved by the Federation Council. The government has the right to choose a way of disposing of these shares (including sales) only after the Duma approves a special law for each respective company. Since this procedure very much complicates sales (although it formally corresponds with international practices), it is apparent that in the medium-term the corporate management of JSCs from the list will be a very difficult matter, and will involve large administrative and financial costs on the part of the state as a shareholder in the situation the government has no funds for this purpose.

In 1998 the government also shortened the official list of strategic enterprises which could not be sold ahead of the schedule. According to the RF government resolution (No. 784 of July 17, 1998, «On Approval of the List of Joint Stock Companies Whose Output (Goods, Services) are of Strategic Importance for Maintaining the Country's National Security and Whose Stocks Being in the Federal Ownership are not Subject to a Pre-schedule Sale»), the number of JSCs with shares in state ownership was sharply reduced to 697 (from 2700 – 3000 in 1995 — 1997). Taking into account the ineffectiveness of present mechanisms of management of state-owned shares' blocks the MSP sought to expand the list of JSCs targeted for sale.

It seems that a similar uncertain situation will persist in 1998. In January of 1999 the MSP submitted to the government a new prognosis list, which included 7 companies: «Svyazinvest» (25 per cent minus 2 shares, Rub. 14 billion), «Gazprom» (2.5 per cent, Rub. 13 billion), «LUKoil» (9 per cent, Rub. 4 million), and shares' blocks in Balashev Integrated Bakery, JSC «Bor,» Design Office for automated transfer lines «Rotor,» «Moselektrofolga.» There is also an alternative list. The Russian Federal Property Fund (RFPF, *Russ. abbr. RFFI*) announced sales of shares in 6 companies: «Gazprom,» «Svyazinvest» holding, JSC «ONAKO,» «Sovkomflot,» «Aeroflot,» «Moscow Inland Shipping Line» (these enterprises are listed in a memorandum to the budget draft for 1999 as a source of Rub. 15 billion coverage of the budget deficit.

Apparently, it is hardly to expect that a new comprehensible governmental concept of renewed privatization policy will appear in 1999.

On the one hand, the government must demonstrate its rejection of the old privatization process, at list at the level of demonstrative refusal to hastily sell blocks of shares in the most attractive companies still in the state ownership. Ideologically it may be explained by a necessity to improve the «manageability» of the state-owned sectors and of its units (it is doubtable if this goal may be achieved at the present amounts of property owned by the state), practically it may be explained by current financial conjecture.

On the other hand, the social and political problem of increasing budgetary revenues may bring to naught any such declaration, and even activate practical attempts to sell the remaining blocks at any price. Simultaneously, any steps towards nationalization of some enterprises or towards cancellation of some transactions are unlikely, since the government is interested in a most favorable restructuring of the foreign debt and in receiving loans from international organizations, as well as in sales of new blocks of shares.

So, the government has a very narrow range of options in its privatization policies. These policies include:

— direct negotiations with potential strategic buyers of shares in the largest corporations remaining in the state ownership to secure budgetary revenues;

— a sharp intensification of administrative measures in managing the state property (blocks of shares, real estate) in order to display the struggle against abuses and to «improve manageability» of the state property;

— organizational restructuring (like the discussed merger of MSP, the Russian Federal Property Fund, and the Federal Bankruptcy Agency (FBA, *Russ. abbr. FUDN*) to display the working out a new concept of privatization and management;

Vague and inconsistent position of the executive branch towards further transactions with the state property is indirectly reflected in statements of high governmental officials:

— former privatization policy «did not create a market economy in Russia. On the contrary, it destroyed all hopes for the productiveness of the economic model created by it»[38];

— however, «deprivatization» (apparently, a terminological substitute for «nationalization») is impossible without serious social conflicts[39];

— in the short-term outlook, the largest companies must stay under the state control (meaning, the suspension of new sales of shares and the exclusion of private outsiders); some small unim-

[38] See: N. Samoilova. “V Rossii ne budet ni natsionalizatsii, ni privatizatsii” (There Will Be Neither Nationalization, Nor Privatization in Russia), *Kommersant*, 1999, February 3.

[39] Meanwhile, the very fact of recognition that serious social conflicts are possible in the society at attempts of nationalization, is, first of all, an evidence that the established system of the ownership rights, even taking into account the involved costs and the criminal component, has become the basis of a new economic model and of a system of social interests; otherwise, an infringement upon ownership rights could not have been seen as a ground for “bloodshed.”

portant projects will be carried out for show of the continuing privatization (for international lending organizations);

— although in this case privatization becomes insignificant as a source of financing budgetary deficit, there may be attempts to issue derivatives of the most attractive base assets[40].

Some ideas concerning the issue of convertible bonds of the «Svyazinvest» holding for sale to small domestic investors have been voiced by present. If the condition of the stock market and its traditional bias towards large «over the counter» transactions is taken into account, the success may be counted on only in case this transaction will become a deferred direct sale of a block of shares to a large investor on a governmental security. At the same time the emitter must be exceptionally attractive for the market or a strategic partner (in fact, now the only such emitter is Gazprom). Small portfolio speculation-oriented investors need, first of all, the signals basing on which they could expect to fix profits from shares' advances in a certain period of time. At the same time, taking into account the current financial and political situation, the approach of the parliamentary and presidential elections, there shall be no illusions in this regard.

4.2. The Consequences of the Financial Crisis for the Corporate Stock Market Operators

In the course of the financial crisis of 1998 the events on the securities market significantly worsened the attractiveness of Russian stocks for foreign and domestic investors. The crisis has revealed the existing shortcomings of both governmental and market self-regulatory systems, as well as of the market infrastructure.

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[40] The legislation describes the issue of such derivative securities somewhat vaguely. According to Article 16 of the law No 123-FZ of July 21, 1997, "On Privatization of State Property and Principles of Privatization of Municipal Property," there is an option that shares in open joint-stock companies created in the course of privatization may be sold to owners of the state or municipal securities certifying their rights to purchase such shares. Article 24 contains a reference to yet non-existing uniform order of carrying out tenders for placement of such securities.

The world financial crisis, which started in 1997, most strongly affected emerging markets, including the Russian one. The downfall of stock indices was first observed in Thailand, Singapore, Malaysia, Philippines, Czech Republic, and Poland in February – March. In May this process manifested itself in China, in June – in Japan, in July – in South Korea, in September – in Chili. Since end-October this crisis has spread over practically all world stock markets.

Russia was not an exception. After the peak of the autumn crisis of 1997 Russia saw a certain rise of quotations alongside with other countries. Alongside with other emerging markets Russia experienced the influence of the changes in strategies of investment institutions across the globe in 1998. Simultaneously, the crisis on the world financial markets caused a relatively high volatility of the majority of national stock indices during 1998.

Even taking into account a sharp downfall of stock indices in 1997, Russia remained the absolute world leader in terms of the stock index rise (88 per cent in 1997 as compared with 1996 figures). In a significant degree it was linked to a perceptible progress in the legislation, the development of securities market infrastructure, an increase in the investment attractiveness of Russian corporate emitters' securities against the background of falling yields of other financial instruments.

Nevertheless, the «Asian crisis,» as well as a decrease in international prices of raw materials was only an exogenous factor of the financial crisis in Russia, which had its specifics. The collapse of the Russian stock markets is impossible to explain only by the unfavorable international conjecture. The latter had only aggravated negative internal trends accumulated in the Russian economy. Precisely these trends were fatal in the development of the situation in spring and summer of 1998.

There is no doubt that such a significant downfall of stock quotations from autumn of 1997 to autumn of 1998 (see Fig. 1) was caused by **a number of factors**, including those of the institutional character[41]:

(1) A danger of a recession across the economy accompanied by a respective downfall of Russian companies' profitability and the aggravation of their financial situation had increased sharply. The Russian stock market collapse, in its turn, caused the further worsening of the finance attracting possibilities of Russian companies.

(2) Default on state debt securities, which internal and external investors saw as the legal nihilism, had seriously undermined trust in securities of Russian emitters.

It shall be noted that the market of the Russian emitters' stocks mirrored the situation of the internal national debt. As Figure 4.1. shows, GKO yield dynamics apparently opposed those of the Russian stock market fluctuations. At the same time, the corporate stock market depended on the situation on the public debt market in terms of volumes and dynamics in 1995 through 1998.

The collapse of the GKO «pyramid» became at the same time the collapse of the Russian stock market due to the global deterioration of the Russia's national investment image after the default on the internal public debt. Indirectly, the condition of the stock market was affected by the indecisiveness of the Russian government and of the RF Central Bank concerning the Ruble depreciation: investors took into account the risk of a possible depreciation in the price of the state securities, what led to a further downfall of the stock market via increasing yields.

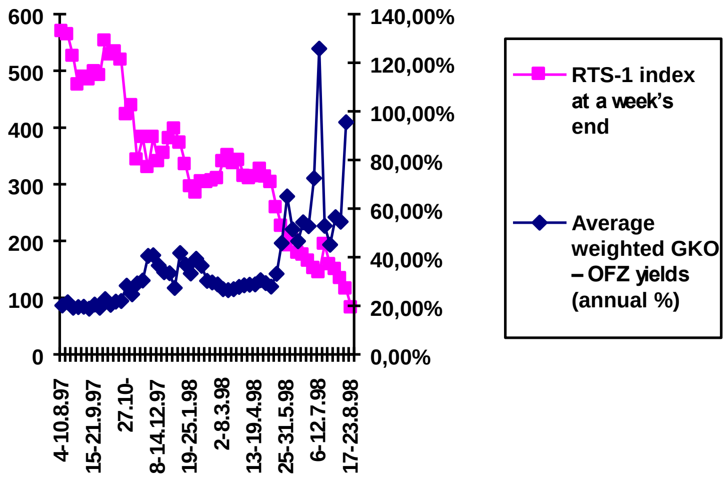
(3) As the leftist government came to power, investors saw an increased hypothetical possibility that many large Russian companies may be nationalized, and that results of a part of privatization transactions may be reviewed. The respective procedures could not be have been carried out without affecting shareholders' interests. In this view, the most characteristic was the sharp intensification of

[41] A detailed analysis of the market conjecture and financial crisis development see in: *Rossiiskaya ekonomika v yanvare – sentyabre 1998 goda. Tendentsii i perspektivy* (The Russian Economy in January through September of 1998. Trends and Outlooks). M.Zh. IET, 1998.

portfolio investors' outflow from the corporate securities market after notorious decisions concerning «UPG of Russia» in May of 1998.

Fig. 4.1

RTS-1 index and average weighted GKO – OFZ yields in 1997 through 1998



(4) There was a higher danger that some of large Russian emitters will be of forced to bankruptcy due to their federal budgetary tax arrears. In such bankruptcies shareholders lose everything.

(5) A sharp downfall of the liquidity of the first echelon emitters and total non-liquidity of the second and third echelon emitters of the Russian stock market had «frozen» investors' funds bringing about a diminishing demand on the market.

(6) The banking crisis linked not only with losses on financial markets[42], but also with the very fact of the liquidation of the main

[42] The GKO – OFZ package in Russian banks' assets was about Rub. 40 billion at the moment of default (without the RF Sberbank assets). Losses of the Russian banks hedging

source of profits (the GKO – OFZ market) had brought about an aggravation of the non-payment crisis, which directly affected the stock market operators.

In fact, funds of domestic investors were paralyzed, while external investors were rapidly leaving the market. Practically all Russian broker companies have found themselves in a tight situation. Coupled with the crisis experienced by commercial banks, it brought about the paralysis of the system of payments for stock transactions and the respective increase in systemic risks.

(7) Foreign investors invested funds via nominal holders, many of whom were controlled by broker companies and commercial banks, who found themselves in a tight financial situation. Investors were worried about possible manipulations with these nominal holders.

(8) Rising opportunities of communist and extremist parties to win the next parliamentary and presidential elections made investors to reassess the probability of forming market economy in Russia.

(9) Capitals exported from Russia, which had started to return to the country via offshore structures, were re-directed towards other investment objects.

The anti-crisis actions of the **market regulator** (the Federal Commission for the Securities Market (FCSM), *Russ. abbr. FKTsB*) proved to be of little effectiveness in the crisis situation to a significant degree caused by dynamics of general macroeconomic indicators. In a certain degree it was related to a legally limited range of instruments the FCSM could employ to influence the professional operators of the securities market.

In fact, all FCSM anti-crisis policies were within the following principle guidelines in 1998[43]:

— to regulate and to stop tenders on trading floors;

Ruble risks of foreign investors made as per different estimates USD 15 to 22 billion due to the collapse Ruble depreciation.

[43] See: *Federal'naya Komissiya po Rynku Tsennykh Bumag. Godovoi Otchet 1998* (The Federal Commission for the Securities Market. Annual Report 1998). M., 1999.

— to restrict future transactions on the market;

— to strengthen control over the financial situation of the professional market operators (group – 20, etc.);

— to lower requirements to the volume of internal capital of the professional market operators;

— to take concrete anti-crisis measures towards collective investors;

— to simplify the procedure of new corporate debentures emission;

— to carry out demonstrative operational actions in order to protect shareholders' rights in certain companies (Oil Company «Yukos,» Oil Company «Sidanko,» Oil Company «Sibneft,» Open Joint-stock Company «Krasny Kotelschik,» «Dal'moreprodukt,» Joint-stock Company «Nosta»);

— to change the norms and regulations of the corporate management (emission requirements, transparency, accounting, etc.).

The next period (September through December of 1998) may be characterized as the period of the **post-crisis market stagnation**. Although some segments of the Russia's financial market could be reanimated already in autumn of 1998, some principal problems remained unsolved until end-1998:

— the vague situation of debts and outstanding interest on debts persisted in autumn of 1998 – 1999[44];

— the final scheme of GKO debt restructuring was not adopted;

— there were no clear program of regulation and reorganization for the banking sector in the crisis situation;

— there persisted the general social and economic uncertainty about prospects of the Russia's economy development in 1999, first of all linked to the budgetary problems.

[44] The total Russian foreign debt made USD 150 billion, in 1999 redemption payments made USD 17.5 billion (to IMF 19 and 4.8 billion respectively, to the World Bank 6 and 0.8 billion respectively, Domestic Hard Currency Loan Bonds (OVVZ) 11 and 1.3 billion respectively, Eurobonds 16 and 1.8 billion respectively, other 98 billion (including 40 billion to the Paris Club and 26 billion to the London Club) and 8.8 billion respectively).

As a result, the remaining viable economic agents did not receive any comprehensible short-term signals that bringing about market stagnation.

The resulting decrease in stock quotations of Russian companies and their diminishing liquidity directly affected **investment prospects**:

– Russian companies can not attract new domestic and foreign investment by new securities placement;

— the state can not sell shares' blocks of large Russian companies to financial investors;

— market quotations of Russian companies fell significantly, what negatively affected possibilities of profitable strategic shares' blocks sales to foreign investors by owners;

— direct investment funds temporarily lost interest in investing in Russian projects (by estimate, they were ready to invest in securities of Russian emitters about USD 1 billion in August of 1998), since to derive profits from such investments by stock placements or sale of shares to strategic investors becomes unfeasible at low prices.

At the same time, low market prices create certain prerequisites for long-term investments.

Moreover, the experience of 1998 is evidence that some companies could borrow funds for expansion of production and restructuring even in the crisis market situation. This positively affected the market situation of such companies («Baltika,» «Vympelkom»). First of all it was true for start-up companies, which initially had modern technologies, management, highly professional staff; were transparent and loyal to investors (shareholders).

Some companies (first of all in communications and oil sectors) managed to place ADRs in January through April of 1998; however, the aggravation of crisis checked this process.

Hypothetically, investors may become more interested in a number of domestic import-substituting industries, which can take advantage of the new situation arising after the Ruble depreciation. While in the past the interest of investors in major Russian emitters (mostly in raw materials sphere) decreased simultaneously with the fall of the raw materials world prices, the depreciation of Ruble in August of 1998 made possible a certain revival of the market due to an inflow of investment resources into Russian companies operating on the domestic market, which were able to increase their output fast taking advantage of a sharp decrease in the Ruble real exchange rate and the respective fall of imports' competitiveness. These prospects depend also on future inflation rates. However, it concerns only direct investments.

Although 1998 saw a sharp increase in the number of newly registered corporate securities emissions (19,941 issues, including 19,848 share issues and 93 bond issues, 2,617 rejections of registration applications), this data shall not be overestimated.

A majority of issues was so called «technical» emissions and were not directed towards additional investment attraction.

Mainly these were operations directed towards increases in nominal value of shares or the distribution of additional shares among shareholders due to increases in internal assets value of joint-stock companies (revaluation of fixed capital, which does not bring additional investment, shares are distributed free of charge and proportionally among all shareholders), consolidation, or stock split. For instance, among 73 shares issues registered by the central FCSM office, 51 issues (69.9 per cent) were conversions (larger face values) and distributions among shareholders, only three issues were placed by public subscription and five issues were placed by closed subscription.

The trend towards increasing interest in issue of bonds among emitters was not apparent in 1998. Since the moment the state registration began and until January 1, 1998, the FCSM and its regional agencies registered 41 issues, in 1998 93 issues were registered. The majority of bond issues were so called telephone loans made in the framework of the presidential program of «Russian people's telephone» (i.e. telephone lines installation). In other words, the overwhelming majority of issued bonds provided not money, but other property equivalent. Convertible bonds prevailed among other bond issues. Among 36 issues registered by the central office of the FCSM, 33 were placed by closed subscriptions.

The most important factor causing an increase in the number of new issues was more active **redistribution of ownership rights** in 1998, as new issues were used as an instrument to the detriment of «strange» or small shareholders. Due to shortcomings of the current Russian corporate and privatization legislation this essentially illegal device was often used in legal forms.

It is also significant that in autumn of 1998 the total volume of re-registrations of transactions with shares practically did not decreased, while the number of professional market operators declined dramatically, and the share of «over the counter» transactions increased significantly. It seems that it was due to a significant increase of transactions involving large blocks of shares in the framework of the post-crisis ownership redistribution.

In 1998 in the financial crisis situation this process of ownership redistribution also took new shapes: reciprocal offsets, securities on debts, sales or transfers of shares' blocks after bank bankruptcies or dissolution of financial and industrial groups, in the course of JSCs' reorganization or bankruptcy, in attempts to cancel first issues of securities, etc. In these circumstances attempts of regional elites to size control over major enterprises in their respective regions became more apparent and successful. Ideas of labor collective ownership and of large state holdings as the basic structural units of the Russian economy were reanimated at the federal level. This trend will persist also in 1999. It may bring about increased instability of ownership rights and will require the implementation of tougher policies for protection of investors' (shareholders') interests.

An intensification of activities directed towards the protection of investors' rights (including infrastructure measures) is necessary in the situation of a current financial crisis as a factor of restoration of the country's investment attractiveness. It is obvious that the complete effect may be reached only by its application within a package of other anti-crisis measures and a settlement of debt problems with investors.

The financial crisis of 1998 was a serious test for the **professional operators of the securities market**. Market operators having funds in state securities suffered significant losses what affected their professional activities.

Before July 1, 1998, there was registered an increase in the number of the professional market operators (broker and dealer activities, trust management of securities) and in their capital. This situation had dramatically changed since August. As on January 1, 1998 there were 1561 (licensed) securities market operators, 1947 as on July 1, 1998, 1698 as on December 31 of 1998[45]. The diminishing number of the operators in the second half-year was caused both by the withdrawal of licenses as a sanction against non-submission of reports, and by rejections of applications for continuation of professional activities.

It is important that broker services experienced the most profound downfall. A trend towards a decrease in the number of professional market operators (by estimate, up to 50 per cent) will persist in 1999. It is possible that these types of professional activities will completely cease in a number of regions (least of all it concerns Moscow, St. Petersburg and Ekaterinburg) caused by the end of the «vacuum-cleaner» market age when small brokers purchased shares for Moscow brokers who sold them to non-residents.

Important changes took place in the organization of trade on the securities market. By end-1998 14 organizers of trade had licenses, three of them in Moscow and two in St. Petersburg. On the whole, a sharp downfall of quotations and trade volumes on the market became a general negative factor causing the sectoral crisis. At the

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[45] Respectively 1102, 1207 and 1110 professional market operators combined broker and dealer activities.
The Bank of Russia granted 938 licenses for carrying out professional activities on securities markets by (in accordance with FCSM general licenses) to credit organizations in 1998.

same time, the dealer market for foreign investors in the framework of the «Russian Trading System» experienced a major crisis 1998, while «classic» exchanges, first of all the «Moscow Stock Exchange» and «Moscow Interbank Currency Exchange,» proved to be more viable in the situation of crisis.

The formation of a network of independent specialized registrars was completed in 1997. As on January 1, 1998, 201 registrars operated in the Russian Federation territory. In 1998 the FCSM granted 3 new licenses and cancelled 28 licenses for registering of inscribed securities owners. In the situation of the financial crisis of 1998 the process of specialized registrars enlargement continued both due to increases in number of client emitters and increases of internal means, and due to the integration (affiliation) of registrars and the liquidation of small noncompetitive registrars. By end-1998 there were 126 licensed registrars in the sector.

A majority of depositors was also licensed in 1998. 116 licenses for depositor activities were granted (including 66 license renewals). At the same time in the situation of financial crisis and unstable ownership rights system the task of creating the national depositary system, including a central depositary, acquires special importance.

For instance, the RF Presidential decree No. 1034 of 16.09.97 «On Securing Investors' and Shareholders' Rights for Securities in the Russian Federation» provided for the creation of the national depositary system. On the basis of this decree[46] the Russian government adopted Resolution No. 741 of July 10, 1998, «On Measures for Creation of the National Depositary System.» The main purpose of the Central Depository (The Central Depositary – the Central Fund of Custody and Processing of the Stock Market Information) created by the resolution is the securing of investors' and shareholders' rights for securities in the Russian Federation.

[46] And the RF Presidential Decree No. 662 of July 3, 1995 "On Measures for Formation of the All-Russian Telecommunications System and Securing of Owners' Rights for Custody of Securities and Payments on the Stock Market in the Russian Federation."

The Central Depository and the national depository system shall perform the following functions:

— to secure safe keeping of information on investors' rights for securities in this way securing ownership rights;

— to secure effectiveness of payments for transactions with securities;

— to diminish credit risks while carrying out payments for securities and monetary instruments, meaning delivery against payment.

The creation of the national depositary system is also aimed at a decrease in costs, the acceleration of payments, involvement of a large number of the system operators, an expansion of the range of securities, access for remote users that implying an open regional policy. At the same time a most important aim of the Central Depository and the national depository system is their integration into international clearing and payment systems for securities.

Collective investment institutions of various types, who had invested a part of their funds into state securities, either voluntary or in accordance with legal requirements, found themselves at the brink of collapse after the default of August 17. As on December 31, 1998, 33 (including 21 open-ended and 12 interval ones) mutual investment funds (MIF, *Russ. abbr. PIF*) and 27 managing companies (according to the number of licenses). Three funds were at the stage of initial placement; two funds were at the stage of voluntary liquidation. The aggregate amount of net assets of the mutual investment funds was Rub. 554 million as on December 31, 1998. The crisis in this sector was directly linked to the collapse of the Russian stock market by apparent reasons.

As concerns so called Bank Managed Common Funds (BMCF, *Russ. abbr. OFBU*), which banks actively established in the first half-year of 1998 as an alternative to mutual investment funds), their incapability was directly linked with the crisis of the universal bank model in Russia, which became apparent in August of 1998.

It is also expected that the total number of investment funds (including investment privatization funds due to their transformation into joint-stock companies) will diminish. Less than 20 funds (out of 100 operating ones) are going to continue their activities as investment funds. Several voucher investment funds applied for transformation into UIFs.

On the whole, a somewhat paradoxical situation formed in the second half-year of 1998: although in 1996 through the first half-year of 1998 a perceptible progress was noted in market regulation, market infrastructure development, protection of investors, the financial crisis of 1998 had practically destroyed the market and closed a stage in its development. In fact, the contradiction, which existed in the early nineties (i.e. at the first stage of the market formation), was reproduced at a qualitatively new level: the market activity was close to zero in the second half of 1998, while in the recent years there had been created a relatively developed institutional market basis.

The seriousness of the financial crisis in 1998 allows to suggest that a new long period of market adaptation to the changed economic situation is inevitable and there are no prospects of activity renewal, at least in the short-term outlook. However, the latter is a necessary condition of a real progress in institutional terms. While in the past a fast growth of markets created new incentives for the development of the market infrastructure, at present a simultaneous long-term crisis of the market infrastructure elements shall be noted.

The **medium-term outlook** for the stock market includes the following major trends:

— a weak and fluctuating stock market will exist for at least 1.5 to 2 years (due to pre-election political and economic factors, first of all, expected high inflation rates, lack of guarantees that planned budgetary revenues will be received, debt problems of Russia at large and of Russian corporations, a further decrease in capitalization of raw materials corporations on the background of falling export prices;

— diminishing numbers of professional stock market operators, their enlargement (merger), intensifying competition among them;

— the post-crisis redistribution of property in financial groups and corporations, which (coupled with low prices on a weak stock market) will bring about mass abuses and infringement on shareholders' rights;

— a small chance that foreign investors will renew their interest in the Russian market due both persisting tax problems and the uncertainty in connection with the banking system restructuring, and to a possible aggravation of the international monetary and financial system crisis;

— new instruments non-typical for the Russian market issued by enterprises in the real sector in the attempt to find alternative sources of financing (corporate bonds, warehouse receipts, mortgages);

— the development of new collective investment forms (close-ended mutual investment funds in the sphere of real estate, etc.);

— more active behavior of self-regulatory organizations of the professional stock market operators and investors (shareholders).

Among most **general market regulation policies** leading to a certain possibility of positive shifts in a few next years may be noted the following:

— maximal stability of the legal and tax regimes, a statement of the new government and Duma that the protection of shareholders' interests will be a priority of the economic policy;

— confirmation of privatization results for major privatized companies the shares in which are traded on the market or belong to strategic investors (UPG of Russia, Gazprom, Svyazinvest, SIDANKO, Surgutneftegaz, YUKOS, etc.) by the new government and by Duma;

— confirmation of the FCSM role as the major regulatory agency on the stock market by the new government;

— more active control over individual broker companies in terms of sufficiency of their capitals, adherence to regulations on payments within securities transactions, correctness of reports on clients' accounts;

— public discussion of implemented regulation policies directed towards sanation of the Russian stock market via license withdrawals and assistance to companies able to overcome the financial crisis;

— a sharp expansion of the FCSM rights to control the observance of shareholders' rights by companies (the right and the obligation to sue companies infringing upon shareholders' rights, etc.);

— more active involvement of international broker companies into operations on the Russian stock market.

4.3. Current Problems of the State Participation in Corporate Management

As privatization progressed and state property volumes decreased, there arose the problem of creating a legal basis for operative and strategic management of state and mixed enterprises in the new environment. No integrated mechanism and no single strategy have been worked out in order to solve this problem. The legal documents adopted in the course of mass privatization (1992 to 1994) may be conventionally broken by 3 groups, or policy guidelines:

- Normative basis for state representation in JSCs with state participation;
- Acts regulating direct management of the state property;
- Documents attempting to introduce the institution of trust for managing shares' blocks in the state ownership.

A rather inefficient management of shares' blocks being in the federal property in 1993 through 1996 caused the continuation of the search for new methods to manage mixed property, which would have been adequate to the realities of the post-privatization period. A detailed appraisal of the normative and legal base evolution allows to note that at present two variants of managing the state blocks of shares, which develop the principles of the first and the third groups of documents appeared in 1992 through 1994, may become an alternative to the institution of state representatives, which had proved its incapacity.

First, the representation of the state interests in JSCs on the contract basis (for individuals – the institution of state agents). At present only first steps are taken to organize the representation of the state interests in JSCs on the contract basis as some state officers and entrepreneurs started their studies in three higher education establishments (the Academy for National Economy at the Government of Russia, the Russian Economic Academy named after G. V. Plekhanov, and the Higher School for Privatization and Business), some of them had already been attested. The representation of the state interests on this basis has been carried out in «Moselektrofolga,» «Sovbunker,» «Kirovo-Chepetsky Chemical Integrated Industrial Complex.» Although the basic documents introducing the institute of agents had been already adopted, this mechanism does not work as a whole yet, mainly due to the lacking concrete decisions on remuneration sources for these activities.

Trust management of the state blocks of shares is considered as another option to increase the efficiency of managing the state shares' blocks.

The resolution of the RF government No. 989 of August 7, 1997 (the revision of April 17, 1998) established common (with no regard to sectoral specifics) «Regulations on Trust Management of Shares' Blocks in the Federal Ownership Created in the Process of Privatization and on Conclusion of Agreements on Trust Management of These Shares.» It was stipulated that the access to these operations may be granted to individuals having licenses to work with securities and legal entities with volumes of internal funds exceeding 20 per cent of the trusted block of shares value.

The first objects of trust management became «Vostsibugol» and «Khakasugol» in December of 1997. However, the further progress in this direction was checked: two coal mining companies («Bashkirugol» and «Krasnoyarsk Coal Company») out of five subjected to the introduction of trust management as per documents of 1996 were excluded by the RF Presidential Decree No. 921 of August 7, 1998. Most probably the grounds for this decision were contradictions between the federal and regional authorities. At the same time, new potential objects of trust management were selected. They were fifty-one per cent shares in coal mining companies «Prokopievskugol,» «Belovougol,» Kuznetskugol,» «Leninskugol» (by the RF governmental resolutions No. 1094 — 1097 of August 28, 1997) and «Kiselevugol,» «Severokuzbassugol,» «Intaugol» (by the RF governmental resolutions No. 468 — 470 of May 20, 1998) owned by the state. The latter decision was seemingly caused by coal miners unrest leading to the blockade of railroads. Twenty five per cent blocks of shares in 12 construction agencies and in other organizations of the former Chief Military Construction Directorate of the RF Defense Ministry were transferred into trust management. The latter became the subject of trust management after its reorganization into the joint-stock holding company «Chief All-Regional Construction Agency «Center» with 25.5 per cent share in the holding and in 12 enterprises mentioned above being in the federal ownership (the RF Presidential Decree No. 588 of May 25, 1998).

«Gazprom» was an especially important object where several new methods of managing the state shares' blocks were introduced simultaneously. After the term of state ownership of a 40 per cent shares' block in «Gazprom» was extended in 1996, the Russian government started to consider the conclusion of a trust management agreement as a replacement for the agreement between the government and «Gazprom» on the entrusted property in force since February of 1994[47]. On May 12, 1997, the President signed Decree No. 478, which established a new body for representation of the state interests in the company – a **collegium**, which should act within the company's management on the basis of decisions adopted by a majority vote fixed in protocols. The

[47] Basing on the Second Part of the RF Civil Code, which retained trust management as a legal definition.

Collegium should be governed by «Basic Provisions of the Structural Reform of Natural Monopolies» adopted by the RF Presidential Decree No. 426 on April 28, 1997. Later the Collegium composition had been changed twice due to new appointments in the government and respective redistribution of duties. At the same time by the RF Presidential Decree No. 478 the Russian government should offer the Chairman of the «Gazprom» board of directors to sign a new trust agreement for **trust management** of 35 per cent (out of 40 per cent; it was due to limitations set by Provision 3 of the RF Presidential Decree No. 1660 of December 9, 1996) shares' block in the state ownership. This agreement was signed at end-1997.

By that time collegiums of state representatives were set at «Rosgazifikatsiya» and «UPG of Russia» (later this practice was also extended to «Svyazinvest» holding). The collegium of state representatives was set at the «UPG of Russia» by the RF Presidential Decree No. 1334 of November 5, 1992, but it mostly acted only formally and without relevant personal composition changes. The state intracorporate control at the «UPG of Russia» was limited mostly due to the fact that the «Gazprom» president was made one of the state representatives at the company, and by the fact that interests of the FR subjects were as a rule represented by general directors of regional power supply companies. In these circumstances the reform of this natural monopoly brought about many conflicts in 1997 through 1998.

Important, but mostly only episodically implemented, were **fragments** of the state policy in the management of the state blocks of shares: 1) personal appointments in boards of directors made by resolutions of the RF government, or by Presidential decrees («Gazprom,» «Norilsk Nickel»); setting of the voting rules for state blocks of shares at shareholders' meetings (by governmental resolutions for oil companies, for «UPG of Russia» and «Rosgazifikatsiya» by decisions of state representatives' collegiums); 3) «strengthening» of this or that enterprise (holding) with the state participation by transfers of state-owned blocks of shares in other enterprises into its charter capital (the transfer of shares' blocks in «Rostelekom,» «Central Telegraph,» in a number of other enterprises into the Svyazinvest authorized capital before the sale of its blocking shares' package, the same was true for a number of coal and oil companies); 4) transfers of shares' blocks into trust management of managing (central) companies within financial and industrial groups, or of holding companies (FIG «Ruskhim,» «Nosta-Gaz-Truby,» «Russian Trade and Industrial Company «Rosmyasmoltorg,» «Biopreparat,» etc.); 5) restructuring («securitization») of the debts to the budget, transfers of shares' blocks as offsets against federal budget debts to certain regions (Moscow, Kalmykia, the Kirov, Sverdlovsk, Novosibirsk, Krasnoyarsk regions).

In the contemporary situation principal claims of the state as a shareholder are the same as those of other shareholder types, be they external investors or working collectives. These claims are as follows:

— the lack of transparency in JSCs activities both for shareholders and the state;

— diminishing share of «outside» shareholders due to additional emissions in favor of «inside» investors made without approval by «outsiders»;

— transfers of material and financial assets from the parent company to subsidiaries being under the control of managers or their friendly companies.

In 1999 state corporate associations (holdings, etc.) may be established more actively. This process became a sufficiently apparent phenomenon already in the period from 1997 to the first half-year of 1998; however at that time it should be seen as a protective centripetal reaction at the micro-level in individual non-competitive or depressed real sectors. At present this is a larger scale process as the state increases its role in management trying to reanimate well-known management methods, which have already proved to be incapable. The degree of this increase will depend exceptionally on the pragmatism and common sense of the executive authorities.

Among a small number of positive instances taking place in 1998 may be noted the fact that «UPG of Russia» instructed its 45 (out of more than 80) subsidiaries to adjust certain provisions in their charters to the law «On Joint Stock Companies.» For instance, the stipulation requiring the approval of the board of directors for a one per cent increase in voting shares owned by a shareholder is illegal and discriminatory.

For another holding (Svyazinvest) it is of principal importance to improve the corporate management situation in order to sell a block of its shares in 1999. In particular, in order to improve control over transfer of assets from its subsidiaries to third parties it has been suggested to include representatives of largest shareholders (first of all, Mustcom Ltd. Consortium) into subsidiary regional electrical communications companies' boards of directors. The concentration of the most profitable businesses within individual subsidiaries may be an option. In 1998 – 1999 the holding's shareholders discussed the following merger options for «Svyazinvest» and its subsidiary «Rostelekom»:

— merger by the exchange of additional issues of shares by one company for shares in the other company;

— «Svyazinvest» pays for a part of «Rostelekom» shares with shares in its subsidiaries, while shareholders exchange «Svyazinvest» shares for shares in «Rostelekom.»

However, in the situation of a chronic financial crisis and low capitalization of the market even after a highly effective reorganization of the holding the attraction of large funds from strategic investor (consortium) may be problematic.

An example of coordinated state participation in a corporate conflict between non-state shareholders was set during an additional issue of shares in the Sayansk Aluminum Plant (*Russ. abbr. SaAZ*) in 1998. Although the problems of corporate control in the aluminum industry are of the multifaceted financial and political character, the applied technology is of interest. In autumn of 1998 the SaAZ charter capital was increased by 2.5 times (via an open subscription) that leading to the decrease in the state share from 15 to 6.15 per cent (the RFFI had no funds to redeem the shares), while the Trans World Group (TWG) saw a decrease in its share from 37.8 to 14.7 per cent (i. e. less than the blocking number of shares). Companies within the «Sibirsky Aluminy» group (which included SaAZ) redeemed the additional issue. The Khakas Property Fund supported the group and voted for the issue. Court proceedings initiated by TWG did not change the situation since SaAZ transferred a number of shares to RFFI in order to restore the 15 per cent state share free of charge (6.5 per cent of these shares were later sold at a privatization auction).

Table 4.3

Some General Data on the Number of JSCs Shares' Blocks Remaining in the State Ownership in 1997 through 1998

State property by category	January 1, 1997	January 1, 1998	End-1998
Blocks of stocks (shares) in JSCs, partnerships and other enterprises of mixed ownership remaining in the federal ownership (as per the "Ownership Register of the RF")	6490	4866	4892*
Blocks of stocks in the federal ownership:	2900**	4235	3316
- below 25%;	558**	1400	1173
- from 25 to 50%;	1037**	2004	1291
- over 50%;	286**	31	470
- 100%	...	..	382
"Golden share" in the federal ownership	1300	631	580
Blocks of stocks in the federal ownership not subject to pre-scheduled sale	2900	...	697

* - by the beginning of the 4th quarter of 1998;
** - include only shares' blocks prohibited for a prescheduled sale
Source: MGI RF database.

All facts mentioned above are evidence that a large-scale reform of the whole state property management system is required to achieve positive shifts in the system of managing state owned shares in joint stock companies and other enterprises of mixed ownership. The urgency of the problem is confirmed by the data in Table 4.3 (residual blocks of shares formally in the federal ownership, but remaining due to various reasons in local property funds are not included; blocks of shares owned by the RF subjects and municipal entities are practically impossible to apprise). The problem of accounting for the state shares in mixed-ownership companies other than JSCs and in newly created companies not involved in the privatization process has been solved.

In connection with this problem the feasibility of implementing a number of long-term, medium-term and long-term measures may be mentioned.

The short-term measures (implementation in less than 1 year): re-attestation of the state representatives, reveal of JSCs where state representatives voted for the dispersion of the federal blocks of shares and inspection of such JSCs for violation of the legislation on JSCs.

The medium-term measures (implementation in 2 to 3 years): the main problem is the **specification of the state competence as an owner in different JSCs** depending on a number of criteria, the most important of which shall be (until the final approval of their list) the size of the state share in a JSC authorized capital. For large and majority blocks of shares (over 25 per cent of the authorized capital) the state (as a strategic owner) shall be able to employ a combination of norms and procedures allowing the carrying out of management functions; for minority blocks of shares (below 25 per cent) the state shall be able to employ a combination of norms and procedures allowing it to carry out controlling functions as one shareholder among many.

The specification of the state competence as an owner in different JSCs requires the solving of three individual problems:

- to achieve greater control over the actions of individuals representing state interests in JSCs by adjusting the respective legislation already in force (mainly outside the legislation activities of the RF Federal Assembly);
- to introduce elementary mechanisms for controlling financial flows and the capital reproduction process in mixed ownership companies with the state participation

and to build these mechanisms into the activities of individuals representing state interests in JSCs;

- to inventory and to range blocks of shares in the state ownership across regions and sectors in order to increase budgetary revenues at all levels, to carry out urgent institutional reforms and to lay grounds for the implementation of active structure and industrial policies in the future.

It is necessary to understand that a greater degree of regulation of the state representatives' activities in JSCs alone can not dramatically improve their sense of responsibility for their actions. It is obvious that positive incentives are also required. In this connection a key problem of the JSC state representatives' activities must be solved in legal terms. This is the problem of remuneration for these activities. This problem was aggravated in connection with the approval of the new law on privatization. According to the new law, state or municipal officers representing state interests have no right to receive remuneration both in monetary, and any other form from open joint stock companies and have no right to cover their functional spending at the expense of the JSCs and third parties.

In order to stimulate the activities of the state representatives and agents it is necessary to assign to them a share in dividends derived from the state owned blocks of shares. The setting up of minimum and maximum remuneration limits may provide a controlling mechanism for prevention of abuses.

The long-term measures (implementation in up to 5 years): a gradual building of a logical management system allowing the state to manage shares in joint stock companies and other enterprises of the mixed form of ownership on case by case basis and to apply programming and purpose-oriented methods. This requires the necessity to set up state's aims for participation in capital of an enterprise, a clear formulation of tasks, creation of a documentary base containing ways and means of influencing the object of management and establishment of effective control mechanisms.

4.4. Banking Crisis Development in the Second Half-Year of 1998.

The banking crisis development in Russia has been caused by several factors and only triggered by the events in August of 1998. The fact that the banking activities regulation and oversight system has not been completed destabilized it and created an independent factor in the development of the banking crisis often defined as a *post-liberalization* crisis.

Rather often the lack of experience among individuals managing banks[48] and a fast growth of bank numbers are listed among factors causing banking crises after the liberalization of the financial sector. Russia and other countries that implemented financial liberalization during transition from the centrally planned systems to the market economies only partly deserve this reproach. There were only too few individuals experienced in managing banking within the market type system, while the experience of managing state owned banks was of little use in the new situation. The statistics prove that "survivability" indicators of "new" banks in Russia were close to average levels. While the percentage of banks continuing operations in mid-1998 made, as per our estimates, 57 per cent of the total number of registered banks, for "new" banks this indicator was at about 59 per cent. In other words, the "mortality" coefficient for "new" banks was at 41 per cent. This figure is higher than the percentage of banks created under auspices of former Promstroibank and Zhilsotsbank of the USSR, which had departed from the market, but by far lower than for banks created on the base of Agroprombank. The experience of banking activities under the planned economy was not an important factor in successful adaptation of banks to the new macroeconomic environment.

However, the grounds of the crisis in Russia could not be reduced to the consequences of the financial liberalization. The risk of crises caused by depreciation persists in the country even in spite of the fact that its currency may be convertible to a certain extent.

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[48] See, for instance, *Euromoney*, July 1998.

The currency situation the majority of the Russian banks had found themselves in made them especially vulnerable to depreciation[49]. The crisis could be also provoked by macroeconomic reasons (a new downfall in the economy in spring and summer of 1998). The delay of a decision on providing guarantees for bank deposits represented a certain danger. The Asian financial markets crisis, which triggered capital outflows from other emerging markets, was also a factor increasing the probability of a banking crisis. The only classical reason of banking crises in recent decades absent in Russia was credit expansion. However, it was substituted for by a headlong expansion of the state debt instruments markets. Any of these reasons alone could have been insufficient to cause the crisis, but in summer of 1998 they appeared simultaneously.

The most dramatic events in the banking sector took place in September, as the dynamics of the major financial indicators demonstrate (see the figures below). The analysis of the major trends in banking activities was based on calculations using the available data from all banks (notwithstanding of their licenses validity), because banks' status on was not important for the appraisal of the crisis scale on that date[50]. The number of banks fluctuated from 1741 to 1733 with the exception of the situation at end-August, when the sampling contracted to 1549 banks. This fact somewhat distorts the indicators' dynamics, but can not seriously affect major estimates since the aggregate assets of not-included banks made just above 2 per cent of the total aggregate assets of commercial banks at the brink of the crisis. The "starting point" was set at end-June of 1998. For calculations were used current and constant prices (basing on consumer price indices at mid-year), banks' balances were converted into USD as per MICEX quotations on respective dates.

[49] See details in: *Rossiyskaya ekonomika v yanvare – sentyabre 1998 goda. Tendentsii i perspektivy*. (The Russian Economy in January through September of 1998. Trends and Outlooks). Annex 1.

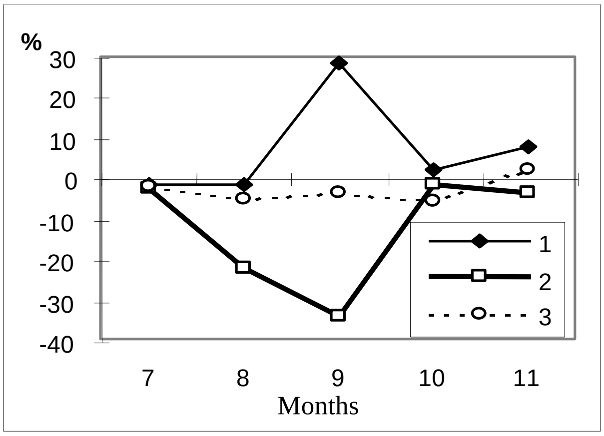
[50] Assets of banks with cancelled licenses made about 8 per cent of the total commercial banks' assets on December 1.

Bank *assets* in current prices terms increased by 38 per cent during five months of the second half-year (from 1.07 to 1.12), however the adjustment for inflation demonstrates a *decrease in assets in real terms* by 13 per cent. In the situation of destabilized macroeconomic environment bank aggregate indicators dynamics is strongly affected by Ruble exchange rates. In 5 months of the second half-year of 1998 the *assets* of Russian banks fell by about 2 times *in USD terms*. As Figure 4.2 demonstrates, the major fall occurred in August and September of 1998 (22 and 34 per cent respectively), after that the downfall sharply decelerated (-1 and –3 per cent in October and November respectively). On this background changes of assets in foreign currencies do not seem significant. As Figure 4.3 demonstrates, their maximum was observed at end-July[51], while at end-November indicators were down by 12.3 per cent; however the downfall was less than 4 per cent as compared with the situation at mid-year. On the background of general decrease in assets in USD terms the share of foreign currency assets increased by 2 times during the observed period (from 29.2 per cent at mid-year to 58.4 per cent at end-November.

[51] The July increase in bank foreign currency assets was mainly caused by the conversion of Ruble denominated FDO into Eurobonds.

Fig. 4.2

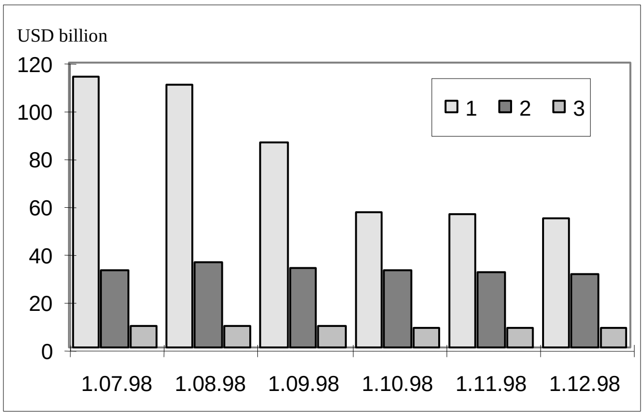
Assets Changes (in % of the previous month)



1. In current prices
2. In USD
3. In constant prices

Fig. 4.3

Assets in USD



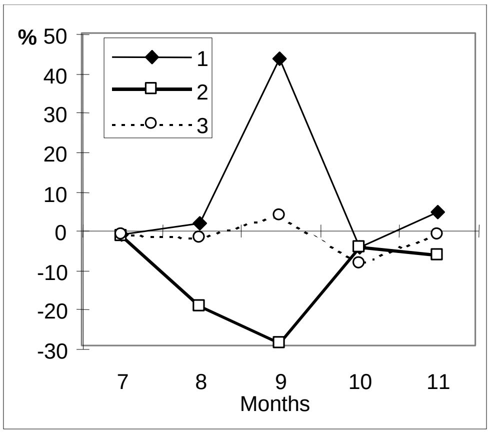
1. Assets
2. Foreign currency assets
3. Foreign assets

Credits to the non-financial sector[52] (CNFS) in USD terms mainly reflected assets dynamics (compare Figure 4.2 and Figure 4.4). The downfall was mainly caused by depreciation of Ruble credits (see Figure 4.5). In October Ruble loans fell even in current prices terms. On the whole, during 5 months the Ruble part of the loan portfolio diminished by 66 per cent in USD terms, practically coinciding with the Ruble depreciation rates. At the same time the credit portfolio deteriorated in qualitative terms: undue loans fell by 25 per cent in current prices terms and by 74 per cent in USD terms in 5 months. The low activity on CNFS credit market abated even more; this is confirmed both by the survey of industrial enterprises in November of 1998[53], and by dull dynamics of banks' interest rates on credits, and by deterioration of data (see Figures 4.6 and 4.7). As the figures demonstrate, the rates announced by banks in October through December remained the same, while the number of banks presenting the "Digest" agency with information on Ruble credits diminished to 3 and of those informing on foreign currency credits to 4. Nevertheless, the share of credits to the non-financial sector in assets somewhat increased (from 45 to 47 per cent).

[52] For calculation of this indicator interbank credits were excluded from the total amount of credits and discounted bills added notwithstanding promisors groupings by industry. Further in the text the term *loan* is used to indicate credits minus bill portfolio.
[53] See: *Banking in Moscow*, No. 1, 1999.

Fig. 4.4

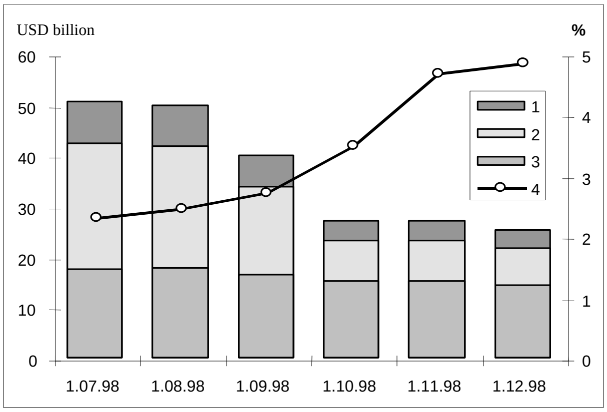
Change in Credits to NFS (in % of the previous month)



1. In current prices
2. In USD
3. In constant prices

Fig. 4.5

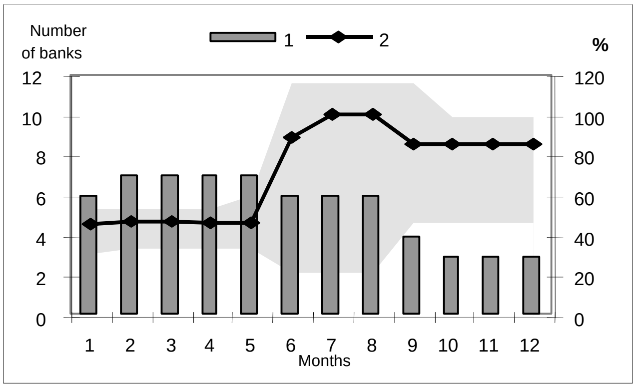
Credits, USD billion



1. Discounted bills
2. Ruble NFS loans
3.Foreign currency NFS loans
4.Outstanding NFS loans (in % of assets)

Fig. 4.6

Three-month Ruble Credit Dynamics in Moscow Banks in 1998

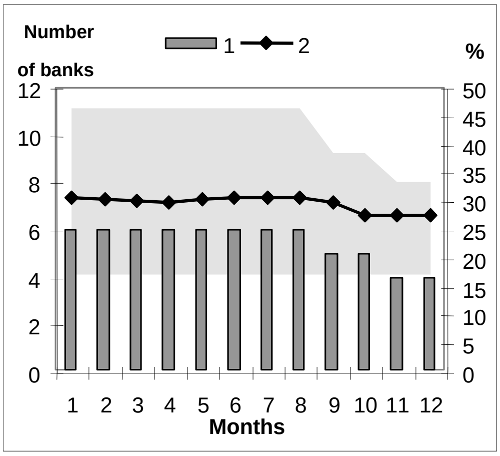


1. Number of banks (left axis)
2. Average rate (right axis, annual interest rate adjusted for reinvestment)

Note: the gray-colored area represents the spread of rates announced by banks.
Source: “Digest” Information Agency

Fig. 4.7

Three-month Foreign Currency Credit Dynamics in Moscow Banks in 1998



1. Number of banks (left axis)
2. Average rate (right axis, annual interest rate adjusted for reinvestment)

Note: the gray-colored area represents the spread of rates announced by banks.

Source: "Digest" Information Agency

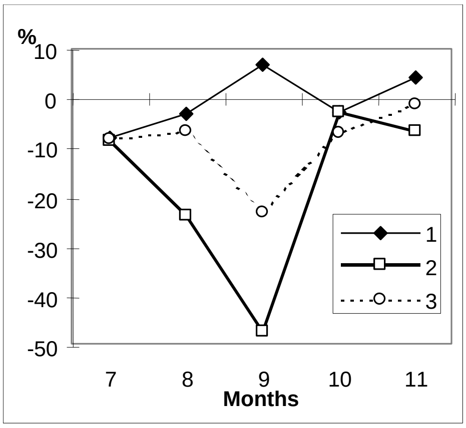
Outstanding credits increased in current prices terms, with a significant peak observed in September of 1998. In USD terms the amounts of outstanding credits are rather close as at mid-year and at end-November. The volume of *outstanding foreign currency loans* fell by 17 per cent in August of 1998; however it sharply increased in September and in November of 1998 (by 24 and 43 per cent respectively). In November the amount of outstanding foreign currency loans somewhat decreased by 3 per cent. As a result, their share in assets increased from 1 to 3 per cent in these months, while the total share of outstanding loans in assets increased from 2.3 to 4.9 per cent, or from 6.2 to 12.1 per cent of the total loan portfolio of banks included into the sampling. The currency structure of outstanding credits had changed: the share of outstanding foreign currency loans in the total outstanding loans to the non-financial sector increased from 39 to 61 per cent. Borrowers' gain from depreciation of Ruble debts is apparent, its volume is by estimate over USD 13.3 billion[54]. The banking system suffered even higher losses than that. An additional factor was the deterioration of the credit portfolio in qualitative terms. Potential losses of banks due to this may be estimated at about USD 2.5 billion basing on banks' balance sheets; the banks' credit portfolio made USD 42.6 billion in USD terms, in case outstanding credit amounts increased by 5.9 percentage points (all other conditions remaining the same) it would mean that borrowers did not repay exactly this amount (the Ruble share of the debt was converted at the mid-year exchange rate).

Aggregate securities portfolio dynamics (see Figure 4.8) were determined first of all by the events on the federal debt instruments (*Russ. abbr. FDO*) markets, since they made a major part of banks' investment into securities (see Figure 4.9). Sharp changes in their currency structure started already in July.

[54] The amount is calculated as the difference between Ruble share of the loan portfolio of the Russian banks in USD terms at Ruble exchange rate as on 1.12.1998 and as on 1.07.1998, not adjusted for potential losses from diminishing demand for credits.

Fig. 4.8

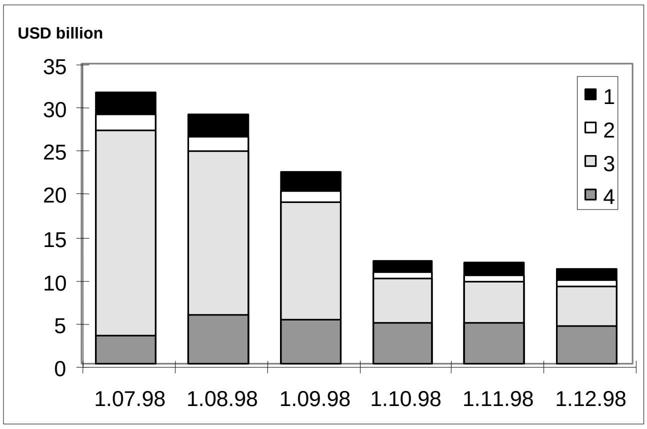
Federal Securities (in % of the previous month)



1. In current prices
2. In USD
3. In constant prices

Fig. 4.9

Securities Portfolio, USD

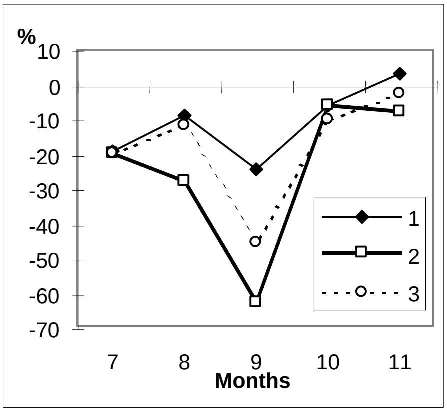


1. Other investment
2. Municipal debt instruments
3. Federal Ruble debt instruments
4. Federal foreign currency debt instruments

Ruble federal debt instruments diminished by more than 19 per cent in July of 1998 due to a partial conversion into Eurobonds and to a price fall (see Figure 4.10). The downfall made 8.6 per cent in August, the maximal decrease was registered in September (by 24.4 per cent, or by Rub. 26.7 billion). In October the rate of decrease in the Ruble section of the Federal debt instruments portfolio decelerated sharply (down to 6 per cent), in November there was registered an increase by 3.2 per cent in current prices terms, or by Rub. 2.5 billion in real terms. Thus, in the period from 1.09. to 1.11 the aggregate Ruble FDO portfolio lost over Rub. 30 billion. The aggregate Ruble FDO portfolio lost USD 8.4 billion in USD terms in 5 months, at end-November it made USD 4.5 billion at the current exchange rate, or USD 12.9 billion at the exchange rate on July 1, 1998.

Fig. 4.10

Change in Investment into Federal Ruble Securities (in % of the previous month)

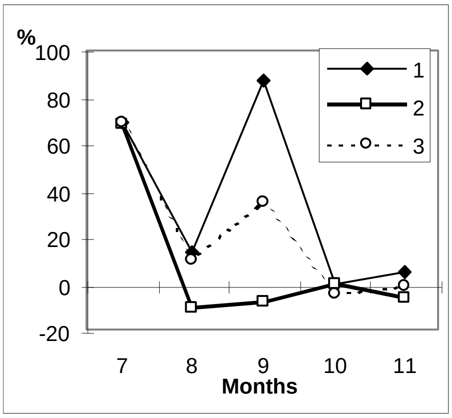


1. In current prices
2. In USD
3. In constant prices

Federal *foreign currency-denominated* debt instruments increased by 69 per cent in July of 1998 as compared with end-June figures (see Figure 4.11). Sberbank is responsible for the major share of the increase as its foreign currency FDO portfolio increased by USD 2.5 billion, while the total FDO portfolio decreased by USD 0.86 billion. In August the aggregate FDO portfolio diminished by almost 10 per cent in USD terms, in the same month the prices of the Russian foreign debt experienced a major downfall (see Figure 4.13). In September the portfolio diminished further by 7 per cent; however its value was higher than at mid-year: USD 4.7 billion on 1.12.98 as compared with USD 3.5 billion on 1.7.98. As a result the share of currency-denominated GDO (State Debt Instruments) in assets increased from 3.7 to 9.5 per cent from mid-1998 to the beginning of December, while the total share of GDO fell from 25.6 to 18.0 per cent of assets in the same period.

Fig. 4.11

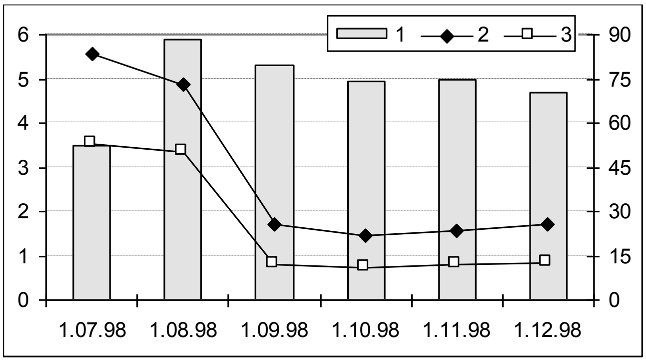
Changes in Investment into Federal Foreign Currency Securities (in % of the previous month)



1. In current prices 2. In USD 3. In constant prices

Fig. 4.12

Currency Federal Securities



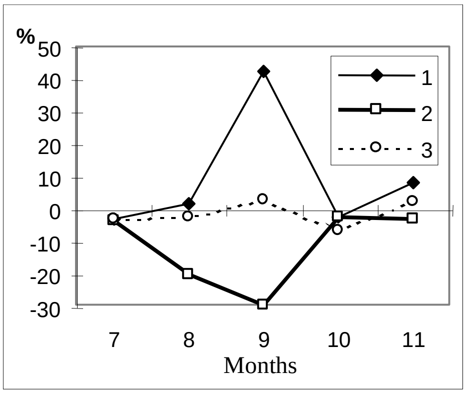
1. Currency Federal securities, USD, left axis
2. Eurobonds
3. OVVZ

Shifts in the currency structure of the FDO portfolio became an important factor in the changes of the *currency position*; while in the beginning of the year the net currency assets of Russian banks were negative and made –2.4 per cent of assets, on 1.08. they had positive values, which demonstrated later a stable tendency to growth making 8.4 per cent of assets by 1.12. Simultaneously net foreign liabilities continued to fall. As on 1.12. foreign assets were still below foreign liabilities; however, the ratio between net foreign liabilities and assets fell from 4 to 1 per cent of assets in 5 months. Such dynamics of currency position allows to come to conclusion that the banking sector fast adapts to the high inflation environment, when the positive net foreign currency assets becomes a source of revenues and a factor improving banks' financial situation.

Liabilities. The total volume of aggregated liabilities diminished by USD 45 billion (48.4 per cent) in USD terms from July 1 to December 1 of 1998. This downfall corresponded to 40 per cent of commercial banks' aggregated assets as on July 1. As Figure 4.14 demonstrates, the maximal downfall by 29.4 per cent occurred in September. *Foreign currency liabilities* also diminished, although not so significantly (by 24 per cent). The maximal downfall (by USD 3.9 billion out of USD 8.6 billion) took place in August. The maximal downfall of foreign liabilities also occurred in August (by USD 2.2 billion; the total decrease made USD 5.8 billion in 5 months, from USD 15.9 billion to USD 10.1 billion, see Figure 4.13). At the same time, the *share of obligations in liabilities* increased from 82.3 to 88.4 per cent in 5 months. The share of liabilities in foreign currency increased from 31.6 to 50.0 per cent, including an increase in foreign liabilities from 14 to 18.5 per cent. Ruble component of liabilities fell by 63.6 per cent in USD terms in 5 months. This approximately corresponds to the Ruble depreciation rate against USD in this period (by 65 per cent). Changes in liabilities structure as broken down by basic instruments see in Figure 4.14. The share of deposits has changed most significantly. The share of deposits in the balance fell by 6.1 percentage points, from 30.6 per cent at mid-year to 24.5 per cent as on 1.12. The share of bank funds increased the most, first of all, the share of interbank credits.

Fig. 4.13

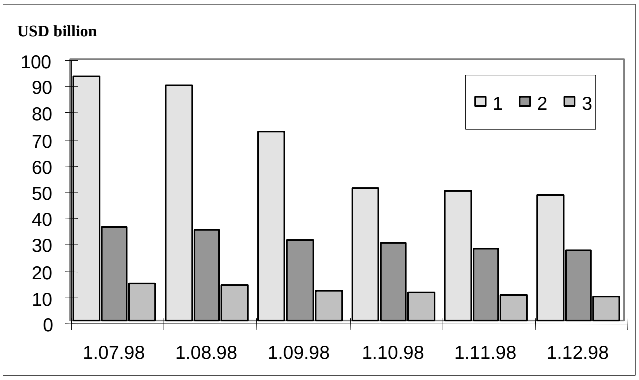
Changes in liabilities (in % of the previous month)



1. In current prices
2. In USD
3. In constant prices

Fig. 4.14

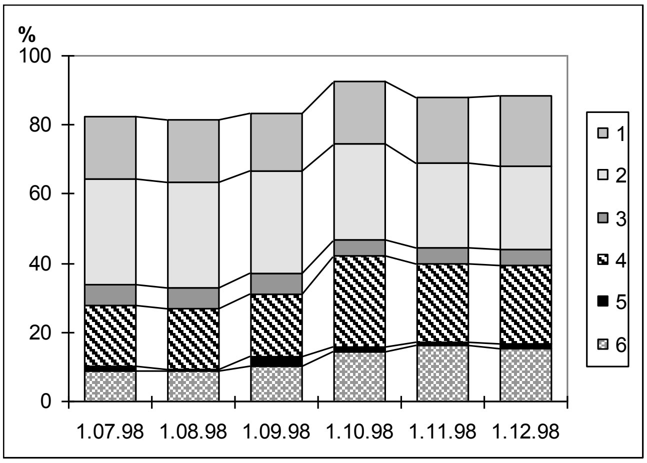
Liabilities (USD)



1. Liabilities
2. Foreign currency liabilities
3. Foreign liabilities

Fig. 4.15

Liabilities Structure (in % of assets)

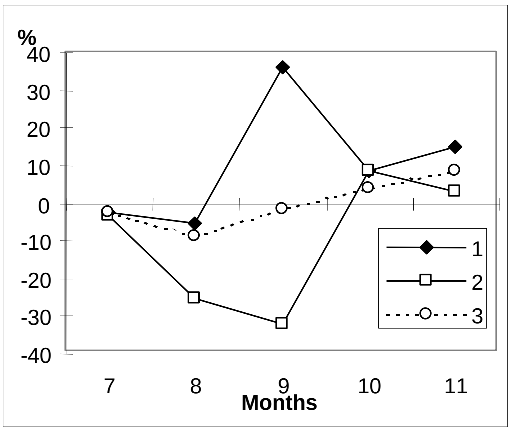


1. Clients' transaction accounts
2. Deposits
3. Debt instruments
4. Banks' funds
5. CBR credits
6. Other liabilities

Clients' *transaction accounts*[55] (see Figures 4.16 – 18). The total amount of the rest balance in clients' transaction accounts fell from USD 20.5 to 11.0 billion in USD terms, or by 47 per cent in 5 months (see Figure 4.16). By our estimate about USD 0.5 billion remained in banks with cancelled licenses as on 1.12.98. The most profound decrease in clients' means in their accounts was registered in August and September of 1998. In October there was registered an increase by USD 0.8 billion.

Fig. 4.16

Changes in Clients' Transaction Accounts
(in % of the previous month)

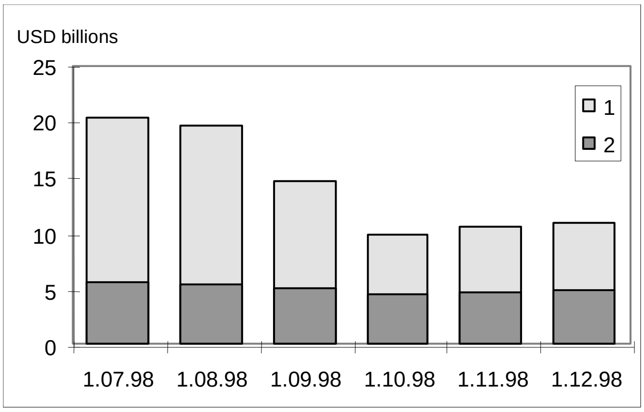


1. In current prices
2. In USD
3. In constant prices

[55] Excluding bank correspondent accounts.

Fig. 4.17

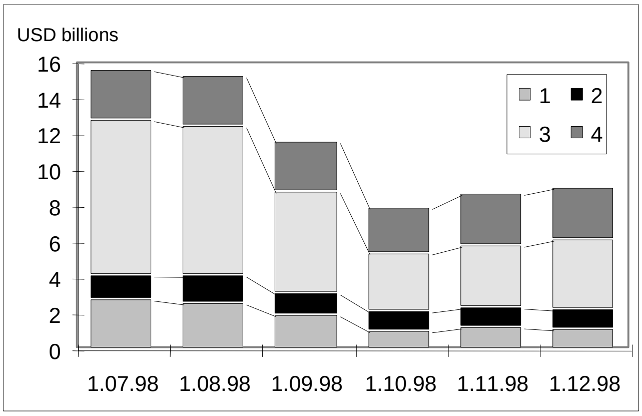
Clients' Transaction Accounts (USD billion)



1. Clients' transaction accounts in Rubles
2. Clients' transaction accounts in foreign currency

Fig. 4.18

Enterprises' Transaction Accounts (USD billion)



1. State enterprises' transaction accounts in Rubles
2. State enterprises' transaction accounts in foreign currency
3. Non-state enterprises' transaction accounts in Rubles
4. Non-state enterprises' transaction accounts in foreign currency

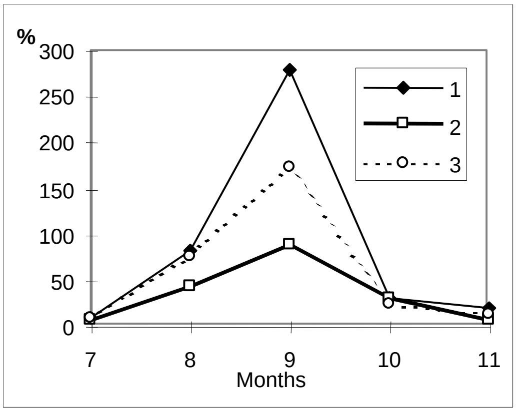
The rest balances in the clients' transaction accounts *in foreign currency* diminished less significantly – from USD 5.7 billion to

USD 4.9 billion or by 14 per cent in 5 months. In November of 1998 there were no registered outflow of foreign currency funds from accounts, although the moratorium for foreign payments was cancelled. The foreign currency rest balances in accounts of budgetary and extra-budgetary funds, as well as of state enterprises, diminished; however, this decrease was compensated by an increase of means in accounts of non-state enterprises (see Figure 4.18).

The clients' unpaid documents amount increased from 0.3 to 2.5 per cent of liabilities. The overwhelming majority of unpaid documents were connected with Ruble payments, payment arrears increases in banks decelerate only in November when the increase made only 6.1 per cent in USD terms after showing two-digit figures for 3 months (see Figure 4.18).

Fig. 4.19

Changes in Clients' Unpaid Payment Documents (in % of the previous month)



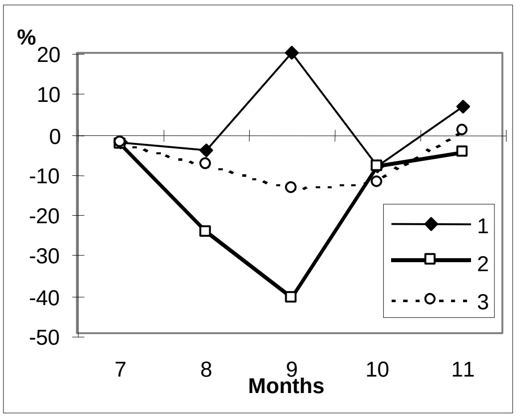
1. In current prices
2. In USD
3. In constant prices

Deposits (see Figures 4.20 – 24). The total deposits diminished by USD 21.5 billion, or by 61.5 per cent, in USD terms in 5 months. Deposits of individuals fell from USD 30.1 to USD 10.1 billion, including *Ruble deposits* – from USD 24.6 to USD 7.0 billion, *foreign currency deposits* – from USD 5.4 to USD 3.1 billion in the same period (see Figure 4.20). As Figure 4.21 demonstrates the net outflow of funds from Ruble deposits in current prices terms continued until October and was apparently renewed in December when Sberbank made major payments to depositors of Most-bank, Mosbusinesbank, Promstroibank, MENATEP, and SBS-AGRO[56]. The Sberbank's share in the total individuals Ruble deposits was over 85 per cent by end-year as compared with 79 per cent at mid-1998. From the total decrease in the USD equivalent of Ruble deposits about 91 per cent were caused by deposit depreciation and about 9 per cent by direct outflows. *Foreign currency deposits* continued to decrease during the whole period. At the same time, the potential outflow amount was, undoubtedly, much higher. Far from all banks, which did not participate in the transfer of deposits into Sberbank, could meet their commitments to their clients in full. The same may be said about the deposits, which remained in largest banks. At last, 3.4 per cent of the total deposits made by individuals remained in banks whose licenses were cancelled as at mid-November. It becomes very difficult to attract new clients in such circumstances; the data on deposit rates becomes rather scarce (see Figures 4.23 and 24). The composition of Moscow banks included into the sampling in order to follow the deposit rates undergoes profound changes as compared with the sampling made in the beginning of the year. Now there prevail banks of the second and third echelons.

[56] As per PRIME-TASS information almost 350,000 depositors transferred deposits from Most-bank, Mosbusinesbank, Promstroibank, MENATEP, and SBS-AGRO to Sberbank as on January 5, 1999. The total liabilities of Sberbank for these deposits made Rub. 4.42 billion. From this amount 77.3 per cent were paid in cash and re-deposited in other forms in Sberbank.

Fig. 4.20

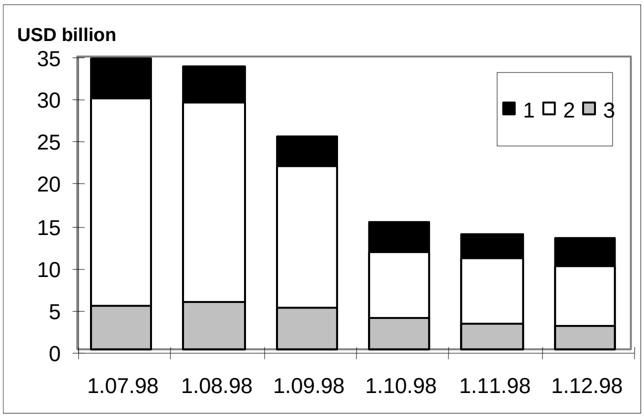
Changes in Deposits (in % of the previous month)



1. In current prices
2. In USD
3. In constant prices

Fig. 4.21

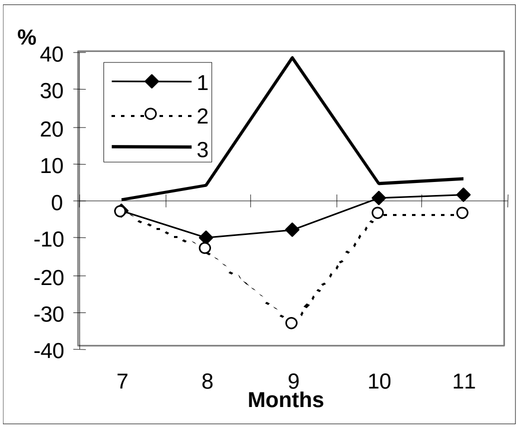
Deposits (USD)



1. Legal entities' deposits
2. Individuals' Ruble deposits
3. Individuals' foreign currency deposits

Fig. 4.22

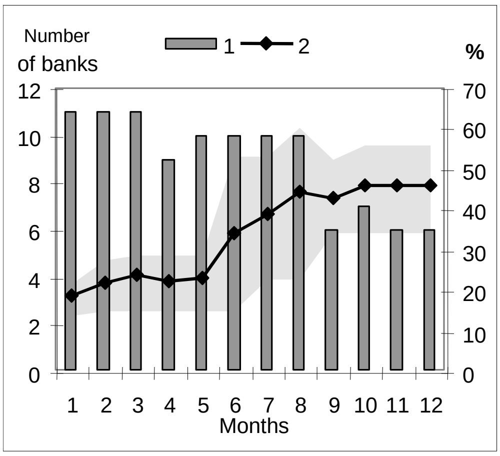
Changes in Individuals' Ruble Deposits (in % of the previous month)



1. In current prices
2. In constant prices
3. Inflation rates

Fig. 4.23

Dynamics of Ruble Deposit Rates for Individuals in Moscow Banks in 1998

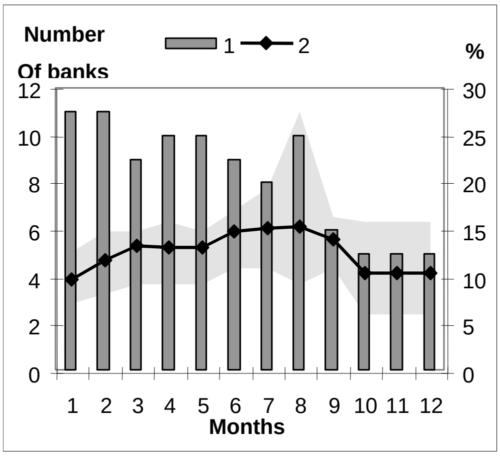


1. Number of banks (left axis)
2. Average rate (right axis, annual interest rate adjusted for reinvestment)

Note: as per MFD-Infotsentr data December rates did not significantly change as compared to November; the gray-colored area represents the spread of rates announced by banks.
Source: Kommersant, MFD-Infotsentr

Fig. 4.24

Dynamics of Foreign Currency Deposit Rates for Individuals in Moscow Banks in 1998



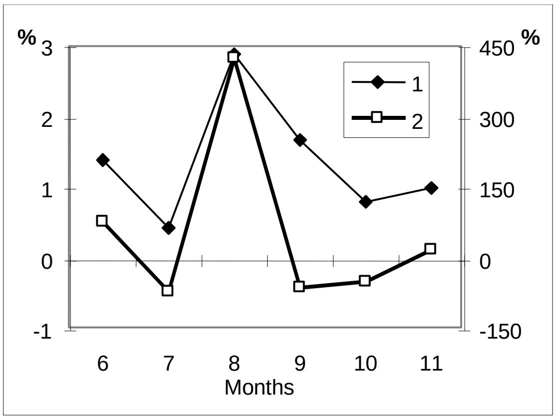
1. Number of banks (left axis)
2. Average rate (right axis, annual interest rate adjusted for reinvestment)

Note: as per MFD-Infotsentr data December rates did not significantly change as compared to November; the gray-colored area represents the spread of rates announced by banks.
Source: Kommersant, MFD-Infotsentr

CBR credits did not reach large amounts on reporting dates. Their share fluctuated at 0.5 to 3 per cent of the commercial banks' aggregated assets. The maximal amount was registered at USD 2.5 billion on September 1, 1998 (see Figure 4.25).

Fig. 4.25

CBR Credits

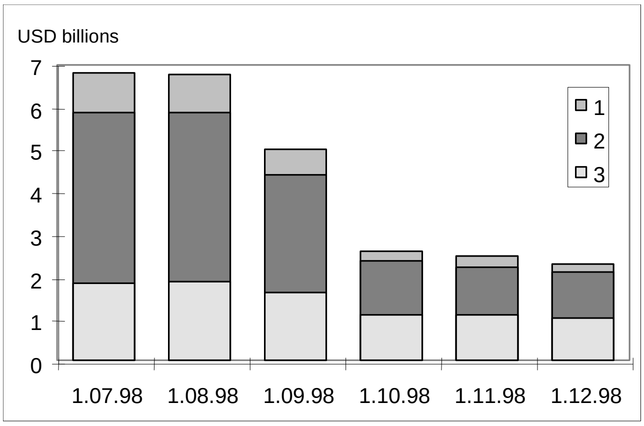


1. CBR credits, in % of assets (left axis)
2. Changes in CBR credits, in % off the previous month, USD (right axis)

Internal debt instruments. Among such instruments Russian banks preferred Ruble bills. It came as no surprise that this type of debt instruments depreciated the most in USD terms. The total amount of bills fell from USD 5.0 to USD 2.1 billion in USD terms, including a decrease in the amount of Ruble denominated bills form USD 4.0 to USD 1.1 billion (see Figure 4.26). The share of market debt instruments in assets fell from 6.0 to 4.2 per cent, including a decrease in the amount of bills from 5.2 to 3.9 per cent caused by a sharp contraction of USD equivalent of Ruble denominated instruments.

Fig. 4.26

Market Debt Instruments (USD billion)



1. Other market debt liabilities
2. Bills in Rubles
3. Bills in foreign currency

Interbank credits of non-residents. The total amount of liabilities to non-residents for interbank credits and other liabilities reflected in balance sheets in the same accounts decreased from USD 12.2 to USD 8.8 billion in 5 months, including a decrease by USD 435 million registered in November. At the same time outstanding interbank credits increased from USD 2 to USD 870 million, i.e. by 430 times. Banks have managed to restructure a part of the indebtedness; however the problem is far from a complete solution. The evidence of this is arrests of foreign assets of some largest Russian banks. As per CBR information, only 30 largest banks should have paid to non-residents for interbank credits and attracted deposits Rub. 27 billion in November and Rub. 16.8 billion in December of 1998[57] (USD 2.7 billion at the exchange rate in the beginning of November).

Capital. Defaults on terminally contracted liabilities and other peculiarities of bank operations' reflection in financial accounting

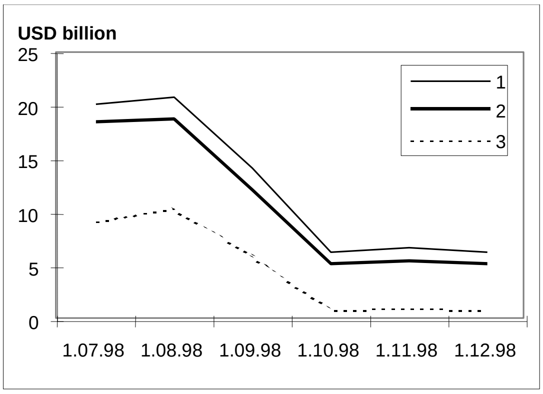
[57] *Vestnik Banka Rossii* (Bulletin of the Bank of Russia), No. 1, 1999.

led to positive values of the aggregated banking system capital in the observed period (see Figure 4.26). As per our estimates the *balance capital* diminished from USD 20.1 to USD 6.4 billion. The major downfall occurred in the period before October 1, 1998, after that capital amount in USD terms stabilized. A decrease in capital calculated in accordance with the CBR Instruction No.1 made more than USD 13 billion, from USD 18.5 to USD 5.3 billion. Capital calculated in accordance with the Basle Committee (BC) recommendations fell by approximately same amount, from USD 17.3 to USD 3.8 billion that leading to a decrease in the coefficient of capital adequacy to 7 – 9 per cent of assets as on December 1, 1998. Formally this level is not critical, although several dozens of banks even by such appraisal are insolvent and should be either denied the right to conduct banking operations, or re-capitalized. However, this appraisal does not take into account a high level and dynamics of assets' immobilization in the Russian banking system. Capital amounts adjusted by *fixed capital investment* according to the Basle Committee's method decreases from USD 9.1 to USD 0.9 billion[58], or down to 1.7 per cent of assets in 5 months. If the Ruble FDO portfolio, which had lost its liquidity, is taken into account, capital amount becomes negative (see Figure 4.27). This appraisal may be only of very approximate character since because of the stopped trading FDO in bank portfolios were not revalued.

[58] Down to USD 1.7 billion in case only banks operating on 1.12 are included.

Fig. 4.27

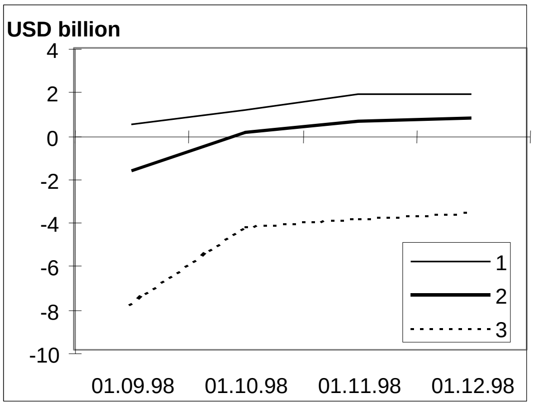
Capital (USD)



1. Balance capital
2. Capital as per CBR Instruction No. 1
3. Capital as per the Basle Committee method minus fixed capital investment

Fig. 4.28

Capital Minus Ruble Investment into FDO (USD)

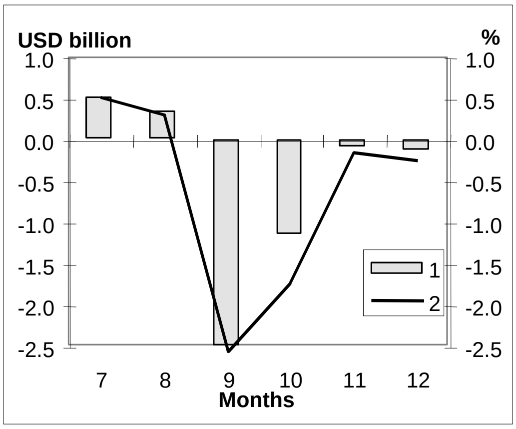


1. Balance capital
2. Capital as per CBR Instruction No. 1
3. Capital as per the Basle Committee method minus fixed capital investment

For the first time in recent years the banking sector suffered losses as per year's results. Banks' *losses* made 3.3 per cent of assets or 3.6 per cent in annual terms in 11 months. Monthly dynamics of this indicator see in Figure 4.29.

Fig. 4.29

Monthly Profits



1. Monthly profits, USD
2. Monthly profits in % of assets (right axis)