



NEWSLETTER

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E.T. GAIDAR'S PRESS CONFERENCE



E.T. Gaidar, Director of the Institute for the Economy in Transition (IET), held a press conference on **April 7, 2004**. E.T. Gaidar presented IET's annual review –

Russian Economy in 2003: Trends and Outlooks – at the press conference. In his assessment of the previous year period and the current period of the Russian Economy's development as a whole he said:

The year 2003 appears to represent a turning point. Yet, one should be extremely careful in stating it, since it is not only accelerated growth itself but also a combination of such parameters as sharp investment take-off, rapid growth in manufacturing of engineering products, sharp increase in engineering imports, rapid growth in engineering exports that are associated with transition to investment growth. They were quite noticeable in 2003 and in the early months of 2004 according to the statistics. It seems that the turning point has been achieved. There is no telling how sustainable it will be, but it seems to be the most significant event among those occurred.

Obviously, the key issue of the current period is prospects of the second cycle of structural economic reforms to be implemented after reelection of the President. Specific features of Vladimir Putin's reelection should be taken into account. He enjoys an unprecedented freedom of political maneuvering, which is beyond measure against the first period of his presidency. At the same time, if the second presidency is his last one, I believe that he is quite sincere about his intention not to amend the current Constitution, then one should realize that this period is relatively short. Because the second presidency will inevitably be associated with resolving political problems, including the issue of a successor to the presidency. This means that a lot can be done, but for a short-term period.

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In 2002, it was time that played a key role in success of the reforms. They were concentrated within 100 days, 75 to be more exact, of presidency. The key documents were submitted to the State Duma the day after Mikhail Kasiyanov was appointed in the government. The first 100 days are extremely significant under the second term of presidency. The change of the government prior to the presidential elections was aimed, as they explained it, to make the most of the very first months of presidency. It remains to be seen whether they succeed or not.

For the time being, the first of those reforms that are likely to be implemented are continuation of the reforms in taxation. It is most simple task, because these reforms could be continued mechanically. I think that a fairly balanced and effective decision has been developed. While during the first presidency the emphasis was made on tax reform, today we have approached a budget expenditures reform, which previously was almost untouched. We have learned to properly collect taxes, but we still have no idea, we do in fact only on paper, on what we actually spend budgetary funds. Presumably, the core of the

next cycle's reforms will be rearrangement of budget-funded entities' organizational structure itself, reforms in financing system of education and health care, as well as elimination of unfunded mandates – in combination with mortgage and military reform.

There is a fundamental problem. There are simple reforms which can be implemented through nothing but a political will. Say, it takes two hours plus a political will to repeal Law 51, which we used to suspend in the budget for many years, if it can not be funded. On the other hand, there are technically sophisticated laws, likewise reforms. It is reasonable to implement a medicine financing reform, which is a technically difficult task. I feel that today there will be no problem with implementing simple reforms, while sophisticated reforms are beginning to slow-down, especially at the background of the changed government, and we are beginning to lose time.

Then E.T. Gaidar answered the questions.

RUSSIAN ECONOMY IN 2003: TRENDS AND OUTLOOKS ANNUAL REVIEW



A conservative hypothesis of the beginning of transition to a new economic growth model – from reconstruction to investment – can be advanced according to last year.

The review includes a detailed analysis of basic trends in the Russian economy in

2003. The review is broken down into four big sections dedicated to various aspects of economic development in Russia, namely social and political background; monetary policy and budget; real sector of the economy; institutional and microeconomic issues. The review is based upon a big statistic data file supported by original estimation and numerous graphic illustrations.

SOCIAL AND POLITICAL BACKGROUND

Economic situation in Russia was quite favorable in 2003. Three factors which governed the stance of the Russian economic policy last year can be distinguished.

First, *continuing economic growth accompanied by a sharp investment take-off*. The basic condition of this factor is represented by increased growth rates since 2000, i.e. the downward trend was curbed.

Second, *favorable economic conditions*. Prices of basic Russian export goods remained high, with prices of energy resources kept up in spite of unstable political situation in the world. The currency situation was found quite favorable too: the ruble gained minimum (only by 2%) against the key importers' currency with substantial decrease in real and nominal USD exchange rate, which restrained competitive pressure upon domestic manufactures.

Third, *aggravation of political struggle spurred at the background of a favorable economic situation*.

Its specific character was only partly determined by presidential elections in 2003. Major political battles were associated not only with electoral cycle but also the logic of post-revolution stabilization in the cleaved society in which basic social groups just started to approach each other in terms of their positions.

The most significant event of the pre-election period was the case with YUKOS oil company. The case was caused not only by M. Khodorkovsky's political activity, who expressed almost avowedly his ambitions with relation to the State Duma and the executive authorities. These ambitions just promoted the course aimed at forced partition of the politics and the business, thus keeping the latter at a distance, out of politics and under the government's control. This event will have a long-term complex impact upon economic processes.

Economic growth issues remained topical for economic and political discussion in 2003. This was promoted by the President in his Message to the Federal Assembly on GDP doubling within 10 consecutive years, which caused a discussion on feasibility and expediency of such goal.

A conservative hypothesis of the beginning of transition to a new economic growth model – from reconstruction to investment – can be advanced according to last year. The year 2003 is distinguished by not only GDP's growth rates (from 4.7 to 7.3%), but also a take-off in investment volume (from 2.6 to 12.5%), as compared to 2002. It is too soon, however, to make final conclusions on the new model of economic growth: structural consequences of the investment boom are unobvious; keeping high prices of the basic Russian export goods hampers objectively structural reforms in the domestic economy; stability of the new trend in investment growth depends on political conditions and, above all, ability of the government to create favorable conditions for both foreign and domestic investors, the latter still remains undetermined. Thus, *the transition from reconstruction growth to investment growth is quite vulnerable*.

Economic policy efficiency depends largely upon efficiency of the decisions made by the govern-

ment. Therefore, administrative reform becomes one of the national policy's guidelines. There two specific features pertaining to the issue of administrative reform, which make the reform substantially complicated. First, a long-term period is required to implement the reform. Second, administrative reform should be implemented by the state machine itself, i.e. by those who are involved most in the reform. At the same time, it would be wrong to reduce the administrative reform to rearrangement of the executive power structure and the number of ministries and departments. This reform is a comprehensive task including solution of a variety of serious tasks.

Summing up the results of 2003 is meant to set priorities not only for the next year but also a long-term period, next political cycle. Among the key issues in promotion of economic reforms for a medium-term period are as follows:

- implement administrative reform as a general condition of state administration efficiency upgrading, including economic policy itself;
- complete conceptual development and commence a large-scale budget reform, gradual transition to a medium-term budgeting;
- update the concept of eliminating the Russian economy's dependence on raw-materials and transform it into a system of corresponding package of measures;
- upgrade the system of medical insurance and restructure the health care system;
- marked advancing in the military reform, primarily in terms of principles of recruitment of the armed forces;
- continue the natural monopolies reform;
- complete negotiations of Russia's accession to the WTO and adopt the required laws;
- develop a regulatory and legal framework and upgrade efficiency of financial institutions, continue the banking reform with a view to improving reliability of the banking system;
- adjust the EC policy allowing for the fact that the EC is a primary foreign economic partner of Russia.

MONETARY POLICY AND BUDGET

Monetary and Exchange Policy

The monetary situation in 2003 was stable and quiet enough. It was for the first time during the entire post-crisis period that consumer price growth did not exceed the estimates of the Government of the Russian Federation in developing basic parameters

of the federal budget 2003 (in 2003 the consumer price index accounted for 12%, which is by 3.1 percentage points lower than in 2002).

Most significant changes in 2003 took place in the currency policy and the balance of payments of the Russian Federation. First, early in 2003, the management of the Bank of Russia announced actually a shift in priorities of the existing monetary policy: The Central Bank of the Russian Federation changed the priority of maintaining the ruble exchange rate with inflation rate monitoring. Second, a redraft of the Federal Law «On Currency Exchange Regulation and Exchange Controls» was adopted in 2003 and took effect on January 1, 2004 (except for some articles). Third, the maintained huge surplus on current accounts (\$39,1 bln US dollars, or by 32.5% higher as compared to 2002) was accompanied by a surplus on capital transactions at the private sector within two quarters last year. All these factors led to a substantial nominal strengthening of the USD/RUR exchange rate, however, the real ruble effective exchange rate (against the basket of currencies) grew insignificantly due to a weak US dollar at the global foreign exchange markets. In addition, the economy underwent dedollarization in 2003.

The reduction of inflation down to 8 to 10% is specified as the main objective in «The Monetary Policy Guidelines in 2004» adopted by the Bank of Russia and the Government of the Russian Federation and approved by the State Duma of the Russian Federation. The Guidelines includes two versions of monetary program for 2004, one of which is based on Urals oil price to the amount of \$18,5 US dollars per barrel, and the second, \$22 US dollars per barrel. Accordingly, the Central Bank of the Russian Federation estimates the money supply growth (M_2) at the level of 19 to 20% for the first scenario and 25% for the second one.

National Budget

A favorable movement in prices of the traditional Russian export goods – crude oil, natural gas, nonferrous metals and lumber – after 1999 was one of the most significant factors that had a positive impact on budget revenues. It should be noted that prices of export raw materials have impact on budget revenues not only directly through the growth of corresponding tax revenues (export duties, mineral tax, petroleum product taxes), but also a general growth in composite demand leading to a growth in income tax and profit tax bases.

Another significant factor, which also had a positive impact on budget revenues inflow, was improved financial situation at inland enterprises due to production recovery encouraged by import-substitution processes and internal demand growth.

Among other factors which had a positive impact on budget revenues are also actions taken by the executive authority: (1) reduction of the accumulated tax arrears, which was supported by a favorable internal economic situation on the one hand, and adoption of the first part of the Tax Code on the other hand; (2) enhanced measures aimed at raising non-tax revenues, primarily those related to the usage of public and municipal property, as well as accounting extra-budgetary revenues of state-owned organizations as part of the budgetary revenues. In general, tax reform became one of the most serious and profound reforms implemented in the post-crisis period.

A variety of amendments to the tax law came into force in 2003 in accordance with the decisions made in 2002. Among the most significant amendments were new chapters to the Tax Code in relation to small business taxation, final repeal of the road tax and introduction of a car tax, as well as changes in the payment procedure of petroleum products tax (introduction of the institution of registration of those who carry out transactions with petroleum products).

As a result of all the amendments made to the Federal Budget's Revenues Law for 2004, the federal budget 2004 lost nearly 81,6 bln rubles as compared to 2003, according to the estimate of the Ministry of Finance. The losses are to be compensated by improving tax payment administration, especially by further reducing tax arrears and implementing measures on tax arrears restructuring, as well as optimizing administration of state-owned property.

The federal budget expenditures for 2004 are scheduled at 17.38% of the GDP with the GDP estimated to the amount of 15,3 trillion rubles. At the same time, 438,2 bln rubles (16.48% of the total expenditures) will be transferred to the Pension Fund of the Russian Federation to pay basic labor pensions, 287,5 bln rubles of interest revenues and 1,9 trillion rubles of non-interest expenditures (10.81 and 72.71% correspondingly). Judicial reform, law enforcement and national security, education, health care and science were marked out as priority items of financing.

Intergovernmental Relations and Subnational Finances

Among the most significant events that took place in 2003 in terms of fiscal federalism is the two basic laws that were approved by the State Duma and came into force as a result of the work performed by the Commission under the auspices of the President of the Russian Federation, which was intended to make proposals on delimitation of subjects and authorities between federal government agencies, government authorities of constituent entities of the Russian Federation and local government authorities. The case in point is a redraft of the Federal Law «On general Principles of Local Self-Government in the Russian Federation», as well as a law on amendments to the Federal Law «On General Principles of Organization of Legislative (Representative) and Executive Bodies at Constituent Entities of the Russian Federation». Full-scale implementation of the new principles of federal relations, including fiscal ones, will allow intergovernmental relations and subnational finances to be rearranged substantially within a medium-term period.

In addition, the measures taken in the course of tax reform can have a significant impact on the budget system at regional and local levels. The case in point is the repeal of sales tax and compensation measures for the lost regional budgets revenues due to the foregoing legislative decision, as well as adoption of a new Tax Code chapter specifying the construction of corporate property tax which is one of the most significant regional taxes. Both legislative decisions came into force on January 1, 2004.

Russian Financial Markets

In 2003, the Russian Federation's internal debt in securities grew approximately by 1.4%, from 654,7 to 663,7 bln rubles (the debt decreased from 6% to 5% of the GDP); 97.8% of the government debt is represented as federal loan bonds. Again, last year saw a considerable decline in earnings in the ruble government debt market: over the year the earnings dropped from 12% to 7–8% annualized, with occasional decrease to 5%. In addition, a substantial yield decline was noted for all traded instruments in the Russian eurobond market during the year.

Most significant positive factors in the current year are government's adherence to the course of political and economic reforms; the steps taken towards solution of the key problems, especially liberalization of the market of goods and services and

natural monopolies' services; stable macroeconomic figures and positive economic growth rates; as well as upgraded investment sovereign rating on Russia. Most significant negative factors are the conflict between the government and YUKOS oil company, which reminded foreign investors of high political risks in investing in Russian assets.

In 2003, regions ran their consolidated budget with the deficit of 50 bln rubles, i.e. 2.6% of budget expenditures, or 0.38% of the GDP. The constituent entities of the Russian Federation ran their budgets with the deficit of nearly 33,9 bln rubles (2.3% of budget expenditures), municipalities ran their budgets with the deficit of 27,4 bln rubles (3.2% of budget expenditures).

In 2003, bonded loans of 23 constituent entities of the Russian Federation and 7 municipalities (as compared to 20 regional and 5 municipal loans in 2002) were registered. The total volume of placed bonds accounted for 67,1 bln rubles in 2003 as compared to 29,1 bln rubles in 2002, thus increasing from 0.27 to 0.46% of the GDP. Out of the total volume (48,7 bln rubles) of net borrowings at territories in 2003, 41,9 bln rubles (86%) was responsible for the growth in net borrowings in the securities market.

In 2003, the Russian stock market regained upward trends. Among the main factors were high macroeconomic figures showing stabilization of the Russian economy, favorable situation with the volume of liquid funds at the banking sector conditioned by high prices of crude oil and petroleum products in the global markets, as well as the RF Central Bank's transactions aimed at stabilizing the national currency exchange rate, and newly upgraded investment rating on Russia. At the same time, in spite of reduced macroeconomic risks, the events that took place in 2003 revealed increased political risks in investment in Russian assets. This was testified mainly by development of the conflict between the government authorities and YUKOS oil company, as well as the outcome of the parliamentary elections, which revealed that democrats failed to collect the minimum limit of votes to be able to be elected to the State Duma of the Russian Federation.

All Russian blue chips gained a considerable increase in market value over the year. Top yield was achieved by the shares of the GMK Norilsky Nickel with the growth accounted for 220.38% (21.97% in 2002), Mosenergo with 114.79% (-17.07% in 2002) and RAO Unified Energy System of Russia with 112.36% (-20.87% in 2002).

REAL SECTOR OF THE ECONOMY

Production Macrostructure

The period between 1999 and 2003 was distinguished by dynamic growth in all sectors and industries of the economy. Economic upturn took place at the background of favorable foreign economic conditions and internal stability in social and political spheres. The GDP grew by 37.5% over the last five years and in 2003 accounted for almost 80% of the 1990's level against the maximum 57.7% drop in 1998. The reconstruction economic growth was characterized by outstripping investment growth as compared to production and consumption behavior. The scale of capital investment in the economy in whole increased nearly by 1,55 times over the same period with the 26.6% increase in final consumption. Expanded investment demand had a most significant impact on the features of structural changes of manufactured and consumed GDP.

A comparative analysis of the annual macroeconomic indicators movement reveals fairly substantial variations in rates by economic sector depending upon the specific factors' impact and development conditions in a particular period. Simultaneous expansion of internal and external demand was a brand new specific feature of the reconstruction growth in the Russian economy between 1999 and 2003.

Market behavior in Russia and other countries encouraged recovery of transformation processes of export revenues into internal market expansion. Intensive growth in investment demand since the beginning of 2003 began to have a dominant impact on the Russian economy's behavior and structure. The share of capital investments in the GDP in 2003 exceeded the average level by 1 percentage point and accounted for 16.4% in the period between 1999 and 2002. The increase in effective demand of the population was satisfied by imported and domestic goods nearly in equal shares.

The volume of GDP in 2003 accounted for 13,3 trillion rubles and exceeded that of the previous year by 7.3%. Growth rates were accelerated at the background of outstripping movement of the foreign trade turnover (the increase by nearly 60% in the GDP in 2003 was associated with internal factors, namely growth in capital investments and earnings of the population, as well as a 30% increase in average annual price of Russian oil in the world market).

A qualitative feature of the Russian economy in 2003 was transformation to the investment mod-

el of growth, which was supported by an upward trend in labor productivity and transformational changes in the employment and labor demand pattern. Labor productivity increased nearly by 8% in the 1st and 3rd quarters of 2003, with this parameter varied within 0.2% (1st quarter) and 3.6% (4th quarter) during 2002. Labor demand was deteriorated at the background of a considerable increase in profits of enterprises and growth in their investment activity.

In 2003, the Russian economy developed under the influence of the most significant factors as follows:

- increased influence of external demand and substantial contribution of the fuel industry to the industrial boom;
- accelerated growth in import of final consumption goods against internal demand;
- outstripping growth of capital investments against GDP behavior and final demand;
- intensive growth in services sector;
- approximation of real wages and labor productivity;
- sustained high consumer demand at the background of the population's propensity to save;
- disinflation accompanied by a tendency for the ruble strengthening and growth in money supply.

Industrial Environment

The last few months of 2002 were found difficult for the Russian industry. In November, consumer demand ceased to grow. Eventually, sales rates declined from +15% to -22% (according to a book) in the period between October 2002 and January 2003. The beginning of 2003 did not appear to be optimistic, however, the situation began to recover as early as February. All industries demonstrated growth in money sales, except for light industry, food-processing industry, electric power industry and construction industry. Obviously, the decline in power supply and construction industries had a seasonal nature. This infused hope into enterprises that the severe situation of the first half of the previous year would not reoccur. Therefore, consumer demand estimates increased instantly by 16 percentage points. No such optimistic forecast was ever registered either before or after February 2003. The ensuing months rather proved these forecasts than not. However, the year-end was distinguished by an absolute reduction in sales and sag.

The Russian industry is still running short of non-monetary transactions under the conditions of

capacity redundancy and unstable money sales. Enterprises believe that barter, veksel deals and netting are required in big volumes. And, no fundamental changes in this opinion were noticed for this last year. The lack of barter, veksel deals and netting was recorded in almost all industries during the polls conducted in 2003. However, non-monetary settlements are losing its former role in the Russian industry. In 2003, the estimated share of cash amounted to the average of 83%, 6% of barter, and 9% of veksel and netting. Electric power industry was leading in cash settlements as before by collecting 92% of cash payments on average. The second after electric power industry were ferrous metallurgy and food-processing industry (89% and 88% correspondingly). The third were light industry, chemistry and petroleum chemistry (86% and 85% correspondingly). Enterprises of construction material industry received a minimum cash (77%) in 2003, with barter's share accounted for 11%, as did veksel and netting.

2003 became another year of Russian industry's progressive advance under the escalation of competitive struggle. This conclusion of all others was made on the basis of key competition indicators being monitored by the IET. The monitoring is based upon regular polling of managers at enterprises on competition problems. First, the share of competitive markets increased (internal competition in Russia was perfectly evident, which was represented by 91% of markets in 2003 against 76% in 1995 and 60% in July 1998, according to the estimates made at enterprises). Therefore, imports in 2003 exceeded the level of 1998. However, it did not lead to catastrophic consequences whatsoever for the domestic industry. Second, in general, Russian enterprises are facing the strongest competition mostly from their domestic counterparts. Competition with foreign manufacturers is outshone by inland competition between Russian enterprises. The aggregate ratings of competition with foreign manufacturers were downgraded below «weak», while they did not reach the pre-crisis record. The aggregate ratings of inland competition between Russian enterprises are getting closer to «moderate». The absolute level of competition in the entire industry remains low.

Investment Processes

The reconstruction growth of the Russian economy is distinguished by a growth in investment demand. There was noted a tendency for outstripping growth in capital investments as compared to GDP

behavior and product release of primary industries of the economy throughout the entire period between 2000 and 2003. In 2003, the share of capital investments in the GDP increased up to 16.4% against the average of 14.9% over the period between 1998 and 1999. The tendency was supported by increase in internal demand, sustained high production profitability, and growth retardation of prices of manufacturers in industry and construction. The volume of capital investments from all sources of financing totaled nearly 2,2 trillion rubles, or 112.5% as compared to the level of 2002.

Growth in economic revenues, personal savings and banking sector had a positive impact on the development pattern, and enabled the downward tendency for investment activity, which developed between 2001 and 2002, to be overcome.

A shift from capital investment financing with own funds of enterprises and organizations to a more efficient use of borrowed funds became a fundamentally new aspect of the economic growth. This is a prominent example of qualitative changes in the development of investment mechanism oriented to simplification of investment resources flows. In 2003, the share of own funds of enterprises accounted for 45.6% of the total capital investment volume against 47.7% in 2000 which saw the highest peak of investment demand over the entire period of reconstruction growth. Changes in proportions of borrowed funds were governed by outstripping growth in bank loans and funds borrowed from other organizations with moderate involvement of budgetary sources of financing. The share of budgetary funds in investment costs funding declined by 1.2 percentage points at the background of changed proportions of the federal budget and budgets of the constituent entities of the Russian Federation.

Upgrading efficiency of economic activity was accompanied by simplification of flows and creation of additional sources of investments. Resource mobilization both in internal and external markets accelerated credit growth in the economy. They increased by more than 46% during 2003 as opposed to 36% in the previous year, by estimate.

The investment demand behavior in 2003 was determined by an aggregate effect of factors on sectoral, technological and reproduction structure of the national economy. Redistribution of investment flows was accompanied by increase in the share of services sector. The economic growth was distinguished by intensive development of service-producing indus-

tries. The share of transport, communication industry and trading accounted for $\frac{1}{4}$ of the total volume of capital investments in the period between 1999 and 2003 against the average of 15% over the period between 1992 and 1996.

Investment activity in real sector of the economy in 2003 increased at the background of changes in their sectoral structure. Total volume and behavior of investments is determined mainly by natural monopolies' industries, oil industry and municipal housing economy. Given that the share of transport, communication industry and fuel industry is represented by nearly $\frac{1}{2}$ of the investment volume in the national economy, it becomes obvious that it is the business activity of these industries that exercise most significant influence on investment demand behavior and structure.

Finally, in 2003, accumulated foreign capital in the economy of the Russian Federation amounted to nearly \$57 bln US dollars, including investments from the CIS countries. Total volume of foreign investments in the non-financial sector of the Russian economy during 2003 is assessed to the amount of \$29,7 bln US dollars without regard to monetary regulation agencies, commercial and saving banks, including ruble investments converted into US dollars. A peculiarity of 2003 is represented by \$6,4 bln US dollars of net inflow of foreign investments in the Russian economy.

Improved investment climate and recovered foreign investors' confidence in the Russian economy is represented by growth in direct investments volumes. In 2003, growth rates of direct foreign investments exceeded the similar indicator of aggregate foreign investments, which spurred growth in direct investment intensity in terms of total volumes up to 22.8% against 20.2% in 2002.

Foreign investments in the Russian economy grew dynamically at the background of significant changes in the sectoral structure. The share of foreign investments in the industry increased as compared to 2002. Service-producing industries still retain their firm position among top-priority industries. Foreign investors kept their interest in traditional extractive industries which account for more than $\frac{3}{5}$ of the total volume of foreign investments in the Russian industry. However, sectoral proportions changed in 2003 as compared to the previous year. The increase in the share of metallurgic industries by nearly 15 percentage points against 2002 was compensated by an increase in the share of fuel industries by

more than 17 percentage points. In 2003, the volume of investments in fuel industries accounted for \$5,3 bln US dollars, which is 2,7 times as much as in 2002.

Geographically, the Great Britain (\$4,6 bln US dollars), Germany (\$4,3 bln US dollars) and France (\$3,7 bln US dollars) were among the leaders in foreign investments in 2003. French investments almost tripled in 2003 against the previous year, while British ones doubled. The increase in German investments accounted for nearly 7% with stabilized investment inflow from the United States. Correspondingly, the share of the Great Britain and France in the structure of accumulated foreign investments in the Russian economy increased as compared to 2002.

High intensity of foreign investments in the Russian economy is determined, on the one hand, by persistent growth in production of goods and services in major industry divisions, thus providing expansion of the effective capital investment zone of the Russian economy's real sector with the yield and risks comparable with investments at the western countries; on the other hand, relatively sluggish economic growth in major leading western countries, which resulted in declined yield and increased investment risks in the traditional capital markets.

Agri-Food Sector

A significant growth in the agri-food sector of Russia was followed by a significant downturn after the crisis of 1998. The increment in growth rates in agricultural industry accounted for mere 1.5%, and slightly higher in food-processing industry, 5%. At the same time, weather-related factors are not responsible for a sharp growth retardation: grain harvest was fairly poor at the previous season against high production of other grain crops, while the previous season revealed the reversed situation with much the same growth rate. These results reveal that the growth factors of the agri-food sector, which were noted after the crisis 1998, have exhausted, while new ones have not been created yet. Under the circumstances, the government policy is making ineffective efforts to retain the behavior of this sector by protectionist measures.

At year-end 2003, agricultural industry recovered by 70% and food-processing industry by 75% as compared to 1991. All in all, the pre-reform production output was not achieved yet. At the same time, a sharp stratification of agricultural manufacturers was noted, which in fact means that some en-

terprises managed to take advantage of the «window of opportunities» opened up in the period between 1999 and 2001, while others are still staying in business owing to liberal budget restrictions for agricultural industry and, apparently, are subject to closure.

Sustained growth in foreign trade turnover of food products was noted due to increase in both exports and imports over the last few years. The share of foreign trade turnover in gross agricultural output reached 61% last year, which is twice that of the previous year. Therefore, the Russian food product sector became more integrated into the world economy over the last few years: integration index of the Russian agri-food sector into the world trade is high enough, 30 to 40%.

The main foreign trade turnover of food products still falls on foreign countries. At the same time, the share of CIS countries, which was just about to shrink in 2002, in Russian food trade grew in 2003, which is associated with strengthening of protectionist tendencies in the Russian foreign trade regulation, which do not expand as far as the Customs Union's countries.

Agricultural policy over the last two years is determined by three main factors which as a whole lead to protectionist tendencies in the government. These tendencies are represented by government's efforts to maintain import substitution behavior created after 1998, negotiations on Russia's accession to the WTO responsible for the attempt to increase the initial level of protectionism, and budget restrictions which force protectionism to take «free» protective measures by way of import quotas and taxes.

The land legislation, which was introduced in the period between 2002 and 2003 (Land Code of the Russian Federation, Federal Law «On Transfer of Agricultural Lands»), was intended to promote transfer of agricultural lands. However, legally favorable conditions of transfer promotion are opposed by organizational restrictions which could arrest official transfer of agricultural lands. It is precisely the official transfer that is in question, because land transfer, if needed, will exist in latent form thus creating unstable conditions of land utilization for agricultural enterprises and citizens.

Research and Development Sector

In 2003, public science and technology policy was governed by two basic documents, namely «The Principles of the Russian Federation's Policy in Development of Science and Technology till 2010 and

in Prospect” (hereinafter “Principles”) and the Russian Federation’s Medium-Term Socio-Economic Development Program (2003–2005) in the section which concerns development of the national science and innovation. However, the efforts made were not always in line with the objectives proclaimed. In fact, implementation of several initiatives had to be deferred to 2004 as they were kept under coordination till late 2003.

Among the top-priority trends in 2003 were as follows:

- attempts were made to optimize the organizational and human resources structure of science;
- creating new elements of the national innovation system;
- developing high technology industries (in particular, information and communication technologies (ICT));
- providing more concern for research and development in the defense industry.

A special public emphasis was made upon a mutual agreement between the NIS’s elements. In particular, a task of creating a technological corridor between science and business was set with the view to commercializing knowledge and providing entrance to new high technology markets. The term “technological knowledge” means creating interaction between key participants of innovation process, developing special innovation projects, supporting venture industry, and improving the existing intellectual property legislation.

Development of high technology industries, primarily information and communication technologies, is an integral element in creation of the NIS. At present, Russia is playing quite a moderate role in this area because only 8% of the Russian population are Internet users. Only Moscow and St. Petersburg overcome the 10% threshold, and thereby show the presence of “information society”.

Research and development at the defense industry is acquiring more significance among the top-priority trends. In 2003, the share of research and development accounted for 38% of the total budgetary allocations (“national defense” item). Research and development financing increased by 22 % in terms of constant prices versus the previous year. The research and development budget is scheduled to grow in 2004 as well. The emphasis is placed upon the projects involving double-purpose products and technologies as defense-related research and development outlays are growing.

Though the total amount of research and development allocations grew up (including constant prices in 1989), the financing was possible mostly due to increase in federal budget expenditures. The share of budgetary research allocations is close to the figure of 1996 when any other financing sources were minimal. It means that science still runs short of extra-budgetary resources. However, domestic philanthropic trends along with changed priorities at foreign organizations and foundations supporting the Russian science claim attention.

The manpower problem in science remained topical last year. The total number of researchers decreased. Their number per 10 thousand persons of economically active population dropped to the minimum over the last 8 years, while the total number of researchers in the public sector increased. At the same time, personnel continued to age. A Concept of manpower protection at the research and technology system and a Draft Federal Targeted Program “Scientific Manpower of the Russian Federation” for 2004 to 2009 which is intended to be the basic to a single system of manpower reproduction in science, were under development at government level throughout the entire year. However, the Program was not considered at a meeting of the President Council for Science and High Technology due to repeated delays.

In 2003, the legislation was updated by:

- developing legislation in the science sector;
- improving norms, regulations and rights to intellectual property;
- amending the general legislation, including science-related provisions.

To date, Russia’s presence at the international market of high technology products is insignificant, its share being estimated 0.35 % to 1 %. This is below the figures of both the First World’s countries and Asian developing countries. The figures of trading in Russian technologies at the international market demonstrate its growth and geographic escalation. However, unprotectable types of intellectual property, which are of lesser commercial value, still continue to prevail in the export structure.

In November 2003, the Foundation for Small Business Promotion in Science announced the inception of a new START program on financing of innovation projects at their initial development period, i.e. the so-called “seed” financing which is in short supply nowadays. The Foundation plans to allocate almost half of its budget (10 mln US dollars) to the program.

Major businesses remain the basis of innovation development. It is the major business that makes "rules of the game", while small enterprises rather adjust themselves to the existing pattern. It is noteworthy that signs of new stage of corporate science development emerged in 2003. TNK, YUKOS, LUKOIL and Norilsky Nickel companies promoted their research and development departments. Today, major financial industrial groups and monopolies engaged in resource extractive industries, power engineering and nuclear power industry intend to invest in research and development. For the time being, corporations choose to finance short-term application-oriented projects which can be paid off in 2 to 3 years.

An implementation plan on innovation promotion and venture investment development for 2003 to 2005 was approved pursuant to the Government Decree (No. 1187-p dated 21.08.2003). The Decree includes a list of all main measures to be implemented in the science sector, namely supporting the major innovation projects, developing small business, regional and sector-specific venture funds in partnership with the state, technology transfer centers, introducing a multi-stage system of personnel advanced training and retraining for innovation sector). The Decree reiterates in many ways the provisions of the "Concept of Venture Industry Development in Russia" developed in 2002 but not approved by the government.

Social-Cultural Industries

A special care at the highest level of the Russian Government was given to medical insurance development. The issue was initially brought up in the annual message of the President of the Russian Federation addressed to the Federal Assembly of the Russian Federation. A special meeting of the State Council of the Russian Federation on March 2003 was dedicated to the issue of medical insurance. The Government of the Russian Federation adopted a Regulation dated 17.03.2003, No. 158, «On Additional Financing of Expenditures on Targeted Medical Assistance to Non-Working Retired Persons in 2003». Since May, pilot testing of a new mechanism of payments for compulsory medical insurance of non-working population with participation of the Pension Fund of the Russian Federation was initiated at several pilot regions. A Federal Draft Law «On Compulsory Medical Insurance in the Russian Federation» was considered and approved in whole at a meeting

of the Government of the Russian Federation held on January 15, 2004.

Last year the government made a step towards strengthening its regulation of therapeutic facilities. The Government of the Russian Federation adopted a Regulation on May 6, 2003, No. 255 «On Development and Financing of Task Performance in Securing State Guarantees to the Citizens of the Russian Federation for Gratuitous Medical Assistance and Performance Control». The Regulation is intended to reconstruct the administration system of medical facilities at regional level and turn the compulsory medical insurance system into a source of financing to cover a share of medical facilities' expenditures on implementation of tasks set by higher authorities. Such scheme comes into conflict with the principles and objectives of medical insurance development set forth in the President's messages and policy documents of the Government.

In respect to the education sector, a pilot testing of new regulations on admission to higher educational institutions and financing of educational organizations, which was launched in the previous periods, continued in 2003. Reforming of the educational system still remained the issue under active public discussion.

An experiment on introduction of a unified state examination (USE) received a considerable scale expansion. The number of participating constituent entities of the Russian Federation increased from 5 in 2001 to 47 in 2003. In 2002/2003 academic years, the experiment was assisted by development of a regulatory system, organizational and administrative potentials.

In 2003, an experiment was continued in Russia on transition to financing various educational institutions by employing the state registered financial obligations (SRFO). Higher educational institutions can use SRFO's funds to cover such operating cost items as wages, accruals to labor compensation fund, and other operating costs. Other cost items are financed by higher educational institutions in compliance with the existing budget cost financing system. Cost planning in the ensuing years is performed for the changing student body on the basis of recalculation of the SRFO's amount by category in accordance with the federal budget for the current year. In 2003, the amount of SRFO was reduced significantly for all categories as compared to the previous year. However, the amount of the first three SRFO categories was then increased for a variety of specialties.

In order to eliminate drawbacks revealed during the experiment, the Ministry of Education of Russia developed a package of proposals on amendments to the existing regulatory and legal framework of the experiment on SRFO transition, which are to be introduced at the second stage (between 2004 and 2005) of the experiment. Therefore, a new mechanism of financing of higher educational institutions on the SRFO basis being tested by the Ministry of Education of Russia, on the one hand, is largely oriented to budgetary support of the students who demonstrate a significant academic performance, as well as those who need social protection, while, on the other hand, it reflects the trend to release stringent requirements for students admission on a free basis. With such approach higher educational institutions will have to admit more students on a pay basis in order to ensure sustained and up-to-date financing.

Federal Law No. 123-FL «On Amendments to Various Legislative Acts of the Russian Federation in Relation to Financing of Educational Institutions» signed by the President of the Russian Federation on July 7, 2003, stands out particularly among the measures aimed at consolidating legal system of financing of municipal educational institutions. It is specified in the document that public guarantees of citizens' rights to public and free general education within municipal educational frameworks are to be financed by allocating subventions to local budgets to the amount required to meet the state educational standard.

Foreign Economic Activity

The year 2003 became one of the most successful years for the development of foreign economic activity in Russia over the last 15 years. In 2003, foreign trade developed under favorable conditions for basic export goods, strengthening of the ruble against the US dollar, and growing internal effective demand. All in all, in 2003 foreign trade turnover accounted for \$210,8 bln US dollars and grew by 25.3% as compared to 2002, according to the data of the Central Bank of the Russian Federation. In 2003, export volume of the Russian Federation became the highest in the history of the country, \$135,4 bln US dollars, which exceeded by 26.2% that in 2002 (\$107,3 bln US dollars). Import volume increased by 23.9%, from 61 bln US dollars in 2002 to \$75,4 bln US dollars in 2003.

Substantial advance in prices of energy carriers, as well as a variety of other raw materials and

goods, became most peculiar to foreign economy development in Russia over nearly the entire period of 2003. It is precisely the favorable movement of global prices of oil and other energy carriers that are responsible for the unprecedented growth rates.

Foreign trade turnover of the Russian Federation with non-CIS countries increased by 24.5%, up to \$174 bln US dollars, in 2003 as compared to 2002. Exports to these countries increased by 25.3%, up to 114 bln US dollars in 2003 as compared to 2002, while imports grew by 23%, up to \$60 bln US dollars. Surplus on trade balance with other countries increased by \$11,8 bln US dollars (up to \$54 bln US dollars).

The growth in export prices in 2003 was accompanied by an increase in export volumes to foreign countries. At the same time, a substantial strengthening of the Euro against the US dollar stimulated significantly the growth in export volumes, which raised competitive capacity of Russian goods against European ones.

Further growth acceleration of the Russian export is restrained by external demand and transportation channels' capacity. Access restrictions for Russian goods to foreign markets also impedes seriously export growth. Ninety three restrictive measures are currently in effect for these goods, which inflicts nearly \$2 bln USD of losses for domestic exporters. The biggest number of restrictions are placed by the European Union.

Economic activity growth encouraged expansion of the internal active demand both of the households (for consumer goods) and enterprises (for investment and intermediate products), which boosted substantially import deliveries.

CIS countries were key trade partners of Russia in 2003 with 35.8% of the Russian trade turnover (37.2% in 2002). Sales turnover with these countries accounted for \$48,3 bln US dollars (119% against 2002). Trade volume with the Central and East European countries accounted for \$17,3 bln US dollars (126% against corresponding period in 2002).

The share of CIS countries in the Russian foreign trade turnover increased insignificantly and accounted for 17.4% (in January through November 2002 – 16,9%) over the first eleven months of 2003. The share of these countries in the total export volume accounted for 15.7%, and 20,4% in import. In 2003, Byelorussia, Ukraine and Kazakhstan remained as before key trade partners of Russia among the borderline countries.

In 2003, the work was continued in order to bring customs legislation into line with the WTO's requirements.

Adoption of the Customs Code of the Russian Federation, which took nearly four years of drafting, became a major event in the Russian foreign economic activity. The norms, provisions and terminology of the Customs Code are being brought into line with the existing Russian laws adopted in the period between 1994 and 2003, as well as the WTO's requirements. The new Customs Code came into force on January 1, 2004 .

In June 2003, the State Duma of the Russian Federation adopted at the second reading a draft law «On Special Measures of Protection, Antidumping and Compensation in Import of Goods». The law is to replace the existing law of 1997 «On Measures of Protection of Economic Interests of the Russian Federation in Foreign Trade of Goods» which is in conflict with the WTO's norms.

In October 2003, the State Duma of the Russian Federation adopted at the second reading a draft law «On Principles of State Regulation of Foreign Trade» submitted by the Government of the Russian Federation. This document is also included in the package of laws required for Russia's accession to the WTO.

In November 2003, the State Duma adopted amendments to the Law «On Customs Tariff» at the first reading.

Thus, Russia has done its best to get prepared to access the WTO. All the required laws have been submitted to the State Duma for consideration.

Russian Defense Economy and Military Reform Trends

The beginning of 2003 was quite favorable for the defense economy of the Russian Federation. The previous year budget was fulfilled, and the budget for the coming year was approved in time. In 2003, the military institution of Russia was financed in accordance with the Budget Law. However, it is transparency and reliability of expenditures that matter from the point of view of civil and social control, not the categories they are attributed to.

Analysis of the returns submitted to the State Duma of the Russian Federation revealed that declassification of a considerable number of military expenditures incurred when a draft budget was under consideration at the Federal Assembly of the Russian Federation, had no effect whatsoever on accounting. First, re-

views on execution of declassified target items and expenditure heads remained classified, though it is a violation of the regulation of the Budget Code. Second, untimely preparation of documents confirming the competence of expenditures, and, as a consequence, untimely receipt of funds by financial bodies of «power» departments had an adverse impact on the provision of military development. A substantial increase in budget expenditure estimates on a variety of items took place in December concurrently with inadequate budget execution management at specified departments (which was evident in particular as compared to the Ministry of Atomic Energy). In addition, the Accounting Chamber of the Russian Federation disclosed non-purpose utilization of 14 bln rubles received from the federal budget by the Ministry of Defense.

The document which specifies general concepts of military development – «Concepts of State Policy of the Russian Federation on Military Development Over the Period to 2010» – would seem not to raise doubts about its compliance with particular tasks for 2003. Specification was needed though.

In May 2003, the President of the Russian Federation in his message to the Federal Assembly named *modernization* of the military institution in Russia among top priorities of the state policy, that is to update it according to the dictates of the time (transition to a professional army, reduce the draft-based military service period, as well as create decent social conditions for the military).

At a meeting at the Ministry of Defense of the Russian Federation held on October 2, 2003 with participation of the President of the Russian Federation, the Ministry of Defense announced a completion of basic structural adjustments and reductions, as well as Armed Forces transition to planned development. Though the President of the Russian Federation did not speak against such optimistic estimates, he made a note that «we have not yet completed all that we agreed on» and specified the existing problems which keep military planning extravagant and ineffective.

In describing the political-military situation, it should be noted that military and military-economic policy of Russia at international level was successful in whole. However, the internal military policy was not marked by success. Personnel policy is to be criticized in particular.

The Government considered twice (in April and July 2003) the manning reform of the military institution of the Russian Federation. The IET's represen-

tatives attended both meetings because the IET is listed among the developers of the corresponding federal target program (FTP). Many provisions initiated by the IET's specialists were included into the final version of the program approved on August 25, 2003, though it corresponds largely to the Ministry of Defense's concept.

Both military reform and military development are complex issues. In 2003, the IET made a comprehensive assessment of estimated military-economic and social effects of the adopted FTP, which leads to the conclusions as follows:

- long-term effects of the FTP may become adverse both in terms of military economy and social economy;

- the task of promotion of transition to a voluntary military service system is essential provided that it is modified substantially, as stated by the Minister of Defense in his report at the meeting held on October 2, 2003. The Minister qualified the FTP itself and its implementation as «promotion of transition of the Armed Forces to a contract-based military service». However, judging by the mission of the military institution of the Russian Federation and social requirements, it is further acceleration of transition to a voluntary military service that is supposed to be promoted in addition to plan schedules of the adopted FTP (in order to amplify them rather than overrule).

Analysis of the military expenditures provided for in the budget 2004, economic development of the country and military expenditures of the previous years make it possible to activate the reform. Military expenditure growth shows a pronounced fading tendency though. In addition, other countries' practices of transition to a voluntary draft system suggest that effective military strength under a contract-based service leads to a substantial cutback at the military institution as compared to that under compulsory military service.

Regarding the development trends for the defense economy of the Russian Federation and military development in years to come, they appear to be positive because the government is repaying its debt obligations to the military. The fact that the President of the Russian Federation included the military reform into the list of most relevant problems in his annual Message in 2003, may guarantee its successful solution. At the same time, this is indicative of the need to continue independent research on expedient methods of military reform activation and actions to be initiated by the executive power and the society.

INSTITUTIONAL AND MICROECONOMIC PROBLEMS

Privatization and Federal Property Management

Among the most significant innovations in 2003 were: (1) gradual implementation of the elements of a new Federal Property Management Concept (approved at a meeting of the Government of the Russian Federation on February 6, 2003) was launched, (2) the periods of privatization of non-strategic objects which are still owned by the government (till 2008) appeared to be more certain (at least in theory). The aforementioned innovations are closely associated with a quantitative acceleration of privatization which is expected in years to come. This affects mostly «release» of the remained minority blocks of shares and corporatization of state-owned enterprises followed by sale of their shares.

A Forecasting Plan (Program) on privatization of federal property for 2003 was adopted by an order of the Government of the Russian Federation No. 1155-p dated 20.08.2002 (as amended on 9.10.2002). Privatization proceeds in 2003 were initially estimated 15 to 20 bln rubles, then (as adjusted by the Government) nearly 51 to 54 bln rubles. There were no relatively major privatization deals, which pull up budget revenues generated from nonrenewable sources, in 2003 as opposed to previous years. Consequently, real budget revenues from property selling (without regard to the 2002 deals) were quite moderate in 2003. Actual amount of the revenues (i. e. without regard to the 2002 revenues carried forward to the budget 2003) was found nearly 12 bln rubles, which is even lower than the estimated amount (15 to 20 bln rubles).

The tendencies (in 2001 through 2002) for dominating revenues from the use of state property remained significant in terms of budget revenues.

Certain positive results were achieved in implementation of the State Property Management Concept and Privatization 1999, adoption of new privatization laws in 2001 and laws on state-owned enterprises in 2002, which conferred more freedom of action on the executive authorities in terms of denationalization and laid a foundation for consideration of new initiatives related to public sector management in 2002 through 2003. The state policy in this field is to be focused on the tasks as follows: 1) federal property classification; 2) de-

veloping new management mechanisms of affiliated installations; 3) optimizing federal property framework.

One of the elements of the new State Property Management Concept is represented by a 3-year privatization program. Such document (Forecasting Plan (Program) on federal property privatization for 2004 and federal property privatization guidelines till 2006) was first adopted by an Order of the RF Government No. 1165-p dated August 15, 2003. The measures to take are scheduled in the sequence as follows:

- in 2003: to privatize government's blocks of shares which accumulate up to 2% of the equity capital of joint-stock companies;

- in 2004: to privatize all joint-stock companies with not less than 25% of government's share;

- in 2005: to privatize all joint-stock companies with 25 to 50% of government's share (in particular, withdrawal from the capital of energy-construction companies, fining industry, foreign economic companies, machine-building industry and cinematography);

- in 2006: to sell government's shares in non-strategic companies where the government holds more than 50% of equity (in particular, commercial aviation companies which are neither involved in provision of national security nor flight operating safety; chemical industry, petrochemical industry, geology, and several agricultural industries), including selling of shares of joint-stock companies which were set up during reorganization of federal state-owned enterprises;

- by 2008: to complete privatization of the federal property which is not utilized for execution of public functions of the Russian Federation; to finally build up a public sector property management system; and to double revenues from federal property utilization.

In our opinion, the program is too ambiguous. Due to a variety of factors:

1. The real privatization course in the period under the law privatization of 1997 is an eloquent evidence of the fact that organizational capacity of regulatory agencies in quick reorganization of public sector are in serious conflict with its scale, with a relatively strict law compliance.

2. The problem of the remainder of blocks of shares still remains traditional, which has been considered since the mid-90s. The number of minority blocks of shares held by the government has de-

creased anyway over the last 10 years (since completion of a large scale privatization in 1992 through 1994). However, the decrease rate allows one to forecast that the problem will not be solved in full within another 3 years.

3. Almost complete liquidation of the institution of state-owned enterprises is proposed indirectly in the foregoing program, which seems to be a sound decision conceptually. It should be noted, however, that this plan is not the first one to deal with a sharp cut of state participation in the economy – the Ministry of State Property of the Russian Federation (as early as 1993–1994) used to predict several times a large scale reduction in the number of state-owned enterprises.

4. The Ministry of State Property's orientation to a maximum possible reduction of state-owned enterprises at all levels with their further incorporation as open joint-stock companies (OAO) will consequently put an extra workload on state administration agencies which will have to act within the frameworks of the corporate law. This generates a need in more state representatives in the management of joint-stock companies.

5. An alternative method of reorganization of state-owned enterprises is to set up public enterprises operating on the basis of day-to-day management. In this case, however, the state is to assume subsidiary liability for liabilities of these enterprises, which may increase public expenditures and put an extra load on the budget system. In all probability, it is particular for this reason that public enterprises were not widely accepted at public sector of the Russian economy.

6. The privatization process can be seriously damaged by aspiration for its completion in the shortest possible period or by a certain date. In spite of the fact that the government's document deals with the Forecasting Plan (Program) of privatization for 2004 and guidelines for federal property privatization till 2006, it virtually includes a list of objects which are subject to privatization in 2004 only.

7. The lack of an opportunity to develop criteria of an efficient non-profit utilization of state and municipal property within a relatively rapid period due to a wide variety of public and municipal functions results in a serious problem.

8. Finally, nothing but simple problems emerge with high-quality legal provision. It is obvious that the proposed legal pattern requires a great deal of allied legal acts, thus arising a store of questions.

Trends and Behavior of Mergings and Acquisitions. Reorganization Processes Development

In general, the trends of 2001–2002 remained significant for 2003, namely continuous concentration of equity capital, integration of enterprises and organizations of the created business-groups, dependence of reorganization strategic targets on institutional «maturity» of a corporate group. Development of corporate management standards was closely associated with the reorganization and long-term strategy of a company. Such tendency as searching for a niche in the international economic relations framework by major Russian groups, which emerged in the period between 2001 and 2002, also remained significant.

In general, we can highlight the following significant processes in 2003 through the beginning of 2004. First of all, *a substantial absolute increase in the number of mergers and acquisitions should be noted in terms of quantity*: total value of deals increased by 7 times in 2003 as compared to 1999, and doubled as compared to 2002 (without regard to the TNK-BP deal). Total number of deals increased nearly by 4 times as compared to 1999, and the increase accounted for nearly 30% in 2003 as compared to 2002.

The impact of such factors as *post-privatization redistribution of property and expansion of major groups* (the latter became less significant) remained significant for assessment of quantitative movement of mergers and acquisitions in modern Russia irrespective of economic growth stages. The «contribution» of major groups to intensification of internal Russian process of mergers and acquisitions in 2003 became less significant not only because of activation of reorganization processes in the groups and their foreign expansion. The main reason is *activation of second echelon economic agents, large-size and medium-size companies* which have enough resources to expand their business by taking over smaller companies.

In the period between 2002 and 2003, further transformation of a variety of major Russian groups became more evident: from multi-industry holding companies and conglomerates, which were typical of the 1990s, to corporate groups with more efficiently managed and structured formations. This is most typical of those groups which formed their «nucleus» as early as the 1990s through the beginning of the 2000s and had already passed the «initial» reorganization stage in various forms.

Horizontal deals remained predominant in terms of quantity in 2003. On the contrary, conglomerate mergers and acquisitions accounted for nearly 10 to 15% of the aggregate volume of deals and nearly 20 to 25% of the total volume of deals. Nevertheless, processes of *building up multi-industry structures and vertical integration* are of a larger scale in product markets, including development of major vertically integrated companies tending to gain control over enterprises which provide for the entire technology cycle of product manufacturing, including sales of products, according to the data of the Ministry of Antitrust Policy early in 2004. These processes govern the growth of aggregate economic concentration.

In addition, *diversification of management models* of major groups became more evident in the period between 2002 and 2003. A majority of major Russian groups are still in the stage of development and growth, while there are only a few major groups with stabilized property and management structure which chose consciously a particular model (financial, operational, options of strategic planning and control).

General trends of mergers and acquisitions are supported by the data on appeals flow filed to the Ministry of Antitrust Policy of the Russian Federation. In 2002 through 2003, over 70% of the appeals considered by the Ministry of Antitrust Policy were referred to purchase of shares within a structure, while the share of merger and acquisition appeals did not exceed 5%. It doesn't mean whatsoever that the Ministry of Antitrust Policy's data are in conflict with the statistics on mergers and acquisitions in Russia: It is typical of the Russian practice when a deal, which in fact represents merger or acquisition, is registered as purchase of shares and assets rather than in accordance with the «reorganization» requirements (counteragents of such deals tend to (1) bypass the required reorganization procedures and (2) deforce creditors of the right to demand early execution of liabilities).

In 2003, a variety of optimistic estimations of the existing rules of mergers and acquisitions were made, which stated that «managers are anxious to consider the idea of incorporation with other enterprises as a type of business restructuring, a basis for improvement of business structure, a type of investment attraction». In our opinion, such estimations are out of the real picture. Indeed, there were noted positive moves, but these were nothing but isolated cas-

es. Three fourth of the current acquisitions are hostile, i.e. they are intended to buy shares by using blackmail, threatening or bribery, as well as get an unlawful access to the register of shareholders, etc., according to the data of the Economic Security Department of the Russian Federation. Furthermore, in the period between 2002 and 2003 the problem of hostile acquisitions with the use of the so-called «administrative resource» became acute enough to meet the lawmakers' notice. At the same time, at the turn of 2003–2004, preparations were made to make merger and acquisition amendments to the law as part of antitrust legislation in whole.

2000 – 2004: In the Way to State Capitalism?

The tendency for greater government control in the economy (in corporate sector), which was noted as early as 2000–2001, became more expressed by 2004. It is obvious that increasing government control through building up major holding companies and expanding government representation at the existing companies is associated with a variety of objective factors, namely technological integration needs, creating bigger structures in terms of international competitive ability, and increasing pressure upon enterprises in terms of budgetary payments.

At the same time, such policy runs into a variety of objective restrictions: 1) efficiency of the existing state property management system, including problems of corruption and civil servicemen's «rent income»; 2) limited number of government assets which make it possible to line up really controlled holding companies; 3) the need to make decisions, in some cases, which investors refer to a system risk (deprivatization, for instance); 4) political and foreign policy factors.

In the period between 2001 and 2002, the government expanded, irrespective of reasons, its economic activity to a greater degree through its executive branch. This process followed a variety of inter-related ways:

- staff changes in the management of natural monopolies and strategic companies with government's share (Gazprom, Ministry of Railroads, Military Industrial Complex (Defense Industry Complex), Ministry of Atomic Energy, Rosspirtprom, etc.);

- continuing reorganization (primarily by merging) of existing companies and creation of new holding companies within strategic industries (consolidation of regional communication monopolists at 7

interregional companies of Sviyazinvest Holding Company at 7 federal districts and etc.);

- repossessing of former (privatized, pledged) assets (former assets of Gazprom – enterprises of SIBUR, Itera Group, etc., pledged blocks of shares of OAO Novorossiysk Morskoe Parokhodstvo (Novorossiysk Ocean Company) and Severo-Zapadnoye Parokhodstvo (Severo-Zpadnoe Ocean Company), etc.);

- «locking» several segments of state property into the President's Administration (as early as 2000, setting up a federal unit to manage government's property at foreign countries and etc.);

- making attempts to revise the norms, which exist since 1992, on distribution of ownership and shares of the Russian Federation in equity capital (ALROSA, for instance);

- establishing control over main cash flows and concentrating cash flows at state-owned banks;

- tough political struggle in 2000–2002 spurred by reorganization of major natural monopolies (RAO Gazprom, RAO Unified Energy System of Russia, Ministry of Railroads).

The issue of centralization and control of main cash flows was further developed in 2003 in the course of pension reform whose failure at first stage in 2003 was recognized by top-ranking officials of the Ministry of Finance and the Ministry of Economic Development and Trade. Non-transparent «selection» of Vnesheconombank for managing public funds, the so-called tender intended to select 55 private management companies, and obscure information campaign for the public convey the suggestion that pension reform served as a cover for completion an opposite task – to maximize the funds remaining under the state control. Private management companies received only 1 to 1.5% of the funds against estimated 6 to 10% for that stage, as reported by the Ministry of Finance of the Russian Federation.

After the first steps towards consolidation of public assets and muscle show for private management companies in 2001–2002, it is time to talk about designing *an alternative strategic approach* on the basis of using private companies (groups) as «authorized» managers of the federal center at a particular region (Tyumen, for instance) or industries (ferrous and non-ferrous metallurgy, for instance). In this case, private groups have visible advantages in receiving *carte blanche* for expansion with federal political support over dealing with trivial illegal schemes with impunity.

In the period between 2003 and 2004, «corporate social responsibility» (given all abstractness of such a concept as applied to business enterprises) became a dominating issue in considering possible relations between the business and the government. A variety of major companies had to prove their loyalty at legal trials they were involved into on economic issues, which actually had a political side effect and injured directly reputation of claimants (Gazprom – NTV, LUKOIL – TV-6, etc.).

In general, we can affirm that in the period between 2000 and 2003 *the government graded companies as loyal (trustworthy, reliable) and others, «patriots» and «cosmopolites»*. Nevertheless, the practice showed rotation between these groups. Some events proved weakness of the «trustworthy» managers in 2003, the YUKOS case, for instance.

To summarize: Property-related government expansion, attempts to establish (extend) public control over main cash flows of the Russian economy and, more widely, *making the business dependant on public institutions, thus ignoring deregulation decisions, administration reform and further privatizations plans*, became dominating trends in the 2000s.

Such policy is likely to result in designing a model of «state capitalism» featured by a combination of elements as follows:

- substantial strengthening (extension of application area) of standard elements of state entrepreneurship, which appears to be considered as a component (quite controversial though) ensuring the Russian national interests;

- creation of favorable (or neutral at least) conditions for a small group of loyal companies, including private ones, graded as «patriots» and supported by a strictly centralized state machine accountable to the President (including legislative structures and judicial power);

- demonstrative (selective) repressive measures (administrative and criminal) against those heavy-weight economic agents which fail to fit the model under construction;

- asymmetry between tasks and methods. Stated and most often reasonable goals – asset withdrawal, transparency of property structures, return of profit centers to Russia, elimination of particular tax schemes, etc. – are implemented by measures which have nothing to do with these goals, including the «property in exchange for freedom» method, instead of reforming these particular fields;

- different understanding of the Russian national interests and the principle of inviolability of private property.

At the same time, the traditionally accepted meaning of «state capitalism» fails to explain in full the model under construction. However, the term «bureaucratic capitalism» appears to be most applicable to the modern development of Russia.

A sound policy of state expansion could not be declared, and never was, together with statements on further development towards competitive market economy. Nevertheless, one is most likely to affirm that the trend for «state capitalism» became more evident in 2003. Under the circumstances, the issues of property rights protection, judicial reform and efficient law enforcement remains topical.

The IET's Annual Review on Russian Economy includes several annexes:

1. Several problems of foreign exchange regulation under a new version of RF Law «On Foreign Exchange Regulation and Control».

2. Budget execution data in 1996 through 2003.

3. Economic legislation review in 2003.

4. Economic programs of political parties.

For full version of the review refer to the IET's website www.iet.ru.

CONFERENCES AND SEMINARS

A regular seminar on **reformation of local self-government systems** was held on **January 19, 2004** under the auspices of the Municipal Development Problems Laboratory. Prof. Franz-Ludwig Knemaier, Director of Municipal Rights Research Center at the University of Wurzburg, Germany, who participated in the development of the European Self-Government Charter, made a report on specific features of organization of the two-tier system of local self-government in Germany.

On **February 20, 2004**, a meeting was held at the IET on the issues of **innovation development in Russia**, as attended by representatives from Russian ministries, departments, funds and the World Bank. The agenda included two reports made by Boris Simonov, Head of the Innovation Development Department of the Ministry of Industrial Science of the Russian Federation, and Alfred Watkins, World Bank's representative. Each of the reporters presented his view of how to improve competitive ability of the Russian industry by more efficient technological commercialization.

B. Simonov specified the guidelines for government support, namely (1) creating conditions for favorable institutional reforms, primarily by developing new legislative acts and making amendments to the existing ones (including three Codes, namely Budget Code, Civil Code and Tax Code), (2) developing infrastructure by supporting Technology Transfer Centers, (3) improving financial mechanisms of stimulation of commercialization. A key element is to disseminate the practice of state-private partnerships and participation financing.

A. Watkins' report included the World Bank's proposals on possibilities of extending a loan to the Russian Federation for the purpose of increasing competitive ability of the Russian economy and commercializing technologies. The proposed project comprises four basic components, namely (1) developing 5 to 10 "Centers of Mastership" to conduct high-grade scientific research by using an upgraded equipment, maintain relations with the market, as well as to conduct postgraduate training, (2) promoting development of the institute of agents in the research and technological sphere, (3) promoting cre-

ation of the Technology Transfer Centers, and (4) promoting skill training centers and programs of technological modernization of industrial enterprises.

Then, the ensuing discussion revealed various, often contradictory, views about what and how the government and the Bank should support in the innovation sector.

The discussion was summarized by Sinelnikov-Murylev S.G., IET Deputy Director. According to his speech, the guidelines of joint efforts of the government and the World Bank include development of infrastructure, including new legislative initiatives, promotion of staff training and educational programs in the field of technological management, as well as the Technology Transfer Centers, «Centers of Mastership» on the basis of intensive study of foreign and domestic practice, both positive and negative.

A panel discussion of **«Financial Stability Analysis of the Pension System: Potential Effects of Social Tax Reduction and Other Changes»** was held at the IET on **February 25, 2004**. Keynote report was made by PhD Pomazkin D.V. (Regionfond National Pension Fund). A personal view of the problem was presented by PhD Baktybekov S.B. (IET).

A workshop on **«Socio-Economic Problems of the Initiated Transition of the Military Institution of Russia to a New Recruitment System»** was held at the IET at the same date. An opening speech was made by IET's Director, Dr. of economic sciences Gaidar E.T. Keynote reporter was Dr. of engineering sciences Tsymbal V.I.

PUBLICATIONS

The works have been prepared with reference to the IET's research project as part of a grant of the United States Agency for International Development (USAID):

Analysis of Budget Arrears in the Russian Federation. Repayment Methods and Preventive Measures

Baktybekov S., Zolotareva A., Kireeva A., Lugovoi O., Nepesov K., Sinelnikov S., Ustinov A., Chebotareva N.

The problem of accounts payable in public sector of the Russian Federation remains topical over the last decade. The work provides investigation into the factors that cause various types of accounts payable and its structure. Development stages of budget legislation in the context of the accounts payable problem at all levels of budget system are analyzed. International prevention practice of accounts payable is reviewed. Proposals on settlement and prevention of accumulated arrears are developed.

Comparative Analysis of Monetary Policy in Economies in Transition

Drobyshevskiy S., Kozlovskaya A., Levchenko D., Ponomarenko S., Trunin P., Chetverikov C.

The work includes an empirical analysis of monetary policy's impact on real output at 12 countries with economy in transition, namely Bulgaria, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Croatia, Czechia, Estonia, as well as a review of the hypothesis on availability of various transmission lines of the monetary policy at these countries. A special section is dedicated to detection of actual (implicit) goals of monetary-policy makers in economies in transition, as well as analysis of positive and negative effects that may result from eurozation of the Central European countries and the East European countries.

Banks. Basic Market Segments of Bank Services in Post-Crisis Stabilization

Mikhailov L., Sycheva L., Timofeev E., Marushkina E.

The work includes a description of the process of real sector crediting by the banks of non-banking

sector in 2002, activity analysis of these banks in the government bond market and in the market of corporate and banker's bonds, as well as funds raising. In addition, the authors examine behavior of funds borrowed by retail banking, situation with the corporate deposit market, and efficiency of banking operations in the period between 2001 and 2002.

Pension Reform: Socio-Economic Aspects ***Isayev N., Marushkina E, Mikhailov L., Smirnov S., Sycheva L., Timofeev E.***

First section of the work includes analysis of the existing level of public pension provision in the Russian Federation. Financial aspects and mechanisms of support of the public pension provision have been considered. The second section is dedicated to the issues of improving the pension legal system in the Russian Federation in the context of the implemented social reforms, including an international practice review and recommendations on pension accruals investment management. In addition, the issues of support for public pension provision in the Russian Federation at present and in prospect have been considered.

Financial Aspects of the Reform in Social Industries

Kliachko T., Popovich L., Potapchik E., Rubinstain A., Sorochkin B., Surkov S., Chernets V., Chirikova A., Shishkin C.

The book includes consideration of drifts of reforms required for financing healthcare financing, medical and social insurance, and occupational education. Analysis of these industries in terms of their interest in reforms is made. First results of pilot introduction of registered public financial obligations in the higher education system are reviewed. Modernization problems of financing of cultural sector are considered.

Immigration Policy in the Russian Federation and Western Countries

Denisenko M., Kharayeva O., Chudinovskih O.

The work includes analysis of the experience gained in migration policy in the Russian Federation over the last decade. The authors present their own

version of the concept of a comprehensive immigration policy. An attempt has made to pool the practice of immigration policy reforming at the Western countries. The focus is made on the measures aimed at attracting skilled labor force and fighting against illegal immigration.

Import Substitution in the Russian Federation in 1998 through 2002

Kadochnikov P., Sinelnikov-Murylev S., Chetverikov S.

The work includes analysis of devaluation of the ruble real exchange rate in 1998 and its further strengthening in consumption and manufacturing of domestic and imported products. Various theoretical aspects of import demand assessment are considered, well-known specifications of foreign trade models, including import-substitution assessment models, are presented. Results of analysis and import-substitution assessment in the Russian Federation are presented. Income effect and substitution effect in shifting demand for import as a result of movements in the ruble real exchange rate is calculated on the basis of the results of assessment of equations of demand for domestic and foreign products.

Analysis of Forecast Peculiarities of Structural Models and Models Using Polling Results at Enterprises

Nosko V., Buzayev A., Kadochnikov P., Ponomarenko S.

The work is a follow-up IET's investigation aimed at analyzing, simulating and forecasting macroeconomic time series. The prime objective of the work in question is to extend a range of forecast models by employing structural models and models using polling results at enterprises. Research findings and conclusions are based on comparison of the forecasts made on the basis of structural models and models using polling results at enterprises with the ARIMA-model forecasts made in previous works.

Investment Behavior of Russian Enterprises **Drobyshevskiy S., Radygin A., Gorshunov I., Izriadnova O., Ilyin A., Malginov G., Turuntseva M., Tsukhlo S., Shkrebel A.**

The work includes analysis of the key factors governing the pattern, goals and volumes of investments at enterprises of the Russian Federation according to their economic situation and equity capital structure. The research is based on the response

of a special poll according to IET's panel of enterprises, as well as macroeconomic statistical data.

Improving the System of Public Purchase of Goods, Works and Services

Zolotareva A., Katamadze A., Kopeikin B.

The work is dedicated to a research of improving the public purchase system in the Russian Federation, including an international practice review and proposals on improving the Russian legislation. The findings of the research formed the basis for alternative versions of the draft law «On Public Placement of Orders for Delivery of Goods, Execution of Works, Provision of Services», as well as a draft law «On Amendments to the Budget Code of the Russian Federation and Administrative Violations Code of the Russian Federation (regulation of procedures of Purchase of Goods, Works and Services for Public and Municipal Purposes)».

Tax Reform in Russia: Problems and Solutions

Anisimova L., Baktybekov S., Bobylev Yu., Kadochnikov P., Malinina T., Nekipelov D., Nepesov K., Sinelnikov-Murylev S., Slavgorodskaya M., Starodubrovskaya I.

The work includes a theoretical and empirical research of the results of the reform of a series of taxes, trends in taxation the regulations within the fiscal system which have not been reformed yet, and improvement proposals for tax legislation are made. In addition, general provisions of fiscal systems employed at Russia and various CIS countries are compared.

Imported Institutions at Countries with Economy in Transition: Efficiency and Costs

Mau V., Zhavoronkov S., Nastavshev D., Shulgin S., Yanovskiy K.; annexes written by Barzhanova M., Golant O., Zhavoronkov S., Malyshva Yu., Novikov V., Kucherenko V., Salimov A., Saahadrin A.

The work includes significance assessment of various institutions imported by the countries with economy in transition to move towards a sustained growth. Formal and comprehensive analysis of institutions of such countries, as well as comparison of several institutions at several countries as an example, shows that «base» institutions, including, in authors' opinion, personal immunity, private property and allied rights, as well as institutions ensuring ex-

ecution of these rights (judiciary establishments, law enforcement agencies, etc.), are most significant, at least under the transition at the end of the 20th through the beginning of the 21st centuries.

Financial Markets in Economy in Transition: Development Problems

Entov R., Lugovoi O., Paschenko S., Polevoi D., Skripkin D.

The research is dedicated to various issues of current situation and development prospects of the Russian financial sector, especially stock market and banking system. The work is broken down into three parts. The first part is dedicated to a study of integration of the Russian securities market into the world financial system. The second part deals with the factors of volatility and return on Russian capital assets. The third part includes various issues of banking sector efficiency, namely a study of fund-saving effects on the scale of activity of Russian lending institutions.

Economic Growth Factors in the Russian Economy

Astafieva E., Bessonov V., Voskoboinikov I., Lugovoi O., Turuntseva M.

The work is dedicated to a study of structural growth of the Russian economy in transition. Considered are various theoretical issues of decomposition growth by cost factor and their assessment, decomposition of economic growth in the Russian economy into extensive and intensive components is made, significance assessment of combined factor productivity growth is made, and its movement for industries and economy in whole is studied. A special task to be resolved in the work is to formally identify structural changes by using econometric methods. A study is made of structural changes in the labor market and their dependence on exogenous shocks.

Problems of Russia's Integration into the United Europe

Mau V., Kovalev G., Novikov V., Yanovskiy K.

The work includes analysis of the relations between Russia and the European Union, as well as prospects of their approaching on the basis of the criteria required by the EC for the countries intending to join the European Union. Russia's compliance to the EC's membership criteria is considered. Conclusions of the Russia's current integration degree into

the EC are made. Analysis is made of the EC's institutions whose import into Russia could, in authors' opinion, be of marked disadvantage for the Russian economy.

All of the foregoing works can be found at website www.iet.ru.

ACADEMIC COUNCIL

A meeting on «**Municipal Housing Economy Reform: Development or Crisis?**» was held by the IET's Academic Council on **November 17, 2003**. PhD Starodubovskaya I.V made a report at the Council.

On **January 16, 2004**, a joint meeting of the IET's Academic Council and Panel Discussion on corporate management in economy in transition was held. The results of a research work on «**Corporate Management in Poland and Russia: Achievements and Outlooks**» of the IET, CASE (Socio-Economic Research Center, Warsaw) and Stafford University (Great Britain) were presented at the meeting. The research was conducted in 2003 as part of an international research partnerships development project financed by the US AID and managed by the IRIS Center (Institutional Reform and the Informal Sector at the University of Maryland, USA).

Reports were made by:

Piotr Kozarzhevskiy (CASE) – Corporate Management Development in Poland: First Decade Outcome.

Aleksandr Radygin (IET) – Corporate Management in Russia: In Search for National Model?

Iradge Khashi (Stafford University) – Legal Framework for Efficient Corporate Management: Comparative Analysis of Economies in Transition.

Marina Turuntseva (IET) – Property and Efficiency: Empiric Experience of Russian Enterprises in 1998 through 2003 .

Rick Woodward (CASE) – Transformations in Polish Companies: Econometric Analysis.

A meeting on «**Import of Institutions by Countries with Economy in Transition: Selection Criteria, Background and Introduction Costs**» was held by the the IET's Academic Council on **April 14, 2004**. PhD Yanovskiy K.E. made a report at the Council.

THESIS COUNCIL

On **February 4, 2004**, Kochetkova O.V. presented a thesis on «**Economic Factors of Electoral Behavior**» in candidacy for a degree of master of economic sciences (PhD).

Dr. of economic sciences Radygin A.D. presided at the Thesis Council's meeting.

Research Instructor – Dr. of economic sciences, Professor Mau V.A.

Official opponents – Dr. of economic sciences, Professor Nureev R.M. and PhD Urnov M.Yu.

The applicant was granted a degree of master of economic sciences by secret voting without a dissentient voice.

Synopsis of the thesis and the thesis itself can be found at the IET's library.

ALL-RUSSIA CONTEST FOR THE BEST GRADUATION WORK ON ECONOMY

WINNERS OF THE CONTEST FOR THE BEST GRADUATION WORK ON ECONOMY IN 2003

In May 2003, the Institute for Economy in Transition announced a regular All-Russia Contest for the Best Graduation Work on Economy for those who graduated from economic higher education institutions and economic departments of higher education institutions of Russia.

An **award for «The Best Graduation Work on Economy»** was instituted for the winners:

- First award (one) – 20 thousand rubles.
- Second award (two) – 10 thousand rubles each.
- Third award (three) – 5 thousand rubles each.

Fifty six economists graduated from Russian higher education institutions in 2003 submitted their graduation works on economy for **the contest**. The institutions are listed below:

Voronezh State University,
Kursk State Engineering University,
Land Development State University,
Moscow State Institute for International Relations (MGIMO) under the Ministry of External Affairs of the Russian Federation,
All-Russian Correspondence Financial-Economic Institute,
Irkutsk State Engineering University,
Higher School of Economics,
Vologda State Engineering University,
Saint Petersburg State University,
Yuzho-Uralsk State University,
Russian Plekhanov Academy for Economics,
Saint Petersburg State University for Economy and Finances,
Moscow State University,
Financial Academy under the Government of the Russian Federation,
Bashkiria State University,
Tomsk State University,
Kemerovo State University,
Amursk State University,
Volga-Region Stolypin Academy for Public Service,
State University for Management,
Tolyatti State University for Service,
Novosibirsk State University,
Vladivostok State University for Economics and Service,

Kuzbass State Engineering University,
Tyumen State Institute for World Economy, Management and Justice,

Saint Petersburg Technical University,
Russian Economic School.

The Contest Commission comprised:

Chairman – Dr. of economic sciences E. T. Gaidar,

Deputy Chairman – Academician R.M. Etnov,

Academic Secretary – A.I. Yashin,

Commission members: Dr. of economic sciences V.A. Mau, Dr. of economic sciences A.D. Radygin, Dr. of economic sciences S.G. Sinelnikov-Murylev, Dr. of economic sciences E.V. Serova, Dr. of economic sciences A.V. Ulyukayev, Dr. of economic sciences C.V. Shishkin.

The Commission examined and selected graduation works to be rewarded:

· **First award** – **Komarova Tatiana Victorovna**, graduate from the Russian Economic School, for the graduation work on «Shadow Economy at Russian Regions»;

· **Second award (one)** – **Zavadskiy Ivan Aleksandrovich**, graduate from the Saint Petersburg State University, for the graduation work on «Mergers and Acquisitions: Causes and Effects, International Experience and Russian Practice»;

· **Third award (two):**

- **Musatova Maria Mikhailovna**, graduate from the Novosibirsk State University, for the graduation work on «Methods of Efficiency Assessment of Mergers and Acquisitions (by the Example of Ferrous Metallurgy Enterprises)»;

- **Derkachev Pavel Vladimirovich**, graduate from the Moscow State University, for the graduation work on «Economic and Geographical Aspects of General Education Financing in Russia».

All the winners received corresponding certificates and cash amounts.

Congratulations!

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