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Section 1.

Social and Political Outlook

1.1 Political Environment and the Economy

Particularities of 1995

During the time which passed since the beginning of the post-communist reforms, the year 1995 became the most successive in the long period of implementation of the standard course of the macro-economic stabilization. At the same time, the general background remained unfavorable enough, even critical at the beginning of and at the end of 1995. The January's climax of the Chechen war and the December's elections finished in the victory of the anti-Government (and anti-stabilization) forces of the communists and nationalists form the political framework of the today's (fourth in the latest three years) attempt to stabilize the Russian economy.

The transition to the stabilization course was extremely complicated for the Government. At the end of 1994, the Russian power bodies were facing the selection of the ways and mechanisms of consolidation of the power and of stabilization of the socio-economic processes in Russia. *For the one hand*, the possibility existed to consolidate the power by the macro-economic stabilization, the strengthening of the market democracy institutions, and, based on these, come gradually to the road of the post-crisis economic rise. *For the other hand*, the Government could try to follow the way of a stricter political regime, capture of the aggressive-nationalist slogans of the opposition (first of all, CPRF and LDPR), beginning of the confrontational interior and foreign policies, thus trying to get down with the political competitors and expel from the political space all kinds of pretenders for power from both the right and left.

As usual, the executive power was disunited; but, for the first time during the post-communist reforms, the sharp contradictions in the President's team became so obvious, and, seemingly, irreconcilable. V. Chernomyrdin and A. Chubais, supported by the President, began implementing the course toward the successive macro-economic stabilization. The "force" bodies, as well as a number of the politicians close to Yeltsin (also supported by the President) began trying to solve the Chechnya problem by military methods. This was creating the danger of transformation of the democratic regime into an authoritarian one. The perspectives of this or that direction were dependent on the actual evolution of the events, on the capacity of their supporters to solve the problems they were facing, to show the efficiency of their activities.

January 1995 was unfavorable for the both alternatives. The Chechnya war could not be finished by an easy and impressive victory, showing the efficiency of the arms and demonstrating the capacity of the Russian power bodies to solve political problems (first of all, of consolidation of power) by the "force" methods.

The economic situation was extremely difficult, too. Under the effect of the inflationist policy of the Summer and Fall of 1994, the main macro-economy indexes deteriorated. The monthly inflation reached 17%, the level of living dropped sharply. At the same time, an attack without precedent was made against ruble by the banking structure playing for decrease. The Government and the Central Bank managed, at last, to protect the ruble exchange rate against the fluctuations (similar to those of the "black Tuesday" of 11 October 1994), but, due to the large-scale interventions of that period the

hard currency reserves of the Central Bank dropped down to almost US\$1 bln, which may be compared with the level of 1992.

However, in Spring, policy (renewed at the end of the Fall) of the limitation of the money stock, reinforced by the refusal by the Government of the inflationary financing of the budget deficit, began giving its fruits. The inflation rates slowed down considerably, and the ruble exchange rate grew not only really, but also nominally. These were the sensible shifts, especially obvious against the background of the continuing war in Chechnya. At the same time, it became obvious that the President began again preferring the economic variant of the consolidation of the regime, hoping to use it as an important ground in the election campaign. Nevertheless, as the Chechnya conflict has not ended, it gives to the supporters of the nationalist course the possibilities to play this card in future, as well, to come to their political purposes.

The stabilization course of the Government, its time limits, the political and ideological distinction of its implementation - all these were directly connected with the elections, of 17 December 1995, to the State Duma and with their results. The preparation to the elections itself effected both the activity of the political elites (especially in the second half of 1995) and the actual political and economic decisions of the executive power.

Nevertheless, in 1995, the absence of a direct and unambiguous connection between the economic situation and the political spirits (especially the behavior of the electorate) was confirmed again. This was obviously shown already by the April referendum of 1993 (when the majority voted for the support of the social and economic course of the time) and by the December 1995 elections which were of a success for the opposition. First of all, voters react on the changes of the social and political situation with a significant delay, and, secondly, their reaction is influenced by a complex set of factors which cannot be reduced to the economic problems only.

The experience of the post-communist States allows for certain general conclusions as of the logic of the relationships between the economic reforms and the political behavior of the voters. The practice shows that getting to the way of growth takes, usually, 2 to 2.5 years, of which about one year is needed for the stabilization itself, and this phase is one of the most painful from the social and political points of view. At the same time, this phase creates favorable conditions for the economic growth which begins in the second year of the stabilization policy. The objective improvement of the socio-economic situation recorded by the statistic bodies does not become obvious for a simple voter: this requires additional 6 to 12 months. And only after this, the Government which implements the reforms, may count for a certain success at the elections. In the other words, the elections of December 1995, coincided with the final stage of the stabilization phase of the economic reform, and this stage is one of the most critical from the point of view of the social consequences.

This could not be resisted by either the propaganda efforts of the authorities, nor by the attempts of the Government to show its care for a plain voter by certain demonstratively populist decisions. Moreover, the Government, having selected the direction toward stabilization, tried to implement this course as successively, as possible, without abuse by the high-cost populist measures. This was, on the whole, a right deed, because such measures would not have given additional votes to the parties at power: voters would have understood them as drawbacks incited by the parties of the rigid opposition making the latter even more popular.

The position of the pro-Government "Our Home is Russia" block (NDR) and of the political forces supporting the stabilization course of the Government (first of all, the "Democratic Choice of Russia", DVR) was also complicated by that the policy implemented was the third stabilization attempt in the four-year period of 1992-1995. At the same time, every new attempt on stabilization

is harder from both the economic and the socio-political viewpoints. The readiness, and, which is main, the capacity of the largest layers of the population to overcome the hardships of the economic instability, while the trust in the capacity of the new authority to implement the planned course, in the availability of the required political will and (or) competence is greatly reduced.

The stabilization transforms and complicates the system of the social and economic interests existing in the society which is reflected at the political level, as well. In present Russian society, there exist several criteria of separation of the relevant groups of interests, and, in the actual economic life, the groups separated by different criteria may overlap.

The complication of the system of interests took place during all the four years of the post-communist transformation. Already in 1993, the differences of the interests of the economic agents, capable or incapable to adapt to the competition economy, became obvious. The former had no need in creation of financial conditions for them (for their evolution the support of the general financial stabilization was sufficient), while the latter could not survive without a constant inflow of cheap money. In the other words, the controversy of the anti-inflationist and pro-inflationist forces formed.

At the beginning of 1994, the conflict based on the external economic course of Russia was added to this controversy, when the issue of the admissibility of the opening of the Russian market for foreign competitors became the object of a vivid discussion. The supporters of the pro-inflationist course, having a low competition potential, were interested in protecting their markets against cheap foreign goods; hence, their slogans were to form a nationally closed highly monopolized economy separated from the world market by strict customs and legal barriers. Their opponents supported the principles of the open economy ensuring the growth of the efficiency by the mechanisms of competition, including international. Thus, the traditional for the Western Europe argument between the free-traders and protectionists became especially urgent for the today's Russia, as well.

Hence, what was new in 1995?

First of all, the stabilization and the strengthening of the real exchange rate of the ruble mean an actual inflow of capital in the country. This creates the conditions for the cheaper credit, for the lower efficiency of the purely speculative transactions in the financial sector, and for the higher attention of the financial institutions to the investments in the producing industries. Already in the second half of 1995, a number of the largest Russian banks began showing a stable interest to the production sphere, which was reflected by both the creation of the special divisions to control the investments, and by the aggravation of the struggle between banks for the possession of blocks of shares of privatized entities.

Secondly, the growth of the real ruble exchange rate resulted in the aggravation of the positions of the exporters and higher competitiveness of the imported goods. The natural reaction of the Government was to increase the import duties and to decrease (up to abolition for certain items) of the export duties. But the latter measure will not be sufficient for the exporters not linked with the fuel and power complex, especially for the not numerous mechanical engineering entities capable to come to the foreign market. And these economic agents form the natural socio-political basis of the stabilization course, and the worsening of their economic situations is the process very dangerous from the political viewpoint.

The problem of the comparative efficiencies of the import and export has one more important aspect requiring a political solution and effecting directly the positions of the influential groups of interests. It concerns the traditional for the medium-level economies issue of the import substitution. The cheaper import may have a positive effect on such domestic industries which depend on the

supplies of foreign goods (such entities are numerous among the exporters). At the same time, this may lead to a critical situation such domestic mechanical engineering entities (first of all, those converted) which have taken the way to the adaptation to the real market demand and are today restructuring their production bases in order to satisfy the potential investment demand of the feedstock and processing industries.

Thirdly, the transformation is going on of the economic and political interests of the financial and trading organizations. These sectors won the most from the inflation which was making their activities exclusively profitable. The stabilization aggravated their economic situation and led to a crisis in which only those who can adapt to the work with the relatively low interest rates oriented rather to the mass of profit than on its norm, i.e., on the sum of the capital invested, will survive. Hence, one can forecast the continuation of the crisis in the spheres of the banking and trading capitals, with the survival of the largest and most stable organizations.

Finally, due to the outlined perspective of the macro-economic stabilization, large financial structures began being more interested in the privatization, in the second half of 1995. The sharp intensification of the struggle for the State-owned (actually, controlling) parcels of shares of stock of the leading Russian entities led to the regrouping of the forces among these structures, to the formation of new unions, and to the surge of the new contradictions. One may suppose that these processes will lead to the aggravation of the domestic political tension, to an obvious or hidden concentration of those unsatisfied in the privatization results around the natural center of such non-satisfaction, the CPRF, being the largest party claiming in an open manner the necessity of the property redistribution on the new, "more equitable" bases.

Results of the Elections and the Economic Policy Outlook

The political struggle of the second half of 1995, which preceded the elections to the State Duma, was especially interesting because the attention of its participants was concentrated rather not on the issues of the current stabilization and of surmounting the crisis in the narrow sense (i.e., stopping the production recession), but on the model of the future social and economic evolution of Russia. And this is natural, because the economic results of the year, the accumulated hard currency reserves, and the inertial potential of the Russian economy (equal to about six months) allow for the conclusion that, in the first half of 1996, stabilization stage will end and the problems of the economic growth will become more actual.

In the other words, the politicians and the parties may continue the discussions on the stabilization results, but the political actualization of these issues will be of low productivity. By the way, it seems, that this fact explains the relatively pacifism of the opposition majority of the 1995 Duma which took, during the electoral period, a number of the resolutions important, of principle, for the economic policy of the Government (on production sharing, on the 1996 Budget, on the nomination of the Chairman of the Central Bank, etc.).

The electoral discussion revealed the presence in the Russian political environment of the three versions of the post-stabilization policy, every one of which is related to the real interests of these or that socio-economic groups and is presented in form of the program milestones of these or that political forces.

There exists the variant of the open market economy supported with the best continuity by the liberal political forces (first of all the DVR), and implemented in the economic course of Victor Chernomyrdin. The most interested in this course are the efficiently operating enterprises and sectors of the Russian economy capable for competition on the domestic and foreign markets.

The two real alternatives to this course have already clearly outlined themselves. For the one hand, the leftist model was proposed. The essence of it consists in the large-scale money and credit expansion with the aim to support the inefficient industries and production sectors; the inevitable acceleration of the prices growth are to be struggled with by the administrative measures: State control of the prices and of the currency exchange rate which will inevitably lead to the rapid spending of the gold and hard currency resources, and, hence, renewed lack of goods. For the other hand, the nationalist model was proposed. It supposes to close the domestic market before the foreign competition, the large-scale State intervention in the economy with the attempts of a strict monetary and crediting policy. The obviously inflationist positions are occupied by both the CPRF and the "Yabloko". As for the nationalist economic ideology, its main supporters were the KRO and, judging by numerous indicators, the LDPR, though the latter does not formulate in any distinct way its economic credo.

The results of the elections allow for certain conclusions of the economic and political character. Though, from the constitutional viewpoint, these results may not have a direct effect on the current economic and political course, they put this course in certain political and ideological limits.

First of all, it should be noted that the KRO, the most consequent defender of the nationalist alternative to the Government's course, suffered a striking defeat. At the same time, an obvious pro-inflationist majority is forming, of the deputies from the CPRF and "Yabloko" which, at a certain course of events (e.g., the dismissal of V. Chernomyrdin) will be supported by lots of representative of the pro-Government NDR block, leaving aside the supporters of Zhirinovski, offsprings of the Soviet "nomenclature".

Nevertheless, the defeat of the KRO does not, in any way, mean the defeat of the nationalist political and economic alternative. The both oppositional models of the economic evolution were closely linked between themselves from the very beginning. The leftist-populist doctrine of the CPRF includes many of the most important components of the nationalist model: protectionism, strict State control over the production, strengthening of the role of the largest-scale (monopolist) economic structures, etc. At the same time, the nationalist model includes such economic and political decisions which leave practically no chances for its non-inflationist implementation.

The victory of the pro-inflationist ideology at the Duma elections does not mean, by itself, the immediate practical implementation of it in the economic course of the Government. Nevertheless, when the President Yeltsin shows obvious political hesitations, and taking into account the Presidential elections to come in June 1996, one can speak of a significant political potential of the inflationist structure in Russia. Thus, we can see a very possible perspective of getting into the trap of the "macroeconomy of populism", of the economic policy characteristic of many Latin American countries of the 20th century.

The results of the December elections and the general political incertitude of the following months will also have unpleasant enough consequences for the solution of such problem (very urgent for the post-communist Russia) as the formation of an up-to-date market of capitals and attraction of foreign investments. It seems not very probable that depression in the stock market which began at the end of February 1994 (the Government linked the way out of this depression with the macro-economic stabilization) will be overcome in the nearest six months as a minimum. This is due, partly, to the bad yet legal regulation of the property relations, and, partly, to the general political incertitude before the Presidential elections: their results, taking into account the results of the elections to the Duma, lead to a serious anxiety of the potential investors. The above is true for both the domestic capital and, of course, to a greater extent, to the foreign capital.

These considerations of the economic and political character should be supplemented by another, purely economic, reasoning. The natural growth of the ruble exchange rate, necessary during stabilization, reduces the efficiency of the investment projects for the foreign investors, thus forming another barrier on the way of the foreign capital. Nevertheless, the experience of practically all the countries shows that, for the foreign investments, the growth of the exchange rate of the national currency never becomes a serious and long-term obstacle: the certain growth of the projects prices is well compensated by the higher stability (economic and political).

Taking into account the results of the elections of 17 December 1995, and, in connection with the coming Presidential elections, two variants of the evolution of the events exist: either the Government's course of 1995 (finalizing the stabilization and gradual transition to the growth phase) will be continued, or the populist policy, based on the, based on the inflationism and protectionism, will be implemented. The choice depends, to a great extent, on the composition of the Government. The Constitution does not envision the immediate dismissal of the Government after the elections. Nevertheless, in January 1996, Boris Yeltsin began serious changes in the Government; these changes may become determinant for not only the character of the economic reforms, but also for the political situation in Russia itself.

In January, the positions of the supporters of the flees strengthened sharply, with the final transfer to the left-inflationist (closed) economy model. The dismissal of A. Chubais and the sharp growth of the influence of O. Soskovets and N. Yegorov support such conclusion.

What are the probable economic consequences of such steps of Boris Yeltsin?

In the short-term, they depend on the set of the actual factors: to what extent will V. Kadannikov, the new vice-Prime Minister, be willing to implement the inflationist course; will the "old" economy team of the Government be "washed out"; and will the management of the Central Bank be capable to implement an independent, responsible policy. But, in any event, the policy of the second half of 1995 conditions the improvement of the situation for the next several months.

As for the long-term consequences, the situation is more complicated. The consistency of the reforms is obviously weakening: the strengthening of the nationalist-populist line in the economy may result in the strengthening of the roles of the monopolists in the domestic market (especially in the form of the financial-industrial groups) and in the limitation of the competition mechanisms, in the attempts to freeze the prices, in the spending of the hard currency resources, and in the strengthening of the role of grants. Most probably, if the management of the Central Bank is not compliant, the attempts to replace it or to amend the laws on the central Bank will be made, in order to limit the independence of the latter. An aggravation of the struggle for the new redistribution of property is very probable.

The main political consequence of the dismissal of A. Chubais consists in that, five months before the Presidential elections, the country did not find any real candidate for Presidency from the democratic, reformist, or, at least, moderate, forces.

Indeed, the odds of Boris Yeltsin for the second term of Presidency are minimal: the social characteristics of his electorate are practically impossible to outline. Signs of a political union between G. Ziuganov and G. Yavlinski are seen. As for the other runners for Presidency, V. Zhirinovski and A. Lebed, they can hardly be called democrats.

In the event of the dismissal of V. Chernomyrdin, the political situation would have had another form. This could let him become an independent figure in running for Presidency. In such event he could have expected the support of a large coalition of the democratic and centrist forces. But a

more probable variant of the events consists in that V. Chernomyrdin will continue heading the Government for, at least, the nearest 2 or 3 months, after which his political destiny will depend, mainly, on the current problems of preparation for the Presidential elections.

Certain Economic and Political Conclusions and Forecasts

The year of 1996 will become the key one for the determination of the strategic milestones of the future economic and political evolution of Russia. This is due to both the political (Presidential elections) and the economic (finalization of the stabilization stage) reasons. Here, for the moment, the two variants of evolution are possible. For the one hand, this is the affirmation of the open economy model, where the economic growth and the relative stability of the prices are results of the high competition level. For the other hand, this is the closed economy system with a high level of the State participation in the economic processes, where the purpose of import substitution dominates the purposes of improvement of the efficiency of the national economy.

For 1996, especially for the first half-year, it is natural to expect the depressive state of the stock market, as well as the continuing crisis in the financial and trade sectors. The latter could have been avoided by returning to the policy of the inflationary financing of the budget deficit, but this will be a suicide for the today's Government.

At last, the strengthening of the struggle for the property under privatization is inevitable. This will have the two consequences. First of all, it will lead to the regrouping of the forces among the leading financial groups, the intensification of the competition between them. Secondly, the role of the CPRF, as the largest in the Duma anti-Government political force and as the natural in the today's situation center of attraction for all those who are or will be unsatisfied with the decisions made for specific investment projects, will be strengthening.

Section 3.

Investment Processes

3.1 Investment Policy

The process of stabilization of the economy is accompanied by the surge of the new trends: the slowdown of the inflation rates in the investment sphere, compared with the consumer market, the fact that, in the second quarter of 1995, the positive rate of the banking interest was reached, and the higher inclination of the population to savings.

The 1995's situation in the investments sphere was determined by the effect of the following factors:

- reduced rates of decrease of the total volumes of investments;
- continuing growth of the living, mainly individual, houses construction;
- deeper de-centralization of the investment activities and changes of the capital investments distribution by forms of property;
- increase of the share of the long-term investments in the economy development;
- slowdown of the prices growth rate in the capital construction; and
- growth of the volume of the foreign investments in the Russian economy.

The 1996's Federal investment policy will be oriented to the formation of the investment environment favorable for the growth of the investment activities of the non-State sector, mobilization of the private domestic and foreign investments for the restructuring of the Russian economy. The social sphere and the support of the high efficiency investment projects will remain the main direction of the use of the State investments.

Under the conditions of the limited investment possibilities of the State, the distribution of the limited out-Budget assets and the State financing of the production oriented investment projects in strict accordance with the Federal targeted programs, and on the competitive basis, acquire more and more importance.

The State support of entities supposes the further development of the paid and repaid basis crediting, while the non-repayment crediting from the Budget will remain, mainly, for the projects of high social importance of non-profit character. The practical implementation of this direction is possible only under a stricter State control over the targeted expending of the money from the State Budget.

The new approach in the investment policy, envisioning the transfer from the distribution of the State investments for the production-oriented purposes to their competition-based distribution was fixed by the Presidential decree of 17 September 1994, # 1928, "On the Private investments in the Russian Federation", the Decree on the Amendments and Supplements thereto of 20 January 1996, and the Resolution of the Russian federation Government of 22 June 1994, # 744, "On the order of Distribution of the Centralized Investment Resources"; the latter one fixes the functions, rights, and obligations of all the participants in the competition.

The analysis of the tenders already carried out shows that the interest of commercial structures in investing in high efficiency project had grown significantly. In 1996, about 600 investment projects, over Rb37 trln worth, were submitted for tenders, with the repayment terms of such projects not exceeding two years.

Russian commercial structures and banks, foreign investors, etc., are highly interested in participating in tenders and they emphasize the evaluation of the investments quality and the State guarantees.

It is intended to organize the selection of the high investment efficiency projects at regional levels, accounting for the mobilization and use of the internal investment resources of the relevant regions.

As for the sources of the centralized investment resources to be distributed at the competitive basis, these will have to be, in addition to the Budget assets, credits from international financial institutions and foreign states to be granted under the guarantees of the Russian Government, plus the payable debts of foreign states to Russia. Besides, beginning from 1996, the formation of the Federal Budget will envision the direction of the repayment-based investment purpose assets to finance high efficiency investment projects, including the conversion ones.

The Federal Investments Program for 1996 envisions to allot Rb3 trln of the State investment resources for their distribution on the competition basis; this will favor a significant mobilization of the private capital, whose share may amount, in 1996, to about Rb15 trln.

To assess the principles of the mixed State and commercial financing of the projects, the Integrated Program for Encouraging the Investments envisions to ensure the mechanism of certification and support of the State guarantees to investors.

The draft Resolution of the Russian Federation Government “On the Additional Encouragement of Private Investments” fixes the measures aimed to ensure the growth of the investment activities of the private sector and of the mixed property sector, which, together, finance up to 64% of the total volume of investments.

To improve the trust in the investments and to attract private investors, including using the securities market, the draft Resolution of the Russian Federation Government “On the Additional Encouragement of Private Investments” envisions to create the mechanism of granting of State guarantees to private investors, including the obligations of the State to recompense a part of the resources in the event of failure of an already certified projects for the reasons independent upon the investor. Herewith, the investor will need to grant its own guarantees, collaterals included. The development of certification of the investment projects and of the order of granting State guarantees to investors are envisioned.

The Federal Investment Program envisions the compensation for the reduction of the Budget financing by insuring and guaranteeing the State-supported investment projects (including by guaranteeing the securities issued by private investors): this will ensure the efficiency of investments to private investors and lower risks.

The insurance of the investments will considerably reduce the risk of entrepreneurs to acceptable levels. The insurance will be both on individual risks and on their combinations (non-commercial risks, consequences of the authorities decisions to limit property rights, consequences of the disposal of the created assets and produce, consequences of the capital and dividends transfer abroad, and changes in the accountancy rules and regulations). The insurance system must be uniform and be used in the interests of both the domestic and foreign investors.

The Resolution of the RF Government of 19 August 1994, # 967 “On the Use of the Mechanism of Emergency Depreciation and Re-Evaluation of Fixed Assets” allowed to enhance the role of the depreciation allotments as the ones forming one of the main sources of the investments financing.

The Presidential Decree “On the Use of the Depreciation in the Investment Support of the Economy Restructuring” which will allow for a better control of the purpose-oriented use of the depreciation allotments is under drafting.

According to forecasts, in 1996, the total volume of the investments due to all the sources of financing will amount to Rb370 trln, or 104% of the 1995 level. It is supposed to invest about Rb200 trln, which is by 1% to 2% higher than in 1995, in the production projects, while for the non-production sphere the figure will be by 5% to 8% higher than in 1995.

The main source of financing of the investments activities is formed by the own assets of enterprises, which will amount to 64% of the total volume of investments. For 1996, it is expected that the share of the depreciation allotments after revaluation (as of the beginning of 1995) in the total volume of investments will grow by 15% amounting to 46.4%.

In accordance with the Presidential Decree of 22 December 1993, # 2270, “On Certain Alterations in Taxation and Inter-Relations of the Budgets of Different Levels”, from 1 January 1994, certain privileges took effect in taxation of enterprises and organizations, in particular, for financing the capital construction.

The customs regime is intended to be controlled on the basis of the differentiation of the import tariff, in particular the customs rates for the machinery and equipment for investment purposes; this will facilitate the import of the capital goods not manufactured in Russia or manufactured in lesser numbers than needed.

The most important normative acts in the investments sphere, intended to encourage the private enterprise are the following: the Decree of the RF President of 17 September 1994, # 1929, “On the Development of the Financial Leasing in the Investment Activities”; the Resolution of the RF Government of 29 June 1995, # 633, “On the Development of the Leasing in the Investment Activities”; and the “Temporary Regulations on Leasing”. The Law “On Leasing”, the resolutions “On the Fund for Support of the Leasing Development in the Russian Federation”, the regulations on the Council of Trustees of the Fund for Support of the Leasing Development in the Russian Federation have been drafted and submitted to the RF Government.

The leasing of the high value equipment is an efficient form of support of the market development in the investments sphere. The expansion of this practice will allow to diminish the financial burden of the investments expenditures and encourage the investment demand on the relevant articles of both the domestic and foreign manufacture. According to certain estimates, at a well developed leasing, the initial investments required to organize a business, recede 3 to 4-fold, which is especially important for the development of the small and medium-size entities. The leasing mechanism allows to improve the efficiency and accelerate the processes of the technical reequipment, reconstruction, and reprofiling of enterprises.

The stock market will play a more important role in the investment activities. In 1996, the share of the investments due to the secondary issuing of securities will amount to 2% of the total volume of the investments in the real sector.

The Resolution on the conditions of granting of the State guarantees against issues of securities to private investors has been drafted; this will favor a better trust in these securities.

The investments policy is oriented toward encouraging the various forms of the housing construction and creation of the favorable conditions for mobilizing for these purposes the out-budget sources of financing, first of all, the money of the population.

In 1996, the practical implementation of the RF President's Decree of 26 July 1995, # 765 "On the Additional Measures for Improvement of the Efficiency of the Investment Policy of the Russian Federation" will begin. These measures have the aim to create the conditions for the efficient use of the savings of the population, for the attraction of the investors to the investments activities using the shared investment funds. The housing construction will also use such securities as the housing certificates and housing bonds.

To mobilize into the economic turnover the unfinished dwelling houses, in accordance with the Presidential Decree of 10 June 1994, "On the Measures to Support the Completion of the Unfinished Dwelling Houses" the transfer of the unfinished construction projects from the federal property to private investors on the competition basis.

3.2 Investment environment in the real sector of economy

Fixed assets outlook

As the economic situation stabilizes and the institutional structure of the fixed assets changes by forms or property, the radically new type of reproduction is forming. Traditionally, the expansion of the labor means functioning in the production had been characteristic for the Russian economy. Herewith, insufficient attention had been paid to the renewal of the fixed assets by removing from the production the worn and obsolete machinery and equipment. The long term effect of this tendency, on the background of the slowing down rates and decreasing volumes of investments in the fixed assets, led to a deeper disbalance of the fixed assets reproduction process, from the viewpoints of technology, distribution by industries, and age.

The restructuring of the national economy is, in a significant extent, linked with the changes of the fixed capital structure and the conditions of its reproduction. Herewith, it is necessary to take into account that the share of the fixed capital functioning in the non-State sector amounts to over 56% of its volume. Due to this, the particularities of the capital resources formation and of the directions of their use by forms of property have to be accounted for (see Table 3.1).

In conjunction with the collapse of the rates and volumes of investments in the fixed assets, in 1994-95, unprecedented for the Russian economy, the rates of growth of the production capital reduced crucially.

The distribution by branches of economy of the functioning fixed capital reflects the fact that the extremely conservative, overloaded economic structure remains at place. Indeed, the distribution of the fixed assets by branches of economy underwent no really significant changes, despite, even, the systematical revaluation of the fixed assets (see Table 3.2).

Table 3.1

Structure of fixed assets by forms of property, %					
	1991	1992	1993	1994	1995
Fixed assets total	100	100	100	100	100
incl.:					
State-owned	91	91	69	53	44
private	9	9	31	47	56

According to Goskomstat.

Table 3.2

Structures of fixed assets and degrees of their wear by branches of economy, 1991-1995, %

	Fixed assets		Wear	
	1991	1995	1991	1995
Fixed assets, total	100	100	35.9	37.2
Commodities producing branches	49.2	53.3	-	42.9
incl.:				
industry	33.7	35.2	49.6	45.8
rural economy	11.4	13.6	22.6	37.4
construction	3.8	4.2	53.3	36.3
Branches providing market and non-market services	50.8	46.9	-	30.7
incl.:				
transport and communications	14.2	12.8	38.1	41.0
trade and procurement	2.9	2.3	-	-

Acc.ording to Goskomstat.

The reduction of the fixed capital growth rates with the reduction of the norms of removal is accompanied by the systematic growth of the wear. The certain decrease of the wear factor in 1995, compared with 1991, was due to the modification of the practice of re-evaluation of the fixed assets, not by the qualitative improvement of the reproduction process. In the period of 1991 to 1995, the factor of renewal of the fixed assets was systematically reducing; in 1995, it made 1.3% against the 6% in 1991 (see Table 3.3).

Table 3.3

Factor of reproduction and updating of fixed assets

(acc. to 1990 balance estimate)

	1991	1995
Factor of renewal, %	6.0	1.3
Factor of removal, %	1.8	1.3

According to Goskomstat.

As the capital resources are limited, it is expedient to remake the structure of the investments for the benefit of acceleration of the technical reequipment rates: this would have let to include the renewed assets in the process of the economic restructuring.

Nevertheless, the analysis of the capital investments reproduction structure shows that, during the last two years, the growth of the share of the expenditures on the new construction has been growing in detriment to the processes of the technical reequipment. The reduction of the production scales and of the degree of utilization of the production facilities leads to higher expenses on the support of the fixed assets in the operating state. Under such conditions, the growth of the share of the non-functional capital at the balances of enterprises worsens their financial situations and, generally, acts as the factor of the unsubstantiated requirements to increase the volumes of investments. From the macroeconomy point of view, the problem is not just in determining the scales of financing, but, rather, in separating the directions of use of the investments.

An analysis of the situation of the assets allows for the conclusion on the necessity to renew and update the production apparatus, first of all, the capital-forming branches. The wear of the fixed capital of branches of the industries producing the capital goods, and the relative systematic decrease of the production rates of the investment products, combined with its extremely bad technical and economic parameters, has an utterly negative effect on the situation of the reproduction mechanism in the national economy.

The fixed capital reproduction is being financed from the accumulation fund in the fixed capital and the depreciation allotments. The share of the gross accumulation of the fixed capital in the gross domestic product has been systematically decreasing: in 1995, it made up 22%. As for the structure of the gross accumulation of the fixed capital, the net investments made up about 68% in 1995, against the 63% in 1991; this was accompanied by the reduction of the expenditures on overhaul.

In the real sector of the economy, the reduction of the total volume of investments, combined with the low efficiency of their utilization, aggravates the problem of the technological backwardness of the production. Under such conditions, the stabilization of the economic situation, combined with the improvement of the investment climate is one of the main directions of restoration of the fixed capital reproduction processes.

Investment activities

In 1995, in the investment sphere, the perfecting of the normative and legal basis and of the forms of the State support of efficient projects continued. So, the conditions were forming for expansion of the non-Budget sources of financing and for mobilization of domestic and foreign investments. The reduction of the direct participation of the State in the investing processes is accompanied by the gradual strengthening of the positions and the growth of accumulations in the non-State sector of the economy. As the economic situation stabilizes, and the savings of the population grow, the mechanism of their mobilization and transformation in the direct and portfolio investments will begin working.

In 1995, entities and organizations of all the forms of property used Rb250 trln worth of capital investments, which equals 87% of the 1994's level.

The reduction of the investing activities was accompanied by the decrease of the construction works volumes, both in the production and non-production spheres (see Table 3.4).

During 1995, the construction of the production purpose projects used Rb140 trln worth of capital investments, or by 17% lesser than in 1994. The capital investments in the social and civil construction reduced by 7%, having equaled Rb110 trln.

The financing of the investments by forms of property reflects the processes of the institutional changes in the national economy (see Table 3.5)

Table 3.4

Pattern of capital investments in 1995
percentage to the preceding year

	1993	1994	1995
Capital investments, total	88	76	87
incl. for projects:			
production purpose	81	67	83
non-production purpose	101	89	93

According to Goskomstat.

Table 3.5

Structure of capital investments by all forms of property from all the financing sources, %

	1993 ä.	1994 ä.	1995 ä.
Capital investments by entities of all forms of property	100	100	100
incl.:			
State	51	34	33
municipal	12	8	7
mixed	25	42	44
private	12	16	16

According Goskomstat.

In 1995, entities and enterprises of the non-State form of property used Rb167 trln of capital investments, or 67% of all the investments in the real sector of the economy.

The share of the State sector investors made up 33%, against the 34% in 1994. Despite the cautious enough behavior of the private investors, joint stock companies are, gradually, strengthening their positions in the investing process; this limits significantly the distribution functions of the State.

The narrowing of the sphere of the direct State participation in the investing activities shows itself in the reduction of the volumes of the centralized capital investments, as well.

In 1995, Rb53.8 trln from the consolidated Budget and Rb27.5 trln from the Federal Budget were allotted for the investment purposes; these make up 11% of the total volume of the investments in the real sector of the economy (see Table 3.6).

For the first time, the Federal Investments Program for 1995 envisioned, in order to improve the investing activities, to direct the Rb1.45 trln of the State investment resources to be distributed on the competition basis. To the end of the year, 713 projects of the estimated cost Rb37.2 trln were submitted for tenders. The volume of the centralized resources they call for makes Rb7.8 trln of the estimated cost. Most of the projects were submitted by the entities of the chemical-forestry and construction complexes (24%), the mechanical engineering complex (14.7%), and the agro-industrial complex (44.2%). By the results of the year, 83 investment projects obtained the State support. The total volume of the State support for these projects was estimated as Rb474.8 bln, which make less than 10% of the year limit.

Table 3.6

Structure of capital investments by sources of financing, %

	1993	1994	1995
TOTAL	100	100	100
incl. the assets of:			
- Federal Budget	19.2	13.4	11.0
- Budgets of Federation subjects	15.1	10.6	10.5
- own assets of entities and organizations	57.4	64.2	62.5
- individual builders	2.6	2.3	3.0
- Budget fund for State support of priority branches, centralized out-Budget investment funds, and other sources	3.3	7.8	10.2
- foreign investments and joint ventures	2.4	1.7	2.8

According to Goskomstat.

In 1995, the financing of the capital investments was extremely unsatisfactory. The Federal Investments Program for 1995 was not fulfilled: of the 206 production sphere projects only 38 were started up, and of them only 15 were completely accepted. The Federal targeted programs were financed by only 60%, while the conversion programs were financed by only one fourth. It was impossible to repay the debts for the works already accomplished in 1994. In whole, as for the State capital investments financed from the Federal Budget, the creditor indebtedness of Rb5 trln is expected, as of the end of the year. The 1996's Budget envisions Rb2.2 trln for its repayment; the remaining share is to be repaid at the expense of the current financing, which will lead to additional difficulties in the financial support of the investments program of the current year.

The main source of the capital investments financing is formed by the own assets of enterprises, whose share makes up 62.5% against the 1994's 64.2%. As the financial situations of entities worsen, the expenditures on the production development and updating in the structure of the money use have the trend to fall from 15.6% in 1994 down to 14.3% in 1995.

The share of the profit in the investment assets decreased against the 1994 level, and amounted to about 15.1%; in whole, this reflects the apathetic character of the investing activities. According to the forecast for 1996, the share of the profit in the investments resources will make up about 12% to 13%; in essence, it determines the tendency to the further reduction of the own assets of entities in the investment resources of the national economy. In this connection, the implementation of the new investing policy creates the real conditions for a significant growth of the volumes and for the targeted use of the depreciation allotments in the national economy. In 1995, the share of the depreciation allotments in the capital investments made 44%, against the 41.5% in 1994; in 1996, it will grow up to 49% to 51%. The real effect of the flexible depreciation policy will be possible only

if the draft law on the use of depreciation, fixing a distinct mechanism of control of the use of the above assets strictly for the investments purposes, is promulgated.

The Federal Investments Program gives a high importance to the securities market. As the inflation processes are overcome, and the production stabilizes, a dynamic evolution of this market should be expected. In accordance with the estimates, the share of the investment resources accumulated by the issues of the securities made 1.5% in 1995; the growth by 1 to 2 percentage points is expected for 1996.

The reduction of the investments in the real sector of the economy is accompanied by the changes in the branches distribution, technological, and reproduction structures of the capital investments. Under the conditions of the economy in transition, the State will have to act, for a number of the most important directions, as the initiator of the investment progress, assist the efficient directions of development of the industrial sector and of the agro-industrial complex.

The capital investments in the production of goods are stably decreasing every year, while those in the services sphere are growing. The investments in the industrial development reduced from 35.9% in 1990 to 33.6% in 1995. The relatively high expenditures on the investments in the industry are supported, mainly, by the fuel and power complex industries: in 1995, their shares made over 1/5 of the capital investments in the national economy and almost 3/5 of the expenditures on investments in the industry; the relevant figures for 1990 made 14% and 39%. The investments support of the rural economy is decreasing sharply: in 1995, 2.7% of the total volume of capital investments were directed to the rural economy, against the 15.8% in 1990. This reduction is explained, in particular, by the shifts in the proportions of the investment resources among the branches of the agro-industrial complex, whose share in the total volume of the 1995's capital investments makes 8.8%.

Table 3.7

Structure of capital investments by branches of economy, %

	1991	1992	1993	1994	1995
Capital investments, total	100	100	100	100	100
including:					
industry	34.7	39.9	36.3	30.3	33.6
rural economy	18.0	10.4	7.3	4.7	2.7
construction	4.5	2.6	2.2	2.9	2.8
transport and communications	9.6	8.7	10.6	11.7	14.5
trade, public catering, and material and technical procurement	1.9	1.3	1.1	1.8	1.9
housing construction	18.1	22.8	24.0	25.5	26.0
other branches of economy	13.4	14.3	18.5	23.1	18.5

According to Goskomstat.

As for the positive shifts of the branches distribution structure of the use of the investment resources, these are, undoubtedly, the higher expenditures on transport and communications. After the 1991-92 recession of the investment activity in the construction of the transport and communications infrastructure, in 1995, the investments in the development of these branches made 14.5%.

The next structure-forming factor of a great social importance is the systematic growth of the expenditures on the investments in the housing construction: it remains one of the attractive directions of the investing activities. In 1995, Rb64.8 trln were directed to the housing construction; these make 26% of the total volume of investments in the real sector. Entities and organizations of all the forms of property put into operation 42.8 mn m² which is by 9% more than in 1994. The 9.9 mn m² of the living surface, or by 23.2% more than in 1994, were put into operation using the own money of the population and the credits for the housing construction.

In 1995, compared with 1994, the rates of the housing construction decreased by 4%, while the construction in the private sector grew by 40%. It should be noted, that, as the scales of construction expand, the volume of the unfinished construction grows. According to the RF Goskomstat, 97 mn m² of living surface were uncompleted, as of the end of the year. These volumes of the unfinished projects are due to the continuing growth of the prices for the construction materials and of the costs of the construction and erection works, for the one hand, and to the lack of the investment resources with the builders, for the other hand.

According to the calculations to the Federal Investment Program and the forecasts for the 1996 Budget, the volumes of the population's money mobilized in the housing construction, will grow significantly: in 1996, their share in the economy will make 4.3% of the total volume of investments.

3.3 Foreign investments

General trends of 1995

The past year has not given the volume of the foreign investments the Government had expected (US\$1.5 bln to US\$2 bln instead of the expected US\$2 bln to US\$3 bln). At the same time, the share of the direct foreign investments in the RF economy grew to 2.9%, in 1995, against the 2%, in 1994.

According to the RF Goskomstat, the direct investments grew, during the year, 2.4-fold, which amounted to US\$1.33 bln to US\$1.4 bln; the estimated volume of commercial credits granted and the bank deposits made in 1995 reaches US\$640 mn to US\$650 mn, which means the growth by 20% to 25%.

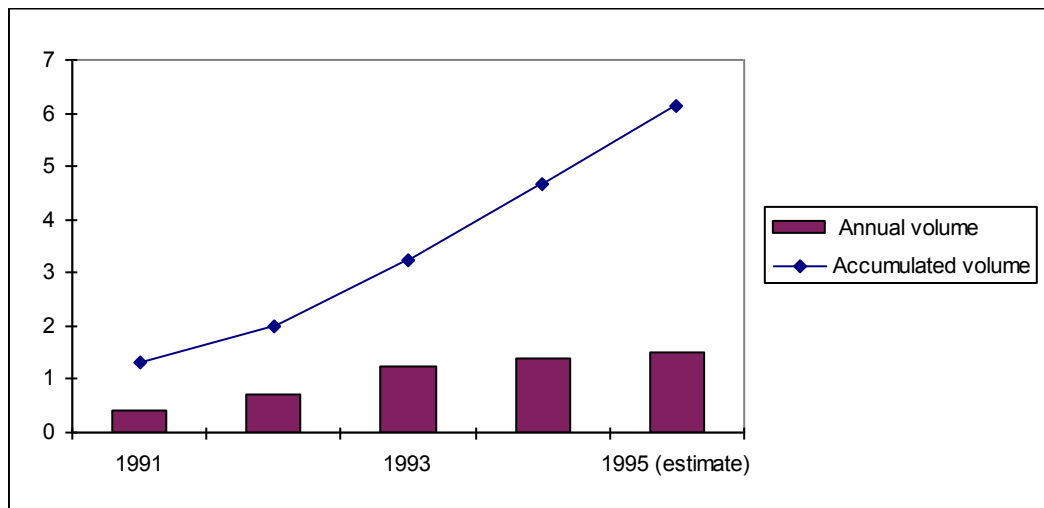
As of 1996, the inflow of US\$2 bln to US\$2.5 bln of investments in the RF economy is forecast (see Fig. 3.1).

It seems that, in 1996, foreign investors will take expectant positions before the coming Presidential elections. What can be expected, is the implementation of the separate "one-time" projects in which significant resources have been already invested.

The analysis of the distribution of the foreign investments by economy branches shows that, in 1995, their priorities changed, compared with the precedent period. In 1993 and 1994, up to half of the foreign investments were directed to the fuel and power complex; in 1995 the relevant share reduced down to 10%. The shares of the foreign investments increased significantly for the trade and public catering (from 5.6% in 1994 to 15% in 1995), financial, crediting, and insurance activities (13% in 1995), and science and science support (8% of all the 1995's investments); at the same time, the growth of the shares of the investments in the cellulose-paper and wood-working industries was moderate (from 3.4% in 1994 to 6.5% in 1995).

Fig. 3.1

Volume of foreign investments, US\$ bln



Just as before, foreign investors preferred to make no hard currency investments in the mechanical engineering and metal working.

The growth of the shares of the trade and public catering, financial and crediting activities, and science and science support in the investment priorities of the foreign investors shows that they go to the branches yielding either the fast repayment, or servicing individual “pointwise” projects. It seems that this trend will undergo no significant changes in 1996.

The distribution by regions of the 1995’s foreign investments shows the remaining importance of Moscow as the “center of gravity” for the investments (57%). Besides St. Petersburg and the Moscow region, the crude oil producing regions (Tiumen region, Tatarstan) are leaders in this field.

The distribution of the ruble share of the foreign investments (reinvestments) corresponded, principally, to the territorial distribution of the hard currency investments: 50% for the economy of the Central region; 18.3% for the West-Siberia region; and 12.6% in the Volga region.

Hence, the concentration by regions of the foreign investments mainly in the Central region shows that the reaction of foreign investors on the formed Russian political climate is adequate. If 1996 does not show any serious improvement of the investment climate in the RF as a whole, the main mass of the hard currency investments will be concentrated in Moscow, to serve, mainly, speculative operations with foreign currencies or the projects to be implemented with the participation of and under the aegis of international organizations.

In the list of the investing countries, leaders are the industrial countries; as of January to February 1995, their share made more than 3/4 of all the investments. After the 9 months of 1995, the greatest investors are the USA, Germany, and Switzerland. As for the accumulated investments, the leading points are the same: USA (US\$1,039.8 bln), Germany (US\$443.6 bln), and Switzerland (US\$92.3 bln).

It should be noted that, during the 1995’s privatization, most entities have not obtained their strategic investors (neither foreign, nor domestic). Hence, the 1995’s privatization was not very favorable for solving the problem of the entities sanitation and economy restructuring. According to certain expert estimates, foreign investors purchased 10% to 12% of shares of stock. It should be noted that this result is composed by all the methods of sale, including the shares of stock purchased using middlemen and substitute firms. The moneys on the inflow of which entities may count are the sums of the declared investment programs of the tenders winners. According to estimates, the total sum of the assets included in the investment programs of the tenders exceeds US\$1 bln. The results of almost every sixth tender have already been canceled. At the same time, the results of a

significant number of the investment tenders have been claimed against by the issuers and the competitors of their winners in arbitration tribunals; hence, the implementation of the investment programs is delayed up to the moment the relevant decisions are made (Commerzant, # 3, 1996, p. 4). Even an approximate estimate of the share of the foreign participants, without speaking of the real investments, cannot be made. The aggregate statistics of the results of the tenders is absent, and the real investments diverge from the applications of the winners, and not only foreign.

During the year the preferences of the foreign investors as of the branches of the economy changed. At the beginning of the year the shares of stock of the wood and wood-working industries were purchased actively. They were significantly undervalued, hence the higher interests of the large investors to these shares of stock.

To about mid-95, the attractiveness of the shares of stock of the river and sea shipping companies grew; to the end of the year, the shares of stock of the communication entities became more popular. During the whole year, a stable demand was observed for the shares of stock of the oil and gas complex and electric power stations.

During the first three quarters of the year, small shares of the blocks belonging to the State were offered for sale (1% to 15%). In parallel with this, the plans were discussed of the grants of the credits to the Government, for which the collaterals were to be the blocks of shares of stock of the largest size and highest profitability entities belonging to the State. The Governmental decisions on this issue envisioned no bans on the participation of foreign investors. What was the unexpected and never before taken measure, was the decision made by the companies themselves (YUKOS, LUKoil) to limit the participation of foreign companies in the sales. (The members of the banking group and the management of the YUKOS Oil Company obliged to never sell, mortgage, or transfer in trust to foreign companies the control block of shares of stock of this oil company (Commerzant-Daily, 15 December 1995, p. 1). In accordance with the decision of LUKoil, the sales of shares of stock of this oil company will be closed for the entities in which the share of the foreign capital exceeds 25%. At the same time, it is known that, during 1995, *Atlantic Richfield* (USA) purchased 75% of the issue of the LUKoil convertible bonds, US\$240 bln worth. Evidently, the patriotic principles, in this case, turned out lesser than the direct benefit. The bonds, granting the right on 6% of the shares of stock, were sold for US\$250 bln, while at the mortgage sale 5% of the shares of stock were offered for US\$35 bln).

The other tendency which began in 1995 and will, undoubtedly, intensify in 1996, is the revision, or, even, cancellation of the results of privatization for certain projects.

During the whole year, this factor was stated as one of the reasons why foreign investors took the waiting position. The demands to revise the results of the privatization, which had, allegedly, resulted in the "hidden intervention" of the foreign capital in order to sabotage the Russia's defense capacity, were often made, during the year; and they are quite possible in future, from the side of those who are unsatisfied with the property distribution.

The disputing of the results of the tenders, sales, and resales of shares of stock is an inevitable process, due to the imperfect laws on privatization. In particular, due to the limitations on the participation of foreign investors in the privatization, the interested foreign firms were purchasing shares of stock using middlemen. The largest and most known scandals were those relative to the shares of stock of the aluminum plants at the beginning of the year and of the defense industry at the end of 1995 and beginning of 1996. (At the middle of 1995, the Parliament hearings "On the Situation of Privatization in the Aluminum Industry" were held. The purchase and resale of the shares of stock resulted in conflicts and aggravated the situations of the entities. The courts of both instances recognized the results of the tender for sale of the blocks of shares of stock of the *Bratsk*

Aluminum Works Joint Stock Company null and void, because of the numerous breaches of laws. The court hearings on the privatization of the aluminum works in Ural are going on).

In the latter case, the issue is namely of the foreign firms. The State Committee for defense industry deposited a claim to the Procurator's Office in order to clear the situation, when certain foreign firms had purchased shares of stock of the defense industry entities, using dummy companies. (*Nic and C Corporation* (USA) purchased shares of stock of 19 defense industry enterprises, having violated the laws on privatization. The General Procurator's Office of the RF deposited in the Arbitration Tribunal the claim to protect the interests of the State and of the Moscow *Avionica* Scientific and Production Complex. It is claimed to recognize null and void the results of the voucher auction, at which the US company purchased, using middlemen more than one third of the shares of stock. Mr. V. Glukhikh, Chairman of the State Committee for defense industry, gave the example of such activities of the *Pioneer* Investment Fund (USA) having interests in the Mil Helicopters Construction Complex).

In the contrary, there are cases, when the foreign firms having acted in full compliance with the laws, were deprived of the property purchased after the decisions on the privatization of entities had been recognized null and void (the decision of the court to cancel the privatization of the Novosibirsk Tin Works with the participation of *Armet* (USA)).

The revision of certain cases of privatization will continue in 1996; it can have a serious restraining effect on the intentions of foreign businesses to invest in Russia.

At the same time, it seems of low probability that the results of the privatization in whole (by all enterprises and industries) will be canceled. First of all, the redistribution of the property transferred the greatest part of it either to the ownership or under control of the directorate (and this layer of the society is influential enough) Secondly, the already formed Russian large capital will prefer to safeguard and strengthen its property and control of enterprises by joining and sharing the ownership with the institutional structures (State Committees, Central Bank), by creating various financial and industrial unions, investing and increasing the profits.

The formation of such structures is a possible in the today's situation way to continue the course on the market reforms and non-totalitarian evolution. The certain succession of the economic policy and economy stabilization, ensured by the above, will create favorable conditions for mobilization of the foreign capital. The presence of the State in large-size financial and industrial structures will give additional guarantees to foreign investors, and the presence of the banks will give the possibility to insure against risks, etc.

Types of behavior of foreign investors

The foreign firms, investing both directly and in portfolios, used, as a rule, more than one method of purchase of shares of stock. At the same time, the types of behavior of these categories of investors, differed significantly in the process of the purchase and use of their shares of stock.

The strategic investors were oriented, as a rule, to the enterprises of the branches generic for their profiles of operation. When purchasing large-size blocks of shares of stock, they often competed with the domestic purchasers and lost the tenders. For these type of investors, the undervaluation of the Russian entities seemed a very important incentive for purchase, but, yet, not the decisive one. The main incentive was the product market. This determined the strategy after purchase: to occupy the dominating positions in the management and to invest in the preferable directions of development. In certain notorious cases (Novomoskovsk Chemical Works, Dalpolymetall) this was, essentially, the policy of keeping down the competitors (in the person of Russian producers) in the

domestic market.(The *Glinco* Concern (Switzerland), holding 54% of the shares of stock of Dalpolymetall, producing lead as end product, is interested to develop the production of only the lead concentrate by the Russian works.) There are examples, when the real investments of the foreign partners were delayed due to the struggle between the groups of holders of large blocks of shares of stock. The real purchase of a large parcel was accessible to only limited numbers of purchasers.

In 1996, the sale to of land plots and the organization of the sale of real estate to enterprises will become the direction competing with the strategic investment and distracting the money from it. In this connection, the main inflow of investments is to be expected in the direct form.

The portfolio investments are not accounted for in the corporate securities market, hence, only expert estimates can be given. They vary around US\$1 bln.

Among the portfolio investors, the three types of behavior are seen:

- the purely speculative one: forming blocks of shares of stock of different companies;
- the purchase of the shares of stock to form the blocks for the available and expected orders; and
- the purchase of a block of shares of stock, and the minimal investments required to sanitize an entity with the purpose of sale of the shares of stock for a much higher (market) price.

The activity of the foreign investors is determined by the underevaluation of the Russian enterprises; this has, partially, compensated the political and economic risks of investing. Thus, Russian entities were evaluated 10-fold lower than the US ones, and 3.5-fold lower than the ones in other developing markets.

The speculative operations in the Russian market are performed, mainly, by the small venture and hedge foundations oriented toward the higher risk operations. Practically no one of the largest world institutional investors implements programs in the Russian stock market.

As for the purchase and formation of the blocks of shares of stock for their further sale, under the orders of foreign investors, both domestic and foreign agents were engaged in this. A typical representative of this type of the agents is the CS FIRST BOSTON: according to the estimates, two thirds of the portfolio investments in Russia were executed by this company in 1994. As of today, it has in its portfolio a combination of the shares of stock of various entities, 7% to 8% of shares of stock of each, in average. It is characteristic that, after the collapse of the securities market in the Fall of 1995, and the removal of foreign money from it at the beginning of 1996, the company re-oriented its operations to domestic customers.

As for the third type of the behavior, it is followed, for example, by the Pioneer Group, USA. To expand its activities in this direction, it purchased the control block of shares of stock (51%) of the First Voucher Investment Foundation, owning shares of stock of numerous Russian enterprises.

In whole, during 1995, the market of shares of stock of the privatized enterprises was, according to the experts of the stock market, under the determining influence of the demand expected from foreign investors. Only to the end of the year, the domestic companies, engaged in self-purchase and formation of the vertically integrated groups or holdings, began influencing the demand more actively.

Foreign investments pattern

The main political factors determining the behavior of foreign investors in the Russian market in 1995 (they will remain determinant further on, as well), were: the continuing war in Chechnya, the serious “left shift” of the RF Parliament after the elections to the RF State Duma and the “leftier” attitudes of the Russian Government; and the uncertainty due to the coming Presidential elections in the RF, the personality of the future Russian President, and the possibility of change in the political environment.

The economic factors which determined the dynamics of the foreign investments in 1995, and whose negative effects will continue in 1996, are the following: the continuing industrial recession; the introduction of the “ruble corridor” in the middle of 1995 and its prolongation up to the middle of 1996; and some other ones.

The weakening, continuing since 1990, due to the industrial recession, of the domestic mechanical engineering being the material basis of the investments retards the creation of the sufficient conditions for the economic growth. At the same time, neither the import of the production technologies using the direct foreign investments, nor the purchase of equipment from abroad during the investment crisis, compensated the decrease of the production facilities in the Russian industry.

The forecast for 1996 recession of the production by 2% to 6% will, again, affect the most the situation with the mechanical engineering; the industry will have to restructure using, mainly, its own resources, without any support from the Budget. The continuation of the industrial recession will increase additionally the need of Russia in foreign investments, narrowing, at the same time, the field for operation of the investors in the industry, and, especially, in the mechanical engineering.

It is highly probable that the reduction of the inclination of the banks and foreign investors to invest in Russian enterprises (it has been continuing during the last five years, and had its expression in the investment crisis) will continue in 1996, as well. Despite the fact that the Russian Government searches for non-traditional sources of financing of the investments in the economy, it does not seem that the behavior of the main economic agents will change to the better: this is due to the continuing general uncertainty in the sphere of the economic policy of the country, the high risks of the financial and legal character, and inefficient control of the investment processes.

Just as before, the most serious problems, without the solution of which, one cannot expect a larger scale inflow of foreign investments in Russia are the following:

- the political uncertainty and instability, expecting the results of the Presidential elections. Hence, the first half of 1996 will be the time of idleness of foreign investors. In the event a representative of the “left” forces is elected President, the growth of the inflow of the foreign capital in Russia, in 1996, is under serious doubt;

- the uncertainty of the legislative policy of the new State Duma. A great preoccupation exists as for the future of the RF Land Code: the approaches to its content are very contradictory, and it seems problematic that any compromise variant of it can be found. The same may be said of the legal regulation of the more progressive forms of mobilization of the foreign investments. This concerns, first of all, the amendments in the effective Law on foreign investments, the laws on concessions, etc.;

- the tendency to broadening the authorities of the local administrations, which needs the legal reclamation and strict delimitation of the functions and authorities between the Center and the Federation subjects, including in what concerns the mobilization of the foreign investments;
- the serious disagreements in the State Duma relative to the results of the privatization process and the outlooks of its continuation. In this connection, a certain persistence of the Parliament as for the limitation of the admission of foreign investors to the process of privatization of Russian enterprises;
- the determination of the reasonable limit of admission of foreign investors to the GKO market; and
- the distinct determination of the priority industries and regions to which particular privileges will be granted, in function of the significance and efficiency of these or that regional or industry-oriented programs for the Russian economy.

Section 4

The real sector of the economy

4.1. Main trends in the real sector of the economy

Economic environment in 1995 was forming in conditions characterized by the monetary policy targeted at achieving financial and economic stabilization. Slowing down of the recession, strengthening of the ruble in relation to the dollar, gradual dedollarization of the economy and preservation of the fast growth in the volumes of foreign trade turnover have positively influenced dynamics and structure of the macroeconomic indices.

Slowing down of the recession in the real sector of the economy has not been stable throughout the year and was being determined by dynamics and structure of the effective demand.

Gross Domestic Product in 1995 amounted to Rb 1,659 trillion and fell by 4 percent in comparison with the preceding year. Industrial production in 1995 was influenced by the continuous shrinking of domestic demand, on the one hand, and by favorable situation on the world markets for the export-oriented industries, on the other. Production growth targeted for export somewhat slowed down the overall industrial recession rate and became a factor for relative stabilization in the real sector of the economy. The volume of industrial output fell by 3 percent in 1995 in comparison with 21 percent in 1994.

Table 4.1

Pattern of main macroeconomic indices in 1993-1995
(in % to the preceding year, in comparable prices)

	1993	1994	1995
GDP	88.0	85.0	96.0
Industry	83.8	79.5	97.1
Agriculture	96.0	91.0	92.0
Capital investment	88.0	74.0	87.0
Goods turnover and paid services	102.0	100.0	91.0
Real disposable money income of the population	114.0	114.0	87.0
Inflation rate, times	9.0	3.2	2.31

Source: Goskomstat

Foreign trade turnover in 1993-1995 has been growing, as a rule, faster than the GDP output. The share of export produce in GDP made up over 20 percent in 1995 as against 13 percent in 1993.

Growing recession in the agricultural sector and continuous low investment activity represented negative trends in the last year. Shrinking of the industrial and agricultural share in the structure of GDP is taking place against the background of growing share of infrastructure.

Development of infrastructure and transportation represents an integral part of forming the market structure of the economy. The share of transportation in GDP rose from 8.4 percent in 1994 up to 11.4 percent in 1995 and in the overall volume of gross domestic investment from 11.7 percent in 1994 up to 14.5 percent in 1995. Underdevelopment of the transportation network and communications represented a factor hampering the process of forming a radically new system of allocation of productive forces of the Russian economy. Slowed fall in the volume of GDP in 1995 has resulted in a decrease by 2 percent in the volume of cargo transportation as compared to the

1994 level. Development dynamics of transportation and communications corresponds to the developments in the production rates in the national economy as a whole.

Financial and economic outlook on the transportation network remains difficult. Price growth for fuel and energy and other resources consumed by the transport sector, high (over 43 percent) capital consumption have led to a corresponding increase in transportation costs which results in a decrease of profitability and increased losses incurred by transport firms. The structure of cargo and passenger transportation undergoes transformations. They are conditioned by the difference in the level of transport tariffs, as well as by the quantity and nomenclature of the rendered services.

As the economic situation stabilizes, a continuous saturation of the consumer market is taking place. On this basis the performance of the retail trade enterprises gradually recovers and normalizes: the chain of shops, the selling space and commodity stock are growing. The change in the ownership structure represents a positive factor in trade stimulation. Eighty seven percent of the retail trade and 70 percent of the public catering enterprises have been privatized. The state sector accounts only for 13 percent in the overall volume of trade turnover. As compared to the last year the sale of consumer goods fell by 7 percent. One must take into account that the changes in consumer prices and the level of income of the population are exerting considerable influence on the dynamics of trade turnover. The volume of food products continues to prevail in the structure of trade turnover.

In production structure of GDP the share of services is steadily rising while the share of goods production is diminishing. The gap between production of goods and services is closing and represents 2 percentage points in 1995 as against 16 percentage points in 1994.

Development of new sectors in the services sphere results in a change in the structure of market and non-commercial services rendered. The share of financial and insurance services in the overall volume of services rendered increased from 14.3 percent in 1994 up to 24.3 percent in 1995. The formation of the new institutional structure of the economy is followed by a reduction in volumes and number of non-market services, in particular, in public health, education and public utilities services.

While analyzing the structure of GDP, one should bear in mind the difference between dynamics of prices for goods and tariffs on paid services.

Development of low material intensive segments in services market against the background of the outpacing growth of tariffs on services in comparison with dynamics of prices for the finished goods and material and technical resources create conditions for cutting the share of intermediate consumption in GDP. The same result is obtained from the structural shifts in industrial production linked with an increasing share of low material intensive branches of the mining industry. However, technical and technological condition of fixed assets and low investment activity hamper solution of the problem connected with lowering the level of material and energy intensity of production. In the current economic environment, preservation of high resources consumption in industry represents a factor which stimulates inflationary rates.

Developments in the production structure of GDP are followed by adjustments in the correlation between main production factors--capital investment and labor. Principally new structure of reproduction is being formed in the economy.

The share of employed in the services sector made up 49.8 percent in 1995 as against 45.9 percent in 1993, while the share of investment in the services sector increased from 30.2 percent in 1993 up to 34.1 percent in 1995. Increase in the demand for services and, correspondingly, gradual redistribution of resources in these spheres of activity somewhat alleviates the situation in the labor and capital markets.

Developments in the production structure along the forms of property represent new and most important factors which influence the formation of GDP structure. As a result of privatization and incorporation, the non-state sector has taken the dominant position and increases its influence in all spheres of business.

In 1995 the share of added value produced by the non-state enterprises was 70 percent as against 62 percent in 1994, of which the share of private enterprises went up from 25 percent to 27 percent. The number of employed in the private sector stands at 33 percent of the overall number of employed in the national economy. The number of employed at the enterprises with mixed forms of property, including enterprises with foreign capital stands at 21.6 percent. State owned enterprises employ 44.7 percent of the total number of the employed.

Institutional transformations taking place in the Russian economy are followed by a redistribution of incomes between wages and salaries and personal entrepreneurial activity.

The share of labor remuneration in GDP went down in 1995 to 32.4 percent as against 38.3 percent in 1993, while the share of mixed income from entrepreneurial activity has gone up by about 15 percentage points for the same period. In the structure of mixed income about half falls on the proceeds from commercial and intermediary activity and about 40 percent falls on the proceeds from agriculture. Development of paid services is followed by a rise in incomes of the self employed people (for example, in health care and education).

Table 4.2

Structure of GDP

	1993	1994	1995*)
GDP	100.0	100.0	100.0
of which:			
Production of goods	51.2	43.1	40.7
of which:			
industry	35.9	27.0	26.5
agriculture	7.7	6.5	6.3
construction	6.9	9.0	8.2
Services	42.0	48.9	51.5
of which:			
market	31.0	35.6	39.0
transportation and communications	7.5	8.4	11.4
commerce	12.1	14.1	12.9
finances, credit, insurance	5.5	7.0	12.5
non-market	11.0	13.3	13.2
Net taxes on foodstuffs and import	6.8	8.0	7.8

* calculated on preliminary Goskomstat data.

Source: Goskomstat

Table 4.3

Structure of capital investments and distribution of the employed by sectors of the economy, in %

	Employment			Capital investment		
	1993	1994	1995	1993	1994	1995*
Total employed:	100	100	100	100	100	100
of which:						
PRODUCTION OF GOODS	54.1	52.4	50.2	69.8	69.0	64.9
of which:						
Industry	29.4	27.1	25.7	36.3	32.0	33.6
Agriculture	14.6	15.4	14.8	7.3	7.0	2.6
Construction	10.1	9.9	9.7	26.2	28.4	28.7
SERVICES	45.9	47.5	49.8	30.2	39.1	34.1
of which:						
Transport and communications	7.8	7.8	7.9	10.6	11.7	14.5
Commerce and public catering	8.5	9.5	9.7	1.1	1.9	2.4
Credits and state insurance	0.8	3.8	4.3			

* calculated on preliminary Goskomstat data.

Source: Goskomstat.

The share of gross profit in the economy in GDP is steadily rising, mainly at the expense of the share of the consumption growth of fixed assets. Revaluation of the capital assets, application of the new norms and procedure of calculating depreciation were followed by an increase in the share of the consumed fixed assets in the gross profit from 21 percent in 1994 up to 32.1 percent in 1995. In these conditions, the share of mixed income including entrepreneurial income, is steadily increasing while the share of net profit is falling which hampers investment in the production sector. In 1992 mixed income in gross profit amounted to about 12 percent, in 1994--24 percent, and in 1995, according to estimates, is above 40 percent.

The share of net taxes in GDP throughout 1993-1995 went up from 8.6 percent to 10.3 percent. Considerable reduction of annual state subsidies to the national economy from 4 percent of GDP in 1993-1994 down to 1.6 percent of GDP in 1995 was followed by an increase in tax withdrawals in GDP in 1995.

With the beginning of reforms in the Russian economy, a considerable change in the correlation of domestic demand and supply is taking place. This is reflected in the analysis of the structure of the produced and used GDP.

Increased orientation towards world markets was followed by an increased share in the volume of export in the structure of production. The change in the production structure in favor of the mining industries is followed by a continuous recession in the production of capital and consumer goods. The volume of production of industrial goods went down by 3 percent in 1995, production of capital goods amounted to 90 percent of the preceding year, and production of consumer goods made up 62 percent of the previous year.

Developments in the production ratio determines main trends in the structure of the final consumption in GDP. The share of the final consumption in GDP made up 66 percent in 1995 and somewhat decreased in comparison with 1994 at the expense of an increased spending on net export of goods and services. Final consumption of the households increased to 42 percent in 1995 from 38.6 in 1994 while expenditure on state administration was reduced by 2.7 percentage points over the same period.

Table 4.4

Structure of GDP at the stage of income formation

	1992	1993	1994	1995
GDP	100.0	100.0	100.0	100.0
including:				
Wages and salaries	38.3	41.2	36.4	32.4
Net taxes and import	10.9	9.1	9.2	11.0
including:				
Taxes on products and import	9.2	7.5	6.5	9.3
Gross profit	50.8	49.7	54.4	56.6
of which:				
Consumption of fixed assets	14.1	14.9	19.5	22.0
Net profit and net mixed				
income	36.7	34.8	34.9	34.6
of which:				
Mixed income	7.2	9.2	14.9	24.0

Source: calculated on Goskomstat data.

In comparison with 1994 there was a reduction in the volume of the households spending on goods. The volume of the retail turnover shrank in 1995 in relation to 1994 after it somewhat stabilized in 1994. It is linked with restrictive monetary policy which makes people's incomes grow slower than the growth rate of consumer prices. If in 1994 real disposable money income of the population grew by 13 percent, then in 1995 it shank approximately by the same volume which led to a cut in purchasing power of the households. Purchasing power of the population for the basic foodstuffs went down by 20-30 percent in 1995 as compared to 1994.

Shrinking of the real purchasing power of the households negatively tells on the state of the consumption sector branches which basically are oriented to the domestic market. Recession in the food processing industry made up 9 percent, in the light industry--31 percent. There is a continuous reduction in production of durables while the market is saturated with imported durable goods.

Domestic commodities represent only 46 percent in the volume of the retail turnover as imported goods make up 54 percent. In 1994 this ratio amounted to 52 and 48 percent correspondingly.

There was a slowing down in reduction of real consumption of paid services by the population to 17 percent of GDP as against 38 percent in 1994. At the same time, the share of people's spending on services in GDP is rising. That is linked with the outpacing growth of prices and tariffs on housing, public utilities and transport services.

Growing share of spending on final consumption in the structure of GDP is followed by considerable changes in their use. The structure of people's spending in 1995 was characterized by the trend of growing propensity to savings with a cut in the volume of the consumption spending. The share of people's savings on average amounted to 19.3 percent in 1995. According to the Sberbank of Russia data, deposits of the population amounted to Rb 46.1 trillion as of January 1, 1996, and increased by 2.63 times over the year. People's deposits at the commercial banks amounted to Rb 24.1 trillion or 34 percent of the overall volume of people's deposits as against 37.8 percent as of January 1, 1995.

The analysis of the structure of the households' final consumption demonstrates that the population is reacting quite promptly and flexibly to the developments in the economic environment and is quickly adapting itself to fluctuations taking place on the financial and monetary markets.

Gross accumulation in GDP in 1995 went down to about 28 percent as against 28.3 percent in 1994. At the same time, the share of gross accumulation of capital assets continues to fall from 24.8

percent in 1994 down to 22 percent in 1995. This is taking place in spite of the revaluation of fixed capital and changes which have taken place in the depreciation policy. The share of fixed production assets in GDP in 1995 went down to 13 percent as well as against 15 percent in 1994. In real terms, gross accumulation in 1995 went down by 9 percent as against 29 percent in 1994. Accumulation of the capital assets fell by 15 percent as against 20 percent in 1994.

The current economic environment does not create favorable conditions for stimulating investment activity.

Continued shrinking in the volume of net capital investment in the reproduction of capital assets is hampered by a trend of net accumulation in the national economy.

Domestic demand for investment goods continued shrinking throughout 1995 although there was an easing of setback in production which has taken place in the capital forming branches of industry. In the first half year production of capital goods fell by 5 percent as compared to the corresponding period of the previous year. At the same time, the first signs of stabilization were followed by slowing down of recession in production of capital goods each quarter of 1995. In June for the first time over the last three years production of means of production increased by 13 percent while the growth of the industrial production volume made up 2 percent. However, in conditions of tight monetary policy there was no revival of the investment activity. The rates of recession in production of capital goods increased by the end of the year.

Shrinking of the effective demand alongside somewhat revival in industrial production led to an increase in stocks of finished goods and further increase in the number of the unfinished construction sites. The share of the stock of the material current assets in GDP went up from 3.7 percent in 1994 to 6 percent in 1995.

Reduction in the turnover rate of the current assets destabilizes financial state of enterprises and the economy as a whole. In order to perfect the financial performance and neutralize devaluation of the internal funds of enterprises when inflation continues, the government considers suggestions to grant enterprises and organizations rights to carry out indexation of current assets and current material costs depending on the growth of prices over each three months.

It is inaccessible or unprofitable for the enterprises to attract external investment resources. Borrowed funds for investment in the volume of capital assets amount to about 15 percent of the overall volume of capital investment, of which credits granted by the commercial banks represent a little bit over 1 percent. Possibility to attract borrowed funds directed to the reproduction of the capital assets depends on the inflation rate and the refinancing rate which determines the cost of credit.

Table 4.5

Structure of GDP Utilization

	1993	1994	1995
GDP	100.0	100.0	100.0
including:			
Spending on final consumption	60.8	67.2	66.0
including:			
Households		38.6	42.0
State administration	38.4	21.7	19.0
individual services	17.2	10.2	9.0
collective services	8.1	11.5	10.0
Non-commercial organizations, serving households	5.2	5.9	5.0
Gross accumulation	31.4	28.3	28.0
including:			
capital assets	22.8	24.6	22.0
changes in stock of material current assets	8.6	3.7	6.0
Net export of goods and services	7.8	4.5	6.0

Source: Goskomstat

In the first quarter of 1995 in spite of high inflation the refinancing rate did not change. It slightly increased from the end of 1994. That made credits cheaper. Reduction in the real effective interest rate on credits down to negative indices (minus 6 percent annual) has led to an increase in the volume of long-term credits in the overall volume of credits.

Beginning with the second quarter of 1995, the financing conditions got worse at the expense of the borrowed funds which have led to the curtailment of the investment demand in the period of seasonal increase in the business activity in the construction sector.

Long-term credits for January-October increased by more than 4.6 times in comparison with the same period of the preceding year and made up 12 percent of the overall volume of credit investment in the economy as against 5.1 percent as of the beginning of the year. Obviously, the development of this trend presupposes application of a flexible interest rate policy, state guarantees and insurance of investment against risks.

Slowing down in the growth of the inflation rate, yield reduction from transactions on the currency market and on the market of state securities, growing propensity of the population towards savings contribute to the accumulation of the free monetary funds in the banking system. Stabilization of the economic situation and yield adjustment in some segments of the money market create conditions for financial institutions to gradually start financing the real sector of the economy.

4.2 Industry

Industrial production pattern

Industrial dynamics throughout 1995 was characterized by the fall of production. At the same time, the rate of industrial recession was the lowest for the whole period of the reform. The fall of production in some branches of industry was accompanied by a noticeable growth of production in other branches (See table 4.6).

Continued decline in production was conditioned by the following factors:

- convergence of domestic and world prices which has led to further downsizing of loss-making enterprises and import substitution;
- tightening of the monetary policy which has led to a reduction in financial support for noncompetitive enterprises, reduction in state credits and purchases of armaments;
- investment crisis which conditioned the fall in production of investment goods;
- fall in effective demand of the population which has caused together with a reduction in production of consumer goods a fall in import substitution;
- fall in effective demand for the Russian goods from CIS countries.

Table 4.6

Industrial production pattern throughout 1990-1995
(in % to the preceding year)

	1990	1991	1992	1993	1994	1995
Industry, total	99.9	92.0	82.0	85.9	79.1	96.7
Electric energy	102.0	100.3	95.3	94.7	91.2	96.8
Fuels	96.7	94.0	93.0	85.0	89.0	98.0
Ferrous metal industry	98.1	92.6	83.6	83.4	82.6	108.7
Non-ferrous metal industry	97.6	91.3	74.6	81.9	90.9	102.1
Chemicals and petrochemicals						
	97.8	93.7	78.3	78.5	71.1	107.7
Machine building	101.1	90.0	85.1	84.4	61.9	90.1
Timber, pulp and paper industry						
	98.8	91.0	85.4	81.3	68.8	93.1
Construction materials						
	99.1	97.6	79.6	82.4	71.1	91.8
Light industry	99.9	91.0	70.0	76.2	52.7	69.3
Food industry	100.4	90.5	83.6	90.8	78.1	91.3

Source: Goskomstat

At the same time, an increase in the value of exports to western countries was followed by a noticeable growth of production in a number of raw materials branches of industry, first of all, in metallurgy, chemicals and petrochemicals. On the whole, production of intermediate goods in 1995 in comparison with the preceding year went up by 0.7 percent, manufacture of the means of production went down by 9.8 percent, of consumer goods fell by 12.1 percent.

Information on month-by-month dynamics of the industrial production in 1995 is represented in Table 4.7.

Due to a relative stabilization of the domestic demand for energy resources and an increase in the value of exports to the western countries, the drop in the volume of production has slowed down sharply in the fuel and energy complex. In the fuel and energy complex the drop in the volume of production in 1995 amounted to 2.5 percent, at the same time production of the electricity fell only by 2 percent. Production of crude went down by 3 percent (in 1994 reduction amounted to 10 percent), gas--by 2 percent, coal--by 3 percent (in 1994--by 11 percent). At the same time, increase in demand on part of metallurgy was followed by an increase in production of coke (by 7 percent).

Noticeable growth in the volume of production in 1995 took place in metallurgy (by 5.8 percent, chemicals and petrochemicals (by 7.7 percent), and pulp and paper industry (by 22.6 percent). Production of iron ore in comparison with the preceding year increased by 7 percent, ferrous metals--by 9 percent, aluminum--by 5 percent, copper--by 15 percent, nickel--by 19 percent, zinc--by 21 percent, ammonia, chemical threads and threads--by 9 percent, mineral fertilizers--by 17 percent, synthetic resin--by 31 percent, cellulose--by 33 percent, paper--by 25 percent (fig. 4.1, 4.2).

The analysis demonstrates that the main factor which conditioned the growth in the volume of production of the majority of commodities was a considerable increase in the value of export of goods. Export growth explains 58 percent increase in production of synthetic resin, overall increase in the volume of production of nitrate fertilizers, 78 percent of increase in production of cellulose and 72 percent increase in production of news-print.

External demand each time becomes a more important factor influencing the dynamics of production of raw materials. In relation to certain items of commodities, it determines current volumes of production and its dynamics. For example, production ratio for export in the overall volume of production of aluminum, copper, mineral fertilizers, cellulose and news-print in the last year made up 70-80 percent.

Therewith, an increase of internal costs of production as a result of both inflation and rise in the real ruble exchange rate have conditioned a noticeable price growth on raw materials both in ruble and dollar terms and convergence of price levels on domestic and world markets (See fig. 4.3, 4.4). Domestic prices have surpassed world prices on many commodities. For instance, the sale price for gasoline in December 1995 amounted to 205 percent of the world price, high quality steel--156 percent, aluminum--110 percent, propylene--174 percent (in December 1994 these correlation amounted to 79, 78, 58 and 65 percent correspondingly). As a result, by the end of the year there was a considerable reduction in the level of proceeds from exports of raw materials. That became a factor for cutting real monthly production volumes in the raw-materials branches of the economy.

Further reduction in investment activity in the economy has determined a fall in the volume of production in machine building industry (See Fig. 4.5). Economic recession in CIS countries was followed by a reduction in the demand for the Russian machine building equipment by the former. At the same time, unlike the raw materials branches of industry, machine building industry can not redirect its production for the markets of western countries due to noncompetiveness of its products. According to our estimates, the production volume of machine building equipment of the investment type makes up in 1995 only 22.8 percent of the 1989 level.

Production volume of consumer goods in the machine building industry has dropped considerably. These goods could not compete with foreign made goods both on the domestic and world markets. For example, manufacture of tape recorders in 1995 went down by 52 percent, color televisions--by 69 percent, video recorders--by 76 percent. At the same time, the share of imported goods (from western countries) in the overall volume of color TV sets reached by the Goscomstat data by the end of the last year 84 percent, video recorders--97 percent of the overall number on sale.

Among segments of machine building industry relatively not so big was the reduction in production of energy (by 4.3 percent), in metallurgy (by 5.3 percent), in chemical and oil equipment production (by 3.7 percent). That promotes the trend towards stabilization of the investment demand from energy, metallurgical and chemical sectors of the economy. By virtue of the fact that there is a constant demand for cars the automobile industry finds itself in a better state (production fall amounted only to 2.7 percent in the last year). At the same time, a drop in the investment in the agricultural sector has resulted in a reduction in the volume of production of tractors and agricultural equipment (a drop by 36.2 percent in comparison with the preceding year).

Figure 4.1

**Indices of Production Volumes in Ferrous Metallurgy in 1992-1995
(seasonal factor--eliminated, January 1990 - 100%)**

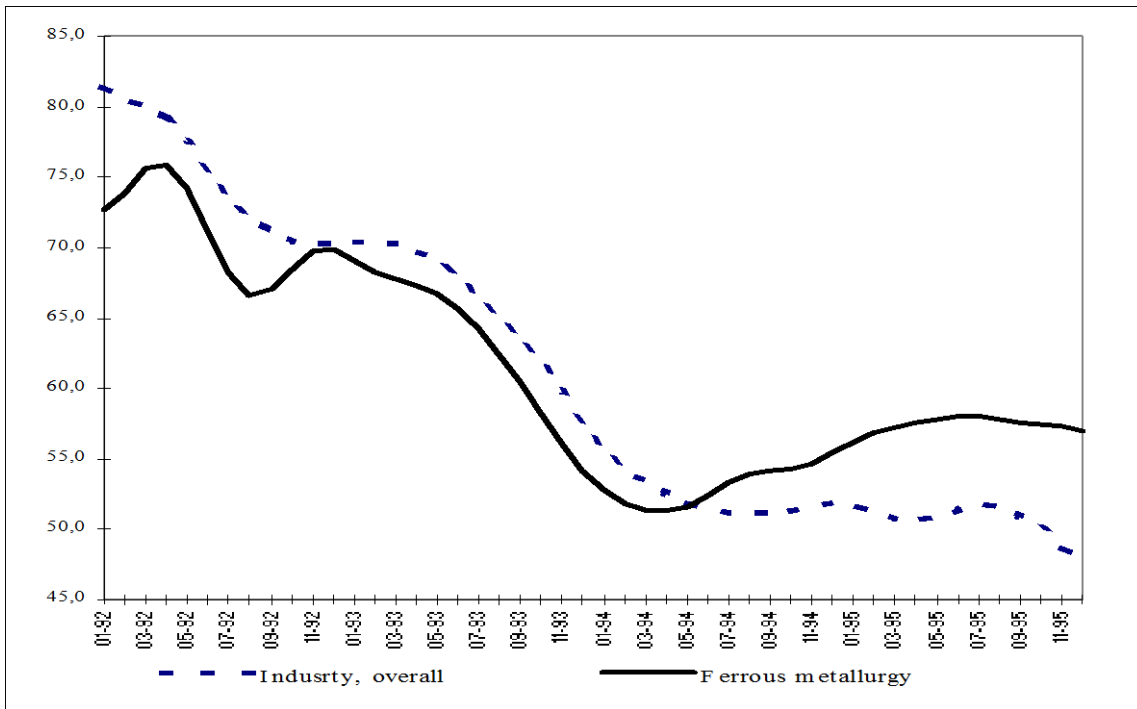


Figure 4.2

Indices of Production Volumes in Chemical and Petro-chemical industry in 1992-1995
(seasonal factor is eliminated, January 1990--100%)

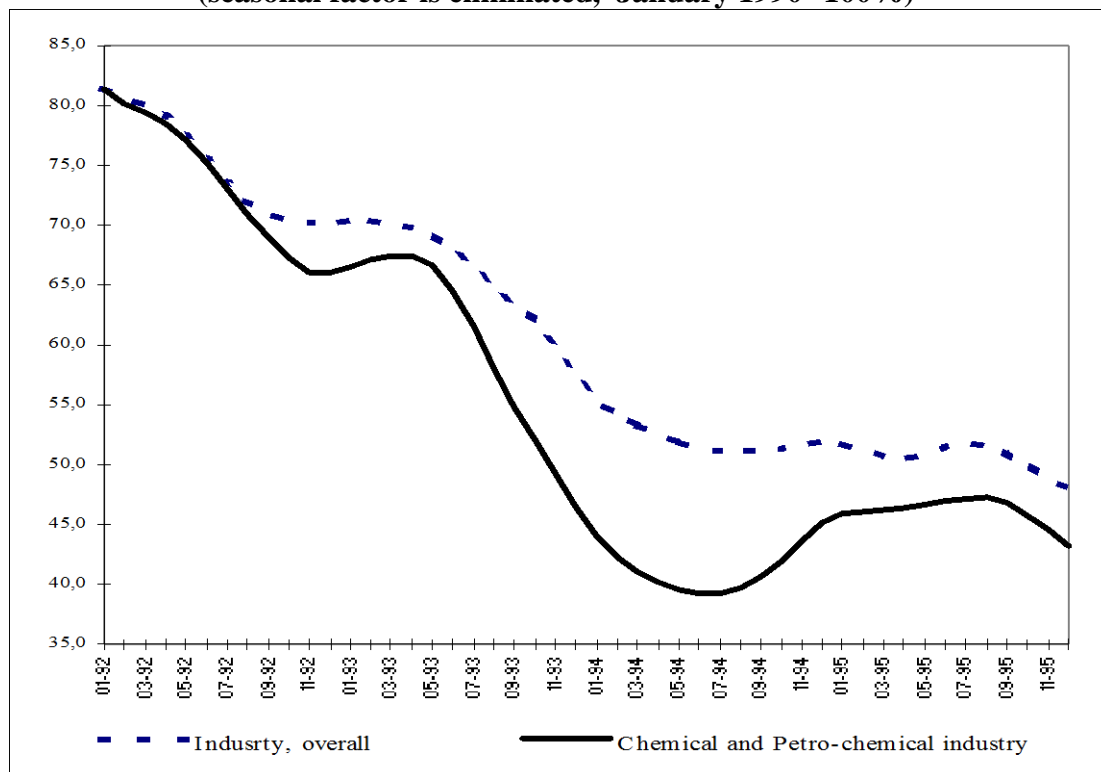


Table 4.7

Monthly indices of industrial production in 1995
(seasonal factor is eliminated, January 1990--100 %)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	
Industry, overall	51.8	51.4	50.8	50.7	50.9	51.5	51.8	51.7	51.0	50.0	48.8	47.9	
Fuel and energy complex	67.0	66.5	66.1	66.3	67.0	67.7	68.1	67.8	6	7.0	66.0	65.2	65.1

Ferrous metallurgy	56.3	56.9	57.1	57.4	57.7	58.0	58.1	57.9	57.6	57.4	57.1	56.6
Non-ferrous metallurgy	76.0	76.8	77.0	77.3	78.1	79.5	80.9	81.9	82.6	83.0	82.8	81.4
Machine building and metal-working	46.4	44.7	43.0	41.9	41.6	41.7	41.5	40.7	39.2	37.4	35.9	35.1
Chemical and petrochemical industry	46.2	46.4	46.5	46.7	47.0	47.2	47.5	47.5	47.1	46.1	44.8	43.5
Timber, Wood working and Pulp and Paper industry	41.4	42.1	42.0	41.5	41.5	42.0	42.5	42.6	41.9	40.7	39.1	36.9
Production of construction materials	40.2	39.9	40.0	40.4	41.3	42.6	43.8	44.0	42.9	40.5	37.2	33.6
Food industry	45.4	45.2	45.0	44.8	44.7	44.6	44.6	44.5	44.0	43.0	41.9	41.0
Light industry	20.6	19.0	17.3	16.4	16.9	18.1	19.0	19.2	18.6	17.4	15.9	14.3

Source: Center for economic development under the government of the RF.

Considerable fall of production has taken place in the light (See fig. 4.6) and food industries (by 31 and 9 percent correspondingly). This is explained both by a reduction in the people's effective demand and noncompetitiveness of the home made goods. According to Goskomstat, the share of the imported goods in the overall volume of the retail turnover reached 54 percent in 1995 (in 1994 it amounted to 48 percent).

Indices of physical volumes of goods manufacture demonstrate that beginning with September 1995 there was a trend towards further industrial recession.

Structural developments

Differences in the dynamics of goods production by the branches of industry have determined considerable changes in the structure of industrial production (See Table 4.8). Given data reflects developments both in the physical production volumes and dynamics of prices on goods manufactured in the branches under analysis. The data illustrate that the last years are characterized by a sharp rise in the share of the fuel and energy complex in the industrial volume. It becomes not only a basis for the export potential, but also as a basis for the Russian economy as a whole. Taking into account the constant demand for energy resources on the world markets and the continuous gap between domestic and world prices for the main types of energy resources (for instance, the level of domestic prices on crude oil in December 1995 amounted to only 62 percent of the world price) further increase of the share of fuel and energy complex in the industrial volume is possible.

There is a growing share of metallurgical complex in the overall industrial volume as compared to the pre-reform level. At the same time, there was a sharp fall in the share of machine building and light industry in the total industrial volume. These trends are obvious while analyzing the structure of industrial production in comparable prices.

Change in the production structure is followed by a considerable redistribution in capital investments and labor resources. Capital investments data show a considerable increase in the share of the fuel and energy complex and metallurgy in the overall volume of capital investments in industry. At the same time, there is a sharp drop in the relative volumes of capital investments into all other branches of industry. For instance, the share of the fuel and energy complex in the structure of industrial capital investments (in current prices) increased from 39.6 percent in 1991 up to 60.2 percent in the first half of 1995. The share of capital investments into machine building over the same period dropped from 20 down to 10.1 percent, into chemical-timber complex--from 10.1 down to 6.6 percent, into light industry--from 3.4 down to 0.8 percent, into food-processing industry--from 9.1 down to 5.7 percent (calculated on Goskomstat data).

Figure 4.3

Dynamics of domestic prices in dollar turms of crude and gase (average wholeslae prices of enterprises, dol/t, dol/th. cub. i)

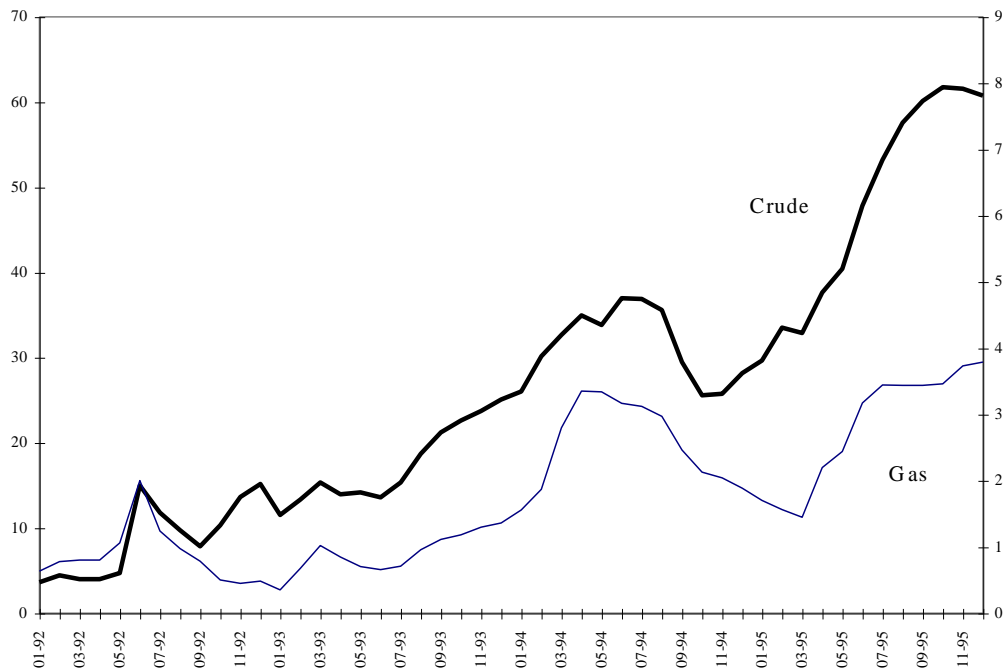


Table 4.8

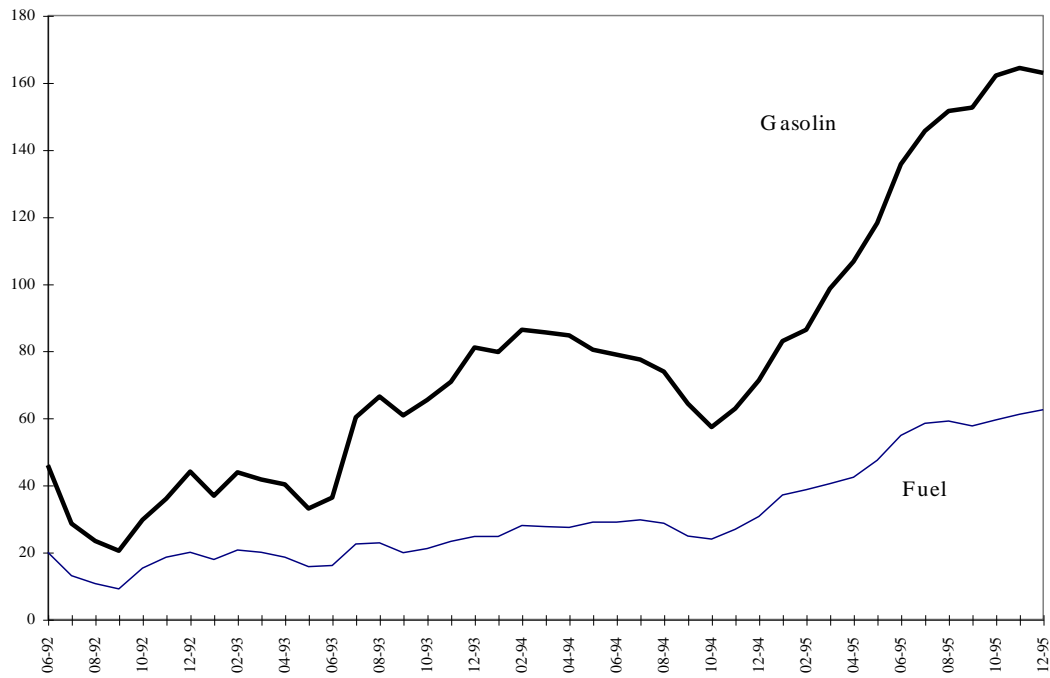
Structure of industrial production in current prices, in %

	1990	1991	1992	1993	1994	1995
Industry, overall	100.0	100.0	100.0	100.0	100.0	100.0
Fuel and energy complex	12.2	11.9	25.3	26.7	29.4	31.0
Metallurgical complex	12.0	11.7	17.8	17.1	16.6	17.1
Chemical and timber complex	12.9	13.2	13.5	11.4	11.7	13.1
Machine building complex	30.8	25.7	20.5	20.3	19.1	17.7
Light industry	12.1	16.5	7.1	5.2	3.1	2.4
Food industry	11.7	13.3	9.8	12.4	11.9	11.3

Source: calculated on Goskomstat data.

Figure 4.4

**Dynamics of domestic prices on gasoline and fuel oil in dollar turms
(average wholesale prices of enterprises, dol/t)**



The data on the structure of employment also reflects the growth of the share of employed in the fuel and energy complex and metallurgy in the overall number of industrial workers. At the same time, steady reduction both in relative and absolute number of employed is taking place in the machine building industry and light industry (See Table 4.9).

Figure 4.5

**Indices of Production Volumes in Machine Building and in 1992-1995
(seasonal factor is eliminated, January 1990=100%)**

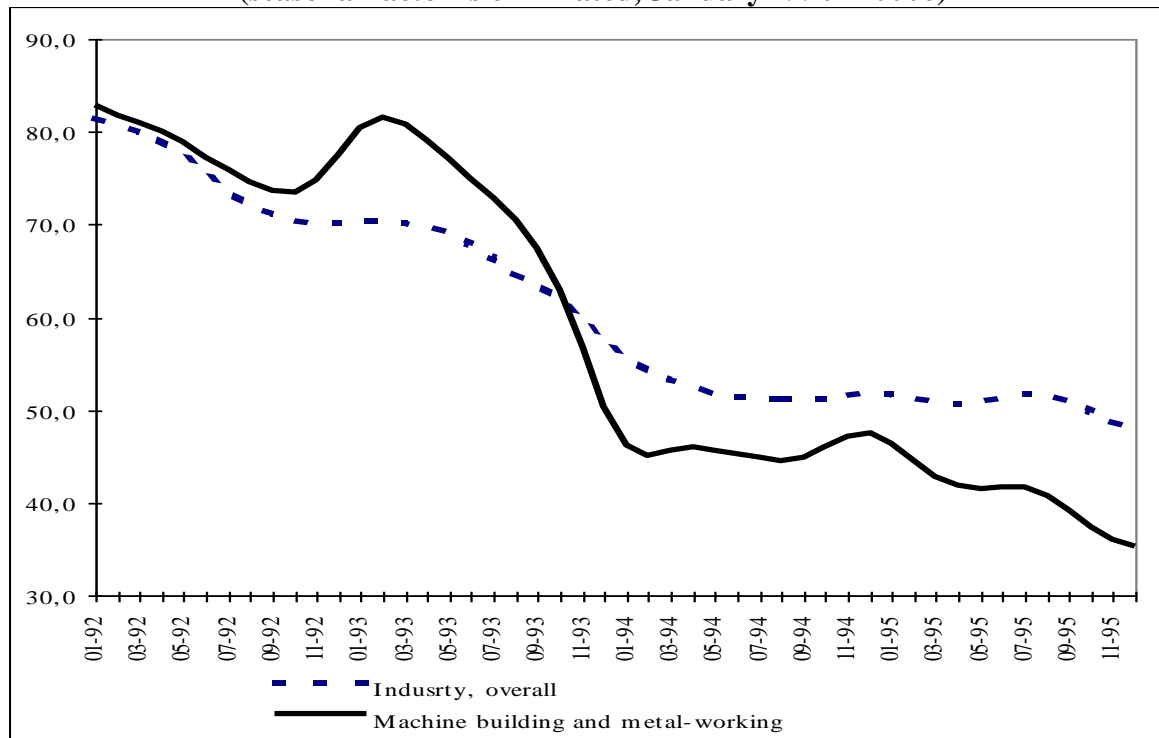


Table 4.9

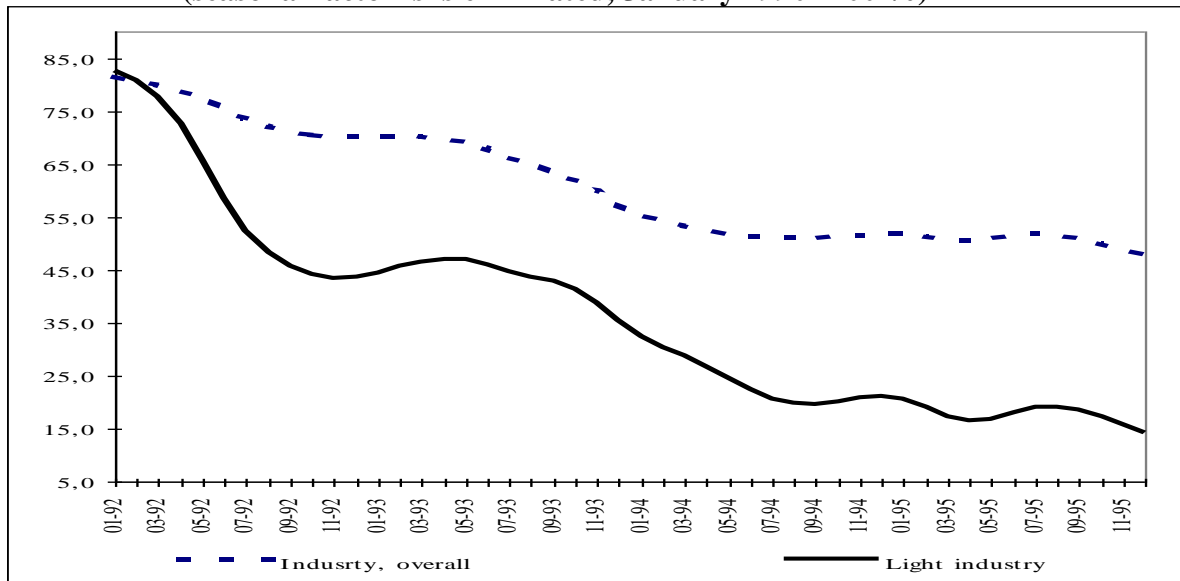
Structure of industrial workers and production personnel, in %

	1990	1991	1992	1993	1994	1995
Industry, overall	100.0	100.0	100.0	100.0	100.0	100.0
Fuel and energy complex	6.4	6.8	7.4	8.2	9.0	9.7
Metallurgical complex	6.0	6.5	6.7	7.1	7.2	8.0
Chemical and timber complex	13.9	14.1	14.8	14.6	14.6	14.7
Machine building	38.2	37.6	35.7	34.2	31.7	30.2
Light industry	10.9	10.7	9.2	9.0	9.2	8.5
Food industry	7.4	7.6	7.8	8.2	8.9	9.4

Source: Goskomstat

Figure 4.6

Indices of Production Volumes in the Light Industry in 1992-1995
(seasonal factor is eliminated, January 1990--100 %)



The analysis of structural changes shows a considerable rise in the share of the fuel and energy complex and metallurgy in the structure of industry. This fact is reflecting not only preservation of relatively high volumes of production in energy complex and the fall in production of investment goods, but a different level of competitiveness in different branches of the economy. Estimates show (See IET survey *The Russian Economy in 1992. Tendencies and Perspectives*) that precisely the fuel and energy complex (except coal mining) and metallurgy are the most competitive branches of the Russian economy judging by the international division of labor.

In other branches of the economy (as well as in agriculture) in spite of the world prices on inputs and output, production remains loss making or low profitable. As a result, the convergence of domestic and world prices, given the present technological structure of the Russian economy, inevitably results in a fall in production efficiency in the non-competitive branches, and as a consequence, to a curtailment of production (to the level of effective production). At the same time, competitive industries preserve higher levels of production, investment and employment which leads to an increase in their share in the industrial structure.

The analysis of the industrial dynamics shows the trend towards a gradual stabilization of industrial production and redistribution of production of goods, investment and labor resources in favor of the most competitive branches of the Russian economy. The analysis of the main aspects of industrial development does not allow, however, to conclude that industrial recession has reached its bottom.

In 1996 considerable tightening of the monetary policy and further convergence of domestic and world prices will determine further curtailment of inefficient production. It is likely also (especially in the first half of 1996) that further fall in the volume of investments will occur. That will result in a drop in domestic demand for intermediate and investment goods which will cause a fall in production in raw materials branches and machine building. Reduction in the real monetary income of the population may also result in a fall in domestic demand.

At the same time, increase in the real exchange rate of the ruble will determine a noticeable reduction in export effectiveness. Export of many goods (for example, oil products and chemical products) is becoming loss making. In these conditions, one can expect a slowing down in the growth rate of exports, there will be a reduction in exports of some goods.

As a result of a reduction in domestic demand and fall in export efficiency, there will be an additional drop in industrial production which can amount to 3-6 percent depending on the real financial, currency and customs policy of the government. Raw materials branches, first of all the fuel and energy complex, and metallurgy will be in a relatively better position. The volume of production in those industries will be close to the production volume in previous year. One should expect some recession in chemical, timber and food industries. The fall of production in machine building and light industry will be considerably bigger than in the economy as a whole. At the same time, preservation of the liberal economic policy would have allowed to create all the necessary preconditions for stabilization and economic recovery in Russia in the coming year.

4.3 Agro-Industrial Complex

General outlook

In 1995 recession in agricultural production continued, however, at a lower rate than in 1994. Gross production fell by 8 percent in 1995. However, if in the preceding period industrial recession as a whole was higher than in agriculture, then the 1995 GDP shank less than the volume of agricultural production. The year is marked with one of the lowest grain harvests for the last fifty years, the rates of recession are not dropping in the livestock sector. Gross production in plant-growing shrank by 4.6 percent which is less than in the good 1992 year, and considerably less than in 1994 (10 percent). At the same time, a fall in the volume of production in livestock sector (10.5 percent) surpassed the volume of the two previous years.

The share of agricultural sector in the overall volume of the national economy is continuing to fall. The share of agricultural sector in GDP does not surpass 6 percent, the volume of foodstuffs in the overall value of export dropped to 1.6 percent. At the same time, the share of the agricultural sector in the total value of capital assets of the country (without the land value) amounted to 14 percent for the beginning of 1996, in investments--about 5 percent, in the total number of employed--about 15 percent. In other words, productivity in relation to the inputs in the agricultural sector is falling faster than in other sectors of the economy.

Nevertheless, 1995 became a critical year for the agricultural sector and agro-industrial complex in adapting to the market requirements.

First, in spite of the drought and accumulated over the reform years problems linked with material and technical provision of agricultural production, in the majority of plant-growing subsectors the production volumes grew due both to an increase in the sown area and to an increase in crop capacity. There was a growth in grain production in Eastern and Western Siberia.

Agricultural producers have started to react more quickly to the market demand on their produce. Last year this fact showed itself in an increase in oil-yielding crops and flax. Interest in an increase in production stimulates an increase in inputs which increases output. For example, for the first time in the last years consumption of mineral fertilizers has grown, so far not significantly (from 1,4 to 1,5 million tons in active substance).

Second, main factors of the financial crisis in the agricultural sector start to be eliminated. Price proportions between agriculture and the 1st sphere of the agro-industrial complex (AIC), between agriculture and the 3rd sphere of AIC having reached world levels, stopped worsening. Debtor indebtedness and dates of payment for the produce supplied are dropping. This factor improves the financial state of the agricultural producers.

Third, market infrastructure started to form in the food processing complex. There have appeared large private firms-integrators which sign contracts on the agricultural commodities, grant in kind credits to agricultural producers to cover their seasonal expenses. Wholesale fairs have become widespread. Private intermediaries are playing a bigger role in food chains, etc. By the end of the year, the ruble corridor made the producers of fertilizers turn to the domestic market. They began to sign profitable contracts with domestic agricultural producers. All this gives a different outlook on the agricultural sector.

The share of direct spending from the federal budget on agriculture was considerably reduced in 1995 (See Table 4.10). However, in spring 1995 the agricultural sector was subsidized for the first time from the budget revenue using the mechanism of the so called in kind credits. For example, oil companies were to supply agricultural producers with fuel and lubricants for seasonal works in account to their debt to the budget. Agricultural producers were to pay off their debt to the budget by the end of the year. This postponement in withholding budget revenue represented an additional appropriation for agricultural sector, which in overall amounted to more than Rb 7 trillion in 1995. By the government's Resolution dated February 7, 1996, their debt in the amount of Rb 4 trillion was deferred for the end of 1997. Eight trillion rubles more make up debt deferral of the agrarian sector on credits received in 1993-1994 together with the interest. That is why, there was no real reduction in federal budget spending on agro-industrial complex last year.

In addition to introducing in kind credits, there were no other improvements in the federal programs in support of the argo-industrial complex. Support was continued in about the same volume as in 1994. After paying off debts on credits and in kind credits, the most considerable federal expenditure on agriculture were leasing programs and programs for compensating purchases of mineral fertilizers (about 1 trillion rubles each). At the regional level, the main part of expenses on agriculture were subsidies to animal husbandry sector.

Table 4.10

Share of AIC in the federal budget expenditure

	1993		1994		1995	
	project	real	project	real	project	real*
Aggregate spending on agriculture and foodstuffs (at the expense of all expenditure categories) in % to all budget outlays	8	7	9	9	3.7	3.8
Expenditure on the category <i>Agriculture and foodstuffs</i> in % to overall expenditure on the national economy	24	39	38	54	22	21.4

* - estimate

Source: The Russian economy in 1994. Trends and perspectives. Moscow, IET, 1995, p. 106. Social and economic outlook on Russia. January-June 1995. Moscow, Goskomstat, 1995, p. 90.

**Main trends and structural changes
in plant-growing and animal husbandry sectors**

Plant-growing sector. There continued a trend towards shrinking of sown area under agricultural crops. As in the preceding year, this was occurring at the expense of cutting the sown area under grain crops and fodder which were taking the main part (89 percent) of the total sown area in the country (See Table 4.11). Sown area under other major crops--sunflower, potatoes, vegetables, and flax--increased and approached or surpassed the average volume of the preceding 4 years. Sown area under sunflower has increased most of all. It is the most profitable crop which has a high export potential. In general, one may note, that in 1995 there was a recovery in the volume of sown area under all crops except grain and fodder to the levels of the second half of 1980s.

In 1995 there were positive developments in the manufacture of plant produce. First, there took place a turning point in the two-year fall in the volume of gross harvests of all major agricultural crops except grain (See Table 4.12). Second, this was followed by an increase in yielding capacity of sugar-beet, sunflower, potatoes, vegetables, and flax which have surpassed the average level of 1991-1994. The harvest of sunflower was a record one in Russia for the last quarter of the century.

Grain crops are an exception. 1995 grain harvest was the poorest for the last 32 years. There was a reduction in the harvest volume of practically all grain crops, but especially sharp drop as compared to 1994 was a drop in the harvests of barley. Record poor 1995 harvest together with a decline in production throughout two preceding years have resulted in a drop in grain stocks. By the end of 1995, they were about three quarters of the 1994 volume. The main part of grain (70 percent) is being kept in store by producers, while grain-elevators keep in store only 30 percent of grain.

Some improvement in the financial outlook on the agricultural producers was followed by an increased possibilities to lay basis for the future harvest. In particular, in the autumn campaign of the last agricultural year the sown area under winter crops and land ploughed in autumn for spring sowing went up (See Table 4.13). This will become a factor for certain growth of yielding capacity next year other things equal.

Table 4.11

Sown area under the main agricultural crops, million hectares

	1994	1995	1986-1990 (average annual)	1991-1994 (average annual)
Total sown area	105	102	N/A	112
Grain	56.3	54.8	65.6	60.2
Sugar-beet	1.1	1.1	1.5	1.3
Sunflower	3.1	4.1	2.4	2.9
Potatoes	3.3	3.4	3.3	3.4
Vegetables	0.7	0.8	0.7	0.7
Long-fibred flax	0.1	0.2	0.5	0.3
Fodder crops	39.6	36.3	N/A	41.8

Source: Agriculture in Russia 1995, p. 60; Social and economic outlook on Russia. January-June 1995, p. 47; Major indices of the agro-industrial complex in 1993. The RF Ministry of agriculture, part I, p. 13.

Table 4.12

Total harvests and yielding capacity of major agricultural crops

	1994	1995	1986-1990 (average annual)	1991-1994 (average annual)
Total harvests, mln.t				
Grain (in weight after treatment)	81.3	63.5	104.3	94.1
Sugar-beet	13.9	19.1	33.2	22.3
Sunflower	2.6	4.2	3.1	2.8
Potatoes	33.8	39.7	35.9	36.0
Vegetables	9.6	11.2	11.2	10.0
Long-fibred flax (fibre), thousand tons	54.1	68.6	124.0	73.0
Yielding capacity, centners/hectare				
Grain (in weight after treatment)	14.4	11.6	15.9	15.6
Sugar beet	126	176	225	167
Sunflower	8.1	10.2	12.7	9.9
Potatoes	101	117	108	107
Vegetables	129	140	154	137
Long-fibred flax (fibre)	4.0	3.9	2.5	2.9

Source: Development of agro-industrial complex and farming in Russia. Issue 2. Goskomstat. 1993, p. 85-88; Social and economic outlook on Russia. 1995, p. 36.

Table 4.13

Dynamics of sowing of winter crops and land ploughed in autumn for spring sowing, mln. hectares

	1990	1991	1992	1993	1994	1995
Winter crops	N/A	22.0	19.5	15.3	14.2	15.3
in % to the total volume of sown area	-	19	17	14	13	15
Land ploughed in autumn for spring sowing	48.0	58.1	40.5	40.5	39.9	41.4
in % to the total volume of sown area	41	50	35	36	37	41

Source: Social and economic outlook on Russia. January-November. Corresponding year; the RF Ministry of Agriculture data, authors' calculations.

Animal husbandry. Situation in livestock sector continued deteriorating. In spite of the fact that the reduction in the livestock population in the current year somewhat slowed down (See Table 4.14), the fall in production of animal products (except milk) increased in comparison with the preceding year (See Table 4.15). At the same time, the fall in production rate in 1995 noticeably outpaced the reduction in the number of livestock. That signified about worsening quality degradation of the livestock and intensification of the sector. One can expect a worse outlook in 1996. In the preceding years a drop in the overall volume of fodder production was offset with a reduction in the livestock number. That way the provision of animals with fodder was increasing (availability of fodder per animal). A 1995 drop in production of fodder was not offset with a decrease in the livestock number. As a result, for the first time in last years provision with fodder per animal has dropped. That situation is aggravated by a low quality of stocked fodder and by an unsatisfactory state in the material and technical base of the fodder production (at the beginning of January 1996 about 40 percent of the fodder producing shops were remaining in the unworkable condition). All these factors allow us to suppose that the crisis in animal husbandry will continue in 1996.

Structure of agricultural production. Throughout 1995 there were sectoral shifts in the structure of agricultural production which was noticeable during the preceding years. The share of agricultural enterprises continued shrinking: in 1995 55 percent of the gross agricultural production was attributed to this sector as against 60 percent in 1994 and 63 percent in 1993. The share of

personal subsidiary plots continued growing reaching 43 percent of the gross production of the sector (38 percent in 1994 and 35 percent in 1993). The share of farmers in the gross production does not change throughout last three years and stays at the level of 2 percent.

The share of the collective sector is falling in animal husbandry, production of vegetables, potatoes and sunflower (See Table 4.16). In those branches a fall in production in the collective sector is offset with private production where the volume of production is either growing (vegetables, milk) or is falling by a slower rate (potatoes, meat, eggs). In contrast to the enumerated above branches, in grain and sugar-beet production the share of agricultural enterprises is rather considerable and remains stable.

Table 4.14

Livestock number in 1995, mln. heads

	as of 1.01. 1996	as of 1.01. 1995	as of 1.01. 1994	01.01.1996 to 01.01.1995, in %	01.01.1995 to 01.01.1994, in %
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>
Cattle	39.2	43.3	48.9	90.5	88.5
including cows	17.4	18.4	19.8	94.6	92.9
Pigs	22.6	24.8	28.6	91.1	86.7
Sheep and goats	28.4	34.5	43.7	82.3	78.9

Source: Agriculture in Russia in 1995. Goskomstat, p. 74; Social and economic outlook on Russia. 1995, p. 38.

Table 4.15

Production of main animal products in 1995, mln. t

	1995	1995 in % to 1994	1994 in % to 1993
Meat (cattle and poultry in live weight)	9.4	87	91
Milk	39.3	93	92
Eggs, billion	33.7	90	93

Source: Social and economic outlook on Russia in 1995, p. 39.

One can expect that rapid developments in the sectoral structure of agricultural production which were taking place in the previous 4 years will slow down and in the future one should not exclude reverse shifts. First aspect is due to the fact that the farms and private subsidiary plots in present economic conditions have practically used up the reserves for their growth. Second aspect is due to the fact that in the long-run the setback in production of the agricultural enterprises will be overcome which will lead to a relative restoration of the share of this sector in agricultural production.

Regional structure of agricultural production. In the reform period there were no considerable changes in the level of specialization in the agricultural production across regions. Market forces have not led to considerable shifts in regional distribution of agricultural production. Attempts at spreading production, for instance, of sugar-beet, beyond the traditional regions of its cultivation turned out to be short-run. Small changes appeared in the production of grain and potatoes (Fig. 4.7). Grain production is being amassed in the regions of its mass cultivation. A decrease in the volume of animal husbandry in northern non-black soil regions is followed with a decrease in sowing forage grain crops. Moreover, such specialization is linked with some increase in the share of non-grain fodder in the fodder balance.

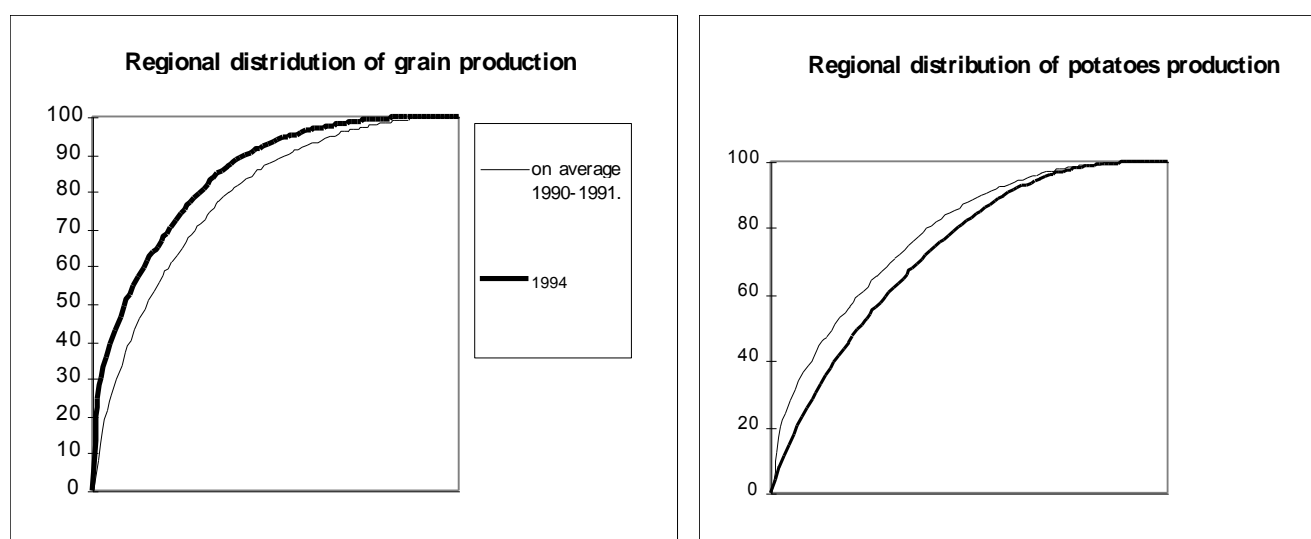
Table 4.16

Production structure of agricultural commodities, in %

	Agricultural enterprises		Farmers		Private subsidiary farms	
	1995	1994	1995	1994	1995	1994
Grain	94	94	5	5	1	0.7
Sugar beet	96	96	4	3	0	0.7
Sunflower	86	88	12	10	2	1.6
Potatoes	9.1	11	0.9	0.9	90	88
Vegetables	25.7	32	1.3	1	73	67
Meat	50.3	55	1.7	2	48	43
Milk	56.5	60	1.5	2	42	38
Eggs	N/A	72	N/A	0	30	28

Source: Agriculture in Russia. 1995, p. 80, 84; Social and economic outlook on Russia in 1995, p. 78, 80, 132.

Figure 4.7

Shift in the level of the regional specialization of grain and potatoes production (Lorenz curves)

vertical - %, horizontal - regions, number

In production of potatoes an opposite trend is taking place--regional despecialization. Potatoes cultivation has shifted to the private sector (dachas, small plots of land) large specialized potato-cultivating enterprises have practically disappeared. Manufacture of potato harvesters have stopped. The problem of self-sufficiency in potatoes have been solved completely. Nevertheless, in the future there will appear a problem of further intensification of this subsector.

Manufacture of means of production for the agricultural sector

Branches of the 1st sphere of agro-industrial complex (AIC) can be divided into two groups which are sharply different relative to their economic state. The first group is formed by enterprises which produce mineral fertilizers. Exports possibilities of this branch determined its steady growth in 1995. The volume of production of mineral fertilizer have increased by 17 percent, exports have increase by 14-15 percent over the year. Moreover, domestic agrarian sector have increased consumption of fertilizers by 7 percent.

Production of mineral fertilizers is the least monopolized sector in the 1st sphere of AIC. Over 3 dozen of enterprises produce mineral fertilizers. However, in 1995 growth of production volumes

was taking place at the enterprises with the capacity over 100 thousand tons per year. In other words, certain concentration of production is occurring in this branch.

Pronounced interest of domestic and foreign investors in operations of main chemical companies represents another noticeable trend in this sphere. MENATEP and Uneximbank banks are major share holders of a number of companies producing mineral fertilizers. Presence of western investors is growing. Over the year, the share of joint ventures in production of mineral fertilizers increased from 14 percent up to 15 percent, and production volumes at these enterprises went up by about one third.

A reduction in export possibilities by the end of 1995 forced major producers of mineral fertilizers to participate in the state programs designed at helping the agrarian sector to purchase fertilizers. In particular, two mentioned banks are ready to grant credits to the government for the implementation of the programs directed at compensating corresponding costs of agricultural producers. Another group of branches of the 1st sphere of AIC finds itself in a totally different economic environment. Lacking access to the world markets, agricultural machinery industry is facing a dramatic fall in demand for its products throughout several years. While general industrial recession amounted to 3 percent in 1995, production of tractors fell by 26 percent, grain harvesters--by 48 percent, forage harvester--by 70 percent. One should take into account the fact that beginning with 1985 production of tractors and harvesters dropped by over 90 percent. According to preliminary data, in 1995 agricultural sector purchased only two thirds of the produced tractors and grain harvesters. One should expect a further production setback in these branches in 1996. Agricultural machinery industry always was a highly monopolized sector: one or two enterprises produced certain types of machines and equipment. At present, industrial recession is followed by an increasing concentration of production. For example, three major tractor producing plants in Russia manufactured about 62 percent of the overall tractor production in 1985. Today, these enterprises produce about three quarters of the total number of tractors. Some enterprises completely stopped producing agricultural machines and equipment (plough, cultivator, automatic drinkers, etc.). In contrast to the producers of mineral fertilizers, agricultural machinery industry is keeping low profile in looking for profitable contacts with agricultural producers. Major monopolists like Rostselmash and Krasnoyarsk harvesters plant find the solution to their problems in obtaining budget subsidies. They do not try to develop leasing of their products, to establish their own sales and service network. The only enterprise which is actively doing it is Vladimir tractor plant.

Outlook on the market of agricultural machinery and equipment is critical. The level of wear out of agricultural machinery is growing. That means that sooner or later demand for means of production on the part of the agrarian sector will grow. Domestic agriculture machinery industry which is unprepared for that will easily loose in competition this market to western producers.

Processing and food industry

A recession is much deeper in food and processing industry than in the industry as a whole. However, in some subsectors production setback in 1995 was not as big as in the preceding year. Production volume of granulated sugar and fish products even went up. As before, the rate of production curtailment is the highest in meat and dairy industry (except production of butter). Production volume in that branch went down by 22 percent during the year.

Production setback in meat and dairy industry, undoubtedly, is connected with further reduction in real incomes of the population in 1995 and consequently with a fall in consumption of animal products. According to our preliminary estimates, elasticity of consumption for meat and dairy products in Russia is very high. On the basis of quarterly data on average monthly consumption of animal products and average quarterly retail prices on those products for the period beginning with

1991 to the 1st half 1995, we have estimated indices of elasticity in Russia overall (naturally, elasticity will vary greatly along regions, however regional statistics of per capita consumption is unavailable). The price elasticity of demand for beef is -2.75 percent, for pork-- -3.74 percent, for milk-- -3.67 percent. The income elasticity of demand for those products was estimated on the basis of per capita income indices in constant 1991 prices. For example, the income elasticity of demand for milk was about 0.7 (average demand elasticity for foodstuffs according to income in OECD does not surpass 0.3). If an increase in real income of the population in 1994 was followed by an increase in meat products consumption (consumption of dairy products has not practically changes), then in 1995 meat and milk consumption dropped.

It should be noted that despite the fact that there is a recession basis in meat and dairy industry, the latter is considered to be a monopoly while implementing the state policy. Throughout 1995 there took place a secondary emission of shares of processing enterprises designed to pass them over into the hands of agricultural producers and suppliers of raw material. Such policy is considered to be dangerous because an industry which is in a critical state requires real investments to implement structural changes. Instead it is being handed over under the control of agricultural producers who find themselves in more critical financial situation. At the same time, food industry is attractive even for the foreign investors. In the first half of the last year the food industry took third place after fuel, chemical and petro-chemical industry in relation to the volume of foreign investment.

A gap in the rates of recession which took place in the meat and dairy industry over the year and per capita consumption of its products is explained by the fact that during last years there was a considerable change in the food chain of these products. First, agricultural enterprises during the first years of reforms strived to develop their own processing shops (their output is not being registered in the official statistics), second, an increasing volume of meat and milk is reaching final consumers bypassing the processing industry (See below). Mentioned factors will be effective over next few years hampering the development of the industry.

Market outlook on agricultural commodities and foodstuffs

In 1995 the volume of state procurements continued falling. There was an increase in procurements from alternative channels, such as, urban markets, its own retail chain, barter sales, sale to private intermediaries.

Against the background of the general reduction in state procurements, dynamics of procurement for the federal and regional funds differ considerably. If projected volumes of procurements for the regional funds have been implemented more or less, then the state of federal fund which size was considerably reduced in 1995 remains very grave.

As of January 1, 1996, the volume of grain procurements made up 10 percent of the projected volume, of oil-yielding crops--145,000 tons (15%); state procurement of potatoes in the federal funds represented only 6 percent of the projected volume, of butter--50 percent, of meat--0.7 percent, of milk and dairy products--10.2 percent, of flax--27 percent. The lack of budget funds required for crediting these purchases remains the main reason for drastic cuts in federal procurements. For example, last year the Federal food corporation, which is responsible for procurements for the federal fund, were to carry them out at the expense of repayable loans to the tune of 1.8 trillion rubles which were transferred to the regions in 1993. The loans were being repaid very slowly. A number of regions instead of purchasing grain spent that money on goods turnover and not only foodstuffs, but on non-food products, on extending loans to the consumers, on making

deposits in commercial banks. The lack of legislation on the procedure of spending budgetary loans for procurement for the federal and regional funds makes these transactions uncontrollable by the state (as Vologda, Tula “grain affairs” illustrated last year).

Price differentiation represents another way for semi-criminal misuse of budget funds allocated for state procurements. Revisions made late last year demonstrated that the average contract prices on grain procurements for the regional funds are 2-3 time lower than the prices of grain procurement for the federal fund. At present, part of the regional grain fund is being reregistered into the federal fund.

The lack of budget funds forced the state to take an unprecedented step in 1995: to take a credit from private banks needed for procurements. A number of banks granted credits to the tune of 3 trillion rubles under the guarantees of the Finance Ministry. The Federal food corporation received 1.9 trillion rubles for procurements for the federal fund, “Roskheloboproduct”--1.05 trillion rubles and “Rosrybmarket” joint-stock company--50 billion rubles. However, the fund were received only by the end of the year, that is why their practically were no procurements in 1995.

All this confirms our findings presented in the previous reports which demonstrate that the state system of procurements of agricultural produce and foodstuffs for the state funds turned into a system of distribution of cheap budget loans between certain voluntarily (without a tender) chosen wholesale purveyors. Neither state customers nor direct producers of the agricultural produce have any guarantees for procurements.

Over the passed year independence of the regions in trading agricultural produce increased. Bypassing state organizations the regions directly exported their produce as well as imported agricultural products, first of all, grain and oil-yielding crops. At the same time, in conditions of shortages of agricultural products administrations of a number of regions banned food deliveries outside the regional borders to the moment of fulfillment of compulsory deliveries for the regional funds.

In 1995 for the first time minimum purchase prices on a number of agricultural products were fixed. However, in conditions of transition the minimum prices objectively can not be used as means of state regulation (the experience of the countries of Eastern Europe illustrates it). As a result, practically throughout the year the minimum prices were below the real market prices (See table 4.18-4.19).

The role of the wholesale fairs have grown. Inner-regional wholesale fairs were taking place widely. At the same time, the practice of organizing inter-regional wholesale fairs was spreading. For example, in October 1995 a large wholesale fair took place in Moscow. At the fair the contracts for the deliveries of foodstuffs were signed to the amount of 200 billion rubles; about 20 regions took part in the fair.

Table 4.17

State procurements of certain kinds of agricultural products in 1995, thousand tons

	1994	1995	in % to 1995	
			to the volume of procurements in 1994	to the production volume in 1995
Total grain	11426	9535	77	15
Cattle and poultry	4187	2970*	71	32
Milk	17978	15135*	84	38
Eggs, million	19827	16707*	84	50
Wool	57	43*	75	N/A

* January-November
Source: Goskomstat.

Table 4.18

Guaranteed minimum prices on basic live-stock products and real average prices of their sale in 1995

(thousand rubles per ton)

	I quarter		II quarter		III quarter	
	guaranteed*	real**	guaranteed*	real**	guaranteed*	real**
Milk	650	567-751 ¹	810	762-708 ³	860	716-759 ⁵
Cattle	2500	2540-7302 ²	3100	6000-10800 ⁴	3560	4638-10800 ⁶
Pigs	3200	3500-8680 ²	4000	6000-13800 ⁴	4600	7300-12482 ⁶
Eggs	180	234-242 ¹	225	246-234 ³	260	241-244 ⁵

* ex producer without VAT;

** ex producer including VAT;

1 - January-March; 2 - the bottom and the upper purchase price in January at 31 meat processing and packing plants (sample); 3 - April-June; 4 - the bottom and upper purchase price in April at 31 meat processing and packing plants (sample); 5 - July-September; 6 - the bottom and upper purchase price in July at 31 meat processing and packing plants (sample).

Source: The Ministry of Agriculture.

Table 4.19

Minimum guaranteed (1) and real average purchase prices (2) of grain in 1995

(thousand rubles per ton)

	July- September (1)	August (2)	September (2)	October-December (1)	October (2)	November (2)
Grain, overall	-	440.4	516.6	-	563.9	639.7
Wheat	430	444.7	565.9	550	554.8	685.8
Rye	280	341.9	387.0	350	451.0	469.8
Barley	420	-	270.3	510	-	441.1
Oats	340	-	321.6	420	-	380.6
Corn	400	-	752.1	500	-	1097.7

Source: Goskomstat.

The passed year was marked by an increased interest to the agro-industrial complex from the companies which previously did not work in that sphere. This interest reveals itself in two ways: through commercial deals and through the organization of production holdings in the food-processing industry. Such financial giants as MENATEP, Incombank and Alfa-Capital demonstrated the maximum activity in the food-processing complex. For instance, Incombank is investing in confectionery and butter and oil industries. As of today, Incombank's investments in the food-processing complex make up about 30 percent of the overall volume of its investments. MENATEP has invested in the food concentrates plants, Alfa-Capital--in the production of margarine and mayonnaise, set breakfasts and pastas.

In addition to direct investment, these companies started contracting for the agricultural produce. For example, according to *Kommersant-Daily* one of the Incombanks' firms--Agroincom--is contracting for the production of sugar-beet and sunflower. Beginning with March 1996, Agroincom has extended credits to about 1,000 farms which cultivate sugar-beet and sunflower in a number of Russia's regions.

Throughout the reform years, the traditional food chains from the field to the final consumer have undergone considerable changes. Surveys conducted by the IET laboratory of the agrarian policy in three regions of the European part of Russia allowed to reveal a number of changes in these chains. These changes are the following:

- diversification of the marketing channels for the agricultural produce and foodstuffs: surveys have revealed that of 86 percent of live-stock products and 83 percent of plant-growing products were sold through three or more marketing channels (See table 4.20);

- trend towards marketing the processed products. Lack of the market infrastructure and marketing problems as well as price disproportions are increasing the number of agricultural producers who market their products processed on the farm or on the give basis. On this basis 49 percent of agricultural producers market flour and cereals, 56 percent of agricultural producers market sunflower-seed oil, 54 percent--white sugar, 42 percent--processed milk;

- wide spreading of alternative marketing channels, such as, large and small private intermediaries, barter deals, marketing through their own retail chain. The most widespread use of new channels is being registered in marketing sunflower and sunflower-seed oil, potatoes and milk (63 percent of the surveyed agricultural producers) and live-stock products (69 percent sample). In marketing meat 69 percent of the producers resort to the non-traditional channels, in marketing grain--53 percent of the producers, flour and cereals--48 percent.

Principal place among non traditional marketing channels for the agricultural produce is taken by barter deals and private intermediaries. An increased importance of barter in the transitional period is connected with the fact that the payment system is unstable, with debt problem and non-payments, high rate of inflation. Agricultural producer prefer to exchange their produce for consumer goods or means of production. Barter is being resorted to by 24 percent of producers of live-stock products, by 42 percent of grain producers, by 67 percent of sunflower producers, by 56 percent of sugar-beet producers. Due to an increased volumes of in kind credits in 1995 extended under the future crops, it is highly probable that part of the deals which are being registered as barter ones in fact represent forward contract.

Private intermediaries were widely used in marketing sugar-beet and sugar, sunflower--by 37 percent of the surveyed agricultural producers, in marketing meat and cattle--by 21 percent of the producers.

**The level of diversification of marketing channels for the agricultural produce
(share of enterprises which resort to three or more marketing channels
in the total number of the surveyed enterprises), in %**

	Agricultural enterprises	Farmers	Private subsidiary farms, overall
Live cattle	72	5	60
Meat	65	73	67
Milk	53	66	56
Live-stock products	94	71	86
Grain	87	44	76
Flour and cereals	53	0	49
Potatoes	56	55	68
Sunflower and sunflower-seed oil	84	68	79
Sugar-beet	48	27	52
Plant-growing products	88	70	83

Source: findings of the surveys conducted among 290 agricultural producers in Pskov, Orel and Rostov regions.

At the same time, there is a trend which demonstrates that small private intermediaries disappear from the grain and oil-yielding crops market. Falling gap between the purchase and sale prices leads makes intermediaries who do not have sufficient current assets gradually leave the market. Large specialized intermediary structures are being organized on the grain and oil-yielding market.

The importance of the traditional procurement system has sharply dropped. It is especially notable in live-stock farming. Cattle marketing to small private intermediaries for cash is widely used.

Foreign trade in agricultural produce and foodstuffs

Major measures in regulating foreign trade in foodstuffs were the removal in 1995 of the institute of special exporters which played a considerable technical role in foreign trade activities in previous years and granting equal rights to all participants in the foreign trade activity.

All previously given customs privileges to the importers of foodstuffs have been abolished effective 15 March 1995. Privileges on levying foodstuffs with VAT and excises were also eliminated and special tax (1.5 percent) and compulsory issuance of certificates for imported foodstuffs effective 28 April 1996.

For 9 months of 1995 as compared to the same period of preceding year, food imports in value terms continued growing and increased by 15 percent, meanwhile the value of export somewhat dropped and made up 95 percent to 1994 level. The negative foreign trade balance in food products increased by 19 percent. At the same time, the share of food products in the overall volume of foreign trade turnover somewhat decreased both in imports and in exports in the preceding year (See table 4.21).

Main item of Russia's food exports were fish and oil-yielding crops. 1995 was noted for the drop in exports of these products both in value terms and in physical volume. Mainly it was due to the introduction of a "soft peg" of the ruble against the dollar, as a result domestic prices have exceeded world prices. At present (January-February), the offered price on the sunflower-seed oil there is falling. Export of grain has grown considerable due to an increase in the world price on grain. For instance, the growth of grain exports in physical terms made up over three quarters of the last year about 155 percent of the level relative to the corresponding period in 1994. Meanwhile, in value terms grain export has grown by 3.4 times. Regions mainly export grain to the CIS countries (Byelorussia, Ukraine, Azerbaijan). Due to a poor grain harvest and a depletion of stocks, the government resolution has introduced export customs duties on wheat and corn effective 1 September 1995. These measures most likely will be ineffective due to the fact that the main country of grain export for Russia is Byelorussia with which there is a custom's union agreement.

Table 4.21

Export and import of agricultural produce, million dollars

	1994 (9 months)	1995 (9 months)	9 months of 1995 relative to 9 months of 1994
Export (FOB), total	45400	55562	122.4
of which: food	938	891	95
Import (CIF), total	27367	32491	118.7
of which: food	7782	9009	115.8
Balance (total)	18033	23071	127.9
of which: on food	-6844	-8118	118.6
The share of food export in the overall export in %	2.1	1.6	-
The share of food import in the overall import in %	28.4	27.7	-

Source: authors' calculations on "Customs statistics on Russia's foreign trade". 1-3 quarters 1995.

Grain imports over 9 months in the value terms increased by more than 1.5 times, however, in physical terms it made up less than half of 1994 volume. According to various estimates, Russia's need in grain imports at present amounts to about 10 million tons. At the end of 9 months, net flour and grain imports did not reach even 20 percent of the required volume. According to preliminary estimates, there was no export of grain, but the import of flour was growing.

On the remaining 7 main groups of imported food items (See table 4.23) there was a considerable increase in imports during the three quarters while the average contract prices were growing simultaneously. The terms of food imports for Russia considerably worsened in 1995.

Definite changes are also taking place in the regional structure. For example, according to the data collected over the nine months of 1995 the share of Russia's exports to the OECD countries have grown, mainly to Japan and Turkey. The share of CIS countries has dropped. The share of OECD (especially EU) and CIS countries as well as the Baltic states has considerably increased (See table 4.22). Food imports from the western countries represent the bulk of imported foodstuffs: deliveries from these countries represent two thirds of meat and meat products imports, nearly all poultry, 70 percent of butter, about 60 percent of vegetable oil, 93 percent of raw sugar.

New import tariffs rates were introduced effective 1 July 1995 which presented an acute problem in mid last year. Average weighted customs duties rate on agricultural produce and foodstuffs all in all increased insignificantly: up from 13.2 percent to about 15.5 percent.

Table 4.22

Regional structure of food export and import, January-September

	1994 ā.				1995 ā.			
	Export mln doll.	%	Import mln doll.	%	Export mln doll.	%	Import mln doll.	%
TOTAL	938	100	7782	100	891.0	100	9009.0	100
including:								
OECD countries	128.0	13.6	1172.8	15.1	217.7	24.4	1907.7	21.2
of which:								
EU (12)	5.7	0.6	707.6	9.1	67.0	7.5	1094.8	12.1
North America	6.5	0.7	296.8	3.8	18.9	2.1	426.8	4.7
Former COMECON countries	10.8	1.1	702.5	9.0	57.2	6.4	833.3	9.2
CIS	276.9	29.5	1160.0	14.9	218.1	24.5	2260.4	25.1
Other	522.3	55.8	4746.7	61.0	398	44.7	4007.6	44.5

Source: authors' calculations using "Customs statistics of Russia's foreign trade". 1-3 quarter of 1995.

Table 4.23

Export and import of main food items for 9 months of 1995 and 1994

	1994		1995		1995 in % to 1994	1994 thsnd t	1995 thsnd t	1995 â % ê 1994 ã.
	mln doll.	%	mln doll	%				
IMPORT								
1. Meat and meat subproducts (including poultry)	796.2	10.2	1220.9	13.6	153.3	786.2	1069.6	136
2. Raw sugar	303.9	3.9	392.4	4.3	129.1	1030.8	1024.2	99.4
3. White sugar	221.9	2.8	528.2	5.9	236.9	654.2	1204.2	184.1
4. Coffee and tea	268.1	3.5	329.8	3.7	123.0	20.7*	18.9*	91.3*
5. Bread grain	403.7	5.2	629.3	7.0	155.9	3046.9**	1431.3**	47**
6. Butter	149.2	1.9	342.9	3.8	229.8	128.6	192	149.3
7. Vegetable oil	42.1	0.5	170.4	1.9	404.0	66.2***	191.2***	288.8***
8. Flour	6.7	0.3	27.2	0.7	405.9	45.5	105.0	231.9
Total along groups	2191.8	28.2	3641.1	40.4	166.1	-	-	-
Overall food import	7782	100	9009	100	115.8	-	-	-
EXPORT								
1. Meat and meat subproducts	11	1.2	8	0.9	72.7	N/A	N/A	N/A
2. Fish and sea products	187	19.9	155	17.4	82.9	N/A	N/A	N/A
3. Milk and dairy products, eggs, other products	60	6.4	50	5.6	83.3	N/A	N/A	N/A
4. Bread grain	52	5.5	166	18.6	319.2	305.7	474.7	155.3
5. Oil-yielding seeds, fruit	65	6.9	43	4.8	66.2	72.5	8.8	12.1
6. Sugar and confectionery made of sugar	60	6.4	57	6.4	95	N/A	N/A	N/A
Total along groups	435	46.4	479	53.8	110.1	-	-	-
Overall food import	938	100	891	100	95	-	-	-

* - only coffee

** - barley, corn

*** - including soy-oil

Source: authors' calculations using "Customs statistics of Russia's foreign trade". 1-3 quarter of 1995

Section 5

Russia and International Economy

5.1. Russia within the International Trade System

According to a medium-term forecast for developments in the area of the international economy, business revival is cumulating momentum after the recession it experienced in early 1990s. It had a relevant effect on the world trade. In 1994 the average international trade turnover showed a 9.5 percent growth being a record figure in the last 20 years and by 3 times exceeding the increase in the international production. In 1995 the World Trade Organization estimated 8 percent increase in trade turnover as compared with a 3 percent growth in the world production. World Bank experts think that in the next 10 years an average increase in foreign trade will make 6 percent annually.

An economic run-up in most industrialized countries was followed by a growing demand for many products and a consecutive price hike on international markets.

Oil markets showed a balance of demand and supply in 1995. Average prices of Dubai oil were at \$ 123 per metric ton, by 14.9 percent exceeding 1994 averages. Owing to small increase in the world oil consumption and practically unchanged supply situation no perceptible change of prices is expected.

A trend of natural gas prices on markets in Western Europe was practically the same as the oil price dynamics. In 1995 average prices were by 13.4 percent higher as compared with 1994.

Prices of nonferrous metals have risen dramatically. In 1995 average world prices were as follows: aluminum -- \$ 1806 per metric ton (20.3 percent rise in comparison with 1994), copper -- \$ 2933 (higher by 23.3 percent), nickel -- \$ 8063 (19.3 percent growth).

As a result of the 1994-95 record price surge in the whole period after the World War II cellulose joined the leaders with a 50 percent price hike (up to more than \$ 1000 per metric ton). According to a middle-range outlook price stabilization accompanied by a slight price rise is expected.

As market relations develop, process of internal price structure formation continues in Russia and it gradually closes to the price system existing on world markets. In 1995 contract prices grew perceptibly, however, prices of a majority of energy resources lagged behind those on the world trade markets in terms of rates of increase. The outcome was a worsening balance between contract and world prices.

An important role in development of the international trade is played by the GATT/WTO which for 48 years tried to work out the fundamentals of a future world trade basing on principles of observance of the Agreement's general regulations aimed to keep up non-discrimination of individual states and to a gradual elimination of barriers slowing down mutual exchange of commodities. Since 1950 the world trade turnover has increased by 13 times and eight rounds of multilateral trade negotiations held under the GATT's auspices have led to a ten-fold cut of average customs duties. At present it makes a bit less than 4 percent.

Table 5.1

Price Balance of Staple Commodities on World Markets

	Balance of contract and world prices		Balance of Russian internal market prices and world prices			
			producers		purchase	
	1994	1995	1994	1995	1994	1995
Oil	99	95	32.9	39.2	35.3	52.3
Premium gasoline	91.3	94.9	50.6	78.1	94.2	148.1
Gas oil	98.9	89.3	56.5	88.1	90.7	139.5
Fuel oil	87.3	75.5	41.5	69.6	61.5	80.1
Natural gas	105.4	69.0	31.6	34.1	48.4	52.2
Coal	95.2	104.0	30.0	44.4	88.3	111.9
Aluminum	70.1	79.1			47.9	94.5
Copper	86.0	87.6			-	100
Nickel	86.9	99.2			61.5	89.7

Source: VNIKI and Goskomstat.

Russia's accession to the WTO will make it possible to tap all measures existing within the framework of this organization in order to protect Russia's economic interests. At present direct or concealed discrimination of Russian producers and traders on markets of certain countries is among factors affecting Russian exports dynamics. Thus, only the ban on Russian uranium exports to the USA has led to losses for Russia, as estimated by some experts, at \$170 million a year. The total number of anti-dumping procedures imposed upon Russia has reached 41. More than a half of them (22) are qualified as openly discriminatory cases or unjustified claims by the Ministry of Foreign Economic Relations.

In the summer of 1995 the first round of negotiations between the Russian delegation and the WTO's Working Group on Russia took place in Geneva. Members of the Working Group apprised information on foreign trade regulations stated in the Russian Memorandum as exhaustive enough.

An outcome of the second round taking place from December 4 to 7 of 1995 was the completion of discussion of the Russian Memorandum on the foreign trade regime as concerns trade in goods. Besides, the first discussion on special annexes to the Memorandum embracing protection of intellectual property rights, trade in services and trade-related investment measures was held. At the same time, the WTO member countries have reserved the right to revert to a detailed discussion on three key issues: if state-owned trade organizations exist in Russia (Moscow denies this); import licensing; subsidizing of external operations. However, even now they agree in principle that the Russian legislation is in accordance with the WTO's rules and norms in these areas of the foreign trade regulation.

There are no apparent opponents to Russia's accession to the WTO, since the world trade, especially in the area of trade in raw materials, cannot be regulated without participation of Russia. However, the admission of Russia may be surrounded by a number of additional obligations not directly following from the WTO requirements. Bilateral consultations held in Geneva have shown that Russia will face some complications in the course of tariff negotiations.

On the whole, the outcome of the second round of Geneva talks has been successful for Russia. The next meeting of the Working Group is planned to take place on May 28 through 31, 1996.

5.2. Regulation of External Economic Activities

In 1995 certain changes were introduced to the mechanism of the state regulation of the foreign trade. In the first half of 1995 the state regulation of oil exports was substantially amended: quotas and licenses in oil exports were abolished alongside with preferences (with exclusion of supply pursuant to intergovernmental agreements) while export duties on oil and oil products were

significantly reduced; certain oil products were excluded from the list of strategically important commodities. Producers' access to channels allowing transportation of oil to other countries (pipelines and terminals in sea ports) became a natural restraint on exports.

The list of strategically important raw commodities was shortened and the institution of special exporters was abolished altogether. The system of contracts' registration became the main instrument of control over exports. Individual preferences granted to participants of external economic activities were abolished, excluding those issued in accordance with the laws of the Russian Federation.

The law "On State Regulation of Foreign Trade" adopted in July came into force in October. The law stipulated what authority in this area shall be with the President, the Government and the Ministry of Foreign Economic Relations. The exclusiveness of the MFER's position was emphasized by the fact that only it was vested with the right to license import and export transactions subject to quantitative restrictions or to approval procedures.

As pursuant to the law, the Russian Government shall submit a program of foreign trade development together with a draft of the Federal budget for the Parliament's approval. Alongside with other provisions this program shall embrace customs tariff rates planned for the year in question as well as the band of their possible fluctuation, thus making the foreign trade more predictable. The Government has the right to introduce export and import quantitative restrictions on national security grounds, to comply with international agreements or to protect the domestic market, however, these measures shall be announced not less than 3 months prior to their actual introduction. The law envisages a possibility to introduce state monopoly for trade in certain products. In this case a special procedure of licensing import and export operations exclusively to state-owned enterprises shall be applied.

As the above mentioned law was effectuated, the Commission of the RF Government on Safeguard Measures in Foreign Trade became fully legitimate and in December it received "Procedures of Investigation Prior to Application of Safeguard Measures" approved by the MFER (*Russ.abbr. MVES*). A possibility to apply safeguard measures against competitive imported products complies with usual practices applicable in the world trade. In this area Russia is late in working out and application of such measures, especially taking into account that Russian exports are often and in most cases unjustifiably subject to discrimination on foreign markets. So, the RF import regime loses its exceptional liberalism which has been characteristic of it until recently.

Tariff regulation. From September through December export duties levels were gradually lowered until their complete abolition since January 1, 1996, with an exception of a small group of goods including oil, natural gas and some other raw commodities.

In June and in October import duty rates were changed. On the whole, changes were made in direction of an increase in tariffs. Earlier goods taxable at 1 percent have constituted a rather significant part of the list, at present this rate is only applicable to certain goods within Group 10 of the External Economic Activity commodity nomenclature (grain) and 1701 (cane sugar, beet firm sugar and sucrose). A 10 percent tariff is now applied to medicines which earlier have been exempt from duties while fish and fish products are subject to a double rise of duties (from 5 to 10 percent) and duties on vegetables were tripled (from 5 to 15 percent). For foodstuffs earlier exempted from duties new tariffs made 5 percent on bananas and citrus fruits, 10 percent on tee and coffee, 15 percent on fresh cucumbers, however, rates of import duties in Russia still remain considerably lower than in the EU countries (16 percent against 21 percent). There were effectuated provisions stipulating a 30 percent duty on goods such as luxuries, tobacco products, alcoholic beverages and weapons.

Tax regulation. As before, close attention was paid to products subject to excise taxation. In July and in December a price difference between excise stamps and special stamps designated for imported tobacco and alcohol products were adjusted. There were created equal conditions for importers of these products both from countries within and outside of the former Soviet Union (ECU 0.1 per unit of an alcohol beverage and ECU 0.01 per unit of a tobacco product). In December the rate of excise tax on tobacco products was increased from ECU 1.2 to ECU 2 per 1000 pieces.

In June the list of products subject to a preferential 10 percent value added tax was shortened; it was again examined in detail in November and some new products were added to it. In December works and services, both produced domestically and purchased, being exported to countries outside the CIS alongside with services concerning the transit of foreign cargo through Russian territory were exempted from the value added tax.

Preferences in External Economic Activities. In October the Government abolished previously applicable preferential taxation of alcoholic beverages imported from abroad by certain legal entities which were exempt from customs duties (for instance, the National Fund of Sports and the All-Russian Society of Invalids). Since December, pursuant to the Presidential Decree "On Customs Preferences" of November 30, 1995, it is inadmissible for Federal agencies to adopt decisions which would provide prolongation of preferences in terms of customs duty exempts and receipts of additional compensations.

In August the control mechanism over incoming export proceeds denominated in foreign exchange was adjusted. All proceeds in foreign currencies shall be entered into accounts with authorized banks--that became a requirement of the customs regime. Customs service now enjoys the right to control all capital flows and apply relevant sanctions if necessary.

In September the control over exports and imports of military-purposed products, works and services, subject to licensing, was tightened.

In December the set of instruments of the state control mechanism over imports was supplemented. The system of foreign exchange control over imports introduced on January 1, 1996, is basing on the same principles as the export control existing since 1994 and envisages the same chain of relations: an importer--an authorized bank--customs. The key document fundamental for the whole control system is a registration certificate for import transactions.

5.3 Foreign Trade Pattern

In 1995 Russian foreign trade was influenced by differently directed factors. A favorable state of the world market and the governmental policy of stimulating exports via regular lowering of export duties provided for a further increase in volumes of trade with countries outside the former Soviet Union and a stable active balance of the foreign trade.

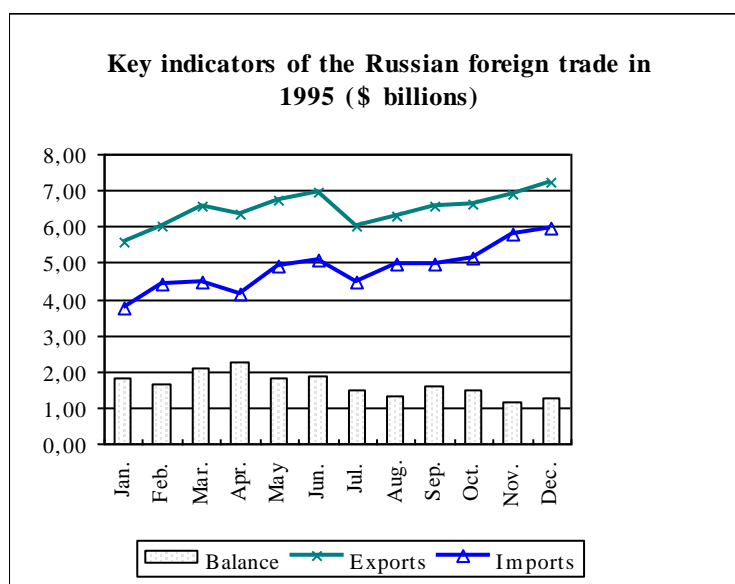
Estimating Russian foreign trade the following adverse factors shall be taken into account: a decline in production, small amounts of investment, rather high inflation rates, insufficient level of state assistance for development of the country's export potential, poor competitiveness of many Russian-made manufactured products, especially of machines and equipment, lack of positive shifts in development of Russia's external relations with countries of the former CMEA, huge external debt, discriminatory barriers banning a number of Russian-made products from external markets. In connection with accession of Finland, Sweden and Austria to the EU Russia automatically became

subject to anti-dumping and quantitative restrictions concerning trade with these countries in steel, textiles, mineral fertilizers, uranium.

Introduction of the “ruble corridor (fluctuation band)” alongside with a relatively high internal price dynamics caused deterioration of export transactions’ effectiveness. However, due to liberalization of energy resources exports, the export sector reacted to the introduction of the “corridor” slower and not so sharply as critics of a fixed exchange rate had believed. At the same time, stabilization of ruble exchange rate created a sufficiently favorable transaction climate for importers allowing them to compensate a part of the loss inflicted by an increase in import tariffs.

Goskomstat reports that the Russian foreign trade turnover, unorganized trade including, made \$ 135.7 billion in 1995, or by 16 percent more in comparison with 1994 figures. Exports were at \$ 77.8 billion (a 18 percent increase) and imports at \$ 57.9 billion (by 15 percent more).

Fig.5.1



The results of external economic activities in 1992 through 1995 are indicative of the fact that Russia re-oriented its trade towards industrialized countries and that the share of **countries outside the former Soviet Union** in the total foreign trade turnover has grown. In 1995 countries outside the former USSR accounted for 78 percent of it. In 1992 through 1995 exports to these countries increased at a record rate in the last 20 years with exports showing a 25 percent growth (\$ 64.3 billion) and imports (together with unorganized trade) increasing by 12 percent (\$ 41.6 billion).

In 1995 growth rates slowed down considerably. Thus, while in the first quarter exports grew by 45 percent as compared with the same period in the last year, in the second quarter it made only 29 percent and showed a modest 15 percent increase in the third quarter. Undoubtedly, export growth rates were affected by the “currency corridor (fluctuation band)” introduced in the second half of the year.

As before, the bulk of Russian exports consists of raw materials. Fuel and energy resources account for the biggest share (41 percent) of exports, while the Fuel-and-Energy Complex production (oil, natural gas, oil products) becomes more and more oriented towards external markets.

In 1995 a decline in export growth rates in real terms was observed as natural gas exports increased by 11 percent (14 percent in 1994), oil products grew by 8 percent (11 percent), oil--by only 1 percent (11 percent).

Growth of exports as calculated in value terms was primarily caused by a favorable situation on the world market. Average contract oil prices of exports in the countries outside the former Soviet Union increased by about 7 percent as compared with 1994 figures, natural gas exports grew by 10 percent while oil products showed a 6.6 percent increase.

Metal exports accounted for a 20 percent share in the Russian exports. Nickel and ferrous metals exports grew most rapidly at 37 and 26 percent accordingly. Average export prices of key metals surged, thus, price of nickel increased by 33.1 percent, of aluminum--by 36.9 percent, of copper--by 24.2 percent, of ferrous alloys--by 24.7 percent, of pig iron--by 14.6 percent. The pattern of metal exports has somewhat changed. Customs statistics reveal a growing number of contracts on export of finished metal articles, however, their share in the total export volumes is still insignificant. These articles are being made according to designs of foreign companies (mostly in aircraft and engineering industries) under a binding condition that they shall be manufactured in accordance with the West European standards and certified by a foreign firm. It is too early to suggest the end of an age of raw exports conducted in their most primitive form, however, the Russian metal industry is given an opportunity to participate in the international division of labor on equal basis and to reach a qualitatively new level of production.

The share of chemicals made 9.6 percent. Mineral fertilizers still remain a key export item in the industry. Export volumes of mineral fertilizers increased by 14 percent in comparison with 1994 figures. Simultaneously, average contract prices also grew (by 24 percent).

Export patterns within the forestry and paper industry tended to be oriented towards raw materials in recent years affecting the structure of currency proceeds accordingly. A third of foreign exchange proceeds was derived from raw timber (logs) exports while semi-finished timber (lumber) accounted for 25 percent of proceeds and processing-intensive products brought only 32 percent.

A considerable increase in physical volumes of exports in the countries outside the former Soviet Union as compared with the previous year figures was reported for logs (37 percent) and cellulose (38 percent). At the same time, average export prices of logs grew by 2.8 percent and of cellulose -- by 96.6 percent.

One of the ways to increase export revenues is an expansion of sales markets for Russian-made weapons and military equipment. Export volumes of military production made \$ 2.6 billion in 1995, that being by 1.7 times more than in 1994.

The share of machines and equipment in Russian exports to countries outside the former Soviet Union contracted to 3.8 percent as compared with 5.3 percent in 1994. Development of new competitive and technologically-intensive products relevant to modern level of requirements on external markets demands large investment and is time-consuming.

Table 5.2

**Volumes of Russian Foreign Trade with Countries Outside Former Soviet Union
in Value Terms**

(without unorganized trade, US\$ billions)

	1992		1993		1994		1995	
	\$ billion	in % to previous year	\$ billion	in % to previous year	\$ billion	in % to previous year	\$ billion	in % to previous year
Foreign trade turnover	79.4	83.2	71.1	89.5	79.8	112.2	97.6	122.3
Exports	42.4	83.3	44.3	104.5	51.5	116.1	64.3	125.1
Imports	37	83.1	26.8	72.4	28.3	105.7	33.3	117.4
Balance	5.4	87.1	17.5	324	23.2	132	31	133

Source: Ministry of Economy of RF.

Table 5.3

Share of Exports to Countries outside the Former Soviet Union in Total Output, %

	1992	1993	1994	1995
Oil	17.0	23.0	28.9	31.5
Natural gas	14.0	16.0	18.0	20.5
Oil products	18.0	21.8	29.7	28.0

Source: Ministry of Economy of RF.

An increase in internal production costs, first of all at the expense of energy and raw materials, more expensive loans, growing transport expenses, aging production assets in extractive and processing branches, deteriorating production situation contributed to diminishing effectiveness of export transactions. At present only export of natural gas, oil, nickel, timber and lumber are profitable. Export of oil products, ferrous and nonferrous metals, chemicals begins to bring losses. However, due to worsening financial situation of Russian enterprises and growing payment arrears exporters prefer to have hard currencies even at declining or altogether negative profitability of exports.

The most dynamic and growing market of the Russian Federation are industrialized Western countries. The largest share of Russian exports goes to Germany (9.1 percent). The USA account for 6.9 percent, Switzerland--for 5.8 percent, Italy--for 5.6 percent, Japan--for 5.5 percent, Netherlands -- for 4.9 percent, Great Britain -- for 4.7 percent and Finland--for 4 percent of Russian exports.

The pattern of Russian **imports** has not been changed considerably. As before, machines and equipment were ranked first and accounted for a 38 percent share of the total imports which grew by 23 percent in comparison with 1994. It was caused by a necessity to provide key branches of the national economy with modern technologies and equipment.

A decline in agriculture followed by deteriorating provision of the populace with domestic-made foodstuffs has led to an expansion of food imports. Such measures as a rise of import duty rates, introduction of excises and of value added tax, abolition of preferences concerning import tariffs, which have been taken lately, contributed to an increase in internal prices of imported goods thus creating prerequisites to restrain imports. However, stabilization of ruble somewhat compensated for the negative impact of growing import duties and excises and helped to increase imports.

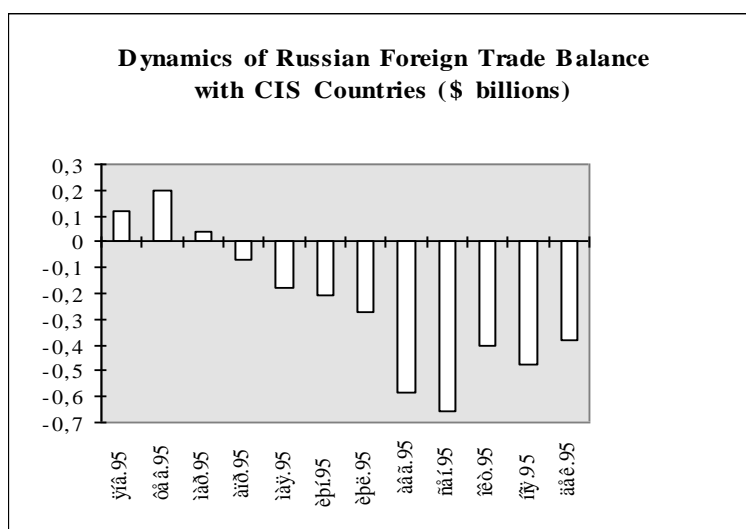
In 1995 imports grew considerably, especially of such products as sunflower oil (a 232 percent increase), poultry (by 70 percent more), alcoholic and non-alcoholic beverages (a 67 percent increase), butter (an increase by 65 percent), frozen meat (by 43 percent more).

In the nearest future dynamics and pattern of the country's foreign trade will be first of all determined by the internal economic situation, i.e. whether it shows signs of business revival or not, by changes in the structure of supply and solvent demand on the domestic market, as well as by exchange rate policies. The regulatory mechanism of the external economic activities may also change due to political factors.

In 1996 exports will grow somewhat slower (at about 1--3 percent rates). It shall be expected that export of major fuel and energy resources will remain at the same level while such products as metals, chemicals, timber, pulp and paper will be exported in increasing quantities.

Oil and natural gas exports will remain profitable if estimated rates of internal price growth prevail.

Fig.5.2



Imports pattern will change impacted by a growth of the share of technological equipment and manufactured consumer goods. Growing imports of key foodstuffs and non-food consumer goods are expected to lead to application of certain measures aimed to tighten protectionist regime in order to safeguard domestic industries in 1996 (there is a possibility that import quotas will be introduced).

In 1995 Russian foreign trade turnover with the CIS countries made \$ 29.8 billion, increasing by 5 percent in comparison with 1994 figures, it is due, first of all, to a price rise concerning fuel and energy products (14 -- 28 percent on the average). Exports made \$ 13.5 billion, or by 9 percent less than in 1994 while imports reached \$ 16.3 billion (a 21 percent increase). The share of the CIS countries in the Russian foreign trade turnover diminished by 2 percent as compared with the previous year figures and made 22 percent.

For the first time in the years of the CIS existence Russia had a negative trade balance with these countries (\$ -2.8 billion) while in 1994 it had a trade surplus of \$ 1.2 billion. Starting from the end of the last year imports from the CIS grew at a fast rate while exports gradually shrank.

We think that the main reason determining the import surplus is an unbalanced, owing to a crisis situation existing in national economies, foreign trade within the CIS framework, that rendering difficulties in settlement of the CIS countries debts, especially those due for fuel and energy resources supply. According to current data, these debts as of January 1, 1996, made Rb 15.6 trillion, or two times more than in 1995. It is hardly justified to attribute Russian shrinking exports to neighboring countries to introduction of the “currency corridor (fluctuation band)” as their fall began as early as April while to the contrary in October some increase in export operations was observed. On the other hand, introduction of the “currency corridor (fluctuation band)” and stabilization of ruble exchange rates enhanced effectiveness of operations of exporters from countries within the former Soviet Union on the Russian market.

As before, the fuel and energy products accounted for the bulk of exports to the CIS member countries (about 50 percent). Total volumes of oil exports diminished by 22 percent as compared with the previous year while export of oil products shrank even more considerably -- by 60 percent, the fact caused not only by payment arrears in reciprocal transactions, but by growing export prices of Russian oil which increased by 28.3 percent in comparison with the last year figures and reached \$ 74.9 per metric ton (that making roughly 70 percent of prices under export contracts with countries outside the former Soviet Union). However, now some CIS countries try to reduce their dependence on Russian energy supply. For instance, Moldavia has already signed an oil import agreement with Iran while Ukraine relies upon cooperation with countries of the Persian Gulf. At

the same time, Russian oil exports to Byelorussia grew considerably as a result of creation of the common customs area, that allowing Byelorussian oil processing enterprises to purchase oil at prices quoted on the Russian domestic market.

The pattern of Russian exports somewhat changed in 1995 as compared with 1994, for instance coal exports grew by 32 percent, iron ore exports increased twofold and export of ferrous metals also showed signs of growth.

As concerns import operations, the role of the CIS member countries remains an important one in terms of providing Russia with foodstuffs. Thus, the share of white sugar imports from these countries reached 80 percent while their volumes increased by more than two times since the last year. There was also observed an increase in imports of grain, meat, butter. At the same time, a trend to purchase fewer consumer goods in countries within the former Soviet Union in connection to availability of cheaper similar products of quality made in the West manifests itself.

The Customs Union of Russia, Byelorussia and Kazakhstan which was established in 1995 and is expected to be joined by some other countries faces a number of objective difficulties and contradictions caused in the first turn by differences in levels of development and directions of reforms. The Intergovernmental Economic Committee which at last started to perform its functions in 1995 still lacks supranational authority; unsettled problems of mutual payment arrears prevent activities of the Payment Union.

Prospects of foreign trade developments within the CIS cannot be estimated in simple terms. The Commonwealth's objective orientation towards integration faces grave political and economic problems. It is probable that in the beginning of next year a negative trade balance with neighboring countries will remain, in particular due to further decline in export of fuel and energy products.

On the whole, the Commonwealth's future, undoubtedly, will depend on the political situation in Russia. As a result of the Communist Party's success at parliamentary elections in December political pressure in favor of the integration will intensify. However, the experience of the last few years demonstrates that Russia's partners within the CIS prefer to act according to their economic interests rather than to political rhetorics. The CIS member countries are interested in an economic cooperation with Russia exactly because it has progressed relatively further on the way of reforms. That is why slackening pace of the reform or a complete stop of the transformation may damage trends towards integration to such extent that any political declarations on closer unity and cooperation will be outweighed.

5.3.1. Balance of Payments

The balance of payments reflecting Russian residents' activities in the external sector reveals the following key facts.

In 1995, the strengthening ruble did not hold back the growth of trade surplus: exports increased at a greater rate than imports.

As during previous periods import of services exceeded their exports, that being primarily attributed to developing tourism to countries outside the former Soviet Union. Thus, import of tourist services exceeded imports by \$ 5366 million. As a result, current accounts balance was by 43 percent less than the balance of foreign trade. Operations of governmental agencies prevailed in the capital account. External debt grew due both to new borrowing and deferments and arrears in debt servicing.

Table 5.4

The Russian Federation Balance of Payments in January--September, 1995

	Consolidated	Including countries	
		outside the former USSR	CIS
Current account	10040	10109	-69
Goods and non-factor services	11684	11893	-209
<i>Trade balance</i>	17710	17270	440
Merchandise Exports (FOB)	57807	46652	11154
Merchandise Exports (FOB, State Customs Committee (GTK) data)	55562	45568	9994
Adjustment of GTK data	2244	1084	1160
Merchandise imports (FOB)	-40097	-29383	-10714
Merchandise imports (CIF, GTK data)	-32851	-23855	-8996
Adjustment of GTK data	-7246	-5528	-1718
<i>Non-factor services</i>	-6026	-5377	-649
Exports	8840	7404	1436
Transportation, insurance included	4194	3435	759
Tourism	3264	2620	644
Construction	65	65	0
Finance	53	51	2
Other	1265	1234	31
Imports	-14866	-12781	-2085
Transportation, insurance included	-2991	-2341	-650
Tourism	-8630	-7398	-1232
Construction	-930	-930	0
Finance	-47	-47	0
Other	-2268	-2065	-203
Balance of labor and capital services (Balance of income)	-1904	-2008	104
Export of services	3589	3257	332
<i>Labor</i>	71	71	0
<i>Capital</i>	3518	3186	332
Participation in equity capital (dividend and profit)	43	40	3
Interest on deposits and securities	540	537	3
Interest on loans granted (schedule)	2935	2609	326
Import of services	-5493	-5265	-228
<i>Labor</i>	-355	-141	-214
<i>Capital</i>	-5138	-5124	-14
Participation in equity capital (dividend and profit)	-183	-180	-3
Interest on deposits and securities (schedule)	-141	-130	-11
Interest on drawings (schedule)	-4815	-4815	0
Current transfers	260	224	36
Received	701	664	37
Repaid	-441	-440	-1
Capital and finance instruments account	-4064	-2602	-1462
Capital account	-484	-338	-146
Capital transfers	-484	-338	-146
Financial account	-3580	-2264	-1316
Direct investment	1142	1106	36
<i>rest of the world</i>	1	1	0
<i>to Russia</i>	1141	1105	36
Portfolio investment	-130	-130	0
<i>Assets</i>	-147	-147	0
<i>Liabilities</i>	17	17	0
Other investment	2475	3827	-1352
<i>Assets</i>	-1643	-13	-1630
Foreign exchange cash and deposits	2358	2163	195
Balance of loans granted (including restructuring and arrears)	3930	4099	-169
Loans granted	14356	13908	448
by authorities, guaranteed	8441	8012	429
used	-69	-37	-32
repaid (schedule)	8447	7986	461
commercial loans guaranteed by authorities, net	63	63	0
By bank sector	-281	-281	0
used	-2494	-2494	0
repaid (schedule)	2212	2212	0
By enterprises	6197	6178	19
used	-24021	-19864	-4157
repaid (schedule)	30217	26041	4176
Deferrals	-435	-72	-363
Loans granted by authorities, denominated in convertible currencies	-435	-72	-363
principal debt	-435	-72	-363

interest	0	0	0
Arrears	-9991	-9737	-254
loans granted	-9991	-9737	-254
By authorities	-9954	-9700	-254
Loans denominated in convertible currency	-9949	-9695	-254
principal debt	-7489	-7399	-90
interest	-2460	-2296	-164
Other	-5	-5	0
principal debt	-5	-5	0
interest	0	0	0
By bank sector	-38	-38	0
principal debt	-37	-37	0
interest	-1	-1	0
Export revenues, not received	-5626	-4458	-1168
Other assets	-2305	-1817	-488
<i>Liabilities</i>	4118	3840	278
National currency cash and deposits	970	640	330
Balance of drawings (restructuring and arrears included)	3098	3250	-152
Drawings	-5910	-5672	-238
By authorities, guaranteed	-4768	-4768	0
used	5037	5037	0
repaid (schedule)	-9805	-9805	0
By bank sector	474	474	0
used	1915	1915	0
repaid (schedule)	-1441	-1441	0
By enterprises	-1616	-1378	-238
export loans	-1616	-1378	-238
used	2654	2056	598
repaid (schedule)	-4271	-34435	-836
Deferrals	6490	6490	0
Loans received by authorities			
Debt of the former USSR	6490	6490	0
principal debt	5560	5560	0
interest	930	930	0
Arrears	2519	2433	86
Loans received	2433	2433	-
By authorities	2433	2433	0
loans, convertible currency	193	193	0
principal debt	193	193	0
interest	0	0	0
Debt of the former USSR	2240	2240	0
principal	580	580	0
interest	1660	1660	0
interest on outstanding debts, included	1320	1320	0
Other	86	0	86
Increment in debt to CIS and Baltic enterprises due under contracts	114	14	100
Other liabilities	-65	-65	0
Reserve assets	-7137	07137	
Adjustment of reserve assets	70	70	
Adjustment of payments, CIS and countries outside the former USSR		-1956	1956
Errors and omissions, net	-5975	-5550	-425
Overall balance	0	0	0

Non-state sector operations were mostly represented by commercial loans, both in terms of merchandise exports with deferred payments and advance payments. As concerns direct and portfolio investment, they remained at an insignificant level.

Growing reliance of residents on ruble was shown by somewhat decreasing amounts of cash foreign exchange.

As a rule, commercial structures accounted for loans granted to non-residents. The main form of such loans was export loans of enterprises.

Non-repatriation of export proceeds became an important factor destabilizing the financial sphere. In January through September of 1995 it reached \$ 5.6 billion, as the State Customs

Committee (GTK) reports. This figure is comparable to all foreign loans drawn by the state in the same period.

The amount of payments due to disburse the official external debt exerted more pressure on the Federal budget as compared with the same period of the last year. While in 9 months of 1994 96 percent of actual payments to disburse the official external debt were financed at the expense of external sources and only \$ 134 million were received from internal sources, in 9 months of 1995 the figures made 89.5 percent and \$ 590 million accordingly.

Section 6

Social Sphere and Labor Market

6.1. Living Standards

Money income

The total amount of household money income in 1995 as calculated by Goskomstat was Rb 942.3 trillion. Changes in the structure of income, first perceptible in 1992 - 1994 and mainly indicating diminishing share of wages and salaries in total amount of income alongside with growing share of other income, continued. At the same time, in 1995 the share of wages and salaries remained relatively stable and even increased in the fourth quarter. For the first time in recent years, in the last months of 1995 a situation arose when an increase in wages coincided with growth rates of all money incomes (Table 6.1.)

Table 6.1

Structure of Household Money Income, %

	1992	1993	1994	1995 I quarter	1995 II quarter	1995 III quarter	1995 IV quarter
Total money income	100	100	100	100	100	100	100
Wages and salaries	69.9	60.5	46.6	39.8	37.9	39.1	40.7
Social transfers	14.0	15.1	15.4	17.2	15.7	17.0	16.9
Incomes derived from property, entrepreneurial activities, other	16.1	24.4	38.0	38.4	42.4	36.3	37.9

Source: Goskomstat

So, the share of wages shrank by 1.5 times in two last years while the share of business and other income increased by 1.6 times. It is necessary to pay attention to the fact that it is hard to interpret the last element in the income structure. A larger part of income in the form of wages paid in the private sector is not taken into account as such by the official statistics. The data on the amount of other income are only an estimate and is not conformed by results of households surveys. Difficulties arising when interpreting individual elements of household income are characteristic of all countries whose economy is in transition. Nonetheless, it shall be probably expected that in the long run a share of income in the form of wages and salaries may stabilize at a considerably lower level than in developed market economies (where it makes, as per different estimates, 65 -- 75 percent of all incomes). In particular, due to serious flaws in the fiscal system applied to individual incomes (taxes on individuals) it is impossible to differentiate "profits" from individual business income.

At the same time, some changes occurred in the fiscal system in 1996 alongside with somewhat stabilizing income on bank deposits and other factors will contribute to stabilization and, probably, to an increase in the share of wages in the total amount of household money income in 1996.

While in 1994 a growth rate of money income was dying away, in 1995 in spite of an observed monthly rise income remained below the levels of income in relevant periods of 1994 calculated in real terms. To a considerable degree the money income dynamics were determined by abating inflation rates and implementation of tight monetary policies. Income in real terms as calculated on quarterly basis more and more lagged behind 1994 figures: while in the first quarter its level made 96 percent of figures observed in the same period of 1994, in the second quarter it was 90 percent, in the third quarter -- 88 percent and only 87 percent in the fourth quarter. On the whole, in 1995 real disposable money income (income minus mandatory payments, adjusted for retail price index) was below 1994 figures by 13 percent.

Growth of household money incomes calculated on monthly basis was considerably more slow than in past years. Thus, income increased by roughly 30 percent from January through December (about 50 percent in 1994) while traditional December “surge” in incomes was much weaker than in past years making only 10 percent in real terms (more than 15 percent in 1994, 22 percent in 1993). It shall be noted that in 1995 the share of interest on current deposits with Sberbank (Savings Bank) of Russia included into December income was considerably less than in previous years (almost 10 percent in 1993, less than 5 percent in 1994, only 2.3 percent in 1995).

Distribution of the RF populace in terms of per capita income in 1995 as estimated by Goskomstat is shown in Table 6.2.

The process of redistribution of household income in favor of groups with high incomes was arrested in 1995, indicators of income differentiation remained roughly constant and even somewhat decreased. Value of Gini coefficient -- a general index reflecting inequality of income distribution -- remained at the practically same level during the year slowly sliding from 0.39 to 0.38. Distribution of the total amount of household money income as broken down by income groups is shown in Table 6.3.

Table 6.2

Per Capita Monthly Money Income in 1995, %

Total populace	100
including those with incomes, Rb thousands:	
below 100.0	2.0
100.1-200.0	12.5
200.1-300.0	17.2
300.1-400.0	15.7
400.1-500.0	12.7
500.1-700.0	16.9
700.1-1000.0	12.5
over 1000.0	10.5

Source: Goskomstat

Table 6.3

Distribution of the Total Household Money Income in 1994 and 1995, %

	1995	1994
Money income	100	100
including 20% groups within populace :		
first (minimal income)	5.5	5.3
second	10.2	10.2
third	15.0	15.2
fourth	22.4	23.0
fifth	46.9	46.3
Gini coefficient	0.381	0.409
Income ratio between 10% of the most and the least prosperous groups of populace, times	13.5	15.1

Source: Goskomstat

It shall be noted that due to a number of reasons the lessening differentiation of household incomes shall be attributed rather to some alteration of calculation methods than to an outcome of real social and economic processes. A break in observation series which occurred in the beginning of 1995 caused sharp fluctuations of differentiation coefficients. Alternative estimates also do not confirm the Goskomstat assessment; the Center for Economic Analysis under the Government of the Russian Federation reported a stable Gini coefficient at 0.400 -- 0.405 in 1995.

The subsistence level (as estimated by the RF Ministry of Labor) made Rb 327 thousand per capita in the end of 1995. At the same time, preservation of the previous expenditure structure within the basic basket used for calculation of subsistence minimum, i.e. orientation towards proportions of money distribution characteristic of low-income households in the early 1990s leads to the fact that the substantive meaning of the indicator calculated by the Labor Ministry methods is

hard to interpret. In particular, an “explosive” surge of tariffs on many public utilities was characteristic of 1994 and 1995. Thus, the Ministry of Labor statistics reveal that living accommodation rent and technical maintenance payments were raised by 8.2 times in 1995, payments for cold and hot water supply by 23 - 27 times (at the same time price index of goods and services in Moscow made 2.4). Since a mechanism of housing subsidies was not worked out, the share of consumer expenditures of low-income households for public utilities increased sharply, however, this situation has found no reflection in the structure of a “minimum consumer basket” which statistical agencies continue to use while making their calculations.

Per capita money income of 24.7 percent of the populace was below minimum in 1995. At the same time, the share of poorest strata diminished gradually in 1995, from 30 percent in the first quarter to 20 percent in the fourth quarter of 1995.

In 1995 poverty became “deeper”, i.e. differentiation intensified within the poverty-stricken group. Income deficit (an amount representing difference between incomes of the poor and subsistence minimum) increased to Rb 36 trillion, or 3.8 percent of the total amount of money income in comparison with Rb 12 million and 3.3 percent of the total income in 1994. The poverty-stricken populace is distributed unevenly across specific regions of Russia. The highest rates of poor households are registered in Yaroslavl, Kurgan and Ivanovo regions, in the Republics of Mordovia, Chuvashia and Udmurtia.

In 1995 the money income -- subsistence minimum ratio was somewhat less than in 1994 (on the year average 202 percent against 238 percent). At the same time, the ratio of subsistence level to minimum wage improved a little: from a 7 times difference in the end of 1994 to about 5 times in the end of 1995. However, this proportion is even worse than, for instance, that existing two years ago (roughly 3.2). The difference between average and minimum wages also declined from 16 times in the end of 1994 to 11.2 times in the end of 1995. It shall be admitted that “minimum wage” social indicator is, as before, misinterpreted by decision-makers, the fact being shown during recent parliamentary debate on the “vexed” problem on the periodicity of its indexation and calculation methods. It seems that exactly the concept of income policy based on the single parameter of “minimum wage”, which is rather loosely related to household money income flows, condemns different “actors”, who express interests of certain social partners, to repeat the same arguments time and again. It is apparent that the compensation mechanism shall be somehow corrected after all. It would be only too natural, for instance, to use a method worked out for compensation of pensions: in the end of 1995 the fixed part of the compensation equaled to 22 percent of its total amount although in the beginning of the year it made only 17 percent.

In December of 1994 the average wage rose to Rb 710 thousand, or by 2 times as compared with December of 1993. The average wage in real terms (as adjusted for retail price index) decreased by roughly 25 percent in 1995, the fact confirming persistence of unfavorable trends appeared in 1994. Another aspect shall be also taken into account and namely the fact that actually paid wages were by 20 percent less than amounts due, so actual decline of real wages was even more substantial. Monthly dynamics of the average wage in the national economy are shown in Table 6.4.

Table 6.4

Average Monthly Wage in the RF in 1995

	Rb thousand	US dollars
January	302.6	78.4
February	321.0	75.4
March	361.5	76.1
April	386.2	76.6
May	429.9	85.1
June	480.6	101.4
July	499.5	110.6
August	520.6	117.9
September	564.5	126.2
October	594.5	132.1
November	615.7	135.5
December	710.0	153.6

Source: Goskomstat

Alongside with general decline in real wages differences between average wages as broken down by branches also increased: for instance average wages of employees in health care, physical culture and social protection agencies made 0.69 in comparison with the Russia's average against 0.78 a year ago, for public education employees this indicator decreased from 0.73 to 0.62, the average wage in cultural and art organizations made 0.57 as compared with previous 0.64 value while those engaged in scientific services received 0.75 of the Russia's average wage (0.76 in 1994). So, the employees in the budgetary sector experienced the most drastic decline in living standards.

The average pension amounted to Rb 233.4 thousand in the end of 1995. While in the beginning of 1995 average pensions were 6 percent below a pensioner's subsistence minimum, by the end of the year these two indicators were practically equal. As per Goskomstat estimate, in real terms pensions declined by about 20 percent in comparison with 1994. Taking into account falling real wages, the ratio of average pensions to average wages somewhat improved in 1995 as compared with 1994 and fluctuated in the band from 0.35 to 0.4.

Cash expenditure

The share of consumer spending continued to shrink in 1995, the decline of this indicator in three last years was from 81.1 percent to 68.5 percent of the total amount of cash expenditure. The structure of household savings underwent further changes. (Table 6.5).

Unorganized savings were mainly accumulated in purchased foreign cash; the increase in cash possessed by households amounted to 55 percent in 1993, 23 percent in 1994 and 15.4 percent in 1995 accordingly. So, purchase of foreign cash, even in spite of introduction of the "currency corridor (fluctuation band)" remained the most common method of protection against inflation as total volume of foreign currency purchases in 1995 (Rb 134.9 trillion) by 2.93 times exceeded deposits and amounts spent on securities. In 1995 the populace's reliance on commercial banks fell dramatically. The flow of organized household savings from commercial banks to the Sberbank (Savings Bank) of Russia intensified and by the of 1995 Sberbank had accumulated 87 percent of the total household savings.

Table 6.5

Structure of Household Savings in 1995, %

	1990	1992	1993	1994	1995
Total savings	100	100	100	100	100
including					
Accumulated savings in form of deposits and securities	60	26	26.7	22.7	21.5
Unorganized savings	40	74	73.3	77.3	78.5

Source: Goskomstat

Consumer market

The consumer market developments in 1995 were influenced by the following factors:

- household real incomes declined; due to substantial wage arrears incomes were received irregularly, especially in the budgetary sector;
- stabilization of income differences led to stabilization of demand and its consequent decline in the consumer market segments oriented mainly towards high-income groups: stagnation on real estate markets, saturation with luxuries;
- the share of goods purchased by the populace on merchandise, mixed and foodstuffs markets continued to grow alongside with shrinking of the share of goods purchased through trade enterprises;
- as price of services grew relatively faster, the share of services rendered to the populace in the total turnover of retail trade increased.

Declining household purchasing power caused a 7 percent decrease in retail turnover in comparable prices, including a 6 to 10 percent fall in the first three quarters and a 3 to 5 percent rundown in the fourth quarter of 1995.

The macrostructure of the retail turnover depreciated in 1995 as compared with 1994 figures: while the share of foodstuffs grew (from 46 to 48 percent), the share of goods shrank accordingly. In the total turnover of merchandise and services the share of services increased from 15 to 17 percent due to the surge of tariffs on services, mentioned above, especially on public services.

Retailers' stock grew in 1995 and could secure 42 days of trade in the end of 1995 as compared with 33 days in the beginning of the same year. As before, non-state enterprises maintained considerably higher merchandise turnover velocity.

Outlook for Living Standards and Consumer Market Dynamics in 1996

According to available expert estimates, nominal money incomes will increase somewhat slower in the first half of 1996 than in 1995. By the mid-year money incomes will increase by more than 40 percent; the income structure as broken down by sources will remain practically unchanged. Alongside with stabilization of wage share, some increase in the share of social transfers caused by measures taken to boost up pensions and some other social spending may be expected. A share of incomes from other sources will, most probably, remain at 38 -- 40 percent what may be attributed to "saturation" of these sources of income. Changes in the income structure may lead to an increase in the share of incomes received by the least prosperous 20 percent group of households, as a result this share may make 5.7 -- 5.8 percent of the total money income. At the same time, the share of the most well-to-do households' incomes will also grow. These opposite directed changes will determine continuation of the trend towards polarization of incomes although less intensive as before. The most probable value of Gini coefficient in mid-1996, as estimated by experts, will be 0.400 -- 0.405.

An uncertainty on inflation developments in the first half of 1996 do not allow to make a reliable estimation of an interval of probable fluctuations of real income index in this period. A relatively smooth and stable dynamics of real incomes in the second half of 1995 allows to assume that development of a considerable gap between nominal income and retail price indices is unlikely in a few next months. Due to the effect of a number of factors, like an increasing share of imported products in retailers' stock, an expected rise of social transfers share, a forthcoming restriction of growth rates of tariffs on public services -- the total real incomes may increase by 2 -- 4 percent by the mid-1996 as compared with December of 1995.

6.2. Social and Cultural Sphere

Health Care

The last year stood out against the background of the general trend towards a step-by-step degradation of the medical service structure embracing the main bulk of the populace. Budgetary funding of the public health in comparable terms fell by 26.8 percent during the year while the GDP decreased by only 4 percent. As a result, the state health care expenditure share in the GDP which grew in 1993 -- 1994 sharply shrank in 1995. When the 1995 Federal budget was adopted, the share of public health was set at 1.7 percent as compared with 1.6 percent in 1994. However, this indicator has reached only 1.3 percent: the actual budget was only 76 percent of its planned targets. Federation subjects' spending on the health care within the total expenditure decreased from 15.7 percent in 1994 to 15.3 percent in 1995. In 1995 the process of replacement of the public health budgetary financing with a system of mandatory insurance payments made by legal entities was underway. While in 1993 the ratio of these financial flows to each other was 85:15, in 1994 it amounted to 82:18 and in 1995 equaled 81:19 (in 9 months of the year).

A relative level of the average salary within the public health system made only 59 percent of the average wage in the industry in the first 11 months of 1995 (1994 -- 73 percent) hitting a 25-year low. By the criterion of per capita social benefits paid to employees, the health care leaves behind only the agriculture. It seems that exactly these factors account for the lessening number of practitioners registered for the first time since the beginning of economic reforms.

1995 was the second year when the mandatory medical insurance system (MIS, *russ. abbr. OMS*) functioned. Erratic way in which the system was introduced and regional variance in the transitory MIS models as they were formed in 1994 persisted without considerable change in 1995. Only few regions continued to work out the normative and legislative base of the MIS, at the same time expanding the circle of organizations and medical services involved in the medical insurance system. A majority of regions suspended implementation of the reform as it has originated a conflict of interests between territorial MIS funds and insurance companies on the one hand and health care management on the other hand.

In the first half of the last year the branch bureaucracy attempted to revise the changes made in the organization of the public health system. The outcome of the MIS introduction and its prospects were debated in the mass media and in the Parliament. The Bryansk and Kemerovo regional authorities took decisions to transfer the right to dispose of money accumulated by the MIS funds to territorial public health agencies. In the spring of 1995 the Ministry of Public Health and Medical Industries attempted to amend the law on medical insurance. In case these amendments had been adopted, both Federal and territorial MIS funds were to be deprived of their rights and subordinated to the territorial health care management. In practice it would have meant the curtailment of the reform and return to the state public health system.

Earlier, the Duma Committee on Public Health has drafted a law of the same title although of principally different contents. The bill was to serve as a guideline of further reforms and stipulated measures directed to strengthen the positions of the MIS funds and of insurance companies. The outcome was that both drafts were frozen. As the Ministry of Public Health has realized that the fifth State Duma will not adopt the law it was interested in, it scaled down the fight against MIS funds. After the hectic debate on the reform issues in the winter and in the spring of 1995 has abated, the number of critical articles in mass media sharply lessened in the summer and autumn. In their turn, the MIS funds have halved the expenditure for their staff as its scope had been the most irritating issue in the discussion and, it seems, began to share more of their revenues with health

care management. In November of 1995 the All-Russian Pirogov Congress of doctors took place. It constituted, in fact, a new form of medical professional association, alternative to the system of branch management. The Ministry of Public Health and the Government attempted, although without success, to prevent the Congress convocation or at least postpone it until after the Parliament elections. The Congress bitterly criticized governmental policies in the area of health care. Soon after that the President has appointed a new Public Health Minister, however, the Ministry's attitude towards the reform remained practically the same.

It shall be expected that new attempts to revise the existent MIS model will be undertaken in 1996 in order to transfer the sole right to dispose of the finance source (mandatory payments of legal entities) to health care agencies. The new composition of the State Duma enhances a possibility that these attempts will prove more successful than in the last year. These planned changes may become a useful tool in the hands of those parties who have won the elections in order to demonstrate an effort to improve the situation in the public health, especially taking into account that any other measures in this area would have required time and substantial funding.

Table 6.6

State Expenditure for Social Sphere by Sector, in % of GDP

	1990	1991	1992	1993	1994	1995
Health care, including:	2.3	2.9	2.5	3.7	3.9	3.0*
State budget	2.3	2.9	2.5	3.1	3.2	2.4
Mandatory insurance payments of legal entities	-	-	-	0.6	0.7	0.6*
Public education**	3.5	3.6	3.6	4.1	4.5	3.4
Culture, arts and mass media**	no data	0.5	0.6	0.6	0.8	0.6

* - data for nine months of the year.

** - State budget expenditure.

Source: calculated on the base of Goskomstat data.

Public Education

In 1995 the social and economic situation in the public education deteriorated perceptibly. It was caused, first of all, by a substantial fall in budgetary expenditure for education and governmental payment arrears. The state spending for education decreased by 26.5 percent in comparable terms during the year. The share of this expenditure in the GDP shrank from 4.5 percent in 1994 to 3.4 percent in 1995. In the last year the implementation of policies directed to a redistribution of the burden of education financing between the Federal and local budgets continued. The share of this expenditure in the Federal budget decreased gradually: 1992 -- 5.8 percent; 1993 -- 4.0 percent; 1994 -- 3.7 percent; 1995 -- 3.1 percent. In comparable terms the Federal expenditure for education was only 32 percent of 1992 figures.

The ratio of the Federal budget expenditure to that of local budgets was 34:66 in 1992, 20:80 in 1993 and 1994 and 15:85 in 1995. At the same time, the share of spending for education in local budget remained in 1995 at the same level as in 1994, namely, at 19.8 percent.

Both 1994 and 1995 budgets did not envisage a separate expenditure item to finance school textbooks publishing. In 1995, as a year before, a situation arose when the publishing of text-books to be freely distributed in the new school year nearly failed.

The most grave signs of mounting aggravation of the social and economic discontent in the public education were regular strikes of employees in this sector. In spring protest actions were taken in 575 educational institutions, 27.2 thousand people participated. After the All-Russia strike of teachers took place in 14 regions on September 26, on December 14 -- 15 there began another teacher strike in which one tenth of country's schools and 342.1 thousand people were involved.

The spring strikes were held in an answer to the RF Government resolution No. 189 of February 27, 1995, on indexation of teacher salaries which stipulated alongside with a formal increase of salaries by 1.3 times from March 1 a simultaneous decline of coefficients set by the uniform tariff scale (UTS) from 10.7 times to 7.5 times. As a result, an actual rise of salaries in real terms was considerably less than it had been expected. Moreover, only 10 Federation subjects began to implement the governmental resolution on March 1, the other were going to study this question only by the end of the second half-year. Even after the system of the UTS inter-grade coefficients effective in 1994 was restored on November 1, 1995, salaries of employees having less than the 13th UTS grade were below minimum subsistence level. As a result, the average salary in public education amounted to only 53 percent of average industrial wages in the first 11 months of 1995 (69 percent in 1994). Such a wage level gap has been registered in the country for the first time in many years.

An attempt of Federal authorities to alleviate the wage situation in the public education on the eve of December Federal Assembly elections through special-purpose transfers amounting to Rb 629 billion to 22 regions of Russia has not brought the desired result. The funds extended by the center were often used elsewhere by Federation subjects while teachers did not received their salaries.

A substantial support for teachers in secondary schools was the International Soros educational program in the area of exact science which amounts to \$ 21 million, 3300 teachers received grants under the program.

In 1995 the structural reform continued in the system of educational institutions. The number of secondary schools increased by 1 percent during the year, educational institutions of new types were created at an accelerated rate: the number of gymnasias rose by 9.3 percent, the number of lyceums - by 8.1 percent. A network of private schools certified by the state increased by 17.5 percent and made 0.8 percent of the total number of secondary schools. The distribution of private schools across the territory of Russia is extremely uneven and is in a close relation to success of reforms implemented by a region. Almost half of them is located in Moscow, St.Petersburg and in the Moscow Region. The structure of private schools funding sources have been profoundly changed during the years since they had come into existence. While at the first stages practically all expenses were with founders, at present payments made by students and parents form the major source of financing. State normative subsidies which are calculated on per student basis (independently of their place of study) do not reach the private schools as for private schools it is extremely difficult to obtain the state accreditation which is a must in order to receive subsidies.

A broad discussion on various draft legislation concerning possible ways of privatization in the educational sphere which took place in 1994 ended with adoption of the Federal law "On Preservation of State and Municipal Educational Institutions' Status and Moratorium on Their Privatization" in April of 1995 which stipulated a three-year ban on privatization of all educational institution independently of their type, including facilities belonging to their productional and social infrastructure. The only principally new provision in the law was that permitting changes in the composition of founders of an educational institution. However, this change is allowed only in cases when new founders are representatives of the legislative or executive authorities, new private founders are not accepted. In the end of 1995 the State Duma adopted the Federal law "On Amendments and Supplements to the Russian Federation Law "On Education" which directly prohibited privatization of state and municipal educational institutions.

The state budgetary financing is not expected to improve in 1996 what determines continuation of a difficult situation in educational sphere as a whole. At the same time, the sectors which have

found their place on the market of educational services will, to all appearances, demonstrate a dynamic development in case no sharp political and ideological changes occurs in the country.

Culture and mass media

The key factor determining the social and economic situation in the sphere of culture was, as also in case of other sectors of the social sphere, the considerable deterioration of budgetary financing in 1995. In the year in question the state real expenditure for culture, arts and mass media fell by 27.4 percent as calculated in comparable terms against 1994 figures, i.e. at the similar rate as in other social sphere sectors. However, the shrinking of the Federal budgetary expenditure share was more substantial and amounted to 40.3 percent. The ratio of the Federal budgetary expenditure for culture to that of the Federation subjects changed accordingly making 33:67 in 1993, 36:64 in 1994 and 29:71 in 1995.

A relative level of “culture and arts” sector employees was only a half of that in the industry in 1995. However it decreased not so sharply as in the health care and education: by 53 percent in 1994 and by 49 percent in 1995.

In spite of the consensus among all political parties that it is necessary to step up the state support of the cultural sphere, which became apparent in the course of the Parliamentary elections and persisted ever since, a serious change of the existing situation may hardly be expected. The most probable consequence is a narrower gap in salaries between cultural workers and employees in other branches of the economy.

The system of the normative and legal regulation of cultural institutions’ activities underwent some changes in 1995. In June of 1995 the RF Government approved “Regulations on Principles of Business Activities Carried Out by Cultural and Artistic Institutions” which had been initiated by the Ministry of Culture. Earlier cultural institutions worked in accordance with a normative document adopted by the Commission under the USSR Council of Ministers headed by L.I. Abalkin. That economic model represented a mix of commercial and non-commercial principles applicable to activities of cultural institutions. As a number of legislative acts on principles of business activities in the market economy was adopted, it became important for the sectoral special interest group to secure the rights enjoyed by cultural institutions in a legal form; the new legislation answered this purpose.

The most important economic and political developments in the sphere of mass media were organizational and economic changes implemented on the first television channel. All broadcasting rights were transferred to the joint-stock closed company “Public Russian Television” (PRTV, *Russ. abbr. ORT*). Among its founders, alongside with the state, was a number of non-state commercial structures which pledged to participate in financing of broadcast. At first it had been planned that “Ostankino” TV company would be engaged in production of TV programs, however, later it was liquidated.

Political importance of this development is apparent -- on the eve of the election an organization amenable to the “party of power” control was created. The State Duma attempted to change the situation by adoption of the law “On Special Privatization Procedure Applicable to Television and Radio Organizations in the RF”, however, the President repeatedly imposed his veto on it.

It is important to note economic implications of these changes: for the first time an amalgamation of the state and private financing of “net public goods” was instituted in this country.

Institutionalization of the non-commercial sector

The effectuation of the first section of the new Civil Code in January of 1995; adoption of the Federal law “On Charity and Charitable Organizations” in June and of the Federal law “On Nonprofit Organizations” in December created the environment necessary to complete the institutional formation of the non-commercial sector in the economy, to develop it and to implement a purposeful, accurately focused state policy in this sector.

Earlier the rights and obligations of nonprofit organization have been stipulated by the legislation rather vaguely. The new legislation minutely defines specifics of nonprofit and charitable organizations activities alongside with the rules concerning disposal of their property; general principles of management and control over such institutions. The spectrum of organizational forms of nonprofit establishments was broadened. In addition to such forms as consumer cooperatives, public and religious organizations, funds, establishments stipulated by the Civil Code two new forms were introduced, namely, nonprofit partnerships and autonomous nonprofit organizations.

However, implementation of the new legislation may encounter two types of obstacles. First, many officials in the central and local governments experience distrust or even an open prejudice to non-state organizations operating in the spheres which until recently have been subject to the state prerogative. An experience of rendering the state support to non-commercial institutions and of constructive cooperation between authorities and nonprofit organizations in order to settle socially important problems is only being acquired and has not become a general rule yet. Moreover, commercial activities of certain organizations which define themselves as nonprofit institutions give grounds for a guarded attitude to organizations seeking state support.

Second, an inevitable vagueness of a number of provisions in the framework of the new legislation may create certain difficulties in its implementation. The adopted laws partly reflect the specifics of current activities within the non-commercial sector and partly are of “prospective” character and therefore have been not proved sufficiently by relevant practices.

6.3 Labor Market and Employment

As it had been prognosticated in the previous IET reports, the development trends pertaining to the Russian labor market underwent no drastic change in 1995. To characteristic features of these developments belong a stabilization of the total number of unemployed as calculated on the base of the ILO methods, a moderate growth of unemployment rate as registered by the Federal Employment Service (FES, *Russ. abbr. FSZ*) of Russia and an apparent effect of seasonal factors on the Russian labor market. Relatively new developments included an apparent deterioration of the demand to supply ratio on the officially registered labor market alongside with relatively stable trends towards reducing numbers of workers subject to shorter working hours or experiencing spells of involuntary unpaid leave and a stabilization of the total number of those active in the economy. (Table 6.7). While in the second quarter of 1994 the number of workers decreased by 1.9 million and their share in the total economically active populace shrank by 0.9 percentage points and in the first quarter of 1995 the number of the employed experienced a further decline by 0.3 million, in the second and third quarters of 1995 employment increased and stabilized at 67.2 million. The shrinking of the employed share within the economically active populace also decelerated: in the first three quarters of 1995 it declined by only 0.4 percentage points.

On the other hand, the rate of increase in the number of the unemployed also decelerated. In the first three quarters of 1995 it rose by 100 thousand people quarterly as compared with 200 thousand people quarterly in the second through fourth quarters of 1994. An average quarterly augment of the unemployed in relation to the economically active population was 0.13 percentage points in the first

three quarters of 1995 in comparison with 0.3 percentage points in the second through fourth quarters of 1994.

These trends represented a natural reaction of the Russian labor market to decelerating rates of the slump: in the second through fourth quarters of 1994 indicators of GDP fall in comparable prices in percentage to the same quarters of 1993 shifted from 84 to 87 percent while in the first three quarters of 1995 (in percentage to the relevant quarters of 1994) they changed from 94 to 96 percent. The flexibility coefficient of unemployment growth to the GDP fall made in the second quarter of 1994 through the first quarter of 1995 2.38 (i.e. a number of the unemployed grew by 2.38 percent to 1 percent fall in the GDP), in the third quarter of 1994 through the second quarter of 1995 -- 2.4 and in the fourth quarter of 1994 through the third quarter of 1995 -- 1.85. The decrease of the coefficient value in the latter period may confirm the previously mentioned hypothesis that there is no serious potential for unemployment growth in Russia.

Table 6.7

Key Indicators of Developments on Russian Labor Market in 1994 - 1995

Year	Quarter	Economically active populace, in millions of people, by the end of a period				
		Total	Including:		The number of unemployed registered at Employment Service to the total unemployment	Individuals involuntary on short time or on unpaid leave
			Employed	Unemployed		
1994	I	74.2	69.3	4.9	1.1	4.4
	II	73.6	68.4	5.2	1.3	4.5
	III	73.4	68.0	5.4	1.4	4.6
	IV	72.9	67.4	5.5	1.6	4.8
1995	I	72.7	67.1	5.6	1.9	4.7
	II	72.9	67.2	5.7	2.0	3.9
	III	73.0	67.2	5.8	2.1	3.7
in percentage to the economically active populace						
1994	I	100	93.4	6.6	1.5	5.9
	II	100	92.9	7.1	1.8	6.1
	III	100	92.6	7.4	1.9	6.3
	IV	100	92.5	7.5	2.2	6.6
1995	I	100	92.3	7.7	2.6	6.5
	II	100	92.2	7.8	2.7	5.3
	III	100	92.1	7.9	2.9	5.1

Source: "Statisticheskoye Obozrenie" (Economic Survey), a monthly journal of Goskomstat, 1995

It is most likely that in the nearest future the labor and employment problems in the country will be of structural and regional character. Indeed, a decrease in absolute augment of the total unemployed number was caused by differently directed changes in number of various categories of marginal workers on the labor market. Thus, while the number of individuals involuntary working shorter time or on involuntary unpaid leave was falling constantly in the first three quarters of 1995 totaling to 1.1 million (in the first three quarters of 1994 an opposite trend was observed; the number of employees in this category increased by 0.4 million), the number of officially registered unemployed constantly grew (by 0.5 million per a relevant period).

It may be presumed that slackening decline of GDP is followed by more rational employment as a part of workers who have earlier found themselves in the situation of "concealed unemployment" can not adapt to new environment: former employers do not need their labor while in the sphere of small business they are unable to cope with competition. According to preliminary estimates basing on surveys of employers, it seems hardly probable that the share of workers currently employed at enterprises experiencing long periods of suspension of production, and who are to loose their jobs in the future, will exceed one third. This category which has little prospects on the labor market includes those who retain formal ties with their employing enterprises and have no other income, even from personal plots of land and depends on the relatives. Proceeding from these estimates it may be assumed that in the medium-term outlook (2 to 3 years) the officially registered

unemployment will rise by 1.2 million bringing the total number of unemployed legally enjoying the rights to receive economic and social support up to 3 -- 3.5 million.

Monthly growth rates of the officially registered unemployment was extremely uneven over 1995. The rate reached its peak in February, December and in January (128.4, 99.3, and 86.2 thousand accordingly) and was at lowest in September, May and in June (6.5, 7.5 and 11.3 thousand accordingly). So, maximal and minimal monthly growth of absolute unemployment values differed by almost 20 times. However, on the whole the change of absolute monthly augments was closely correlated to traditional seasonal relaxation of tensions on the labor market caused by availability of jobs, mostly in the tax-free sector of the economy, in the spring and summer months of the year (Table 6.8).

Table 6.8

Growth Rates of Officially Registered Unemployment in Russia in 1993 - 1995, %

Month	1993	1994	1995
January	8.78	6.98	4.57
February	10.14	10.71	7.51
March	5.71	9.49	4.46
I quarter	26.66	29.67	17.43
April	2.60	8.91	3.36
May	-1.36	3.34	0.38
June	-3.15	3.31	0.57
II quarter	-1.98	16.26	4.34
July	-0.00	5.12	2.18
August	-0.00	5.13	2.42
September	-1.11	2.41	0.31
III quarter	-1.55	13.18	4.98
October	3.17	3.48	1.80
November	6.97	5.04	4.00
December	7.23	5.56	4.46
IV quarter	18.34	14.74	10.59
Annual totals	44.63	95.79	42.25
Memorandum:			
1) absolute augment of unemployment, thous. people	257.8	800.3	691.2
2) average monthly augment of unemployment, thous. people	21.5	66.7	57.6

Source: calculated on the base of monthly FES statistics.

The officially registered unemployment increased by 42.3 percent in 1995, or by 2.3 times less than in 1994. However, this indicator was different across the regions of Russia. While four regions (Orel, Magadan, Kursk and Lipetsk) experienced fall in unemployment (by 43 percent, 11 percent, 10 percent and 1 percent accordingly) in the Chita region it rose by 3.26 times, in the Ingush Republic -- by 2.81 times, in the Smolensk Region -- by 2.76 times. However, this rate differentiation apparently did not affected ranking of regions in terms of unemployment: out of 10 regions with the highest unemployment rates by the beginning of 1995 (the Ivanovo Region, the Republic of Ingushetia, Pskov, Yaroslavl, Vladimir, Kostroma Regions, the Komi Autonomous District, the Kirov Region, the Republics of Kalmykia and of Mordovia) only the Republic of Mordovia and the Kirov Region had left this group to be succeeded by the Republic of Udmurtia and the Nenetsk Autonomous District. The group of 10 regions with the lowest growth rate of unemployment was also stable (the Smolensk Region, City of Moscow, the Republic of Sakha (Yakutia), the Belgorod Region, the Aginsk Buryat Autonomous District, the Chita Region, the Republic of Tatarstan, Orenburg, Volgograd and Rostov Regions). In this group only the Aginsk Buryat Autonomous District and the Chita Region experienced a sharp surge of unemployment and were replaced by Lipetsk and Kursk Regions.

Moreover, the differentiation of the officially registered unemployment levels increased across regions. While in the beginning of 1995 the gap between the minimal (0.83 percent in the Smolensk Region) and the maximal (8.4 percent in the Ivanovo Region) levels of unemployment made 7.57

percentage points, in the beginning of 1996 it made already 11.67 percentage points. All-Russian unemployment figures, as registered by the FES in 1995, increased from 2 percent to 2.84 percent, or by 0.84 percentage points.

In 1995 unsatisfied demand was less on the registered unemployment market, therefore the competition over vacancies has become more severe. While in the year's beginning there were 5.02 registered unemployed per vacancy on average, in the beginning of 1996 this figure reached 7.52, or was by almost 50 percent more. Only in Moscow the number of vacancies exceeded the registered unemployment by the beginning of the year, at the same time, in the Ingush Republic, the Ivanovo Region, the Komi Autonomous District, the Pskov Region and the Republic of Tuva more than 100 unemployed struggled over each vacancy (in the Ingush Republic -- more than 400 per vacancy).

The average duration of unemployment in Russia has also increased from 7.7 months to 10.3 months. In 23 regions the average registered unemployment duration exceeded one year (there were only 7 such regions in 1994).

The relations between key indicators characteristic of the labor market situation in Russia are shown in Table (6.9).

In 1995, as a year earlier, three relationships were the most close:

- a) that between the unemployment level and a number of unemployed per vacancy (coefficient of correlation decreased by 8.4 percent in 1995);
- b) that between a number of unemployed per vacancy and the unemployment duration (the closeness of the relation intensified by 49.3 percent in 1995) and
- c) that between the unemployment level and duration (the coefficient value has increased by 30.1 percent).

In 1995, the employment redistribution processes across branches were observed against the background of the general decline in number of those employed at enterprises within the economy (in October of 1995 it was by almost 1.7 million less than in October of 1994) (see Table 6.10). As the employment in industry, agriculture, construction, trade and public catering, science and science services sharply fell (by 2.2 million), some branches demonstrated a rather steady growth of employment, among them housing and communal services, public education.

Table 6.9

Spearman's Rank Coefficient of Correlation Between Some Indicators of the Situation on the Russian Labor Market in 1995 (upper values in cells) and in 1994 (lower values in cells)

	Unemployment growth rates	Unemployment level by the end of a year	Number of unemployed per vacancy by the end of a year	Unemployment duration in December	Share of placements in employment in the total number of unemployed taken off the register in December
Unemployment growth rates	1 1	-0.04582 -0.21021	0.077507 -0.25703	0.147564 -0.08366	0.065514 (*)
Unemployment level by the end of a year	-0.04582 -0.21021	1 1	0.712338 0.7776	0.54121 0.415918	0.081857 (*)
Number of unemployed per vacancy by the end of a year	0.077507 -0.25703	0.77507 0.7776	1 1	0.633528 0.424396	0.23437 (*)
Unemployment duration in December	0.147564 -0.08366	0.54121 0.415918	0.633528 0.424396	1 1	0.115406 (*)
Share of placements in employment in the total number of unemployed taken off the register in December	0.065514 (*)	0.081857 (*)	0.23437 (*)	0.115406 (*)	1 1

(*) relevant coefficients were not calculated for 1994

On the whole, the ratio of separations to hiring made 3.56:1 in witness of the fact that the employment situation has not deteriorated at least (in the period from May of 1994 through May 1995 this ratio was 4.94:1).

Amount of wage and consumption funding per worker did not apparently affect employment rate at enterprises across branches of the economy. Relevant coefficients of correlation of the Spearman ranks equaled to 0.091 and 0.101 (the calculation was based on branch ranking as per indicators under observation). As before, interbranch flows of labor depended on such unformalizable factors as opportunities to receive nontaxable incomes, working conditions and consumer services, workers' readiness for skill conversions, etc. A considerable rise of the employment in such traditionally underpaid sectors as health care, culture and arts may be attributed to a developing commercial sector within these branches.

Table 6.10

Labor Mobility at Enterprises, Institutions and Organizations within the Russia's Economy in October of 1994 through October of 1995

Enterprises, institutions, organizations in:	Change of average number of workers on payroll		Share in average number of workers on payroll in October, %	
	thous. people	%	1994	1995
Industry	-1007.8	-3.2	30.4	29.4
Agriculture	-648.3	-6.2	14.8	14.0
Construction	-295.3	-7.0	8.1	7.7
Trade and public catering	-132.4	-4.7	5.5	5.4
Science and scientific services	-131.7	-9.7	2.6	2.4
transportation	-60.1	-1.6	7.3	7.5
Logistics and sales	-18.3	-4.7	0.8	0.7
Geology and prospecting of deposits, geodesy and hydrometeorology agencies	-15.6	-7.9	0.4	0.4
Procurement	-15.3	-10.4	0.3	0.3
Communications	-6.3	-0.8	1.6	1.6
Computer services	-3.5	-9.0	0.1	0.1
Forestry	-1.7	-0.6	0.5	0.5
Real estate transactions	-0.4	-14.6	0.0	0.0
General commercial activities on the market	1.2	6.6	0.0	0.0
Culture and arts	15.3	1.7	1.7	1.8
Health care, physical culture and sports, social security	49.4	1.3	7.3	7.7
Lending, finance, insurance	52.8	8.1	1.3	1.4
Administration	74.5	6.1	2.4	2.6
Public education	195.3	3.7	10.1	10.8
Housing and communal services , nonindustrial consumer services	246.2	12.6	3.8	4.4
Other	20.9	3.4	1.2	1.3
Total	-1681.2	-3.2	100	100

At the same time, the flexible mentality of scientists was responsible for an intensive outflow of employees from the science which is stagnating within its unchanged structure.

In 1995 the key labor policies of the FES were somewhat changed (Table 6.11), a growing share of job placements in the total number of unemployed taken off the register bears witness that they were intensified.

It seems that slowing recession in Russia accounts for the fact.

Table 6.11

**Unemployment as Broken down by Reasons of Taking off the Register
in December of 1994 and 1995, %**

	1994	1995	Change in percentage points
Total off-register, including:	100.0	100.0	0
job placements	34.6	39.5	+4.9
professional education	11.4	10.9	-0.5
Early retirement	5.9	4.7	-1.2
Other	48.1	44.9	-3.2

Section 7

Institutional and Microeconomic Developments

7.1. Privatization Process in Russia in 1995

7.1.1. General pattern of the privatization process

Sharp deceleration of privatization was the main outcome of 1995 in quantitative terms (Table 7.1). Less than 4000 enterprises submitted privatization applications, roughly 6000 enterprises were privatized (5 percent of the total number of privatized enterprises). Across branches privatization outcome was as follows: trade accounts for 33 percent of privatized enterprises, industry -- for 20 percent, construction -- for 11.5 percent, public catering -- for 7.4 percent. On the whole, 90 percent of enterprises privatized in 1995 are small businesses having fewer than 200 employees and average assets at Rb 15.4 million (in old prices); 55 percent of them were subject to the small-scale privatization. About 36000 enterprises were at different stages of corporatization by January of 1996, over 27000 state-owned (municipal) enterprises were registered as transformed into Joint Stock Companies (as compared with 24,000 as of January 1, 1995).

Table 7.1

Key Indicators of Privatization Developments in the RF

Cumulative totals since January 1, 1992, as of:	1.1 1993	1.1 1994	7.1 1994	1.1 1995	7.1 1995	1.1 1996
1.State-owned enterprises maintaining independent balance sheets (units)	204998	156635	138619	126846	119879	90778
2.Privatization applications submitted (pcs)	102330	125492	137501	143968	147117	147795
3.Applications rejected (pcs)	5390	9985	11488	12317	12876	13295
4.Applications under implementation (pcs)	46628	24992	19308	17491	15277	13214
5.Applications implemented (pcs)	46815	88577	103796	112625	117406	118797
6.Selling price of property (Rb billions)	57	752	1107	1867	2091	2510
7.Property value under applications implemented (Rb billions)	193	648	958	2357	2401	-
8. State-owned enterprises transformed into Joint Stock Companies (JSCs) whose stocks are on sale (units)	2376	14073	20298	24048	25816	27040
9. Leased enterprises, including leased with option to buy (units)	22216 13868	20886 14978	20606 15658	16826 12806	15655 12556	14663 12198

Source: State Committee for the Management of State Property (*Russ. abbr. GKI*)

As the ownership structure is formally assessed (in terms of privatized enterprises numbers), it may be noted that the aggregate private sector exceeded the state sector for the first time only by August of 1995 (50.5 percent and 49.5 percent accordingly). In the GDP terms this line was not crossed even by end-1995. This rate deceleration is an objective process bearing witness that in spite of any conceptual or ideological aims it is necessary to suspend the forced acceleration of the quantitative rates achieved in the course of implementation of the mass privatization program.

The Federal budgetary revenues from privatization were composed of the following elements in 1995:

- 1) Loans for shares auctions embracing 12 enterprises have brought Rb 5.1 trillion against the expected 2 to 3 trillion for 29 enterprises;
- 2) Blocks of shares traded through auctions and tenders in 1995 accounted for Rb 1.5 trillion¹ as compared with the expected 4 to 5 trillion from sale of shares in 136 most attractive Russian enterprises;

¹30 special auctions organized by the Federal Stock Corporation (to be referred in more detail below) have brought 3/4 of the total budgetary revenues from auctions, investment tenders and closed subscription. In particular, it bears witness of a practically "zero" revenue derived from sales of residual shares in the overwhelming majority of large and medium-sized enterprises (according to S.Belyaev's estimate there were about 7000 such enterprises in 1995).

3) Placement of convertible Lukoil bonds accounted for Rb 1 trillion. Investment tender for 25 percent of "Svyazinvest" shares (revenues in amount of Rb 1.9 trillion had been expected) flopped due to the attitude demonstrated by both parties (Italian STET policies and requirements of the Russian government). On the whole, the aggregate Federal revenues from privatization were estimated at Rb 7.6 trillion as compared with planned Rb 8.7 trillion. The privatization revenues of Rb 12.387 trillion are planned for 1996.

In a sense this amount is a guarantee (although a poor one) that maybe a certain set of privatization measures will be continued in the framework of governmental policies what is at present necessary mainly for ideological reasons. At the same time 1995 practices and primarily loans for shares auctions do not give grounds for optimism. We think that even in the beginning of 1996 (when all 12 auctions were already over) it is difficult to forecast an outcome of these auctions. It is not only the question of a special method of attracting funds to the budget, but in more broad terms it is the problem of stimulation of nomenclature redistribution of property which can be assessed only taking into account many factors:

- political factor (unclear outcome of the presidential elections in June of 1996 and corresponding changes of policy in the sphere of ownership)²;

- legal factor (some doubtful legal procedures applied in the course of auctions may give pretext for cancellation of transactions by courts);

- economic factor (minimal efficiency of transactions from the point of view of (a) potentially larger profit on sale of share blocks after predistribution operations and in a favorable market situation; (b) inflow of real investment into enterprises);

- "bank" factor (the government apparently tend to treat major banks on the "friend-or-foe" principle. The sources of financing of certain transactions are a separate problem);

- "financial and industrial" factor (the government stakes on "friendly" national groups of growth -- financial and industrial groups).

At the moment it is still not clear if these practices continue in 1996. There is also an uncertainty on the government's intentions to pledged blocks of securities. It is not by chance that the pledgees' right to sell the shares will come into force not on January 1, but on September 1, 1996: in case the outcome of the presidential elections in June of 1996 is favorable enough to increase their market value, the possibility that the government will repurchase these shares for more profitable resale shall not be ruled out. Finally, for an "ordinary" investor these procedures are hardly of a great interest as in order to attain success substantial financial resources and powerful lobbyist efforts are a must.

After completion of the first (voucher) stage of the privatization it was intended, or at least declared, that the investment component of the privatization process will be moved to the foreground as a priority of monetary schemes (to a certain extent, by analogy with Hungary and Germany). "The Basic Principles of the State Privatization Program Applicable to State-Owned and Municipal Enterprises in the Russian Federation after July 1, 1994" approved by the Presidential Decree of July 22, 1994 remain, although with a number of exceptions, a basic document regulating the implementation of privatization at its cash stage³. Are there any perceptible positive shifts from the viewpoint of the privatization-investment mix? Let us single out only key problems relevant to

²In some respects this activity brings to mind actions of the Union government of 1990 - 1991 in the framework of nomenclature spontaneous privatization.

³At the same time, provisions of the Privatization Program approved by the President in December of 1993 which do not contradict the Basic Principles remain effective.

the privatization process in 1995. It is important also in view of the fact that all trends to be discussed below will pertain to 1996 -- 1997 situation (providing other circumstances remain unchanged) and will create a certain behavioral framework for prospective investors.

After the completion of the mass privatization program the state still have a considerable number of shares in privatized enterprises; the problem of selling these shares (what shares to sell, with what purpose, to whom and at what price) has become a key factor determining both future privatization policies and intensive lobbying in this sphere.

In the first half of 1995, according to Goskomstat, only controlling block of shares owned by the state amounted to 67 million shares with face value of Rb 51.3 billion (or 19 percent of the total charter capital of the JSCs created during this period). The state had controlling interest in 330 enterprises (27 percent of all enterprises privatized in this period) and "golden share" option was implemented at 200 enterprises. On the whole, the state and municipalities owned 51 percent shareholdings in 1976 enterprises in 1992 through 1994 (7.9 percent of the total), "golden share" options was implemented during privatization of 1004 enterprises (4 percent of the total). Over the same period more than 90 holdings were established alongside with "integrated structures" within the fuel and energy complex.

The experience bears witness that the state is an incompetent manager of the stocks in the federal ownership in the present environment. At the same time, this problem is hard to settle taking into account the realities of Russian economic policies and of the current political situation:

- 1) budgetary considerations require to sell "more, at a higher price and faster";
- 2) a temptation to sell practically everything at a go faces grim realities: the lack of adequate solvent demand and a clear danger of the collapsing security market;
- 3) sale of shares in the most attractive enterprises is temporarily inefficient because of an apparent undervaluation of their assets and simultaneously difficult due to political reasons of the multilateral lobbying together with redistribution of "influence" which is underway in certain branches under the cover of organizational and legal reforms;
- 4) the most unprofitable enterprises (blocks of shares) still in the state ownership must be sold in order to lighten the burden of budgetary expenditure, however it is doubtful that any buyers will turn up.

Only in March of 1995 the GKI and the Russian Federal Property Fund (RFPF, *Russ. abbr. RFFI*) made public an unofficial draft list of enterprises subject to sales in 1995. The list included more than 7000 enterprises in "non-strategic" branches whose shares were held by property funds. By June a draft of the governmental resolution "On Approval of the List of Joint Stock Companies Established in the Course of Privatization Process Whose Output (Goods, Services) is of Strategic Importance for Maintaining the Country's National Security and Whose Stocks Being in the Federal Ownership are not Subject to a Preschedule Sale". The list comprised 3054 enterprises in all branches of the economy.

In the summer of 1995 the work on drafting a list of enterprises which would be allowed to sell shares ahead of schedule (about 5800 enterprises in all branches of economy) continued with the purpose to submit it to the government for approval. In August the GKI at last completed a special plan-schedule for sale of shares in 136 large enterprises in September through December of 1995: "United Energy System of Russia", "Lukoil", "Yukos", "Sidanko", Volgo-Don River Steamship Line, "Svyazinvest", shares in nuclear industry enterprises, in enterprises engaged in extraction of

precious metals, in air companies and airports, in chemical and engineering complexes, in light industries, metallurgy, forestry and wood-proceeding industries, in enterprises of fuel and energy complex, geology). Cash auctions and specialized auctions prevailed among methods of sales, there were planned also 44 investment tenders, several investment auctions. At the same time, from our point of view, the motivation underlying these sales, i.e. budgetary interests, is a rather adverse factor as expedient predistribution operations carried out in accordance with international standards at enterprises which are relatively attractive as they are would allow for a sharp rise of profitability of relevant transactions both for the budget and for the enterprises.

As early as in February of 1995 the Russian Federal Property Fund together with regional property funds and a number of lending institutions established the Federal Stock Corporation (FSC, *Russ. abbr. FFK*) assigning to it the status of the RFPF's general agent in conducting all-Russian and inter-regional auctions. Nonetheless, first inter-regional and all-Russian cash auctions where shares of privatized enterprises should be sold were held only in June of 1995. By October 14 such auctions have taken place totaling to 30 in the course of the year (according to the FSC data) and embraced United Energy System of Russia (UES of Russia), Rostelekom, Uralmash, oil companies, Novorossiysk Sea Shipping, Vyborg Integrated Pulp and Paper Mill, Ust Ilimsk Timber Industrial Complex, a number of medium-sized enterprises.

In spite of the fact that selling prices exceeded starting prices by 3.3 times on average (the maximum excess -- by 35 times -- was registered at "Medexport" auction) investors have demonstrated little interest to the sales. As the FSC and a group of the GKI experts report, it was due to the following reasons:

- competition of the part of state securities (including Federal loan bonds (FLB, *Russ. abbr. OSZ*) issued for the public);
- competition from loans for shares auctions where much larger blocks of shares or controlling interests were traded (for instance, 51 percent of Sidanko shares);
- small blocks of "blue chips" (10 to 15 percent) sales (15 percent Sidanko stocks have been put up for an auction, 74.79 percent of the block sold);
- in a number of cases auctions were postponed or canceled after the start of the application procedures (for instance, the case of Yukos oil company);
- attempts were made to sell shares at prices far exceeding market quotations (the United Energy System of Russia)⁴.
- special auctions through which socks of oil companies were traded were actually initial placements of their stocks, that creating additional difficulties for determination of starting prices as no market quotations were available.

As it was to be expected, legal entities dominated these auctions in financial terms (84 percent of funds), however, 89 percent of applications were submitted by individuals. With a high degree of certainty an estimation allows to attribute applications of individuals exceeding Rb 100 million to managers of the JSCs on sale⁵. In fact, the populace has not used the opportunities to participate in special auctions available for individuals.

⁴Before 4.5 percent of shares were put up for a special auction, the authorized capital had been increased by 308 times. Due to this fact, the starting price equal to the face value turned out to be too high and only 13.77 of the block were sold.

⁵A. Privalov. Ne khuzhe, chem bylo s vaucherami (No Worse Than It Was With Vouchers). *Expert*, 1995, No. 8, pp. 33 -- 34

In spite of numerous declarations of “the beginning of the investment age” in the Russian privatization, the dilemma “investment -- budget” is apparently settled to the benefit of the latter. To a considerable degree it is determined by political motivation based on the striving to achieve an immediate aim (budget 1995) to the detriment of long-term strategic targets (attraction of investment and restructuring of enterprises).

Legislative activities are traditionally important for the privatization process. By the autumn of 1995 the State Duma drafted three projects: amendments to the 1991 Privatization Law; the law “On Alienation of Blocks of Stock”, the essence of this draft is that the Parliament shall approve lists of blocks of stock in Federal ownership to be sold during a given year; the law “On Trust Property Management” which combined two alternative projects: “On Trust Management” and “On Trust Property (Trusts)”. The essence of the integrated project was an attempt to circumvent the direct ban both on the principle of property splitting and trust as such imposed by the Civil Code and to create a legislative base for property management. There are also more than four drafts of the law “On Nationalization” including those stipulating that a working collective has the right to initialize nationalization.

The experience bears witness that even a mention on a possibility that a certain legislation will be adopted may directly influence *expectations of economic agents (investors)*. Moreover, drafts of the most important legislative acts tend to live their own life creating a “terror environment” for relevant sub-legislation and the legislative base as a whole. In this sense, there is no equally destabilizing factor for investors than ill-considered in economic terms provisions of politicized law drafts.

Nevertheless, the most important event in the legislative sphere was the adoption of the Federal law “On Joint Stock Companies” in 1995 and its effectuation on January 1, 1996. Henceforth all privatized enterprises in the form of a JSC in whose charter capital the state has interest less than 25 percent and whose privatization plans have expired are subject to its implementation. According to estimates of a number of experts, this law is apparently in interests of JSC managers. However, taking into account a number of provisions stipulating various mechanisms designated to protect shareholders’ rights the general assessment of this law as a well-balanced in terms of corporate governance seems to be more justified.

At last, it is possible to say that a new stage of “nomenclature struggle” over retaining of control in a number of branches of economy has sharply intensified after the beginning of discussions within the Government on sale of stockholdings in the federal ownership. In fact, a regular major conflict between “functional” and “branch” agencies (perhaps for the first time since August of 1993) has taken place because of their apparently opposing interests: to provide for the budget (to sell shareholdings) against maintaining the appearance of one’s own necessity if not in enterprises’ eyes then only in the eyes of the Government (to hold blocks of shares). An apparent example of “branch partisans”’ victory was the creation of a giant holding “Russian Metallurgy” on September 22, 1995. Similar projects exist also in the engineering complex, in oil and petrochemical industries. As concerns the oil sector and a perpetual “reshuffling” of Federal shareholdings taking place in this branch, the problem here is more serious than it seems: it is a question of not only nomenclature struggle, but of redistribution of property among new economic structures. It is apparent that such a trend does not create incentives for any non-nomenclature outside investor. It may be presumed that adoption of the law “On Financial and Industrial Groups” which in present Russia remind rather of loose conglomerates will assist not only to industrial growth, but first of all to enhancement of bargaining power of specific financial and industrial alliances in their relations with authorities.

On the whole, there were no privatization boom in the first one and a half year after start of the cash privatization, and it is not worth expecting it in 1996 - 1997. As before, enterprises cannot

count on privatization as a source of substantial investment. Owing to this fact, the statements which have been recently made by some top officials in the Russian Government to the effect that transition to the “point (*enterprise-specific*) privatization” and to an individual approach to privatization of enterprises will be implemented in 1996 in practice may have only one meaning: continuation of the policy aimed to “pull out” certain attractive enterprises for a prompt sale with purposes being very far from actual attraction of investment and creation of strategic owners, of restructuring purposes. So far, there is also no sign of transformation of prospective investment demand (which undoubtedly exists) into real one. From our point of view, the way to settle this problem (apart from political and macroeconomic shifts which are not discussed in this section) may be found first of all in the sphere of institutional transformations and development of new economic and legal mechanisms: capital market, corporate governance, investment institutions.

7.1.2 Small-scale privatization

Outline. By January 1, 1995, 84.3 percent of enterprises subject to the small-scale privatization program (*i.e. the privatization scheme for small enterprises*) have changed their ownership patterns: 84.4 percent of enterprises in trade, 83 percent -- in public catering and 84.8 percent of those engaged in consumer services were privatized.

In spite the fact that the process of the small-scale privatization is near completion and has been already over in some regions, as in 1994 enterprises in these sectors prevailed among all those privatized across branches. Moreover, their share somewhat increased due to decline in the total number of privatized enterprises and the shrinking share of enterprises subject to privatization in the base branches of the economy (industry, agriculture, construction, transportation and communications).

An increasing importance of the small privatization for the entire privatization process is reflected through a substantial increment of privatized objects share in the total number of enterprises across sectors in 1995 as compared with 1994 figures. On the whole the share of privatized enterprises within the group of branches subject to the small-scale privatization program increased by 9.1 percent in comparison with 6.7 percent in 1994. Trade establishments accounted for this accelerated rate while in public catering and in consumer services the share of privatized enterprises grew at a slower rate than in 1994 (Table 7.2).

Nonetheless, the absolute number of objects privatized during the year fell from 10.85 thousand in 1994 to roughly 4.5 thousand in 1995, *i.e.* by almost 60 percent what according to Goskomstat figures (which slightly differ from GKI data) rather closely correlate with declining rates of privatized enterprises numbers in all branches. The rates of decline in numbers of privatized establishments in trade and consumer services were considerably slower in 1995 (Table 7.3). than in 1994 when the absolute number of privatized enterprises grew.

Table 7.2

	Annual Increment of Privatized Enterprises' Share across Sectors, %			
	Total	Trade	Public catering	Consumer services
1992	36.8	36.1	32.1	40.8
1993	31.8	32.6	31.9	29.8
1994	6.7	3.0	14.3	10.0
1995	9.1	12.7	4.7	4.2

Source: calculated according to GKI database.

Table 7.3

Number of Privatized Enterprises
(in % to previous year)

	Total	Trade	Public catering	Consumer services
1993	132.6	130.2	156.1	137.9
1994	29.6	34.9	24.0	22.8
1995	41.8	43.3	45.5	36.3

Source: calculated according to GKI database.

Monthly selling prices of privatized enterprises were less (except in August) than in December of 1994 what had a relevant effect on ratio of the selling price of all privatized enterprises (since the start of privatization) to the starting price. On January 1, 1996, this indicator made only 2.8 percent decreasing from 4.4 as of January 1, 1995 (3.45 as of July 1, 1995), however, the aggregate starting price of all privatized (since the beginning of privatization) increased by 2.3 times during 1995.

The dynamics of this indicator reveal a considerable decrease in interest of investors participating in privatization to establishments engaged in trade and consumer services caused by availability of more profitable investment objects and by the fact that a majority of most attractive enterprises in these sectors had already acquired new status. In this relationship it is interesting to look at the data shown in Table 7.4 which reflects coefficients of correlation between selling and initial prices of privatized enterprises, and rates of consumer prices growth in relevant periods.

It is evident that profitability of property sales in the course of small-scale privatization permanently lagged behind inflation rates in spite of the fact that the main payment facilities in this area were money and not vouchers which represented the chief instrument of payment in the process of privatization of large and medium-sized enterprises in 1993 -- 1994. The closest gap between privatized establishments selling and initial prices was maintained during 1994 when property of privatized enterprises was reevaluated and privileges of working collective shrank. In 1995 the gap began to widen again.

Table 7.4

Relationship between Annual Coefficients of Excess of All Privatized Enterprises Selling Price over Initial Price, and Inflation Rate

	(A)	(B)	(C)
1992	7.9	26.1	30.3%
1993	7.45	9.4	79.3%
1994	2.9	3.24	89.5%
1995	1.6	2.31	69.3%

Notes: A - ratio of selling price of enterprises privatized during a year to their starting price (in number of times);

B - index of annual consumer prices growth (in number of times);

C - relationship between (A) and (C), %;

coefficient of excess of privatized enterprises selling price over initial price for 1992 is given as a cumulative total as of January 1, 1993 because of too insignificant results of small-scale privatization before 1992, there is no data available on this period.

Source: calculated according to GKI database.

The experience of the last three years alongside with a small number of establishments privatized in 1995 among all enterprises which changed their ownership patterns (ca. 5.7 percent) allow to draw a conclusion that buy-outs of leased property and tenders prevailed among privatization methods. Each of these two methods has accounted for privatization of more than 40 percent of all enterprises since its beginning, at the same time, auctions and reorganizations into Joint Stock Companies together provided change of ownership patterns at 15 -- 20 percent of enterprises. It seems that working collectives owned two thirds of all privatized establishment, the same share as by end-1994.

As concerns privatization methods and buyers composition across the array of enterprises privatized in 1995, since in the second half of 1995 there were no new factors which could seriously affect the course of the small-scale privatization it may be safely predicted that the outcome will be very similar to that observed in the first half of the year when working collectives purchases about 57 percent of enterprises privatized during this period, i.e. considerably less than in 1992, 1993 and rather close to results achieved during 1994. The share of legal entities among all buyers of privatized establishments roughly equaled to the 1994 level while the share of individuals remained insignificant (see *Rossiyskaya ekonomika v pervom polugodii 1995 goda* (Russian Economy in the first half-year of 1995) (Issue 13).

Regional Variance. As of January 1, 1996, Volgo-Vyatka, Ural, Western Siberia and Eastern Siberia economic regions were distinct among all eleven Russia's economic areas in terms of the smallest number of privatized enterprises (less than 80 percent). Better progress in implementation of the small-scale privatization program in 1995 was noted in Northern and Far East economic regions where share of privatized enterprises increased by 20.3 and 16.2 percent accordingly.

Six Russian regions (the Ulyanovsk Region, Mordovia, Kabardino-Balkaria, Northern Osetia, Bashkortostan, Sakha (Yakutia) form a zone where more than a half of enterprises have not been privatized yet. In five regions (the Kirov Region, Kalmykia, Dagestan; Komi and Yamal Nenetsk Autonomous Districts) the share of privatized establishments varies from 50 to 60 percent. In eleven regions (Komi, Karelia; Kaliningrad, Lipetsk, Sverdlov Regions, Tatarstan, Krasnoyarsk Territory; Khanty Mansy, Evenk, Koryak, Chukotka Autonomous Districts) 60 to 70 percent of enterprises were privatized. In Komi, Kalmykia and in Tatarstan the share of privatized enterprises for the first time exceeded a half of all trade and consumer services establishments in 1995.

A substantial share (from 30 to 50 percent and more) of objects prospective for the small-scale privatization remain in the state ownership in the Far North territories and areas equated to them which are subject to special provisions of the Inter-Republican Privatization Program determining privatization procedures in these territories (Annex 2 to the Basic Principles of the State Privatization Program Applicable to State-Owned and Municipal Enterprises in the Russian Federation after July 1, 1994) and in the regions whose authorities due to various reasons have distanced themselves from economic policies of the Federal Government.

In accordance with the initial price to selling price ratio values for all enterprises privatized since the beginning of 1992 through January 1, 1996, the Russian economic regions may be divided into 4 groups relevant to descending order of this indicator:

1) Northwest (13.3) and Far East (11.5); 2) Central Black Earth, Northern, Volgo-Vyatka, Eastern Siberia (from 4.4 to 3.8); 3) North Caucasus, Ural, Western Siberia, Central (from 2.9 to 2.3); 4) Volga (1.1). The highest values of the selling-price-to-initial-price coefficient in terms of individual regions were observed in the Maritime Territory (26.1); Astrakhan (23.2), Murmansk (22.9), Pskov, Sakhalin (from 20 to 21) Regions; St.Petersburg (16.8); Kurgan (14.1), Omsk (13.6) Regions; Buryatia (11.6), Kamchatka, Kirov, Ulyanovsk, Vologda (from 10 to 11) Regions. In all other Russian regions values of this indicator were below 10.

Small-scale privatization prospects. Today it is apparent that the small-scale privatization tends to loose in importance in the course of time. The bulk of enterprises subject to it has already been privatized. The outcome of the First All-Russian Retail Trade and Public Catering Census as of November 1, 1994, reveals that only 13.3 thousand trade establishments and 2.2 thousand public catering enterprises remained in the state ownership, or 15 and 25 percent of the totals across these sectors accordingly. In 1995 state-owned enterprises accounted for only 13 percent of retail trade turnover and for 17 percent of consumer service volumes (the latter figure is as in January through

September of 1995). Newly created private establishments and not privatized enterprises which earlier had been in the state ownership (a result of the “from above” privatization) begin to gather in importance. It may be noted that on the whole the small-scale privatization has assisted to initiate the privatization process in the country, contributed to general liberalization of economic activities and to normalization of the situation on consumer markets at the initial stage of transition of the Russian economy.

Nonetheless, in the environment of slackening privatization rates, of uncertainty on maintenance of the state ownership over large and medium-sized enterprises, privatization of trade and service establishment remaining yet in possession of the state may be seen as a reserve of this process, first of all from the viewpoint of larger revenues for local and municipal budgets. It seems that this motivation will be revealed rather in regions with low privatization levels, or in those where fast privatization did not bring in large revenues. The factors affecting the privatization process as a whole (political situation, inflation rates, assortment of establishments attractive for investment) will also be of importance for the small privatization progress.

The most important issue for privatized trade and service enterprises remain the question of real estate ownership (buildings and facilities) which in the course of ownership pattern transformation were leased to them with buy-out option. Although documents stipulating buy-out of leased facilities were adopted as early as in February and August of 1994 as it was stipulated by the relevant provisions of the State Privatization Program of December 24, 1993 and of the Basic Principles of the State Privatization Program Applicable to State-Owned and Municipal Enterprises in the Russian Federation after July 1, 1994, the practical experience bears witness that the situation remains practically the same. For the small-scale privatization program the problem of real estate ownership to a certain extent is similar to the question faced by privatized large and medium-sized enterprises: buying out the land upon which they are located.

Other important issues the enterprises privatized under small-scale program are facing include restrictions on change of production profiles, availability of credit, optimization of channels for merchandise inflows. Besides, most local authorities are not inclined to secure independence of establishments within small-scale privatization framework and use a broad range of economic and administrative mechanisms to influence their behavior, heavily relying on the lease status of real estate, regulation of pricing policies concerning a certain range of merchandise, control over observation of privatization conditions.

7.1.3 Scenario-based outlook on privatization process developments in Russia in 1996 through 2000

The most important trends and prospects of developments in individual aspects of the privatization process (alongside with post-privatization economic transformations, and institutional and legal environment in which enterprises are to operate) at the stage of transition from the short-range to the medium-range systemic transformation give grounds necessary to work out a summary scenario-based forecast in this area for the period until year 2000. This forecast comprises three major scenarios: optimistic, pessimistic and realistic ones.

Optimistic forecast may be described as a forecast on “moderate, stable, evolutionary development of reforms” which would exclude serious political and social cataclysms in the Russian society and state as well as extremes of a radical pro-market reformism. Among prerequisites of this scenario the following ones shall be singled out:

- the political stability of the society coupled with a consistent, formally pro-market ideology in all branches of authority;

- the existence (stable development) of really democratic institutions of authority as a prerequisite to “filtering out” (to detach from) overtly populist or openly group-specific (department-specific) decisions basing on political ambitions, lobbying, corruption, criminal connections;

- a civilized comprehensive system of legislation (and its enforcement) which would maintain stability of the legal framework alongside with flexible mechanisms of adjustment as well as a strict observance of legal norms and a tight control over this observance;

- the consistency in implementation of economic reforms on the whole and an efficient state regulation, really efficient macroeconomic policies, maintenance of close coordination between privatization and post-privatization policies, and investment- attraction targets and restructuring of enterprises.

In case these prerequisites would exist, the following qualitative and quantitative outcome of reforms may be expected:

- the completion of an intensive process of ownership rights redistribution in accordance with the outcome of the “technical” privatization and creation of a stratum of owners interested in a long-term strategic corporate governance (with outsiders having 60 to 70 percent in authorized capital, trust operations with shareholdings in the state ownership including, insiders having 30 to 40 percent share with inclusion of a 15 to 25 percent interest of the management);

- the state will “keep away” from execution of ownership functions excluding only strategically important sectors (enterprises, blocks of stock) in the process of gradual “residual” sales of assets (shareholdings), oriented towards maximization of revenues;

- an efficient functioning of a well-managed system of the state ownership and the state entrepreneurship which embraces carefully chosen:

1) budgetary (state-owned) enterprises;

2) state-owned corporations;

3) private corporations in which the state has an interest;

4) subsidiaries of state-owned corporations operating strictly within private international law framework.

- formation of a transitory, although stable, model of corporate control representing a mix of the American model and of the European continental one (domination of external owners, a parity between bank and non-bank financial institutions, a legal protection for all groups of stockholders);

- a manifestation of long-time stability on the market of corporate securities (basing on growing capitalization, transparency, liquidity, enhancing market capacity, formation of a ramified functional and technical infrastructure);

- a stable system of investment institutions;

- an effective real estate market, land including, together with a set of tight legal guarantees protecting land transactions;

- an efficient bankruptcy procedure proved by the practical implementation as an external factor to control and to influence enterprise management;

- formation of a stable “middle” class which would not be interested in restoration of the former political and economic systems;

- on this base (the general prerequisites outlined above are a must) a chain “savings -- investment -- economic growth -- savings” may be turned on and a real restructuring of Russian enterprises will be executed.

It is also important that the qualitative outcome as mentioned above may be reached, according to our estimate, not earlier than after 10 -- 15 years, although exactly this period from 1996 through 2000 will be crucial for Russia in terms of forming the base necessary to obtain these results.

Pessimistic forecast primarily takes into account key destabilizing factors retaining their significance (and in case the forecast will turn out as a true one even gathering in importance): economic, legal, political, regional, etc. It is important to take into account a possibility of destabilizing influence exerted both on the part of the conservative (leftist, ultra-etatist, partisans of the command and administrative system) and on the liberal (pseudo-liberal) trends in the Russian reform policies. The latter circumstance renders it necessary to draft at least two sets of medium-term transformations in the ownership sphere under the pessimistic scenario.

Sub-scenario A - developments along the conservative way. A possibility that this pessimistic sub-scenario will be implemented depends first of all on radical political changes in all Russian authority institutions and, accordingly, on attempts to restore the administrative state methods of managing enterprises (nationalization and dispossession of new owners).

A “soft” modification of this sub-scenario may embrace:

1) existence of the private sector created in the course of the small-scale privatization (retail trade, public catering, consumer services);

2) maintenance of the private corporate sector of economy alongside with forced nationalization (of entire entities or only of controlling interest therein) of 30 to 40 strategic enterprises in the fuel and energy complex, non-ferrous metallurgy, engineering, transportation, communications and in a number of other sectors.

In any case, the ownership rights pattern being at the stage of formation will be subject to destabilization caused by political and ideological motivations, that leading in practice to suppression of attempts to form not even an efficient, but any model of corporate governance and of a security market. An inevitable outcome will comprise preservation of the inefficient state sector which in present circumstances is unable to overcome the structural and investment crisis independently and demands constant funding coupled with protectionist measures.

Creation of incentives to develop collective (although not corporate) ownership patterns at enterprises (implemented as an ideological compromise between private and state forms of ownership) may become an additional adverse factor in this situation as in the circumstances when a real competitive environment is lacking, every individual enterprise will experience enhancing dependency motivation, or a tightening nomenclature control and regulation.

Incompetence of state as a large shareholder across a majority of sectors of the economy (not denying its role as a legislator, a controller and a regulator) has been proved by the current practices of corporate governance. In combination it means a retreat to the starting positions (as of 1980s -- early 1990s) in terms of formation of possible institutional models of investment resources mobilization.

Sub-scenario B -- developments along liberal (pseudo-liberal) way. This rather pessimistic scenario bases on domination of a formally ideological approach aimed to the ultra-radical market reforms and oriented towards a concept that the state is absolutely incompetent in its role of an owner.

In privatization terms implementation of this scenario embraces unjustified acceleration of quantitative rates of a formal transference of state-owned assets (shareholdings) to the private (quasi-private) sector. In terms of quantity, this scenario deems as ideal a private sector embracing minimum 80 -- 90 percent of the economy both in terms of enterprises numbers and in terms of GDP percentage. At present this acceleration rate is impossible to maintain on a voluntary and incentive base, but only by administrative and coercive methods.

A nihilistic attitude towards the legislation currently in force and, furthermore, to all transactions (contracts) made within the present legal framework is a characteristic feature of the approach under observation (it is also true for sub-scenario A). Under pessimistic sub-scenario B it would be admissible to cancel (revise) any earlier adopted decision succumbing to pressures of the current at that time political situation. As experience reveals, under cover of ultra-liberal slogans it is possible for sectoral structures, bank groups, financial and industrial groups and criminal societies to actively carry out group-specific, lobbyist activities aimed to redistribute ownership and revenues derived from it. In fact it means re-animation of nomenclature privatization model alongside with other types of spontaneous privatization at a new stage.

Outcomes of this pessimistic sub-scenario will inevitably be:

- formation of a giant but feeble quasi-private sector, which will not be able to operate without state support and which can be described as a corporate sector only in formal terms (existence of JSCs);
- on this basis will arise real prerequisites of nationalization of some enterprises involving all costs of ideological, legal, financial nature;
- a permanent destabilization of ownership rights and, accordingly, a protracted period of their initial distribution and redistribution;
- insufficient guarantees of ownership rights, as in the new situation it will be possible to contest transactions made before;
- a weak securities market susceptible to sharp fluctuations with insufficient liquidity and capitalization;
- a prolonged unstable situation for internal and external investors;
- lack of a real state control over maintenance of legal discipline in the sphere of ownership and securities market (transactions, licenses, liabilities arising under privatization contracts, etc.).

The sub-scenario B of a more moderate nature will be closing with the optimistic outline, however, the absence of prerequisites necessary to put the optimistic scenario into practice, which were described above, will determine its specifics.

The realistic forecast bases on a hypothesis that in the medium-range perspective the present balance of social forces in the Russian society will persist. In these terms a dominant trend of developments in the sphere of privatization and the post-privatization environment, in which enterprises will function in 1996 -- 2000, will be a conflicting combination (although not a balanced

compromise) of the moderate (“soft”) variants of A and B sub-scenarios of the pessimistic outlook. It seems paradoxical, but this conflicting combination is in a certain sense a factor of reciprocal neutralization of the adverse influence of each of these scenarios in their extreme forms. Leaving the problem of transaction costs arising in the course of implementation of such a scenario aside, this combination will create certain prerequisites for the transformation of this realistic scenario into the optimistic one not earlier than in 2000 -- 2010.

In practice the implementation of the realistic scenario will inevitably imply a relatively *prolonged transitory period* (“transition within transition”) between the first and the second stages of the systemic transformation in the sphere of ownership relations. Let us single out the most important trends characteristic of this period in terms of privatization:

- development of a new stage of nomenclature struggle between “functional” and “branch” Ministries to retain (to transfer) control over a number of economic sectors;

- intensification of ownership redistribution processes between economic and financial structures within the general tendency towards concentration of the stock capital (the degree of intensification will mainly depend on the political factor and prospects of change of power);

- strengthening of the banking sector (including methods of indirect administrative pressure) as a subject of the corporate control;

- predomination of principle of direct sales of assets (stockholdings) in the course of “residual” cash privatization;

- formation of powerful financial and industrial oligarchic structures on the base of strengthening ties between authority agencies (officials), management and banking structures in the framework of already existing and new financial and industrial alliances (including regional ones);

- at the same time, enterprise directors will try to retain the maximum degree of control, while its “erosion” and partial concession of ownership (control) in exchange for investment resources are possible only on the base of a tight monetary policy, discontinuance of support to unprofitable enterprises, and a set of efficient and proved by practice bankruptcy procedures;

- persistence of present trends of extremely slow development of land market (buy-out of land plots upon which privatized enterprises are situated);

- a slow development of the real estate market as a whole due both to the unadjusted legislative base and the lack of guarantees to owners, and policies of local authorities which try to retain administrative control over the private sector.

On the securities market in short and medium-range perspective it is to expect the development of processes which alongside with formation of an abundant supply may cause a chronic crisis of the emerging market:

- owing to a difficult financial situation, or to lack of a real strategy for the future development many enterprises will conduct direct sales of complete blocks of stock accumulated by the management, or parts thereof;

- “unloading” of a number of blocks of stock purchased at voucher auctions by former voucher funds or other intermediaries in order to pay to their stockholders or to improve their financial situation;

- a possible destabilization of the market due to an “unloading” of stocks in the federal ownership;

- many enterprises try to improve their situation at the expense of additional issue of stocks which hardly can be placed through an open subscription without an interested investor.

To a considerable degree the prospective development of the securities market and the system of investment institutions in Russia will be determined by such factors as their balance in terms of “power” and competition abilities; the relation to the forming pattern of ownership and corporate governance (a relationship between types of investors and types of investment institutions); the relation to the structure of the securities market segmentation which at present is in the process of formation in Russia (the relation between types of securities and types of investment institutions); in connection with the general situation on securities markets and prospects of the state regulation in this sphere; with development of real estate markets.

Undoubtedly these prospects will also to a considerable degree depend on a settlement of urgent concrete problems, for instance:

- development of the material basis; technologies of trade; informational infrastructure; registration, depository and clearing activities;

- formation of a uniform state system of market regulation;

- risks involved in operations with securities;

- inflation rates and dynamics of ruble exchange rates (as a factor of efficiency of investment into securities);

- accessibility of information on securities market situation, market “transparency” both at macroeconomic and microeconomic levels;

- availability of qualified personnel;

- expansion of the state debentures market and state demand for money;

- efficiency of the supervision system concerning the financial situation of investment institutes (liquidity norms, reservation of funds);

- a possibility for non-banking investment institutions to keep clients’ accounts for operations with securities;

- consistency of existing accounting rules with the character of transactions on the securities market and with international standards.

On the whole, the following major trends will be characteristic for Russian investment institutions in the future:

- development of a system of mutual investment funds of different types which is restrained only due to an inadequate legislative base (regulation of technical procedures) of their activities;

- for different types of investment funds a gradual orientation to the generally accepted international standards in terms of investment behavior and preferred types of securities;

- a persistent uncertainty on the investment (mediation) role of commercial banks on securities markets (universality or specialization in certain functions);
- the minor role played by financial brokers and investment banks in capacity of independent investors (alongside with their main intermediary functions);
- intensification of competition between commercial banks, different types of investment funds and other institutions for the role of financial intermediaries in attraction and “transformation” of savings into investment;
- the special importance of a fiscal reform for investment institutions;
- the special importance attached to transparency of information on situation an issuer is in for practically all investment institutions as compared with a lesser importance of information on trade transactions;
- competitive (from the viewpoint of a consumer of resources) development of such security market segments as stocks of privatized enterprises and state securities, their importance for all investment institutions;
- a growing importance of shifts in behavior and structure of investors for professional market actors;
- a considerable importance of households as investors for investment and other funds as compared with their minimal importance for brokers;
- a persistent importance of foreign investors for banks and brokers.

Taking into account the scenario-based forecast, described above, and key trends (factors) defined in it renders the possibility to formulate the central target of the state regulation concerning medium-range privatization and post-privatization transformations: **creation of an environment allowing a practical transformation of the realistic scenario into the optimistic one at least in the period from 1996 through 2000.**

7.2. Changes in the Structure of Enterprises' Stock Capital

An analysis of trends in formation and dynamics of the structure of Russian privatized enterprises capital in 1994 -- 1995 allows to draw following important conclusions:

first, initial placement of privatized enterprises stocks is a relatively short stage of the initial fixation of ownership rights, inevitably followed by a series of secondary transactions;

second, the process of concentration of the stock capital which has been diffused in the course of voucher privatization is underway;

third, a dominant role in this process is played by enterprises' management which uses a broad set of direct, indirect, legal and illegal methods of establishment (maintenance) of control;

fourth, participation of outside investors (first of all large ones) in the stock capital has a great potential for increase, however, it has not resulted in more efficient management of enterprises yet;

fifth, one of the most prospective ways to participate in capital of privatized Russian enterprises both for domestic and for foreign investors is to purchase a share in capital through secondary transactions with first issue stocks or newly issued stocks;

sixth, in spite of the problems of corporate governance exactly additional issues of corporate securities are the sole source of financing for certain groups of enterprise. The latter factor inevitably leads to erosion of present barriers on the way of participation in the stock capital.

An analysis of the first wave of initial placement of Russian privatized enterprises stocks allows to assume that the structure of stock capital of emerging JSCs tends more to the continental European model with its tight majority control over capital than to dispersion Anglo-American one, although, of course, with allowance for Russian specifics and costs of the transition period.

On the other hand, at present it is impossible to assert that Russian banks are able to efficiently exercise corporate control (and strategic ownership of stocks) functions characteristic of commercial banks in continental Europe. It is related both to corporate politics of enterprises management and to the lack of connections “a strategic stockholder (trustee, pledgee) -- a source of financing” applicable to banks.

This allows to arrive to a conclusion that the forming model does not perceptibly improve efficiency of privatized enterprises. Although a majority of blocks of stock is concentrated in the hands of relatively large institutional stockholders, at the present stage it is not designated for long-term management and control over enterprises and, therefore, is not an incentive for permanent investment related to reconstruction and development of enterprises. In this context the problems of development of corporate securities markets and investment institutions (first of all of the mechanism allowing transformation of a market on which prevail large blocks of stock into a market based on plurality of investments) gathers in importance as a subject of the state regulation.

The results of practically all surveys conducted in 1994 through 1995 and used for this research allow to single out the following key trends in the dynamics of stock capital structure of Russian privatized enterprises:

- reduced number of workers;
- stabilization or growth of the share of administrative staff (management);
- growing share of large outside investors which has perceptibly accelerated after the start of stock sales in the framework of the second privatization stage;
- stabilization or insignificant increase of the small investors share;
- slowly reducing share of the state (at least before the start of sales at the second stage of privatization);
- slowly increasing share of foreign investors.

Judging by the data on aggregate stockholder groups (Table 7.5) it may be said that the total share of insiders is shrinking at the expense of decreasing numbers of rank and file workers while the share of outside stockholders in the JSCs’ capital grows due to large institutional investors (commercial banks, investment funds and broker agencies). The share of the state in stock capital of a majority of enterprises (with the exclusion of strategic sectors and a number of largest JSCs) does not in fact play a key role. All these trends, from our point of view, will persist in 1996. Their dynamics allow also to draw a conclusion that these trends will intensify with other things being equal. Their development will be primarily determined by such factors as a situation on the securities market and procedures of corporate governance in Russia.

Table 7.5

Changes in Shares of Major Stockholder Groups in Stock Capital in 1994 -- 1995
(averages, in % of authorized capital)

	April, 1994	December, 1994	March, 1995	June, 1995	July 1996
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					(estimate)
Insiders, total	62	60	60	56	51
- workers	53	49	47	43	35
- management	9	11	13	13	16
Outsiders, total	21	27	28	33	45
- large	11	16	17	22	32
- small	10	11	11	11	13
State	17	13	12	11	4
Total	100	100	100	100	100

Note: the following data are used and generalized: results of surveys conducted by the State Committee for the Management of State Property of the RF, by the Federal Commission for Securities and Capital Markets under the RF Government, by RAM, IET, REB, J.B. Blasi's research group. Since the analysis bases on very different groups of enterprises, it is of a somewhat conventional character. Such specifics as large blocks of stock in federal ownership in strategic sectors were excluded. At the same time, a considerable degree of coincidence of data in different surveys made in the same periods allows to arrive to a conclusion that these generalized figures are highly reliable.

A forecast on future development of the Russian model of corporate governance and control presupposes that many factors shall be taken into consideration, among these factors the most important (besides the general economic and political orientation) are the following:

- complete formation of the securities market model;
- an inevitable arrival of Russian enterprises on the securities market in search of investment resources and, consequently, their orientation towards a liquid and pluralistic market;
- development of a system of financial institutions (intermediaries) which will be adequate to demands of the Russian populace and which will provide an efficient transformation of savings into investment;
- the degree of the state influence on activities of largest corporations, which will persist also in the future, a character and intensity of changes in relations of the state and privatized enterprises;
- further shifts in ownership structure on the national scope (real dominance of the private sector over the state and mixed ones);
- development of forms and methods of joint stock enterprise behavior and of relations between them.

Basing on this and taking into account elements of a transitory situation the following stable characteristics which shall be typical for *the Russian model of corporate governance in the medium-range perspective* may be singled out:

- a prolonged existence of a parity between inside and outside investors;
- managers will execute a combined job of stockholders and managers, and play a combined role of outside (through their companies, funds, etc.) and inside (administration) stockholders;
- among outside investors maintenance of a parity between banks on the one hand and non-banking financial institutions and other legal entities on the other hand;
- slow (reciprocally compensated) processes of reduction of the share of enterprise employees in the stock capital and increasing share of small outside investors.

The formation of such a model means, in particular, a prolonged reproduction of conditions for interest conflicts and infringement on stockholders' rights. In this sense, the problems of legal regulation of procedure norms applicable to JSCs functioning are of exceptional importance.

In the end, the aim of the state regulation is to form models of corporate governance and of securities markets which would assist a successful development of privatized enterprises, to rational utilization of limited resources and favorable structure shifts in the economy as well as to optimal coordination of interests of different groups. The formation of the new owner, really more efficient than the state is a long-term goal which may be achieved in the process of redistribution of the initial, highly dispersed structure of ownership emerged in the course of voucher privatization, providing favorable external conditions at the national and regional levels will persist.

7.3. Enterprises with Foreign Investment

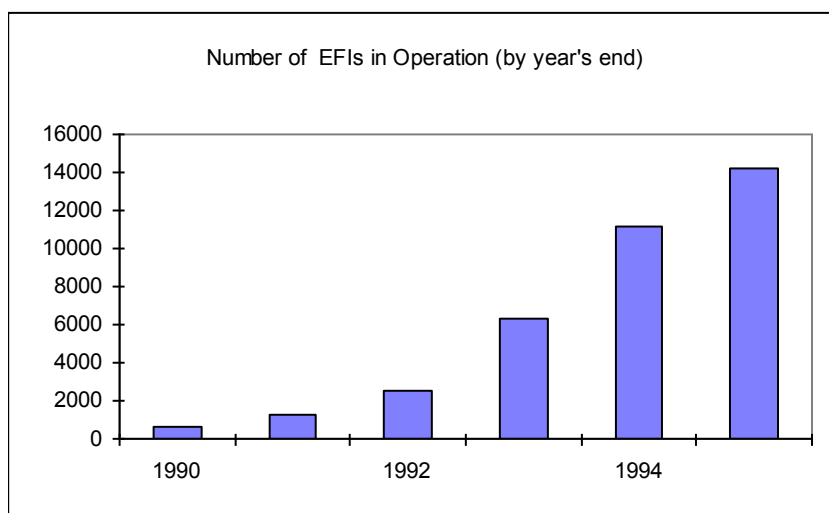
As Goskomstat reports, in January through September of 1995 13395 enterprises with foreign investment (EFI, *Russ. abbr. PII*), among them 11403 enterprises with foreign investment originated from countries outside the CIS and 1992 -- from the CIS countries, operated in Russia.

According to expert estimates by the end of 1995 their number has reached 14200, 12100 of them with investment coming from countries outside the CIS and 303 -- from the CIS states. The total number of people employed by these enterprises reached 397 thousand; the number of workers at EFIs with countries outside the CIS made 367 thousand while EFIs involving capital from the CIS countries employed 30 thousand of workers. (Fig. 7.1).

It seems that a striking difference between number of EFIs involving investment from countries outside and within the CIS primarily depends on political factors which provoke separatist tendencies in certain CIS states even in spite of the damage to traditional ties between enterprises which have existed in the former Soviet Union. Besides, a traditional orientation of the RF and the CIS member countries towards development of their external relations first of all with industrialized countries and the underdeveloped RF legislation regulating its external activities concerning the CIS also tell upon this fact.

The distribution of EFIs by output volumes and investment amounts shows a high concentration of capital. Thus, first five enterprises in the fuel industry account for 94 percent of total investment into this sector in 1995, in construction -- for 89.4 percent of investment, in wood working and pulp and paper industries -- for almost 60 percent, in engineering and metal working -- for 52 percent of investment.

Fig. 7.1



Although in 1995 the inflow of foreign capital into the country was rather insignificant, certain positive trend became apparent in qualitative terms. Thus, in January through September of 1995, as Goskomstat reports, investment made by two times more than in the relevant period of 1994. Primarily the direct investment accounted for this fact as it increased by 3.5 times during this period. Positive qualitative shifts were also perceptible in terms of foreign investment made in rubles. In comparison with 1994, ruble investment are made not only by enterprises with partners from the CIS, but from other foreign countries as well. In 1995 Goskomstat reported a considerable increase in ruble investment in operative EFIs as compared with 1994 figures (by 7.5 times as comparing summary outcome of three relevant quarters); this fact bears witness that foreign investors are going to continue joint activities in Russia.

Besides, it is important for the country that reinvestment is directed to material production sectors and first of all to engineering (25 percent). Enterprises involving CIS capital account for 18 percent of all ruble investment while EFIs with investment from European countries and the USA account on average for 10 percent of ruble investment each. It seems that Cyprus which leads in terms of ruble investment into Russia reinvests ruble funds arising from capitals of Russian origin.

The sectoral structure of direct investment changed considerably in the last year. Thus, in contradistinction to 1994 when branches of the fuel and energy complex played the leading role, in 1995 Goskomstat registered largest investment into EFIs in trade, public catering, in finance and credit sphere, in science and science services. However, in terms of accumulated investment the leading role is played by EFIs engaged in oil and natural gas industries; the Ministry of Fuel and Energy reports \$ 2 billion of foreign investment into the sector as of mid-1995.

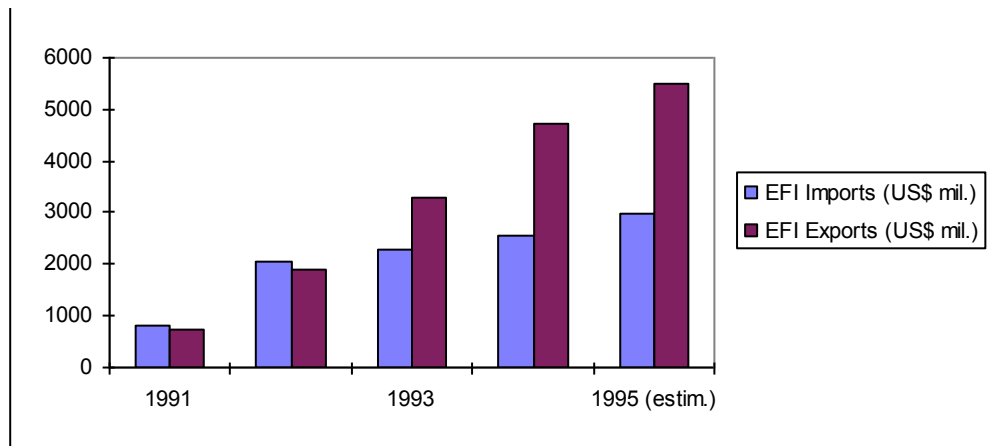
The regional structure is still dominated by large business centers (Moscow, St.Petersburg) and by raw materials-producing regions (Tyumen, Tomsk, Sakhalin Regions).

In January through September of 1995 EFIs exported goods and services amounting to \$ 4.1 billion (7.1 percent of the total Russian exports) including \$ 3.8 billion to countries outside the former Soviet Union (8 percent) and \$ 0.3 billion to the CIS countries (2.7 percent). Estimates put the total EFIs exports in 1995 as \$ 5.5 billion. A majority of goods exports were absorbed by Italy (\$ 0.5 billion, or 12 percent of the total exports), Germany (\$ 0.5 billion, or 12 percent), Great Britain (\$ 0.4 billion, or 10 percent), the USA (\$ 0.3 billion, or 6 percent).

In nine months of 1995 EFIs imports amounted to \$ 2.3 billion (6.9 percent of the total Russian imports), including imports from countries outside CIS -- 2.1 billion (98.9 percent) from the CIS -- \$ 0.2 billion (1.7 percent). The total imports in 1995 are estimated at \$ 3 billion. A majority of goods was imported from Great Britain (\$ 0.2 billion, or 9.2 percent of the total EFIs imports), Finland (\$ 0.16 billion, or 7.0 percent), Ukraine (\$ 0.1 billion, or 2.5 percent) (Fig. 7.2).

Fig. 7.2

Data on Imports and Exports of Enterprises with Foreign Investment



A persistent growth of exports was characteristic of the period, first of all at the expense of export of energy resources. Imports dynamics were somewhat slower due to saturation of the domestic market and tariff constraints on a number of goods.

The efficiency of EFIs, calculated as output per employee ratio was considerably higher than similar indicators typical for the totality of Russian enterprises.

The following important projects of 1995 shall be mentioned:

- a \$ 80 million investment in continuation of the EBRD 25 year project concerning development of the Verkhnevozeysk oil field executed by joint venture (JV) “Komi Arcticoil”;

- development of Western Siberian Priobskoye oil and natural gas deposit with participation of companies “Amoco Eurasia Petroleum” (USA) and Yukos (Russia) involving future investment in amount of \$ 25 billion during 20 years. Besides, “Amoco” is conducting negotiations on its participation in exploitation of Timano-Pechora and Yamal oil and natural gas deposits;

- in the end of June, 1995, the production sharing agreement concerning oil and natural gas extraction under “Sakhalin-I” project was signed, the project envisages a \$ 15 billion investment from American “Exxon”;

- a French consortium “Garoner” has started organization of the first logistic center -- an international terminal for goods and raw materials with modern infrastructure for freight handling, marketing and other services -- on the Russian territory, in Tatarstan. Its prospective development envisages a permanent exhibition and fair, creation of a free economic zone;

- “General Motors” and Yelabuga Automobile Factory signed an agreement on establishment of a joint stock company in June of 1995. The total amount of the project is \$ 1 billion, \$ 300 million shall be invested at its first stage. The partners’ interest in the project is as follows: 50 percent for “General Motors”, Russian and Tatarstan founders -- 25 percent for each;

- “Mars” company is building 4 enterprises and plans to construct other 10 in the nearest future (production of chocolate bars and candies). Insofar, projects under construction have absorbed \$ 100 million, the total investment is estimated at \$ 1 billion;

- American “Pratt and Whitney” (a subsidiary of the “United Technologies”) plans \$ 50 million worth projects in the Russian aircraft production; among them: development of an aircraft engine for a new IL-96M plane together with “Ilyushin” Aircraft Construction Bureau; of a new generation of gas turbines, etc. The American firm creates a joint venture together with JSC “Perm Motors” which is to manufacture aircraft and industrial engines and to execute their post-sale servicing.

In the process of their operations in Russia EFIs face numerous problems which worsen, or even render impossible their “normal” (as understood by a law abiding foreign investor) functioning. For instance, there lacks a developed legislation directed to protect foreign investors. The tax legislation is oriented towards immediate reception of taxes by the state, the number of taxes is over 40 while calculation methods and payment procedures are subject to the permanent alterations. Taxes, export and import duties, and tariffs often make investment into production economically inefficient. Corruption among officials has reached such a scope that the entire process of reform is in danger. Complicated procedures applicable to certification of EFIs products are often a means of indirect pressure on producers. The accounting system does not correspond to international standards: for instance, real costs of enterprises are not to be subtracted from the taxable profit.

Prospects of EFIs creation and functioning will be to a considerable degree determined, first, by changes of the situation both in the country as a whole and in the regions, second, by readiness of individual economic entities to absorb and efficiently utilize foreign investment.

It seems that foreign firms will retain their interest in investment into the fuel and energy complex in 1996, and adoption of the law “On Production Sharing” will immensely contribute to this.

Intensification of joint business activities may contribute to creation of more favorable (privileged) conditions for EFIs’ operations in certain sectors and regions being of priority for the Russian economy, this trend is supported by the “Comprehensive Program on Stimulation of Internal and Foreign Investment into Russian Economy” adopted by the Russian Government on October 13, 1995.

7.4 Major Trends in Industrial Enterprise Restructuring

This analysis is based on empirical data obtained in the framework of the Ministry of Economy complex project “Monitoring of the Situation Enterprises are in and their Behavior” which primarily concerns medium-sized enterprises in the civil sector. 25 directors from 7 towns of the Central Economic Region were thoroughly interviewed in the summer of 1995, the interviews were supplemented with a study of accounts and investment plans of their enterprises; alongside with this research a questionnaire survey of enterprise managers was conducted in accordance with panel samples of the Russian Economic Barometer (REB) and the IET’s Laboratory of Market Surveys in the end of 1995.

Environment

The economic environment of enterprises is characterized by rather tight financial constraints, decelerating inflation rates and declining inflation expectations. Access to short-term credit resources was limited by high real interest rates while long-term loans availability was restricted primarily by non-price constraints. In a number of industrial sectors aggregate demand stabilized and even somewhat grew. However, enterprise managers experienced further enhancement of competition, first of all on the part of Russian producers and somewhat less intensive one on the part of imports from countries outside the CIS.

Upon completion of the voucher stage of privatization, the activity at regional cash auctions offering state-owned blocks of stock slack. However, intensive secondary redistribution of ownership is underway; the main trends here are further concentration of shares in the hands of working collectives as a whole, redistribution of stocks within collectives to the advantage of “the director’s team”.

Years of work in the environment of open inflation, increasing restraints on availability of financial resources from state agencies and lending institutions gradually trained enterprise managers to financial difficulties. The administration has already adjusted itself to existence of such difficulties (also in terms of mentality) and relies first of all on adaptation to demand constraints and the changed structure of economic ties as a way out of this situation. The center of emphasis has also shifted. Although the problem of current financing still retains its vital importance, many directors feel that increasing costs represent an equal, if not even more urgent problem. It is linked with competition, demand, investment. Enterprises' behavior both in terms of a passive adaptation and in terms of an active conscious policies implemented by the management shows enhancing trends towards restructuring.

Adjustment strategies: survival and restructuring

Current financial situation. Lack of working capital aggravated by mutual payment arrears and bad debts is characteristic of a majority of enterprises. Enterprises settle these problems in different ways. Some entities managed to improve the situation in the last year, having made up for losses and maintaining a relatively high level of output. However, there are certain managers who consider exactly the lack of working capital to be the major constraint on increasing of output.

To meet the needs of current turnover enterprises have to seek short-term loans which put a heavy burden on costs. At a number of enterprises repayments of interest are comparable with payroll expenditures. Some enterprises refuse to take expensive loans trying to rely on their own resources and, of course, debts. Many enterprises seek assistance of barter which often involves multi-linked and ramified operations. Out of 187 enterprises surveyed by REB in 1995 62 percent resorted to barter to alleviate their supply problems (this measure is ranked first in terms of importance).

A typical strategic behavior of enterprises since the beginning of reforms has been accumulation of mutual payment arrears as they hoped that the state financial inflows will settle this problem. This strategy has undergone some changes. As before, a majority of enterprises is in debt to their suppliers and experiences payment arrears on the part of their customers, however, they actively "work" on debts. Some contacts with customers are permanently underway at the level of top managers, sometimes in the form of requests, demands or even outright blackmail when producers threaten to stop deliveries. In extreme situations a complete severance of ties is possible, in cases when financial prospects of a partner are unfavorable. Directors, either spontaneously, or consciously do not allow debts to exceed certain levels. Accordingly, acceptable customer-specific debt amounts are worked out and in case they are exceeded deliveries stop. The notion of these amounts is flexible and depend on current demand for products, on the number of prospective customers. Taking a decision on severance of ties, managers compare losses involved into this action with costs of maintenance of relations. These policies became a certain indicator of the debt situation. At a majority of surveyed enterprises the level of receivables lowered to 8 -- 15 percent of sale volumes by mid-1995 although in 1992 through mid-1994 it reached 30 -- 40 percent, or even a half of sale amounts. An adverse side of this process was enhancement of other payment arrears types: wage and budgetary arrears.

Policies concerning stocks have also changed. Finished stocks permanently increase, since directors sometimes prefer rather to work "for warehouse" than to borrow products for an uncertain time. At the same time, stocks of supply fall. They are seldom hoarded since financial situation does not allow for this. Huge reserves of the pre-reform times have been spent a long time ago, however, now managers do not deem such scope as necessary. Some directors would like to have a large stock either due to inflation expectations, or in order to be able to fulfill a new order. Some of them try to hoard stocks according to available means ("we've received money -- let's buy for future

use”). Others are even ready to use loans comparing possible increase in prices with interest rates (for instance, this behavioral pattern was characteristic of a flour mill having a stable demand against the background of fluctuating prices of raw materials).

Advance in costs. The other side of financial situation -- an advance in costs -- begins now to draw more and more attention as it becomes more and more difficult to automatically include costs in selling prices. Alongside with increase in costs of supplies, the advance of expenses for fuel, energy and especially for railroad transportation (where cost advance endangers many economic links) is perceptible. In the cost structure predominates a trend towards growth of overheads costs including interest, expenditure for idle productional machinery. Only certain enterprises experience growing costs of raw material component in their cost structure (usually at enterprises having difficulties in search for replacement of raw materials or suppliers). Payroll expenditure is usually stable or falling.

The last year demonstrated a significantly intensified attention of the management to supply problems. An active restructuring of the system of economic ties (including those with traditional partners) has began. As a survey conducted on the base of the REB sampling has revealed, 57 percent of enterprises sought new suppliers and another quarter resorted to services of intermediaries what also represents a form of the search for alternative suppliers. Improvement of the raw materials base forms a keystone of investment policies implemented at a number of enterprises. Roughly 9 percent of them invest into development of their suppliers, in organization of new enterprises, in various forms of vertical integration, including establishment of subsidiary JVs.

Enterprises continued active sales policies and strove for minimization of costs, for acceleration of turnover and for an increase in (stabilization of) output in order to provide for financial inflows. A search for new markets, new consumers was underway, accompanied by rejection of traditional but insolvent ones. Enterprises established marketing departments, trading centers, in certain instances formed dealer networks, made attempts, however feebly, to study markets. Enterprises enhanced order-specific work including orders made by small customers (earlier they tried to reject such clients). Market policies also influenced production, there were made attempts to change output mix and to diversify activities, although only those involving low costs. In the years of reform the potential of change was exhausted and enterprises needed large-scale investment.

Among measures directed towards improvement of sales, as a survey conducted on the REB sampling reveals, curb on prices was ranked first in 1995 (by 65 percent of enterprises). 45 percent of economic entities introduced changes in their output mix, 29 percent actively worked with intermediaries and dealers, almost a quarter of enterprises resorted to advertisement.

Restructuring of economic ties went on against the background of financial stabilization. The most important factors of restructuring were prices of raw materials and selling prices of enterprises, attention paid to the transportation component, to terms and conditions of payments for supplies, possibility to resort to barter operations.

It seems that price curb depends primarily on changes in external situation or on reduction of profitability. The work on minimization of enterprises' internal costs concerns only most apparent reserves. Although many managers dwelled on measures directed to save fuel, electrical energy and raw materials, in reality (the fact confirmed by inspections of a number of enterprises) decisions are taken in a way of reaction to current shifts in prices of resources and in transport tariffs. Only few enterprises undertake improvement of technological processes, including those in auxiliary production, directed to minimization of costs.

As to labor resources, their redundancy even now existing at certain enterprises was partially diminished by outflows from employment which were underway in 1994 through early 1995. They were mostly caused not by conscious policies implemented by administrations, but by voluntary quits of workers; however, directors “assisted” to this process, in particular through wage arrears and reduction of wages.

What concerns current demand in terms of its volumes in the nearest future and problems of efficient management of it, enterprises possess a considerable excessive production potential. There are no active strategies allowing for its removal from enterprises’ ownership in view, even in spite of growing preservation costs. The prevalent way to restructuring of assets is leasing. At present integration processes prevail and a wish to keep assets for a future use is predominant, while existing assets (especially vacant buildings and rooms) are observed as a “capital”, an advantage in implementation of investment projects. Cost burden has not reached a critical mass yet and is partly thrown on to consumers, partly on creditors, budget including.

At the same time, the task to cede a part of social utilities acquired a primary importance. Some activities (although not always successful) directed to transfer housing and children institutions to local governments were perceptible. Certain enterprises try to keep some facilities which involve low maintenance costs (health care utilities, cultural and sport facilities, sanatoria) and attempt to use them in commercial purposes. It is especially difficult to get rid of social utilities in small towns.

Development strategies: investment policy

Investment activity. An overwhelming majority of enterprises has realized the necessity to implement active investment policies and to execute rather extensive long-term projects as an element necessary for survival. It enhanced investment activities of enterprises which included a complex set of works concerning formation of investment projects (feasibility plans, ideas, etc.); search for and contacts with prospective investors, cooperation with the federal and local governments, sectoral associations (information, consulting, lobbying, etc.). Regional authorities preoccupied with problem of jobs and formation of the taxable base are the most natural allies of enterprises in their struggle for investment. These activities are accompanied with search for information and distribution of information on the enterprise, on its investment projects. Enterprises employ external consultants, firms engaged in information services. Banks are actively playing role of consultants, intermediaries and lobbyists in investment policies of stockholding enterprises and those of their ordinary clients.

Table 7.7 contains data received on the base of the REB sampling which characterizes activities of enterprises along different lines of investment. A considerable group of enterprises did not invest at all. The most frequent investment activities which shared the leading position in the rating were purchase of equipment and reconstruction of enterprises. Investment into working capital (which can not be deemed as an investment in the strict sense of the term, however, at a number of enterprises they are understood as “investment into production development”), in housing construction and other social utilities shared third and fourth rankings. Although at present a majority of enterprises badly need working capital a modest share of such investment (17 percent) manifests certain shifts. Only two years ago enterprises considered lack of working capital as a problem of the state, today many of them realize that they should settle this problem without assistance.

Investment plans of enterprises. A majority of enterprises has realized that an elaborated investment plan is necessary for a search for investors or in order to seek subsidies. An analysis of a number of concrete plans (projects) reveals that many documents are worked out formally, in accordance with “rules of the game” which require such a plan as a first step towards initialization

of contacts with an outside investor or power structures as a way to convey information about themselves.

Table 7.7

Investment of Enterprises in 1995
(in % to the number of respondents)

Investment lines	Enterprises, total	including branches producing:		
		consumer goods	investment goods	intermediate goods
No investment	47	41	49	52
Purchase of equipment	32	35	20	38
Reconstruction of enterprise	25	21	20	35
Investment into working capital	17	15	20	15
Housing and social utilities construction	16	12	13	23
Purchase (construction) of other objects - land, stores, etc.	6	12	2	4
Purchase of stocks, securities	4	5	4	2

In practically all plans the technology questions, specifications of purchased equipment are well elaborated while economic and marketing feasibility reports are poorer or outright fictitious. However, there were exceptions: orientation towards internal demand (improvement of the raw materials base), plans supported by preliminary agreements with consumers. A number of managers demonstrated a blind faith in outside consultants who offered not quite feasible ideas. Other enterprises still use plans drawn on the eve of reforms and had not been revised since.

Among revealed motivations determining formation of projects/ plans prevailed: change of output mix, improvement of products quality alongside with utilization of enterprises capacities, experience, potential. Projects aimed to replacement of basic or auxiliary technologies were rare.

Sources of investment and investors. Quantitative assessments of accessibility of investment to enterprises were received in the course of interviewing 430 enterprises of the IET sampling by questionnaires are shown in Table 7.8. An apparently restricted access to external sources of financing while 40 percent of enterprises made no investment at all reflects an unfavorable investment climate in the industry.

Table 7.8

Accessibility of Investment Sources to Enterprises in 1995 through the first half of 1996
(in % to the number of respondents)

Sources of investment (investors)	Enterprises, total	including branches producing		
		consumer goods	investment goods	intermediate goods
Funding from federal or local budgets	12.3	16.3	9.4	11.2
Internal funds	43.0	40.0	45.0	43.3
Long-term banking loans	10.5	13.3	12.1	6.7
Direct bank capital	1.2	1.5	1.3	0.8
Funds of industrial enterprises	4.9	6.0	2.0	6.0
Russian private business	2.6	2.2	3.4	1.5
Foreign investors	3.5	4.4	2.0	4.5
Funds of sectoral structures, holdings, etc.	3.0	3.0	4.0	2.2
no funds attracted*	41.2	40.0	41.0	41.8

* Including enterprises which have not answered the question. Therefore estimation of source accessibility may be understated.

It shall be emphasized that only 2.5 to 5 percent of enterprises attract investment at micro-level (private capital, foreign investors, industrial enterprises) while participation of banking capital is an extremely rare occasion.

Investment climate. Investment activities of enterprises is the sphere most hardly stricken by transitory conditions, tightening financial restrictions. The unfavorable investment climate was determined by persistent inflation and shifts in the aggregate demand causing uncertainty in assessment of market prospects. All this is reflecting in unattractiveness of industry as a sphere of

investment while enterprises have no funds necessary to implement extensive investment on their own.

At the micro-level exist institutional and behavioral restraints. In spite of enhancing market policies and attempts to master basics of marketing many managers demonstrate inability to work “in market environment” and inadequate assessment of would-be demand. To a considerable degree it shall be attributed to the lack of skills and insufficient qualification, but most importantly, to the lack of information (on prices, sales, consumers, etc.), inadequate informational infrastructure.

The present organization of production and management at Russian enterprises, first of all in the civil sector, becomes a bottleneck which scares off prospective investors (especially foreign ones) and creates additional risks for investment. Preservation of excessive capacities, a striving for the broad diversification of operations alongside with retention of centralized schemes of management basing upon functional principles, poor quality of investment projects -- all this makes investors doubt efficiency of management.

A restraining role is played by managers’ orientation towards “closeness”, drive to use external funds without waiving their control over capital. In words almost all directors are ready to start a second issue or sales of stocks, however, there are few who are ready to sacrifice their controlling interest. There are already examples of ownership redistribution to the advantage of outside investors, however, redistribution processes on the whole are of non-market nature and are controlled by enterprise management.

Evolution of the behavioral pattern

A typical for transitory period “survival” pattern of enterprises’ behavior as described in the 1994 IET’s report, undergoes gradual modification. Preservation of economic ties has relegated to the background. Many managers do not deem preservation of the working collective as a primary goal anymore, although the sphere of labor relations usually does not experience serious pressure. In the framework of survival behavior increases the role of independent adjustment to financial constraints while orientation towards financial backing from the state weakens. Enterprises try to get rid of the burden of the social sphere with the help of local governments. However, integration trends towards preservation of the enterprise as an entity prevail, excessive capacities are being preserved. Orientation of managers towards maintenance of a tighter control over their enterprises is still predominant, consequently, enterprises’ funds are spent for purchase of additional blocks of stock, for payments of dividend. Calculations made on the base of survey conducted by the IET’s sampling (299 JSCs and business partnerships) reveal: a working collective as a whole owns more than 52 percent of stocks on the average, former employees hold 11 percent, governmental and federal agencies -- less than 10 percent. Stocks are distributed among other external owners in the following way: Russian private business holds 10 percent, individuals and industrial enterprises -- 5 percent, sectoral associations -- 3 percent, foreign companies and banks -- 2 percent each.

In answer to tightening of financial and demand constrains enterprises intensified short-term type restructuring, at the same time managers’ efforts were more aimed to external aspects of activities than to technological and organization processes. At the same time, a part of managers has realized the necessity to search for strategic decisions, has in practice begun to work out elements of a strategy. However, a question of its complex formation still remains unsettled. Only small part of enterprises have clear strategic aims and try to achieve them. The subjective conditions tell upon this -- management qualification, lack of experience relevant to the new situation and of information, however, objective factors also play their role. It is necessary to emphasize in this connection that a relatively easy availability of short-time loans and excessive constraints on

medium-term and long-term credits slow down both short-range and long-range restructuring of the industry.

Regionalization of economic relations is enhancing. Both actions directed to restructuring of economic ties and existing type of investment activities which are carried out only in case the local authorities, or good business acquaintances “approve” of them. Alongside with regional self-sufficiency of labor markets enhances territorial segmentation of the merchandise (resource) market. At the same time the “capital” market also apparently develops regional features to a considerable extent controlled by local authorities. Their policies affect also external capital, foreign one including. However, it is also necessary to mention that in many towns, especially small ones, local governments are open to contacts with prospective investors and are ready to assist and support them while they are preoccupied with problems of local budgets and of preservation of jobs. However, an intervention of local authorities in implementation of projects in order to achieve their own ends shall not be excluded: local governments have enough levers of power.

7.5 Business Situation in Industry

In 1995 the IET conducted 12 surveys of industrial enterprise managers in accordance to the harmonized European questionnaire of business situation test which gives a notion of assessments and forecasts forming at the enterprise level. 196 enterprises of Moscow and of the Moscow Region participated in the survey.

Demand

In accordance to enterprises' evaluation the decline in demand for their products, which started in the Summer of 1994, continued in 1995. The balanced difference reached -19 percent; in the second and the third quarters of 1994 this indicator made -60 percent. An increase in demand was registered only in food industry (+14 percent) and in non-ferrous metallurgy (+11 percent). In other industries answers “no changes” prevailed, however, the overall balance was negative.

Slackening demand constrains were manifested also through the ranking of factors restraining production development in the industry. Limited demand shifted down along the scale and was ranked third (57 percent). Payment arrears were up ranking second (61 percent). Lack of working capital was ranked first (79 percent).

In the second quarter of 1995 the rate of decline in demand accelerated again. The balance (“increase” vs. “decrease”) has reached -39 percent. Reports on decrease in demand prevailed in all branches with an exception of construction which experienced the beginning of a seasonal pickup.

Evaluations of demand, naturally, also deteriorated. The share of answers “less than normal” increased to 85 percent and was at the level of February--March 1994 when a tight monetary policy of the Government run the industry in a very difficult situation.

The degree of correlation between production and demand reached 84 percent in May. This indicator is calculated as a percentage of coincidence between enterprises' evaluation of production and demand and rises when industry experiences tightening demand constraints. In 1994 this indicator hit 83 percent (April) and in December 1992 when demand was satisfactory enough was as low as 58 percent.

At a decreasing solvent demand enterprises only with difficulty agreed to adequate curtailment of production, lay-ups of capacities and lay-offs. Production began to “outpace” demand -- the share of

reports on overtaking dynamics of output as compared with demand dynamics increased to 30 percent in June (in January such answers made only 23 percent).

In the third quarter declining rate of solvent demand decelerated. The balance (increase vs. decrease) rose to -26 percent. Enterprises reacted by decelerating curtailment of production and by more cheerful forecasts. An increase in demand evaluations made 8 points. The share of answers "normal" rose to 18 percent.

In October the second round of intensification in curtailment of solvent demand began. In one month the balance fell by 13 points. The most intensive decline in demand was observed in petrochemistry, engineering and woodworking. Growing demand (positive balance) was retained only in ferrous metallurgy.

Accelerating decrease rate of demand provoked a sharp decline in assessments. The balance of answers (above--below normal) fell to -87 percent and equaled to the absolute minimum reported in February--March 1994. It seems that a sharp acceleration of demand decline rates in October was unexpected by enterprises. The share of answers "below normal" increased to 93 percent in petrochemistry, to 92 percent in engineering and to 88 percent in woodworking.

According to enterprises' assessments curtailment of solvent demand continued until end-1995. Only engineering enterprises reported on decelerating decline in demand (from -45 to -36 percent) and those in food industry (from -69 to -58 percent). In other industries balanced differences reflected tightening demand constraints. A coincidence of changes in production and demand was registered for 59 percent of enterprises.

A decline in demand determined a deterioration of its evaluation. In December 92 percent of enterprises assessed demand as "below normal". Such a high degree of dissatisfaction has been registered for the first time, even in the Spring 1994, in the time of a generally recognized industrial crisis the share of answers "below normal" rose only to 88 percent. A slight improvement of evaluations was registered only in food industry (-75 percent vs. -81 percent). At engineering and petrochemical enterprises the balance of assessments made -95 percent, the minimum of the month. A coincidence between evaluations of demand and production was registered for 82 percent of enterprises.

Forecasts of changes in demand considerably differed from actual demand dynamics. The difference makes about 30 points while forecasts and actual changes in production and prices seldom differ more than by 20 points.

Since April (the start of registration of forecasts on demand) till July forecasts improved and have reached positive (in terms of balance) values. Later surveys have begun to register growing pessimism which persisted until November. In December industrial enterprises began to report more cheerful forecasts. It is probable that this tendency will continue in the first months of 1996. At the same time, it is necessary to note that actual dynamics of production, demand and stocks does not give grounds for such optimism.

Stocks

In the first quarter of 1995 enterprises could rather successfully control their finished stocks. The balance of assessments (above -- below normal), although reflecting a surplus of stocks, was at a rather low level (+1 -- +3 percent) while in January it made +46 percent.

In the second quarter a moderate increase in surplus stocks began: by June the balance reached +12 percent. These developments were caused by an intensive decline in demand while enterprises increased their output. However, in the third quarter relaxing demand constraints allowed enterprises to avoid the crisis concerning finished stocks and in August assessments again were as low as +3 percent.

A sustained growth of excessive finished stocks began in September. An increase in the share of answers "above normal" was caused by more intensive decline in demand which was not followed by an adequate decrease in output. Even rather considerable deceleration of selling price growth (from September through December the balance of actual price change decreased by 40 points) was not able to prevent accumulation of stocks.

Output

Dynamics of actual changes in output demonstrated two explicit peaks when balances between answers (increase vs. decrease) reached the best values in the entire period when surveys were conducted. The first peak occurred in January and manifested the complete recovery from a deep crisis of 1994. At that time the balance reached -12 percent after -58 percent registered in July of 1994. In September 1995 the balance hit the survey absolute record of -9 percent. In April the rate of industrial recession accelerated to -29 percent, in November it made -28 percent. These figures represent the worst values of the last year.

As surveys of business situation reveal, since April till September 1995 enterprises could combine an increase in output with decelerating price rates. Everything seems to indicate that at that time there occurred a rare moment of policy coordination between the Central Bank and the Government coinciding with the enterprise behavioral pattern, this combination could become a real basis for recovery from the crisis of industry. A traditional reaction of Russian enterprises to monetary policy of the authorities usually manifested itself through simultaneous increase in output and prices when credit constraints relaxed and a curb on output and prices when these constraints were tightened.

Inflationary expectations

Inflationary expectations of industrial enterprises declined by 40 points (from +87 to +47 percent) during 1995.

The first substantial decrease in expectations was registered in the course of the May survey and made 10 points. Neither demand, nor stocks, nor output dynamics could provoke such considerable change in price expectations at that time. From January till April a decline in inflationary expectations made only 6 points.

In 1994 a similar sharp drop in inflationary expectations (from +64 to +50 percent) was registered in June. However, at that time enterprises reported the most pessimistic forecasts on output dynamics (-40 percent). At present, the abating inflationary expectations coincide with forecasts on increase in output which continues to improve three months in succession. At the same time, prospects for retention of the present level of output are evaluated much higher at 59 percent. However, in September 1993 the latter indicator value was at its highest (60 percent).

The second decline in inflationary expectations occurred in September through November. The balance between answers (will increase -- will decrease) dropped by 27 points. In December their level fell another 4 points and hit its lowest of all time when surveys were conducted.

7.6 Business Outlook in Construction

Assessment of construction

In 1995 six regular surveys of business situation were conducted among managers of building organizations. The data received in their course reveal considerable changes in business situation in construction.

The major developments in construction as compared with 1994 became sharp fluctuations in evaluations of change in physical volumes of building and assembly works (BAW, *Russ. abbr. SMR*) occurring against the background of extremely low utilization ratio of productive capacities.

In January 1995 there was registered the lowest level of assessment of changes in amount of construction works. The balance difference between answers “increased -- decreased” reached -51 percent. By May the decrease in amount of works decelerated considerably (-11 percent). In July, for the first time since November of 1993 building organizations reported on increasing production volumes; an increase in amount of works accounted for a balance value at +10 percent. However, in September a negative trend was again characteristic of BAW amount dynamics (balance at -5 percent); by June this trend developed into a considerable recession (-44 percent).

During the year the production program remained in plight. From 53 to 70 percent of building organizations worked in the situation when productive capacities were extremely underutilized. Balances of production program evaluation (“above normal” -- “below normal”) were by 7 to 25 points below last year’s figures and fluctuated in the band from -69 to -48 percent.

In June of 1995 against the background of increase in BAW amount values of utilization ratio were at the maximum: the balance increased to -48 percent while the share of “normal” evaluations reached 41 percent. July assessments give a good notion of increasing dissatisfaction of respondents with their production programs as compared with 1994. In July of the last year the change in amount of works (increase -- decrease) was evaluated at -3 percent and production level balance (above -- below normal) -- at -40 percent.

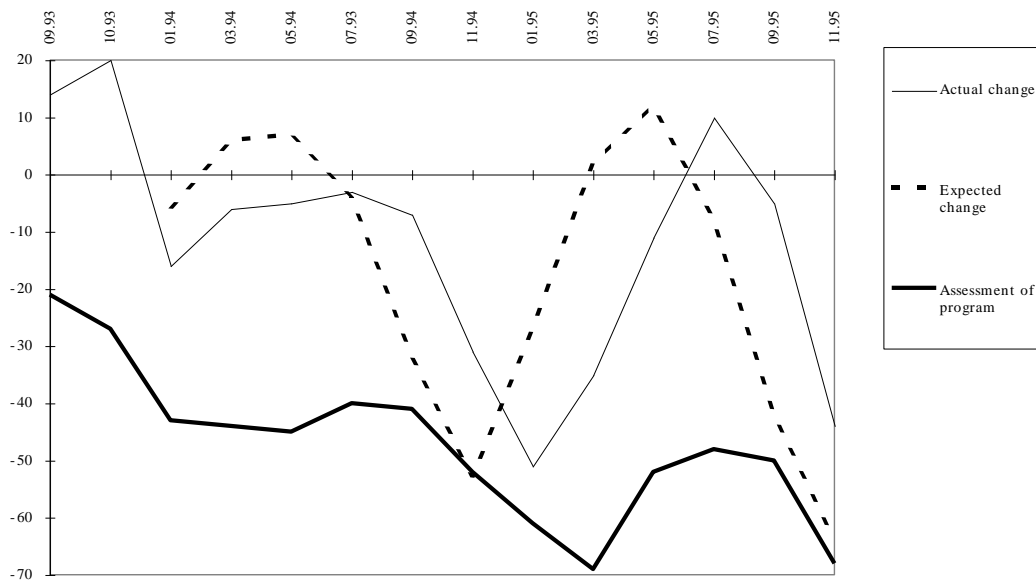
It is of a special interest to compare the substantial fluctuations of the utilization ratio in 1995 with expected and actual changes in amount of BAW (Fig. 7.3).

The discrepancy between balances of expected and actual changes in amount of works made from 2 to 11 percentage points. Curtailment of amount of works in January and in November similar to the last year events sufficiently correlated with expectations of managers. However, in 1995 the situation with utilization of productive capacities was so difficult that expected decrease in amount of BAW caused a perceptible deterioration of assessments of the production program. Expected and actual indicators of utilization ratio decreased from -52 to -61 percent and from -50 to -68 percent accordingly.

The worst evaluations of the production program were registered in March at the level of -69 percent while assessments of BAW amount recovered from -51 percent in January to -35 percent. The share of organizations operating under a normal workload reduced to 24 percent. It was connected with the fact that actual amounts of work were by 8 points less than expected while 33 percent of organizations reporting on an increase in amount of works in March did not reach a normal level of utilization of productive capacities.

Fig. 7.3

Assessment of Production Program and Changes in Amounts of Works



In May despite expectations that workload will increase a decline in production was not stopped. In spite of this an improvement of evaluations of BAW amount was enough to increase the capacity utilization ratio from -69 to -52 percent. In July expectations that works amount will increase made +12 percent and only by 2 points exceeded actual value of the indicator, however, 41 percent of respondents from those who expanded their activities were dissatisfied with their production program. It reveals that building organizations relied upon more intensive growth of production.

Both in January and in November 1995 the recession affected all spheres of building activities. In the beginning of the year the lowest assessments were registered in construction of infrastructure objects: a decrease in amount of works to -60 percent, the level of evaluation of utilization ratio at -66 percent. In November, against the general background indicators of volume and levels of production in housing construction stood out with highest value of balance for the former indicator (-35 percent) and the lowest for the latter (-74 percent).

A major reason behind the fact that actual BAW amount lagged behind prognosticated values in March and in May were serious complications in the sphere of socio-cultural and administrative construction. In this group of organizations curtailment of production was evaluated by the balance of -49 percent in March and -40 percent in May, that being by 25 and 37 points below corresponding expected values. In this sphere of construction a decrease in works amount continued even in July (-4 percent), however, evaluation of workload increased from -83 to -49 percent.

An increase in amount of works in July was only in part underlain by seasonal variance in construction of infrastructure and agricultural objects. From May through July assessments of amount of works made by organizations across the spectrum of construction rose by 32 -- 44 points. Enterprises specializing in industrial and housing construction obtained even more substantial amounts of BAW than they expected: an increase in amount of works accounted for a balance of +25 and +10 percent while expected values were +11 and +5 percent accordingly.

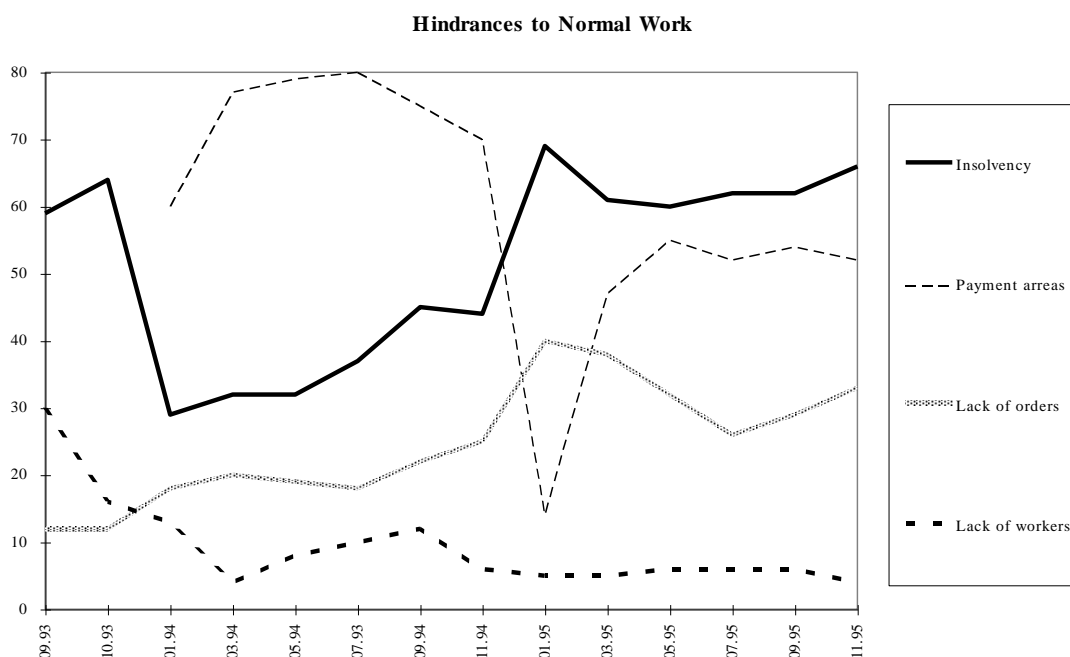
Recovery of the negative trend in dynamics of amount of works in construction in September was caused mainly by shrinking amount of works in infrastructure construction where balance of changes fell to -20 percent while expected value was -3 percent.

Constraints on growth of construction

Results of business situation surveys in 1995 have not considerably changed the ranking of factors which restricted development of the construction sector. As before, the major restraints were represented by problems of financing of BAW caused by insolvency of customers and payment arrears. The frequency with which these two factors were mentioned varied from 60 to 69 percent and from 44 to 55 percent accordingly. The importance of the third factor - lack of orders - was confirmed by 26 to 40 percent of organizations (Fig. 7.4).

In January and in November 1995 the problem of customer insolvency was especially acute: 69 and 66 percent of respondents accordingly pointed it out. Thus, the recession in the beginning and in the end of the year was seriously affected by financial limitations of customers.

Fig. 7.4



Among organizations which picked out customer insolvency as a major restraining factor, 45 to 48 percent deemed it to be the only restraint in their work while 21 to 23 percent of respondents combined it with payment arrears. The most frequent answers on payment arrears were registered in May (55 percent) and in September (54 percent), i.e. before and after the period of BAW amount growth.

In September 1995 a question on arrears in financing was supplemented to the questionnaire. Only 3 percent of respondents, as the latest surveys reveal, reported on coincidence of financing to the progress of BAW completion. On the average, financing arrears made 3.1 months in September and 3.4 months in November.

From January through July the share of organizations experiencing serious problems in their search for orders shrank from 40 to 26 percent and again increased to 33 percent by November. 36 to 39 percent of respondents from their number considered that this restraint was their sole difficulty while for 20 percent lack of orders was aggravated by lack of funding or arrears in financing of works.

In the first half-year of 1995 average orders security increased from 3.9 to 4.6 months. However, in July this indicator decreased to 4.1 months. It was caused by increasing share of short-term orders

(1 to 3 months) in the entire structure of provision with orders from 38 to 46 percent. By November the average value of the indicator fell to 2.7 and the share of short-term orders made up 51 percent; 30 percent of organizations had orders for less than a month.

Value of indicator of the average period of financial security from January to September fluctuated within 1.8 to 2.5 months band, and in November its value fell to 1.4 months. At the same time 62 percent of respondents were in a dire financial situation (security for less than a month). In November there was registered the minimum average provision with orders and financing in the entire period under observation since September 1993.

Section 2

Monetary and Budget Spheres

2.1 Public finances

Up to the Fall 1994, the Government, headed by Chernomyrdin, adhered to the so-called “moderate-limiting” financial policy. This policy was targeted at gradual stabilization of the national economy. The question was to ensure for 1995 a lowering of the rates of inflation to get to 3% - 5% monthly to the end of the year.

But, in practice, in 1994, this “moderate-limiting” financial policy was expressed in the support of the Budget deficit of 7% to 10% of GDP, of the about 9% monthly growth rates of the Central Bank credits, of M_2 growth rates of about 10% monthly, and, at last the about 8% monthly prices growth. The highest rates of growth for the money stock were recorded in May to July 1994 (17.1% in May, 13.4% in June, and 12.9% in July), which, with the six months lag, led to the growth of the inflation rates growth up to 15% to 16% in October to December 1994. At the same time, about 75% of the increase of the Central Bank credits were the credits to the Government.

At the beginning of the Fall 1994, the Government changed sharply its concept of the macroeconomic policy. Instead of the moderately strict monetary policy, a radically new scheme began being developed. The purpose of it was to make the monetary and budgetary policies stricter in such a way, that it would ensure, by the end of 1995, the real financial stabilization with the monthly inflation rates of about 1%.

Budget Planning for 1995

In November 1994, the Government submitted the draft 1995 Budget, developed within the framework of the new concept of the macroeconomic policy, to the State Duma. After its rejection in the first reading, and after the work of the Reconciliation Commission, at the beginning of 1995, the Ministry of Finance submitted to the Duma the amendments to the draft Budget and to the macroeconomic program. The work of the Reconciliation Commission with the Finance Ministry for amending the Budget was formal enough. In order to avoid the repeated situation of the previous year with the approval of the high nominal Budget indexes, the Government made, in 1995, a deliberate technical fault: the calculations to the Budget did not correct the parameters characterizing the evolution of the inflation processes. At the same time, already in the Fall 1994, taking into account the dynamics of the money supply, one could forecast the high rates of the prices growth in 1995, which brought to significant corrections in the macro-economic calculations.

The draft Budget based on such corrections was approved by the State Duma in the last, fourth, reading on 14 March 1995. There, the confrontation between the fractions of the State Duma hindered the approval of practically all the amendments submitted by individual deputies or their groups. As a result, if we omit small things, the Government-proposed variant of the Budget was approved. The main parameters of the Budget are shown in Table 2.1.

The situation with the Budget planning for 1995, described above, though badly reflecting the reality, turned out, nevertheless, much more preferable than that of 1994. The underrated prices growth and GDP volume, taken into account in the calculations by the Ministry of Finance, allowed to avoid, last year, the situation with the approval for the Budget of the unrealistic nominal volumes of incomes and expenditures.

With the inflation rates 1.5-fold higher than accounted for in the Budget calculations (2.31 actual and 1.6 in accordance with the calculations of the RF Ministry for Economy used when drafting the Budget), the nominal volumes of the Budget incomes, much more lower both in the nominal expression and as percentages of GDP allowed to finance the nominal expenditures volumes approved for the Budget without increasing the deficit.

Table 2.1

RF Federal Budget for 1995

Parameters	Percentage of GDP accounted for when developing the Budget (Rb925 trln)		Percentage of forecast GDP (Rb1,500 trln)		Percentage of actual GDP (Rb1,659.2 trln)	Execution for 1995, % of the actual GDP
	draft law, October 1994	Law of 14 March 1995	Law of 14 March 1995	Law of 12 August 1995	Law of 6 December 1995	
INCOMES						
Incomes from taxation, incl.:	12.7	13.8	8.5	8.5	10.6	10.27
Profit tax	2.6	2.6	1.6	1.6	2.7	2.47
Personal income tax	0.4	0.3	0.2	0.2	0.2	0.2
VAT	4.9	5.4	3.3	3.3	4.5	4.27
Excise taxes	1.0	1.0	0.6	0.6	0.9	1.07
Special tax		0.6	0.4	0.4	0.5	0.44
Royalties for the use of natural resources	0.2	0.2	0.1	0.1	0.1	0.18
License duty for production and sale of alcohol	0.2	0.2	0.1	0.1	0.0	0.0
Land tax	0.0	0	0	0	0.1	0.01
Taxes on foreign trade	2.1	3.5	2.1	2.1	1.5	1.46
Other taxes, duties, and levies	1.3	0.1	0.1	0.1	0.1	0.2
Non-tax incomes and assets of the Budgetary targeted funds	2.9	5.1	3.1	3.1	3.0	3.48
Total incomes of the Federal Budget	15.6	18.9	11.7	11.7	13.5	13.67
EXPENDITURES						
State administration	0.5	0.4	0.3	0.3	0.3	0.27
International activities	1.9	2.3	1.4	1.4	1.3	1.3
National defense	4.9	5.3	3.2	3.4	3.6	2.87
Law enforcement activities	1.7	1.6	1	1.1	1.2	1.16
incl. Federal Courts system	0.1	0.1	0.1	0.1	0.1	
Fundamental research	0.6	0.7	0.4	0.4	0.4	0.29
National economy	3.9	4.6	2.8	2.9	2.7	2.18
Education	0.9	1	0.6	0.6	0.7	0.52
Culture, art, and mass media	0.3	0.4	0.2	0.2	0.2	0.17
Public health and physical culture	0.5	0.5	0.3	0.3	0.3	0.21
Social policy	0.3	0.5	0.3	0.3	0.7	0.23
Repayment and service of the inner debt	1.2	0.9	0.6	0.6	0.5	0.56
Service of the external debt	1.1	1.6	1	1	0.9	0.94
Other	4.6	5.9	3.6	3.2	3.5	3.7
incl. financial aid to other levels of power	3.1	3.1	1.9	1.9	2.3	1.76
Expenditures of extra-budgetary targeted funds	1.1	1.3	0.8	0.8	0.8	0.85
Total expenditures	23.4	26.8	16.6	16.6	17.2	16.61
Excess of incomes over expenditures	-7.8	-7.9	-4.9	-4.9	-3.6	2.93
Domestic financing	4.5	3.3	2.1	2.1	1.8	1.41
Foreign financing	3.3	4.6	2.8	2.8	1.8	1.52

Execution of 1995 Budget

The underestimation of the inflation rate of 1995, and, hence, of all the nominal values of the Budget plan resulted in that the 1995's incomes of the Federal Budget exceeded 1.3-fold the ones planned in the Law of 14 March. As for the inflation, it was, as mentioned above, 1.44-fold higher than accounted for in the Budget calculation. This discrepancy is explained by the overvalue of the real incomes of the Budget in the Budget calculations. Nevertheless, the overfulfillment of the plan for incomes allowed to finance the expenditures in a higher volume than planned initially, but only by 115%. The formal reason for the lower overfulfillment of the plan for expenditures consists in the underfulfillment of the plan for the deficit financing. The deficit was reduced by Rb12.8 trln,

i.e., by 17% of the planned. It is important to note that different kinds of expenditures were corrected in different ways. E.g., the expenditures on the social policy were 270%, on the State administration 132%, on the defense 122% financed, while the expenditures on culture and art were only 108% financed.

The data on the fulfillment of the Federal Budget by months of 1995 are shown in Tables 2.2 and 2.3.

Table 2.2

Execution of 1995 consolidated Budget, % of GDP

Parameters	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
INCOMES												
1. Income taxes, profit taxes	6.93	7.28	8.71	10.02	10.65	10.40	9.92	10.04	9.64	9.27	9.18	9.25
1.1 Profit tax	4.75	5.01	6.30	7.57	8.29	8.07	7.62	7.82	7.48	7.13	7.04	7.04
1.2 Personal income tax	2.18	2.27	2.41	2.45	2.36	2.32	2.27	2.20	2.14	2.12	2.12	2.20
1.3 Other taxes on income or profit				0.00	0.00	0.00	0.03	0.02	0.02	0.01	0.01	0.01
2. Taxes on labor payment fund							0.29	0.26	0.26	0.26	0.26	0.26
3. Taxes on goods and services	10.09	9.23	8.99	9.19	8.87	8.65	8.71	8.21	8.05	8.04	8.10	7.99
3.1 VAT on the goods and services produced and rendered in the RF territory	7.29	6.52	6.30	6.24	5.93	5.68	5.73	5.38	5.18	5.16	5.17	5.11
3.2 VAT on the goods imported to the RF territory	0.54	0.58	0.51	0.58	0.58	0.60	0.64	0.65	0.65	0.65	0.68	0.64
3.3 Excise taxes, incl.:	1.01	0.99	1.07	1.24	1.34	1.42	1.35	1.26	1.35	1.37	1.44	1.46
crude oil, including gas condensate												
3.4 Special tax for financial support of the strategic branches of the national economy	1.22	1.13	1.08	1.10	1.00	0.92	0.89	0.81	0.75	0.73	0.68	0.66
3.5 Other taxes on goods and services	0.03	0.02	0.02	0.02	0.02	0.02	0.10	0.12	0.12	0.13	0.13	0.14
4. Taxes on property	0.41	0.44	0.52	0.71	0.98	0.95	0.94	1.01	0.98	0.94	1.00	1.01
4.1 Tax on transactions with securities	0.08	0.06	0.08	0.08	0.07	0.07	0.07	0.07	0.07	0.06	0.06	0.05
4.2 Other taxes on property	0.33	0.38	0.44	0.64	0.90	0.88	0.86	0.94	0.91	0.88	0.94	0.96
5. Payments for use of natural resources	0.57	0.58	0.67	0.65	0.64	0.66	0.66	0.67	0.72	0.74	0.72	0.74
5.1 Payments for mineral resources	0.06	0.08	0.09	0.08	0.08	0.08	0.33	0.35	0.36	0.36	0.34	0.35
5.2 Allotments for reproduction of the mineral feedstock basis	0.09	0.10	0.11	0.10	0.10	0.11	0.11	0.12	0.14	0.15	0.14	0.14
5.3 Taxes on land and rental payments				0.01	0.01	0.01	0.13	0.14	0.17	0.18	0.19	0.20
5.4 Other payments for use of natural resources	0.42	0.40	0.47	0.46	0.44	0.46	0.09	0.06	0.05	0.05	0.05	0.05
6. Taxes on foreign trade and external economic operations, incl.:	0.88	1.33	1.44	1.76	1.74	1.60	1.58	1.53	1.54	1.50	1.47	1.46
6.1 Import duties	0.55	0.48	0.48	0.50	0.48	0.48	0.46	0.45	0.44	0.46	0.45	0.51
6.2 Other taxes on import								0.00	0.00	0.00	0.00	0.00
6.3 Export duties	0.33	0.85	0.96	1.26	1.26	1.11	1.12	1.08	1.10	1.04	1.02	0.95
7. Other taxes, duties, and levies	2.64	2.64	2.66	2.80	2.76	2.48	1.11	1.13	0.95	0.95	0.96	0.95
TOTAL TAXES AND PAYMENTS	21.53	21.50	22.99	25.13	25.63	24.73	23.21	22.85	22.14	21.69	21.68	21.67
NON-TAX INCOMES												
1. Incomes from State properties or activities	0.06	0.03	0.37	0.41	0.38	0.29	0.35	0.46	0.41	0.37	0.34	0.36
1.1 Transfer of profit from RF Central Bank			0.34	0.39	0.35	0.27	0.22	0.32	0.27	0.23	0.20	0.21
1.2 Other incomes from State properties or activities	0.06	0.03	0.02	0.03	0.02	0.02	0.14	0.15	0.15	0.14	0.14	0.15
2. Incomes from sale of State property	0.13	0.12	0.11	0.11	0.11	0.11	0.11	0.10	0.10	0.10	0.19	0.28
3. Incomes from sale of State stocks	1.04	2.07	1.75	0.29	0.22	0.18	0.15	0.20	0.32	0.38	0.87	0.80
4. Incomes from sale of land and non-material assets							0.00	0.00	0.00	0.00	0.00	0.00
5. Incoming capital transfers from non-State sources												
6. Administrative payments							0.02	0.02	0.02	0.02	0.10	0.04
7. Penalties	0.00	0.00	0.00	0.00	0.00	0.00	0.03	0.03	0.03	0.03	0.03	0.03
8. Levies on special services							0.00	0.00	0.00	0.00	0.00	0.00
9. Incomes from external economic activities, incl.:	0.84	0.84	1.06	2.19	1.82	1.63	1.41	1.38	1.34	1.29	1.26	1.21
centralized export	0.24	0.29	0.35	0.30	0.25	0.23	0.19	0.20	0.19	0.18	0.20	0.00
10. Other non-tax incomes	0.01	0.00	0.01	0.01	0.01	0.01	0.56	0.48	0.45	0.45	0.44	0.52
11. Free transfers							0.00	0.00	0.11	0.11	0.01	0.01
12. Free of charge transfers from other levels of power				x	x	x	ō	ō	ō	ō	ō	ō

12.1	Grants for closed administr. regions				x	x	x	0	0	0	0	0	0
12.2	Subventions				x	x	x	0	0	0	0	0	0
12.3	Assets transferred under mutual settlements				x	x	x	0	0	0	0	0	0
12.4	Transfers				x	x	x	0	0	0	0	0	0
13.	Other free of charge incomes							0.01	0.00	0.00	0.00	0.00	0.00
14.	Incomes from State-owned entities and institutions							0.03	0.04	0.04	0.04	0.04	0.04
15.	Inflows from incomes to the accounts of taxation bodies							0.20	0.16	0.14	0.05	0.05	0.04
TOTAL NON-TAX INCOMES		2.06	3.06	3.29	3.01	2.54	2.22	2.87	2.89	2.98	2.86	3.32	3.32
INCOMES FROM TARGETED BUDGET AND EXTRA-BUDGETARY FUNDS		0.02	0.02	0.03	0.06	0.08	0.12	0.58	1.11	1.27	1.17	1.23	1.20
Allotments to form targeted Budget funds (-)								0.20	0.08	0.08	0.08	0.10	0.11
TOTAL INCOMES		23.62	24.58	26.31	28.19	28.25	27.07	26.47	26.77	26.30	25.64	26.13	26.09
OUTLAYS													
1.	State administration	0.67	0.73	0.77	0.72	0.75	0.74	0.74	0.70	0.69	0.69	0.70	0.72
2.	International activities	0.73	0.75	0.61	0.80	0.84	1.12	1.07	0.95	0.97	0.96	1.17	1.30
3.	National defense	1.24	2.77	3.12	3.26	3.15	2.96	2.86	2.67	2.47	2.61	2.95	2.87
4.	Law enforcement and security	1.20	1.34	1.38	1.37	1.40	1.29	1.48	1.44	1.51	1.49	1.53	1.54
5.	Fundamental research and support of scientific and technical progress	0.12	0.27	0.40	0.32	0.36	0.37	0.33	0.31	0.30	0.31	0.33	0.29
6.	State-rendered services to national economy, incl.:	6.28	7.08	8.59	8.56	9.03	8.94	8.57	8.59	8.25	8.17	8.16	8.16
6.1	Industries, power industry, and construction	5.92	6.52	7.51	7.65	8.06	8.02	2.87	2.84	2.67	2.72	2.76	2.19
6.2	Rural economy and fishing	0.04	0.27	0.77	0.60	0.62	0.58	1.34	1.36	1.27	1.23	1.19	1.23
6.3	Protection of environment and of natural resources, hydro-meteorology, mapping, and geodesy	0.08	0.08	0.09	0.09	0.09	0.10	0.13	0.11	0.11	0.12	0.13	0.12
6.5	Transport, roads, telecommunications, and informatics	0.03	0.03	0.03	0.03	0.04	0.03	0.72	0.77	0.74	0.77	0.77	0.78
6.5	Development of market infrastructure							0.00	0.01	0.01	0.01	0.01	0.01
6.6	Housing and public utilities							3.30	3.31	3.28	3.14	3.12	3.66
6.7	Prevention and liquidation of consequences of emergency situations and disasters	0.21	0.19	0.19	0.19	0.22	0.21	0.20	0.19	0.18	0.17	0.18	0.17
7.	Social services	5.98	6.80	7.60	7.86	8.18	8.27	7.82	7.58	7.36	7.31	7.46	7.65
7.1	Education	2.85	3.15	3.41	3.43	3.71	3.86	3.59	3.42	3.31	3.27	3.34	3.40
7.2	Culture and arts	0.34	0.39	0.50	0.53	0.52	0.51	0.41	0.40	0.39	0.39	0.40	0.42
7.3	Mass media	0.09	0.05	0.11	0.10	0.10	0.10	0.15	0.14	0.14	0.13	0.14	0.14
7.4	Public health and physical culture	1.98	2.29	2.49	2.61	2.64	2.59	2.49	2.45	2.36	2.35	2.38	2.44
7.5	Social policy	0.72	0.92	1.09	1.19	1.21	1.21	1.17	1.17	1.17	1.17	1.20	1.25
8.	Servicing the State debt	2.36	1.45	2.13	3.22	2.10	2.01	1.86	1.63	2.35	1.59	1.50	1.50
8.1	Servicing the inner debt	0.76	0.60	1.05	1.95	0.95	0.81	0.68	0.62	1.30	0.59	0.55	0.56
8.2	Servicing the external debt	1.60	0.84	1.08	1.27	1.15	1.19	1.18	1.01	1.06	1.01	0.95	0.94
9.	Replenishment of State stocks and reserves	1.00	0.75	0.61	0.64	0.61	0.56	0.59	0.67	0.64	0.67	0.63	0.94
10.	Expenditures by State targeted Budget funds				0.03	0.07	0.13	0.35	0.77	0.91	0.81	0.87	1.00
11.	Other expenditures	1.85	1.53	1.58	1.73	1.84	1.82	1.64	1.65	1.56	1.52	1.92	1.68
11.1	Financial aid to other levels of power				x	x	x	0	0	0	0	0	0
	Grants transferred from budgets of the RF subjects for closed administr. regions				x	x	x	0	0	0	0	0	0
	Grants given to closed administr. regions				x	x	x	0	0	0	0	0	0
	Subventions				x	x	x	0	0	0	0	0	0
	Transfers for leveling of incomes				x	x	x	0	0	0	0	0	0
	Transfers due to VAT												
	Assets transferred under mutual settlements				x	x	x	0	0	0	0	0	0
11.2	Other expenditures not related to other items	1.85	1.53	1.58	1.73	1.84	1.82	1.64	1.65	1.56	1.52	1.92	1.68
TOTAL OUTLAYS		21.43	23.46	26.79	28.53	28.32	28.20	27.32	26.95	27.00	26.13	27.21	27.65
CREDITING MINUS REPAYMENT		3.60	1.83	2.31	2.27	1.98	2.03	1.88	1.75	2.02	2.01	1.68	1.73
1.	Loans from Budget	0.36	0.44	0.79	1.04	1.12	1.08	0.90	0.91	1.23	1.31	1.22	1.09
	Loans to budgets	0.33	0.45	0.65	0.66	0.65	0.70	0.25	0.19	0.15	0.12	0.07	0.08
	Repayment of loans by budgets							0.01	0.01	0.01	0.01	0.01	0.03
	Offset of loans by budgets				0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.00
	Loans from budgets granted to ministries, departments, entities, and organizations	0.16	0.12	0.27	0.50	0.58	0.50	0.96	0.95	1.14	1.26	1.18	1.10
	Repayment of loans by ministries, departments, entities, and organizations	0.13	0.13	0.13	0.12	0.11	0.11	0.30	0.21	0.19	0.21	0.22	0.24

Credit for goods									0.00	0.15	0.16	0.21	0.18
2. State credits to CIS countries			0.00	0.01	0.01	0.02	0.01	0.01	0.01	0.01	0.01	-0.04	-0.04
Credits granted			0.00	0.01	0.01	0.02	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Credits repaid								0.00	0.00	0.00	0.00	0.05	0.05
3. State credits to foreign Governments	-0.21	-0.24	-0.18	-0.24	-0.19	-0.20	-0.20	-0.22	-0.20	-0.18	-0.19	-0.16	
Credits granted	x	0.01	0.11	0.08	0.14	0.12	0.10	0.08	0.08	0.07	0.07	0.09	
Credits repaid	0.21	0.25	0.28	0.32	0.33	0.32	0.30	0.31	0.28	0.25	0.26	0.25	
4. Foreign crediting resources issued to entities and organizations	1.14	0.80	0.68	0.67	0.63	0.61	0.65	0.64	0.58	0.56	0.51	0.49	
Credits granted	1.19	0.87	0.73	0.72	0.66	0.64	0.68	0.66	0.60	0.56	0.53	0.51	
Credits repaid	0.05	0.06	0.05	0.04	0.04	0.03	0.03	0.03	0.02	0.00	0.02	0.02	
5. Credits for conversion needs	0.00	0.00	0.00	0.00	0.00	-0.01	-0.01	-0.01	-0.01	0.00	0.01	0.01	
Credits granted		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.02	
Credits repaid	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01	
6. Credits for investment needs	0.06	0.04	0.03	0.02	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.01	
Credits granted	0.06	0.04	0.03	0.02	0.02	0.01	0.01	0.01	0.01	0.01	0.01	0.01	
Credits repaid	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01	
7. Deficit of transfer of incomes by Central Bank	2.25	0.80	0.99	0.77	0.40	0.52	0.51	0.32	0.29	0.27	0.16	0.30	
8. Deficit of transfer of allotments from budgets of RF subjects in targeted budgetary funds								0.11	0.10	0.03	0.01	0.02	
TOTAL EXPENDITURES AND LOANS MINUS REPAYMENTS	25.03	25.29	29.09	30.79	30.30	30.23	29.19	28.70	29.02	28.14	28.89	29.38	
EXCESS OF INCOMES OVER EXPENDITURES AND LOANS MINUS REPAYMENTS	-1.41	-0.71	-2.79	-2.60	-2.05	-3.16	-2.72	-1.93	-2.71	-2.50	-2.76	-3.30	
GENERAL FINANCING													
1. Domestic financing													
1.1 Credits of the Russian Federation Central Bank for financing of the Budget deficit		1.45	1.36	0.88	0.66	0.41	0.15	0.03	-0.01	-0.01	-0.01	-0.07	
Credits received		1.45	1.36	0.97	0.73	0.56	0.45	0.37	0.31	0.27	0.24	0.21	
Repayment of principal debt				0.09	0.07	0.16	0.30	0.34	0.32	0.28	0.24	0.28	
1.2 Change of the balances of the Budget assets at the bank ruble accounts	-1.01	-2.30	-1.00	-1.22	-1.18	-0.66	-0.48	-0.41	-0.25	-0.31	-0.46	-0.14	
Balances as of the beginning of the period	5.52	2.74	1.74	1.27	0.95	0.75	0.60	0.49	0.41	0.36	0.31	0.28	
Balances as of the end of the period	6.52	5.04	2.74	2.49	2.13	1.41	1.07	0.90	0.67	0.67	0.78	0.42	
1.3 State short-term bonds (GKO)	0.87	1.33	1.38	1.52	1.69	2.01	1.77	1.58	1.50	1.60	1.63	1.66	
Mobilization of assets	0.87	1.33	1.38	1.52	1.69	2.01	1.90	1.69	1.60	1.68	1.70	1.72	
Repayment of principal debt								0.12	0.11	0.09	0.08	0.07	0.06
1.4 Saving loan								0.00	0.07	0.13	0.12	0.12	
Mobilization of assets								0.00	0.07	0.13	0.12	0.12	
Repayment of principal debt											0.00	0.00	
1.5 "Golden" certificates		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Mobilization of assets							0.00	0.00	0.00	0.00	0.00	0.00	
Repayment of principal debt		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
1.6 State Treasury bills					-0.11	-0.08	-0.07	-0.12	-0.10	-0.09	-0.07	-0.09	
Mobilization of assets											0.00	0.00	
Repayment of principal debt					0.11	0.08	0.07	0.12	0.10	0.09	0.07	0.09	
1.7 Treasury bonds	-0.06	0.52	1.64	1.20	0.61	0.34	0.21	-0.04	0.63	0.00	0.08	-0.03	
Mobilization of assets	0.01	1.21	2.25	1.96	1.64	1.56	1.49	1.36	1.32	1.34	1.32	1.32	
Repayment of principal debt	0.07	0.69	0.61	0.76	1.04	1.22	1.28	1.40	0.69	1.34	1.24	1.35	
1.8 Other State securities	-0.10	-0.09	-0.11	-0.11	-0.09	-0.09	-0.07	-0.08	-0.08	-0.07	-0.04	0.03	
Mobilization of assets											0.03	0.15	
Repayment of principal debt	0.10	0.09	0.11	0.11	0.09	0.09	0.07	0.08	0.08	0.07	0.07	0.12	
1.9 Credits from State extra-budgetary funds													
Mobilization of assets													
Repayment of principal debt													
1.10 Budget loans granted by upper budgets	0.02	0.09	0.16	0.16	0.15	0.23	0.18	0.16	0.14	0.11	0.05	0.05	
Grant of loans	0.02	0.09	0.16	0.16	0.15	0.23	0.19	0.16	0.14	0.12	0.05	0.05	
Offset of loans								0.00	0.00	0.00	0.10	0.10	
Repayment of loans							0.00	0.01	0.01	0.01	0.05	0.05	
1.11 Other domestic borrowings	0.00	0.05	0.07	-0.11	-0.01	0.09	0.10	0.12	0.14	0.13	0.22	0.24	
Mobilization of assets	0.21	0.18	0.19	0.19	0.25	0.31	0.27	0.28	0.28	0.30	0.41	0.40	
Repayment of principal debt	0.21	0.12	0.11	0.30	0.26	0.21	0.16	0.16	0.15	0.17	0.19	0.16	
TOTAL DOMESTIC FINANCING	-0.27	1.06	3.49	2.32	1.72	2.25	1.80	1.24	2.03	1.50	1.52	1.77	
2. External financing													

2.1 Credits by international financial institutions	0.46	0.29	0.24	1.81	1.93	1.46	1.53	1.50	1.50	1.70	1.66	1.78
Reception of credits	0.09	0.06	0.06	1.64	1.82	1.44	1.51	0.07	0.07	0.07	0.07	1.78
- tied	0.09	0.06	0.05	0.06	0.05	0.06	0.07	0.07	0.07	0.07	0.07	0.07
- untied	0.00	0.01	0.00	1.58	1.77	1.38	1.44	0.00	0.00	0.00	0.00	1.71
Rate difference by credits	0.37	0.23	0.19	0.17	0.11	0.02	0.03	1.44	1.43	1.63	1.59	0.00
- tied	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
- untied	0.37	0.23	0.19	0.17	0.11	0.02	0.03	1.44	1.43	1.63	1.59	0.00
Repayment of main debt by credits	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
- tied								0.00	0.00	0.00	0.00	0.00
- untied								0.00	0.00	0.00	0.00	0.00
2.2 Credits by Governments of foreign States, foreign commercial banks and firms, granted to the Russian Federation	-2.33	-1.14	-0.78	-0.74	-0.78	-0.69	-0.50	-0.57	-0.57	-0.44	-0.37	-0.37
Reception (use) of credits	1.10	0.81	0.68	0.66	0.62	0.58	0.62	0.59	0.53	0.49	0.46	0.44
Repayment of main debt by credits	3.43	1.95	1.46	1.39	1.39	1.27	1.11	1.16	1.10	0.94	0.84	0.81
2.3 Credits by Vneshtorgbank												
Reception of credits												
Repayment of main debt by credits												
2.4 Changes of balances of Budget assets at bank accounts in foreign currencies	3.56	0.89	0.09	-0.80	-0.82	0.14	-0.11	-0.25	-0.24	-0.28	-0.04	0.11
Balances as of the beginning of a period				1.71	1.28	0.99	0.80	0.65	0.55	0.48	0.42	0.37
Balances as of the end of a period				2.51	2.10	0.85	0.91	0.91	0.80	0.76	0.46	0.26
2.5 Other external financing		-0.40	-0.25									
Reception of credits												
Rate differences												
Repayment of main debt by credits		0.40	0.25									
TOTAL FOREIGN FINANCING	1.69	-0.35	-0.71	0.27	0.33	0.91	0.92	0.69	0.69	0.97	1.24	1.53
TOTAL FINANCING	1.41	0.71	2.79	2.6	2.05	3.16	2.72	1.19	2.71	2.48	2.76	3.3
FOR INFORMATION:												
Arrears (% of GDP), total	24.41	24.22	21.83	28.23	31.66	27.09	26.04	31.17	29.81	30.17	34.91	29.07
VAT	12.15	12.24	11.44	12.84	11.85	10.84	12.00	12.47	13.00	14.63	14.93	13.48
Profit tax	5.14	4.63	4.09	8.26	11.05	8.79	7.05	10.40	9.41	8.13	11.21	8.75
Personal income tax	0.02	0.01	0.01	0.01	0.01	0.01	0.04	0.04	0.03	0.02	0.04	0.03

Table 2.3

Execution of Russia's 1995 Republican Budget, % of GDP

Parameters	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
INCOMES												
1. Income taxes, profit taxes	1.76	1.78	2.33	2.81	3.16	3.04	2.93	3.06	2.95	2.80	2.73	2.67
1.1 Profit tax	1.74	1.76	2.21	2.63	2.97	2.84	2.73	2.85	2.75	2.60	2.54	2.47
1.2 Personal income tax	0.01	0.01	0.12	0.19	0.19	0.20	0.20	0.20	0.19	0.19	0.19	0.20
1.3 Other taxes on income or profit				0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2. Taxes on labor payment fund							0.00	0.00	0.00	0.00	0.00	0.00
3. Taxes on goods and services	6.96	6.12	5.81	5.98	5.82	5.71	5.83	5.51	5.51	5.92	6.00	5.81
3.1 VAT on the goods and services produced and rendered in the RF territory	4.84	4.09	3.90	3.85	3.68	3.52	3.65	3.45	3.36	3.78	3.78	3.63
3.2 VAT on the goods imported to the RF territory	0.54	0.58	0.51	0.58	0.58	0.60	0.63	0.65	0.65	0.65	0.68	0.64
3.3 Excise taxes, incl.:	0.60	0.57	0.62	0.79	0.88	0.96	0.91	0.83	0.95	0.96	1.04	1.07
crude oil, including gas condensate							0.00	0.46	0.41	0.31	0.00	0.35
3.4 Special tax for financial support of the strategic branches of the national economy	0.97	0.88	0.78	0.76	0.69	0.63	0.61	0.55	0.51	0.50	0.46	0.44
3.5 Other taxes on goods and services	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.03	0.04	0.04	0.04	0.05
4. Taxes on property	0.06	0.06	0.07	0.07	0.07	0.07	0.07	0.07	0.06	0.06	0.06	0.05
4.1 Tax on transactions with securities	0.06	0.06	0.07	0.07	0.07	0.07	0.07	0.07	0.06	0.06	0.06	0.05
4.2 Other taxes on property							0.00	0.00	0.00	0.00	0.00	0.00
5. Royalties for the use of natural resources	0.15	0.18	0.20	0.19	0.19	0.20	0.19	0.18	0.20	0.21	0.19	0.18
5.1 Payments for mineral resources	0.06	0.08	0.09	0.08	0.08	0.08	0.06	0.06	0.07	0.07	0.06	0.06
5.2 Allotments for reproduction of the mineral feedstock basis	0.09	0.10	0.11	0.10	0.10	0.11	0.09	0.09	0.11	0.11	0.10	0.10
5.3 Taxes on land and rental payments				0.01	0.01	0.01	0.02	0.02	0.01	0.02	0.01	0.01
5.4 Other payments for use of natural resources	0.00	0.00	0.01		0.00	0.00	0.02	0.02	0.02	0.02	0.01	0.01
6. Taxes on foreign trade and external economic operations, incl.:	0.85	1.31	1.42	1.74	1.73	1.59	1.58	1.53	1.54	1.50	1.46	1.46
6.1 Import duties	0.52	0.46	0.47	0.49	0.48	0.47	0.46	0.45	0.44	0.46	0.45	0.51
6.2 Other taxes on import									0.00	0.00	0.00	0.00
6.3 Export duties	0.33	0.85	0.96	1.26	1.26	1.11	1.12	1.08	1.10	1.04	1.02	0.95

7. Other taxes, duties, and levies	0.20	0.18	0.18	0.19	0.18	0.18	0.14	0.12	0.11	0.12	0.11	0.10
TOTAL TAXES AND PAYMENTS	9.97	9.63	10.02	10.99	11.16	10.79	10.73	10.47	10.38	10.62	10.56	10.28
NON-TAX INCOMES												
1. Incomes from State properties or activities	0.06	0.03	0.37	0.41	0.38	0.29	0.24	0.34	0.29	0.25	0.22	0.23
1.1 Transfer of profit from RF Central Bank			0.34	0.39	0.35	0.27	0.22	0.32	0.27	0.23	0.20	0.21
1.2 Other incomes from State properties or activities	0.06	0.03	0.02	0.03	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
2. Incomes from sale of State property	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.03	0.03	0.11	0.21
3. Incomes from sale of State stocks	1.04	2.07	1.75	0.29	0.22	0.18	0.15	0.20	0.32	0.38	0.87	0.80
4. Incomes from sale of land and non-material assets									0.00	0.00	0.00	0.00
5. Incoming capital transfers from non-State sources									0.00	0.00	0.00	0.00
6. Administrative payments							0.00	0.00	0.00	0.01	0.08	0.02
7. Penalties	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01
8. Levies on special services								0.00	0.00	0.00	0.00	0.00
9. Incomes from external economic activities, incl.:	0.84	0.84	1.06	2.19	1.82	1.63	1.40	1.37	1.34	1.29	1.25	1.20
centralized export		0.29	0.35	0.30	0.25	0.23	0.19	0.20	0.19	0.18	0.20	0.00
10. Other non-tax incomes	0.01	0.00	0.01	0.01	0.01	0.01	0.04	0.03	0.05	0.04	0.04	0.04
11. Free transfers		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
12. Free of charge transfers from other levels of power		0.01	0.01	0.01	0.01	0.00	0.00	0.01	0.01	0.01	0.01	0.01
12.1 Grants for closed administr. regions									0.00	0.00	0.00	0.00
12.2 Subventions									0.00	0.00	0.00	0.00
12.3 Assets transferred under mutual settlements		0.01	0.01	0.01	0.01	0.00	0.00	0.01	0.01	0.01	0.01	0.01
12.4 Transfers									0.00	0.00	0.00	0.00
13. Other free of charge incomes									0.00	0.00	0.00	0.00
14. Incomes from State-owned entities and institutions									0.00	0.00	0.00	0.00
15. Inflows from incomes to the accounts of taxation bodies							0.20	0.16	0.14	0.05	0.05	0.04
TOTAL NON-TAX INCOMES	1.95	2.97	3.20	2.92	2.45	2.13	2.07	2.15	2.17	2.06	2.63	2.55
INCOMES FROM TARGETED BUDGET AND EXTRA-BUDGETARY FUNDS				0.02	0.06	0.10	0.32	0.79	0.94	0.85	0.92	0.93
Allotments to form targeted Budget funds (-)							0.20	0.08	0.08	0.08	0.08	0.08
TOTAL INCOMES	11.93	12.60	13.22	13.92	13.66	13.01	12.93	13.33	13.41	13.45	14.03	13.68
OUTLAYS												
1. State administration	0.32	0.33	0.33	0.26	0.31	0.29	0.30	0.28	0.27	0.27	0.27	0.27
2. International activities	0.73	0.75	0.61	0.80	0.84	1.12	1.07	0.95	0.97	0.96	1.17	1.30
3. National defense	1.24	2.77	3.12	3.26	3.15	2.96	2.86	2.67	2.47	2.61	2.95	2.87
4. Law enforcement and security	1.16	1.30	1.35	1.35	1.37	1.26	1.16	1.14	1.14	1.15	1.18	1.16
5. Fundamental research and support of scientific and technical progress	0.11	0.25	0.38	0.30	0.34	0.34	0.31	0.30	0.28	0.29	0.31	0.29
6. State-rendered services to national economy, incl.:	1.38	1.97	2.69	2.34	2.72	2.70	2.41	2.39	2.23	2.27	2.25	2.18
6.1 Industries, power industry, and construction	1.02	1.41	1.62	1.44	1.75	1.78	1.63	1.61	1.54	1.58	1.59	1.55
6.2 Rural economy and fishing	0.04	0.27	0.77	0.60	0.62	0.58	0.48	0.50	0.43	0.43	0.40	0.37
6.3 Protection of environment and of natural resources, hydro-meteorology, mapping, and geodesy	0.08	0.08	0.09	0.09	0.09	0.10	0.09	0.09	0.09	0.09	0.09	0.08
6.5 Transport, roads, telecommunications, and informatics	0.03	0.03	0.03	0.03	0.04	0.03	0.03	0.03	0.03	0.03	0.03	0.03
6.5 Development of market infrastructure									0.00	0.00	0.00	0.00
6.6 Housing and public utilities									0.00	0.00	0.00	0.00
6.7 Prevention and liquidation of consequences of emergency situations and disasters	0.20	0.18	0.19	0.17	0.22	0.20	0.18	0.17	0.16	0.15	0.15	0.15
7. Social services	0.52	0.92	1.17	0.97	1.27	1.29	1.18	1.12	1.06	1.10	1.17	1.12
7.1 Education	0.33	0.48	0.53	0.39	0.63	0.66	0.57	0.53	0.51	0.52	0.56	0.52
7.2 Culture and arts	0.01	0.04	0.07	0.07	0.07	0.07	0.06	0.06	0.06	0.07	0.08	0.07
7.3 Mass media	0.09	0.05	0.11	0.10	0.10	0.10	0.11	0.10	0.09	0.09	0.10	0.10
7.4 Public health and physical culture	0.02	0.18	0.24	0.22	0.26	0.25	0.24	0.24	0.20	0.23	0.23	0.21
7.5 Social policy	0.06	0.17	0.22	0.19	0.21	0.20	0.20	0.20	0.19	0.20	0.21	0.23
8. Servicing the State debt	2.36	1.45	2.13	3.22	2.10	2.01	1.86	1.63	2.35	1.59	1.50	1.50
8.1 Servicing the inner debt	0.37	0.60	1.05	1.95	0.95	0.81	0.68	0.62	1.30	0.59	0.55	0.56
8.2 Servicing the external debt	0.78	0.84	1.08	1.27	1.15	1.19	1.18	1.01	1.06	1.01	0.95	0.94
9. Replenishment of State stocks and reserves	1.00	0.75	0.61	0.64	0.61	0.56	0.59	0.67	0.64	0.67	0.63	0.94
10. Expenditures by State targeted Budget funds				0.03	0.07	0.13	0.35	0.77	0.91	0.81	0.87	0.85
11. Other expenditures	1.69	1.84	2.11	2.12	2.10	1.93	2.05	2.01	2.03	2.50	2.99	2.76
11.1 Financial aid to other levels of power	1.01	1.42	1.75	1.64	1.49	1.30	1.22	1.20	1.24	1.69	1.76	1.76
Grants transferred from budgets of the RF	0.04	0.04	0.05				0.00	0.00	0.00	0.00	0.00	0.00

subjects for closed administr. regions												
Grants given to closed administr. regions	0.05	0.05	0.05	0.10	0.09	0.08	0.08	0.07	0.07	0.06	0.06	0.06
Subventions		0.08	0.09	0.11	0.11	0.11	0.11	0.11	0.10	0.11	0.11	0.12
Transfers for leveling of incomes	0.64	0.59	0.80	0.81	0.79	0.68	0.67	0.67	0.72	0.76	0.83	0.86
Transfers due to VAT										0.40	0.35	0.31
Assets transferred under mutual settlements	0.28	0.66	0.76	0.62	0.50	0.42	0.37	0.35	0.35	0.36	0.41	0.42
11.2 Other expenditures not related to other items	0.68	0.42	0.36	0.48	0.61	0.63	0.82	0.81	0.79	0.81	1.23	1.00
TOTAL OUTLAYS	10.50	12.32	14.49	15.30	14.88	14.60	14.14	13.91	14.36	14.23	15.31	15.24
CREDITING MINUS REPAYMENT	3.29	1.47	1.81	1.76	1.48	1.56	1.50	1.35	1.60	1.61	1.32	1.37
1. Loans from Budget	0.05	0.07	0.30	0.53	0.62	0.61	0.53	0.50	0.81	0.93	0.86	0.73
Loans to budgets	0.02	0.09	0.16	0.16	0.15	0.23	0.18	0.16	0.14	0.11	0.05	0.05
Repayment of loans by budgets							0.00	0.00	0.00	0.00	0.00	0.01
Offset of loans by budgets				0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.00
Loans from budgets granted to ministries, departments, entities, and organizations	0.16	0.12	0.27	0.50	0.58	0.50	0.45	0.46	0.62	0.76	0.69	0.60
Repayment of loans by ministries, departments, entities, and organizations	0.13	0.13	0.13	0.12	0.11	0.11	0.11	0.10	0.08	0.08	0.08	0.09
Credit for goods									0.15	0.16	0.21	0.18
2. State credits to CIS countries			0.00	0.01	0.01	0.02	0.01	0.01	0.01	0.01	-0.04	-0.04
Credits granted			0.00	0.01	0.01	0.02	0.01	0.01	0.01	0.01	0.01	0.01
Credits repaid							0.00	0.00	0.00	0.00	0.05	0.05
3. State credits to foreign Governments	-0.21	-0.24	-0.18	-0.24	-0.19	-0.20	-0.20	-0.22	-0.20	-0.18	-0.19	-0.16
Credits granted	0.00	0.01	0.11	0.08	0.14	0.12	0.10	0.08	0.08	0.07	0.07	0.09
Credits repaid	0.21	0.25	0.28	0.32	0.33	0.32	0.30	0.31	0.28	0.25	0.26	0.25
4. Foreign crediting resources issued to entities and organizations	1.14	0.80	0.68	0.67	0.63	0.61	0.65	0.64	0.58	0.54	0.51	0.49
Credits granted	1.19	0.87	0.73	0.72	0.66	0.64	0.68	0.66	0.60	0.56	0.53	0.51
Credits repaid	0.05	0.06	0.05	0.04	0.04	0.03	0.03	0.03	0.02	0.02	0.02	0.02
5. Credits for conversion needs	0.00	0.00	0.00	0.00	0.00	-0.01	-0.01	-0.01	-0.01	0.00	0.01	0.01
Credits granted		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.02
Credits repaid	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01
6. Credits for investment needs	0.06	0.04	0.03	0.02	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.01
Credits granted	0.06	0.04	0.03	0.02	0.02	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Credits repaid	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01
7. Deficit of transfer of incomes by Central Bank	2.25	0.80	0.99	0.77	0.40	0.52	0.51	0.32	0.29	0.27	0.16	0.30
8. Deficit of transfer of allotments from budgets of RF subjects in targeted budgetary funds								0.11	0.10	0.03	0.01	0.02
TOTAL EXPENDITURES AND LOANS MINUS REPAYMENTS	13.79	13.78	16.30	17.05	16.36	16.15	15.64	15.26	15.96	15.84	16.63	16.61
EXCESS OF INCOMES OVER EXPENDITURES AND LOANS MINUS REPAYMENTS	-1.86	-1.19	-3.08	-3.13	-2.70	-3.14	-2.71	-1.93	-2.55	-2.39	-2.60	-2.94
GENERAL FINANCING												
1. Domestic financing												
1.1 Credits of the Russian Federation Central Bank for financing of the Budget deficit		1.45	1.36	0.88	0.66	0.41	0.15	0.03	-0.01	-0.01	-0.01	-0.07
Credits received		1.45	1.36	0.97	0.73	0.56	0.45	0.37	0.31	0.27	0.24	0.21
Repayment of principal debt				0.09	0.07	0.16	0.30	0.34	0.32	0.28	0.24	0.28
1.2 Change of the balances of the Budget assets at the bank ruble accounts	-0.53	-1.68	-0.47	-0.46	-0.30	-0.26	-0.13	-0.12	-0.13	-0.13	-0.32	-0.14
Balances as of the beginning of the period	0.20	0.10	0.06	0.07	0.05	0.06	0.05	0.04	0.03	0.03	0.02	0.02
Balances as of the end of the period	0.73	1.78	0.53	0.53	0.36	0.31	0.17	0.15	0.16	0.16	0.34	0.16
1.3 State short-term bonds (GKO)	0.87	1.33	1.38	1.52	1.69	2.01	1.77	1.58	1.50	1.60	1.63	1.66
Mobilization of assets	0.87	1.33	1.38	1.52	1.69	2.01	1.90	1.69	1.60	1.68	1.70	1.72
Repayment of principal debt							0.12	0.11	0.09	0.08	0.07	0.06
1.4 Saving loan									0.07	0.13	0.12	0.12
Mobilization of assets									0.07	0.13	0.12	0.12
Repayment of principal debt									0.00	0.00	0.00	0.00
1.5 "Golden" certificates		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Mobilization of assets							0.00	0.00	0.00	0.00	0.00	0.00
Repayment of principal debt		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1.6 State Treasury bills					-0.11	-0.08	-0.07	-0.12	-0.10	-0.09	-0.07	-0.09
Mobilization of assets						0.00	0.00	0.00	0.00	0.00	0.00	0.00
Repayment of principal debt					0.11	0.08	0.07	0.12	0.10	0.09	0.07	0.09
1.7 Treasury bonds	-0.06	0.52	1.64	1.20	0.61	0.34	0.21	-0.04	0.63	0.00	0.08	-0.03
Mobilization of assets	0.01	1.21	2.25	1.96	1.64	1.56	1.49	1.36	1.32	1.34	1.32	1.32
Repayment of principal debt	0.07	0.69	0.61	0.76	1.04	1.22	1.28	1.40	0.69	1.34	1.24	1.35
1.8 Other State securities	-0.10	-0.09	-0.11	-0.11	-0.09	-0.09	-0.07	-0.08	-0.08	-0.07	-0.04	-0.04
Mobilization of assets	0.00					0.00	0.00	0.00	0.00	0.00	0.03	0.02
Repayment of principal debt	0.10	0.09	0.11	0.11	0.09	0.09	0.07	0.08	0.08	0.07	0.07	0.06
1.9 Credits from State extra-budgetary funds									0.00	0.00	0.00	0.00

Mobilization of assets										0.00	0.00	0.00	0.00
Repayment of principal debt										0.00	0.00	0.00	0.00
1.10 Budget loans granted by upper budgets										0.00	0.00	0.00	0.00
Grant of loans										0.00	0.00	0.00	0.00
Offset of loans										0.00	0.00	0.00	0.00
Repayment of loans										0.00	0.00	0.00	0.00
1.11 Other domestic borrowings	0.00	0.00		-0.18	-0.09	-0.10	-0.08	-0.02	-0.02	-0.03	-0.04	-0.01	
Mobilization of assets	0.00	0.00			0.05	0.00	0.00	0.05	0.04	0.03	0.03	0.05	
Repayment of principal debt				0.18	0.13	0.10	0.08	0.07	0.06	0.06	0.07	0.06	
TOTAL DOMESTIC FINANCING	0.17	1.54	3.79	2.86	2.37	2.23	1.78	1.24	1.86	1.42	1.35	1.41	
2. External financing													
2.1 Credits by international financial institutions	0.46	0.29	0.24	1.81	1.93	1.46	1.53	1.50	1.50	1.70	1.66	1.78	
Reception of credits	0.09	0.06	0.06	1.64	1.82	1.44	1.51	1.51	0.07	0.07	0.07	1.78	
- tied	0.09	0.06	0.05	0.06	0.05	0.06	0.07	0.07	0.07	0.07	0.07	0.07	
- untied	0.00	0.01	0.00	1.58	1.77	1.38	1.44	1.44	0.00	0.00	0.00	1.71	
Rate difference by credits	0.37	0.23	0.19	0.17	0.11	0.02	0.03	0.00	1.43	1.63	1.59	0.00	
- tied	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
- untied	0.37	0.23	0.19	0.17	0.11	0.02	0.03	0.00	1.43	1.63	1.59	0.00	
Repayment of main debt by credits	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
- tied							0.00	0.00	0.00	0.00	0.00	0.00	
- untied							0.00	0.00	0.00	0.00	0.00	0.00	
2.2 Credits by Governments of foreign States, foreign commercial banks and firms, granted to the Russian Federation	-2.33	-1.14	-0.78	-0.74	-0.78	-0.69	-0.50	-0.57	-0.57	-0.44	-0.37	-0.37	
Reception (use) of credits	1.10	0.81	0.68	0.66	0.62	0.58	0.62	0.59	0.53	0.49	0.46	0.44	
Repayment of main debt by credits	3.43	1.95	1.46	1.39	1.39	1.27	1.11	1.16	1.10	0.94	0.84	0.81	
2.3 Credits By Vneshtorgbank													
Reception of credits													
Repayment of main debt by credits													
2.4 Changes of balances of Budget assets at bank accounts in foreign currencies	3.56	0.89	0.09	-0.80	-0.82	0.14	-0.10	-0.25	-0.24	-0.28	-0.04	0.12	
Balances as of the beginning of a period				1.71	1.28	0.99	0.79	0.65	0.55	0.47	0.41	0.37	
Balances as of the end of a period				2.51	2.10	0.85	0.90	0.89	0.79	0.75	0.46	0.25	
2.5 Other external financing		-0.40	-0.25										
Reception of credits													
Rate differences													
Repayment of main debt by credits		0.40	0.25										
TOTAL FOREIGN FINANCING	1.69	-0.35	-0.71	0.27	0.33	0.91	0.93	0.69	0.69	0.98	1.25	1.53	
TOTAL FINANCING	1.86	1.19	3.08	3.13	2.70	3.14	2.71	1.93	2.55	2.39	2.60	2.94	
FOR INFORMATION:													
Arrears (% of GDP), total	14.48	14.90	13.69	16.16	16.16	14.59	15.24	16.82	16.49	17.37	18.68	15.87	
VAT	7.97	8.19	7.73	8.45	7.78	7.47	8.73	9.17	9.53	10.58	10.84	9.80	
Profit tax	1.96	1.81	1.76	3.40	4.27	3.38	2.84	4.10	3.76	3.25	4.36	3.49	

Tables 2.2 and 2.3 show that the situation with the execution of 1995 Budget was, on the whole, stable. In 1995, the incomes of the consolidated Budget amounted to 26.1% of GDP. As for the incomes of the Republican Budget, they amounted to 13.7% of GDP, or about 13.85% of GDP taking into account the final turnovers of 1995 (see Figures 2.1 and 2.2).

The expenditures of the Federal Budget were accomplished as the incomes, assets from the financial market, external credits, and the credit of the first quarter of 1995 by the Central Bank to the RF Government to cover the cash gaps (1.36% of GDP) were coming. Thus, the order of financing of the Government, approved by the Law on Budget for 1995, excluding the credits by the Central Bank (except the one mentioned above) from its sources, had a serious influence on the improvement of the responsibility for the Budget expenditures.

During the six months, the expenditures of the Federal Budget amounted to 98% of the ones planned for the first half-year. The largest percentages of the half-year plan accomplishment are seen in the replenishment of the State stocks and reserves (300%), miscellaneous (138%), and the expenditures on the international activities (198%). The lowest percentages have been recorded in the social and cultural events (78%), the science (84%) and in the national economy (84%). The expenditures on the defense were financed by 87% of the planned, the expenditures on the laws enforcement were financed by 99% of the planned.

In the first six months of 1995, the expenditures of the consolidated Budget amounted to 28.2% of GDP (compared with the 1994's 37.8% of GDP); the expenditures and loans minus repayments made 30.2% of GDP (compared with the 1994's 41.5% of GDP).

Fig. 2.1

Revenues, Outlays, and Deficit of the RF 1995 Federal Budget (% of GDP)

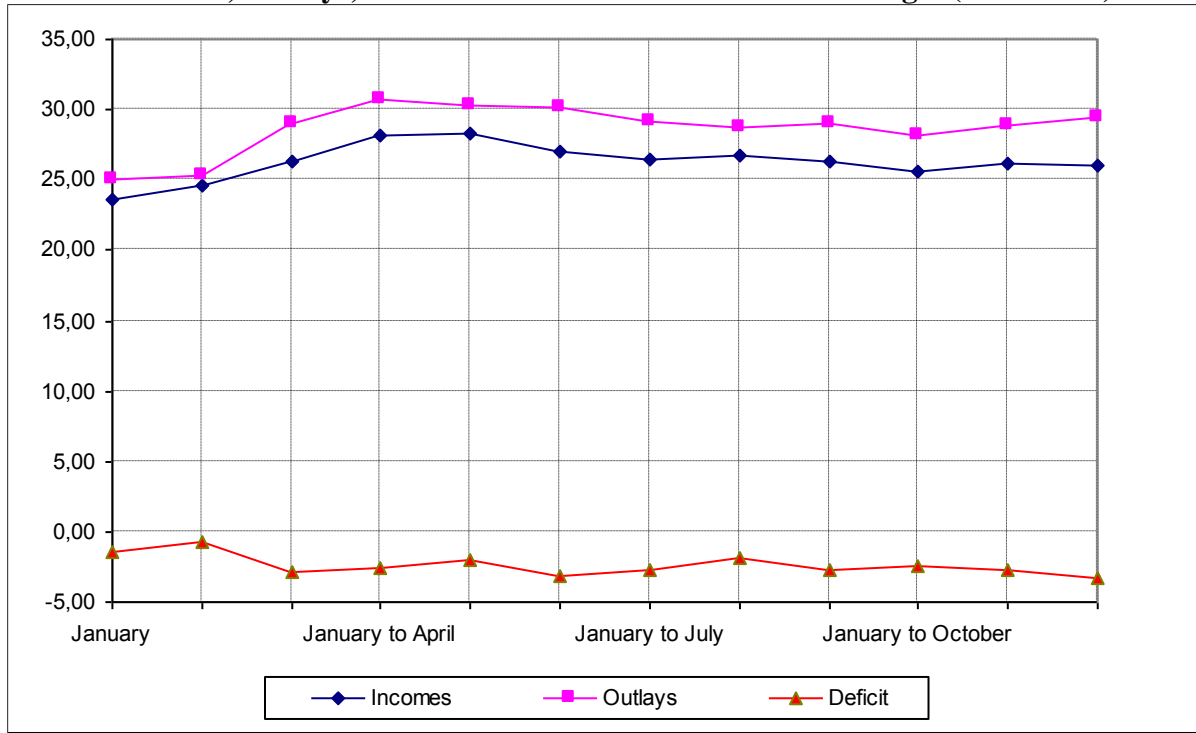
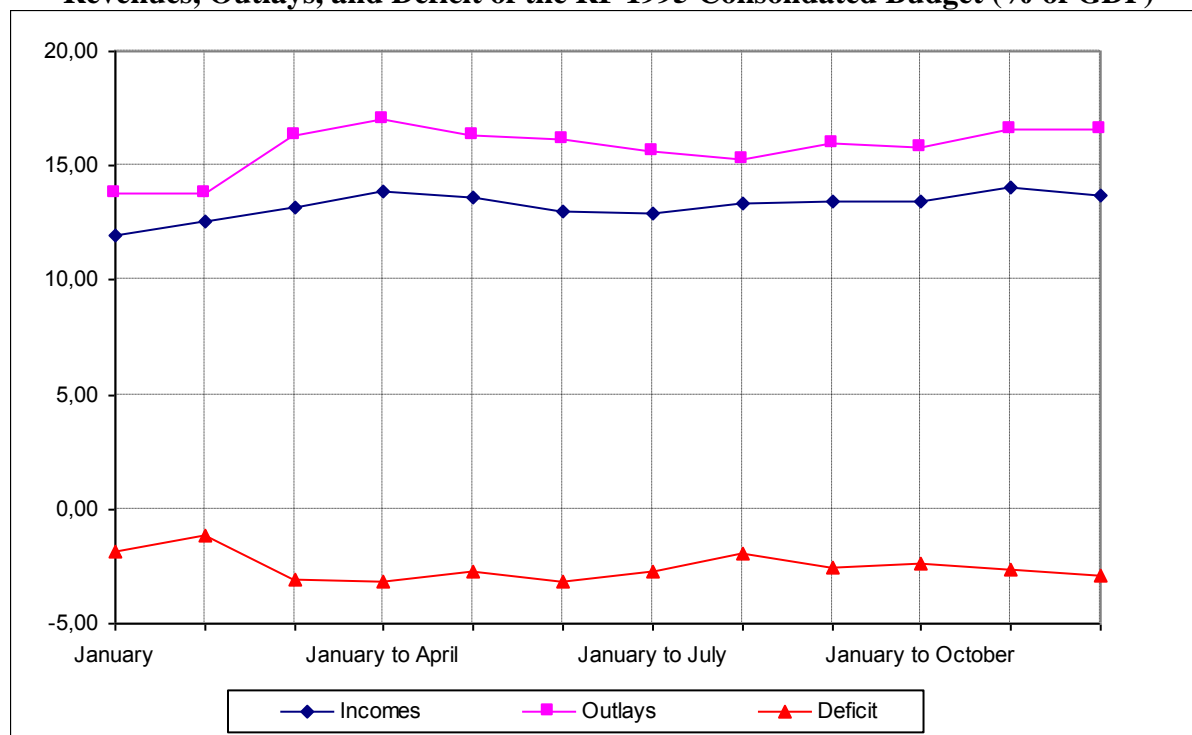


Fig. 2.2

Revenues, Outlays, and Deficit of the RF 1995 Consolidated Budget (% of GDP)

As of the third quarter of 1995, the slowdown of the trend toward the reduction of the actual expenditures by the main items of the Federal Budget should be noted. Nevertheless, to the end of the year, the expenditures decreased again; for the whole year they amounted to the following: 0.27% of GDP for the State administration; 2.87% of GDP for the defense; 1.16% for the law enforcement; 0.29% of GDP for the science; 2.18% of GDP for the national economy; and 1.12% of GDP for the social purposes. At the same time, the expenditures on the replenishment of the State stocks, the expenditures of the targetted budgetary funds, and the miscellaneous expenditures grew.

As of 1995 on the whole, the expenditures Budget (despite a certain increase of the expenditures in the last months of the year) was executed by 94.18%, compared with the values fixed by the December draft of the RF Law "On the 1996 Federal Budget". As of 1995, the expenditures of the Federal Budget amounted to 15.2% of GDP; the expenditures and loans minus repayments amounted to 16.6% of GDP; and, taking into account the final turnover, they amounted to 16.9% of GDP. The main expenditures items were financed by no more than 90%, including: 87.05% for the State administration; 83.23% for the defense and law enforcement bodies; 86.93% for the national economy; and 78.45% for the social services.

The above data show that, in the expression, the expenditures decreased, in 1995, by 34% and by 21%, compared with the preceding year, for the Federal Budget and for the consolidated Budget, respectively.

As it is known, the draft 1995 Budget supposed that from the Rb30.6 trln of the domestic loans, about one third of this sum would be received from the issue of the Treasury bonds. But during the discussion on the Declaration of the Government and Central Bank of the RF on the economic policy for 1995, the decision was made to refuse the net issuing of these securities because they were allocated under the interest much lower than the market one. Instead, the Ministry of Finance developed the new instrument of borrowing, namely, the federal loans (Resolution of the RF Government of 15 May 1995, # 458). These securities are coupon bonds distributed for one-year

term under floating yield, to be determined in accordance with the dynamics of dividends on the GKO's.

The 1995 Budget deficit was financed from domestic sources in the volume of 1.41% of GDP and from foreign sources in the volume of 1.53% of GDP. The deficit financing was accomplished by 77.31%. The domestic financing was accomplished by 77.95%, and the foreign financing was accomplished by 76.67%.

Among the domestic sources of financing, the largest ones are the GKO's and the OFZs, amounting to 1.66% of GDP. The saving loan gave 0.06% of GDP. The financing is negative from the Central Bank credits (-0.07% of GDP), as well, as from the treasury bills and bonds (-0.12% of GDP). The balances of the Budget assets at bank accounts dropped by 0.14% of GDP.

The credits by international financing institutions amounted already to 1.78% of GDP. The net financing from the credits of foreign governments and foreign commercial banks and firms was negative: -0.37%. The balances of the Budget assets at bank accounts in foreign currencies dropped by 0.12% of GDP.

The above data show that the today's tightening of the budget policy may be compared, we dare say, only with the changes of 1992, when the Government managed to reduce significantly the Budget expenses due to the similarity of the macroeconomic situation, when the prices leap after their liberalization was much higher than the Budget calculations supposed. As it should have been expected, the underestimate of the inflation rates of 1995, assumed in the Budget calculations, facilitated significantly the process of its execution. The revenues accumulated allowed to finance more fully than in the preceding years the nominally (in the approved draft) high, but in reality significantly depreciated expenses of the Federal Government. Nevertheless, contrary to the 1992's situation, the today's budget restrictions are perceived by the economic agents much more calmly. According to the data from the IET's interviews with managers of various industries entities, from the press, from the results of hearings in the Duma, the receivers of the assets from the Budget complain, mainly, not the low volumes of financing, but the lower financing compared with the plan. In 1995, this financing, as it has been noted above, was not very high compared with 1994.

Taxation Policy

As in the previous years, in 1995, the dynamics of the tax revenues was to a great extent determined by the changes introduced into the legal and normative base of the taxation system.

The revaluation of the fixed assets made as of 1 January 1995 decreased the taxation base by the profit tax due to the growth of the depreciation allotments on the reevaluated fixed assets of entities, which resulted in a significant drop of the payment of the profit tax in January 1995, compared with December 1994: Rb3,714 bln (4.7% of GDP), and Rb7,041 bln (8.36% of GDP), respectively.

The Federal Law of 25 February 1995, # 25-FZ "On the Special Tax from Enterprises, Institutions, and Organizations to Finance the Support of the Principal Branches of the National Economy of the RF and to Ensure the Stable Operation of the Entities of these Branches" reduced, from 1 April 1995, from 3% to 1.5% the special tax introduced by the Presidential Decree # 2270 in December 1993, envisioning its abolition from 1 January 1996.

In the first quarter of 1995, the tax revenues amounted to 22.99% of GDP, which corresponds to the share of the tax revenues in GDP to the end of 1994; the shares of taxes in the tax revenues made: 27.40% for the profit tax, 27.40% for the VAT, 10.48% for the income tax, and 4.67% for the excise taxes. The relatively low share of the income tax may be explained, in particular, by the consequences of the re-evaluation which had no time to be eliminated by the inflation. But it should

be noted that the relatively low shares of the taxes in the shares of GDP may be also explained by the significant growth of GDP: in percentage to the preceding months GDP growth made 5.88% in February and 13.65% in March.

To eliminate the influence of the statistical particularities of the accounting of the monthly GDP, the tax revenues corrected for the prices growth index from December 1994 may be considered. If such approach is used, it shows the growth of revenues from all the taxes, except VAT, from January to March.

The Law “On Amendments and Supplements to the Law of the Russian Federation “On the Profit tax of Enterprises and Organizations””, # 64-FZ, dated 25 April 1995, made changes in the regulations on the intermediary entities, fixed by the Decree # 2270, which latter fixed, after long discussions, (as for the tax placed in the budgets of the subjects of the Federation) the maximal rates of 22% of the profit for enterprises, including foreign legal entities, and 30% of the profit from the intermediary operations and transactions for the exchanges, broker offices, banks, and insurers (the limit rate for the intermediary activities becomes equal to 43%). The same Law enhances the list of the payers by covering the subsidiaries and other divisions of enterprises having their own balances and settlement accounts. The order of placement of the profit tax in the incomes of the budgets of the subjects of the Federation by location of the structural divisions having no settlement accounts. The share of the profit to be transferred in the budgets of the subjects of the Federation by location of such divisions is determined in proportion with the labor payment and cost of the fixed production assets.

In accordance with the above Law, from 1 January 1995, the enterprises with foreign investments will settle with the Budget as for the profit tax in the general order; namely, they will pay every quarter-year the advance payments of the tax and submit to the taxation bodies the accounts and calculations of the tax on the actual profit.

The Law of 25 April 1995, # 63-FZ, enforced from 28 April 1995, “On Amendments and Supplements to the Law “On the VAT””, abolished the VAT privilege for the housing construction works, and limits the list of the goods covered by the 10% rate. This list had been approved by the Resolution of the Russian Government # 659 of 1 July. In accordance with this Law, the deductions of the sums paid to suppliers from the VAT to be transferred to the Budget was allowed for all the paid for, related to the expenses, material resources, not only for the ones actually related for the expenses. For the trade organizations, except the retail trade, the sum of the VAT due is determined as the difference between the VATs received from the purchasers and paid to the suppliers. Accordingly, they are also covered by the general order of offset of the VAT paid to the suppliers, i.e., by the fact of payment. The liability of the Russian partners for the payment to the Budget of the VAT by the foreign entities, selling their products in the RF territory and not registered in the Russian taxation bodies, was introduced.

April and May 1995 were characterized by the growth of the tax revenues as percentage of GDP, except for the income tax. The growth of the minimal labor payment from Rb20,500 up to Rb34,400 from 1 April, and up to Rb43,700 from 1 May resulted in the reduction of the tax inflows down to 2.09% of GDP in May and 2.20% of GDP in June 1995. The accumulated tax inflows also decreased to 2.32% of GDP to June. Hence, the share of this tax in the tax revenues decreased accordingly (9.40% in the first half-year). The highest share of the tax revenues in GDP was received in April 1995: 30.45%; of them, the shares of the taxes were: 10.77% of GDP for the profit tax, 6.11% of GDP for the VAT, and 1.67% of GDP for the excise taxes. This happened despite the growing arrears: they grew for all the taxes from 21.4% of GDP in March to 26.89% in April (the relevant figures made 11.21% and 12.23% for the VAT, and 4.01% and 7.87% for the profit tax.

However, in May and June the tax revenues dropped for the taxes on the whole (21.63% of GDP for June, and 24.73% of GDP for the first half-year), for the profit tax (7.32% of GDP for June, and 8.07% of GDP for the first half-year), and for the VAT (4.86% of GDP for June, and 5.68% of GDP for the first half-year). At the same time, the excise taxes continued growing to 1.71% of GDP for June, and 1.42% of GDP for the first half-year. The arrears grew, in May, to 32.27% of GDP for the taxes on the whole, and 11.27% of GDP for the profit tax. At the same time, in April, the rates of increment of GDP dropped to 7.33%, compared with March, while in May and June they grew to 19.11% and 15.71%, respectively.

In the second quarter-year, the tax revenues (in the December 1994 prices) grew, especially in April and May, due, mainly, to the inflow of the profit tax (see Fig. 2.4).

Fig. 2.3

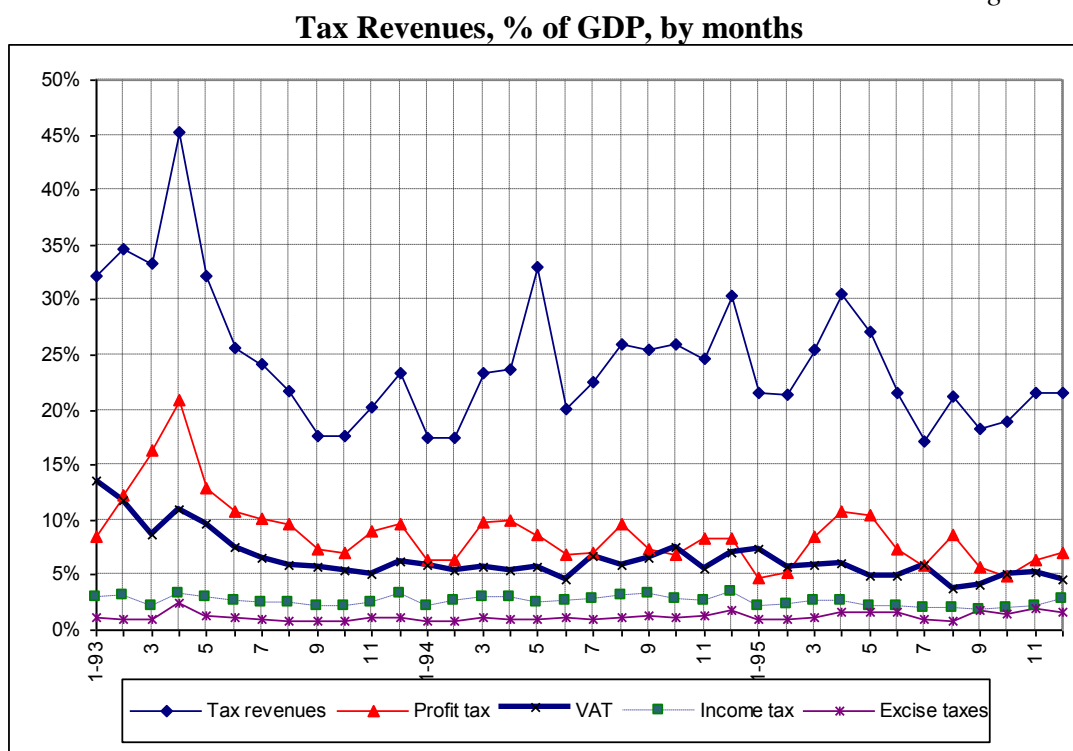
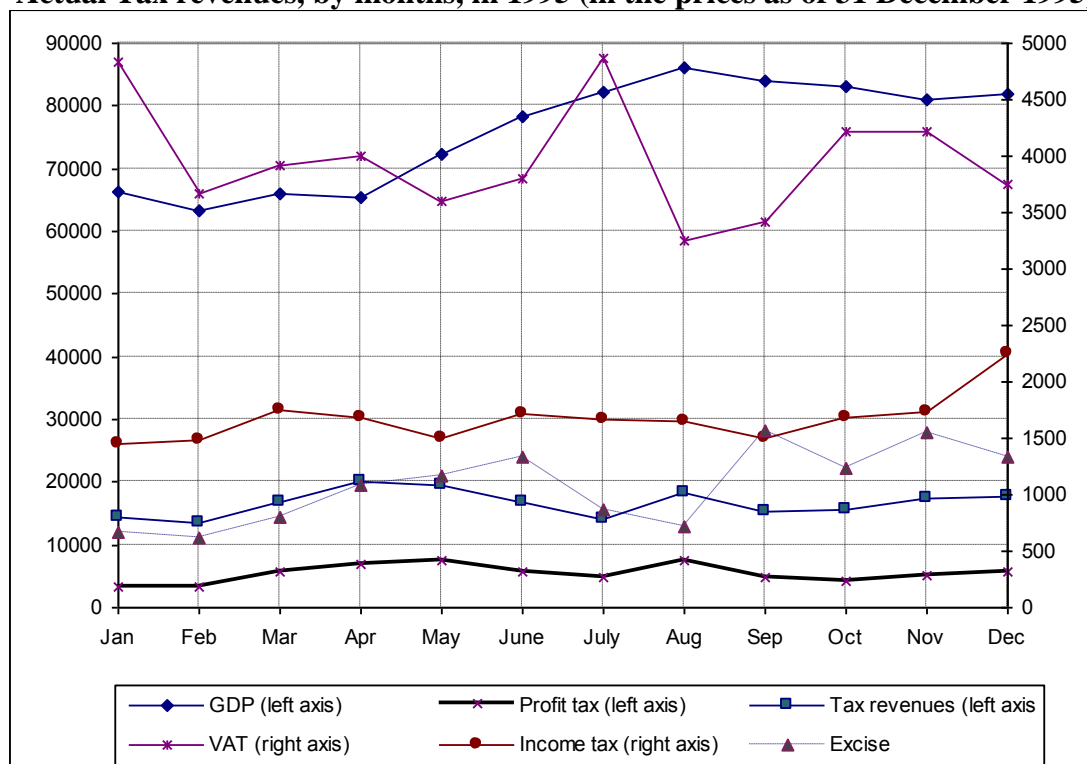


Fig. 2.4

Actual Tax revenues, by months, in 1995 (in the prices as of 31 December 1995)

The Law of 4 August 1995, # 1225-FZ, amended the terms of payment of the income tax: it is to be paid by fact of labor payment; the clause on its payment in the month following the month in which the labor payment is calculated.

The Law # 116-FZ, of 27 July 1995, increased the minimal labor payment to Rb55,000 from 1 August 1995. This may have led to the decrease of the revenue of the income tax in August (down to 1.91% of GDP) and September (down to 1.79% of GDP). Partially, the decrease of the tax by the amount of excess of the labor payment over the normalized value reflected itself in the September's decrease of the revenues of the profit tax down to 5.65% of GDP.

In total, as of the results of the third quarter-year, the tax revenues amounted to Rb245,884.3 bln, or 18.25% of GDP. The shares by taxes in the tax revenues made 33.79% for the profit tax, 23.39% for the VAT, 9.65% for the income tax, and 6.10% for the excise taxes.

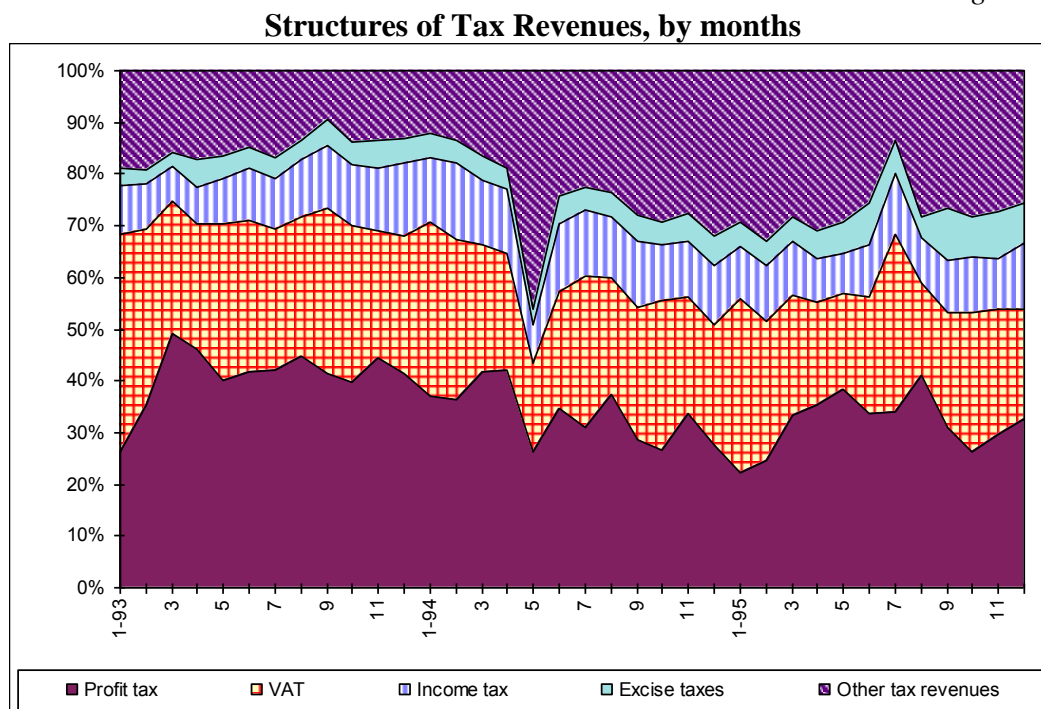
In the real values (in the December 1994 prices), the decrease in tax revenues was observed, compared with the period from April to July, except the peak in August due to the growth of the real inflow of the income tax. The growth, in June, of the real revenues from the VAT was accompanied by the drop of the real inflows of the taxes on the whole, and of the profit tax, in particular.

The fourth quarter of 1995 showed the growth of the tax revenues in percentage of GDP, from 18.25% in September to 21.6% in December. A certain effect must have come from the practice to include the final turnovers of the year in the results of December. When considering the real values, one can see the growth of the tax revenues on the whole, and of the profit tax, the significant growth of the income tax in December (due to the payments to the employed by the results of the year), and the drop of the VAT inflow in December.

Nevertheless, if the accumulated balance is considered, it shows that the share of the tax revenues in GDP continued decreasing from 22.14% down to 21.67%. Beginning from the April's peak in the tax revenues, such trend was observed during the three quarters of the year.

In the fourth quarter-year, the shares of the taxes in the total volume of the tax revenues grew somehow from 30.98% in September to 32.27% in December for the profit tax, from 9.82% to 12.74% for the income tax (despite the growth of the minimal labor payment), while the shares of the VAT (from 22.34% to 21.27%) and of the excise taxes (from 10.25% to 7.54%) decreased (see Fig. 2.5). If the accumulated balance is considered, there were no obvious changes in the structure of the tax revenues; a certain increase of the shares of the income tax and excise taxes, and a certain decrease of the shares of the profit tax and VAT were observed.

Fig. 2.5



A separate attention should be paid to the taxation of the foreign trade. The individual foreign trade privileges were abolished, in accordance with the Presidential decree # 244 “On the Loss of Force and Effect of the Decisions of the RF President as for Customs Privileges”, dated 6 March 1995, in the two steps: from 11 March, and from 15 May. In accordance with the Law “On Certain Issues of Granting Privileges to Participants in the Foreign Economic Activities”, promulgated by the State Duma on 24 February 1995, all the foreign trade privileges, except those envisioned by the Laws “On the Custom Tariff”, “on the Excise Taxes”, and “On the VAT”, and by the Customs Code, were abolished.

Actually, the privileges for the largest exporters were abolished in accordance with the Order of the State Committee for Customs of the RF, of 20 December 1995, # 763, “On the Loss of Force and Effect of the Normative Acts of the Russian State Committee for Customs on the Issues of Grant of Privileges for Payment of Custom Duties”. Before this, for the entities having privileges, either the terms of payment were extended, or the losses were compensated. According to the Ministry of Finance, during the year, the total volume of Rb3 trln of compensations was paid.

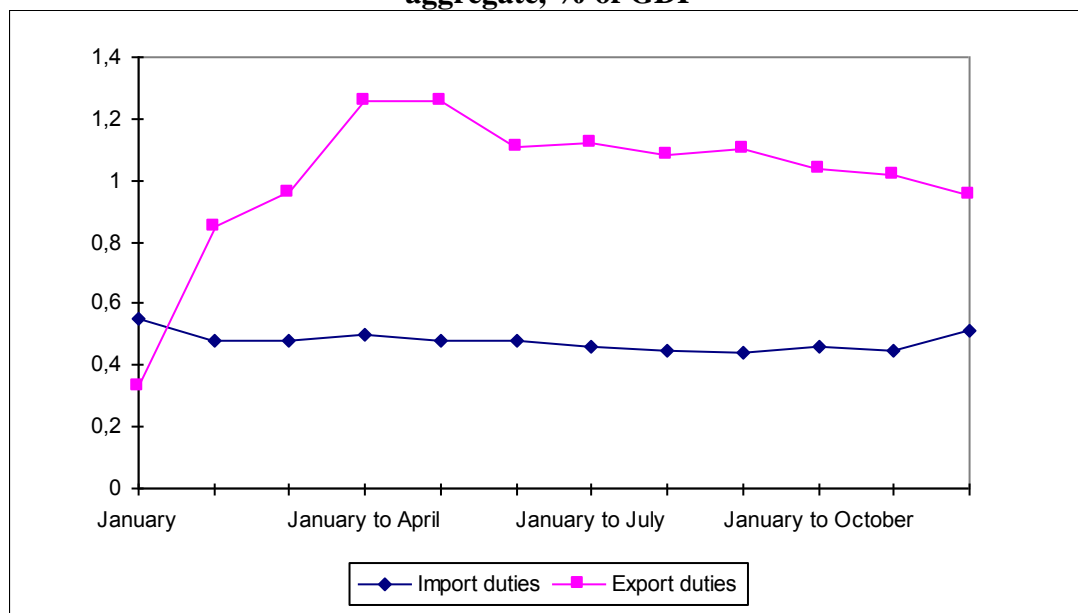
In 1995, amendments to the order of the tariff control of the foreign economic operations were made by numerous resolutions (see Section 5.2 “Control of Foreign Economic Activities”), raising, on the whole, the import duties, and decreasing the export duties.

As Fig. 2.6 shows, these decisions did not influence the dynamics of the inflow of the import duties to the Budget. This confirms again, that, in 1995, these inflows were determined, mainly, not by the duties rates, but by the size of the base, assessed by these import tariffs; its size was determined by the values of the different privileges. In 1995, the inflow of the export duties to the

Budget was more variable. After a certain growth in the Spring, the value of the export duties reached 1.1% of GDP (0.5% of GDP in 1994). Then, a smooth decrease of the volume of these revenues to the Budget was observed, down to 0.95% of GDP for the whole year, compensated, to a certain extent, by the growing revenues from the excise taxes.

Fig. 2.6

Import and Export Duties to the RF Federal Budget, aggregate, % of GDP



When analyzing the tax revenues to the Budget, the attention should be paid to the dynamics of the arrears. At the end of 1994, the arrears made 2.4% of the annual GDP for the consolidated Budget, and 1.47% of the annual GDP for the Federal Budget.

As of the percentage of the monthly GDP, at the end of 1994, the arrears were reducing, and, at the beginning of 1995, the arrears were growing. In January, the arrears for the consolidated Budget made 24% of the monthly GDP. In May and June, the process stabilized: the volume of the arrears made 32% of the monthly GDP in May and 27% of the monthly GDP in June (see Figs. 2.7 and 2.8).

A similar dynamics was observed for the arrears for the Federal Budget: in January they amounted to 14.0% of the monthly GDP; as of 1 September, the arrears for the Federal Budget grew up to 16.5% of the monthly GDP. The main growth was due to the arrears for the VAT.

In January 1995 the delayed arrears for the consolidated Budget made 18% of the total sum of the arrears, while in February, March, and June, the relevant values made 74%, 78%, and 82%, respectively.

For the entities of the material production sphere not paying dividends and having arrears as for the payments to the Budgets and the extra-budgetary funds, the order was established, according to which 30% of the assets coming to the settlement (current) accounts were directed to cover the labor payment, while the remaining money were to be directed to cover the arrears.

Fig. 2.7

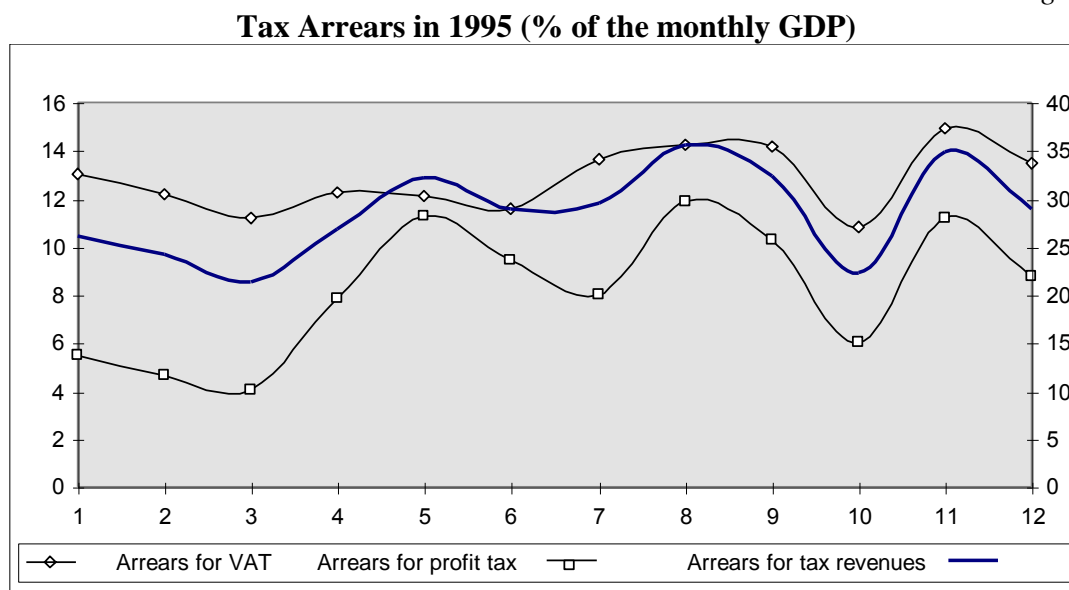
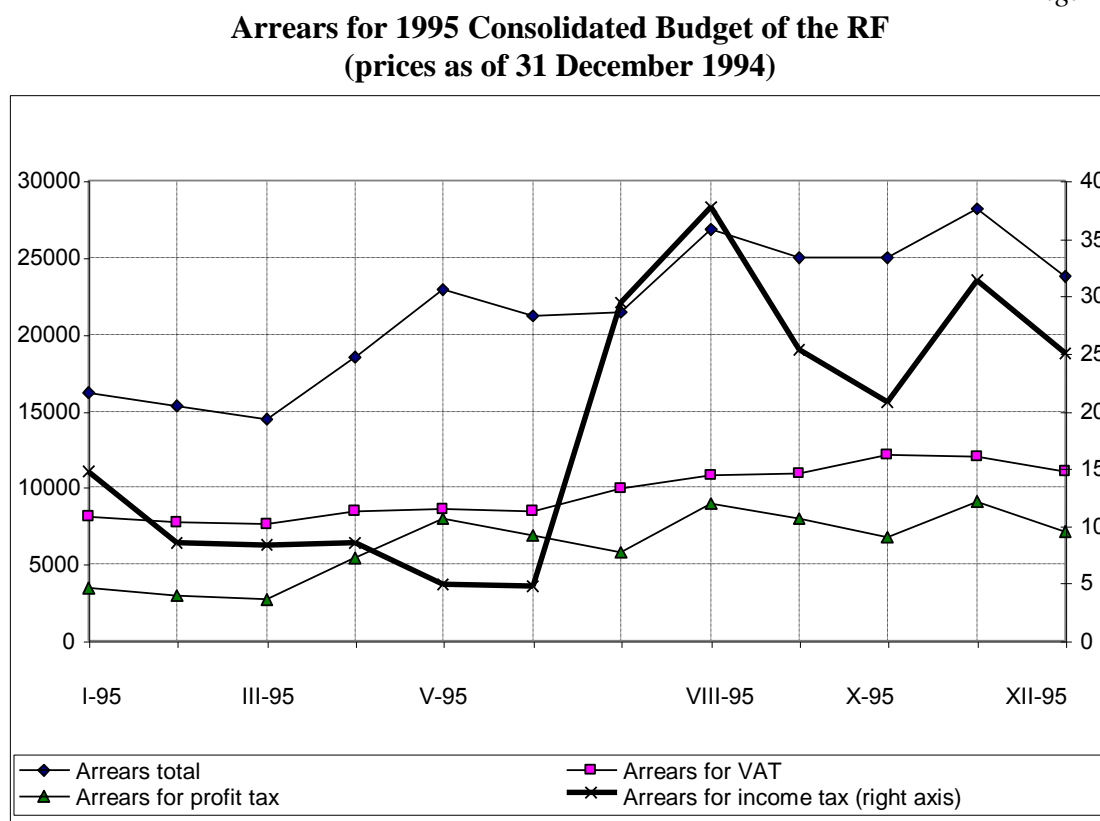


Fig. 2.8



As for the results of the year, the arrears for the taxes to be paid to the consolidated Budget made 29% of the December's GDP (in December 1994, the relevant figure amounted to 17.4% of the monthly GDP). The arrears to the Federal Budget dropped by 2.8% amounting to the 15.8% for the year (in December 1994, the relevant figure amounted to 11% of the monthly GDP). As most of the arrears volume from a limited number of entities, the commission concentrated on revealing such entities and working with them. As a result of the measures taken by the Federal Budget (according to various estimates) about Rb4 trln were received. On the whole, in 1995, the growth of the arrears made 2.4% of the annual GDP; but if the arrears accumulated since 1992 are considered, the consolidated Budget could have received the additional 3.3% of GDP, should they have been covered. The structure of the arrears had insignificant variations, and, to the end of the year, the

share of the arrears for the VAT to the Federal Budget grew, while the relevant share for the consolidated Budget dropped (see Figs. 2.9 and 2.10).

Fig. 2.9

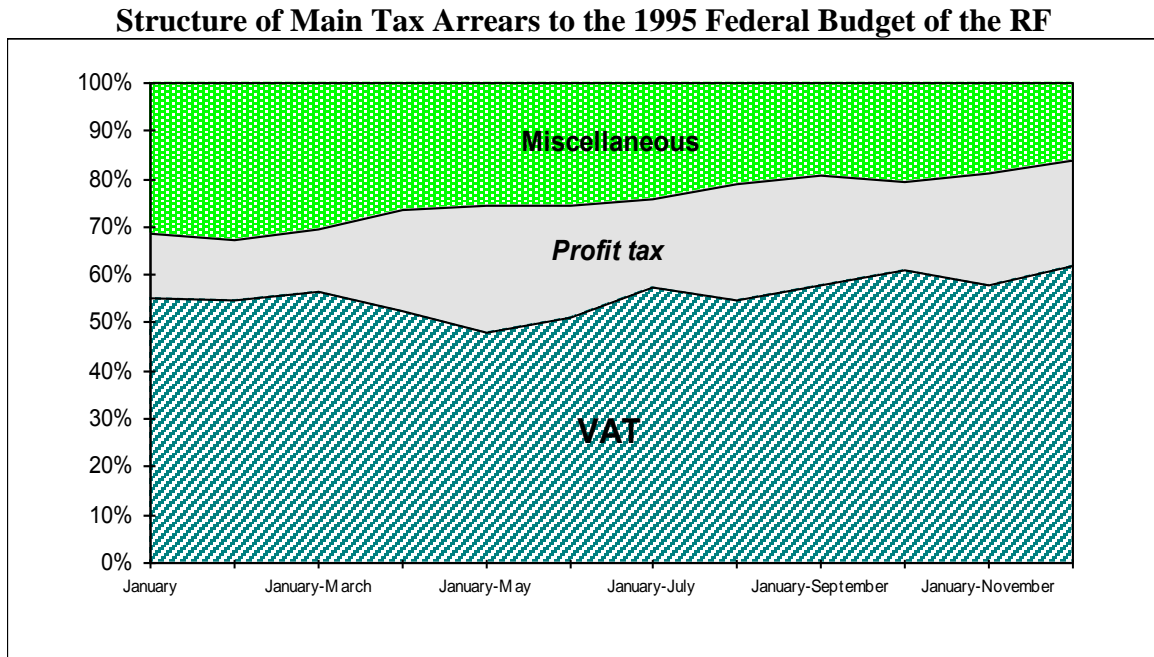
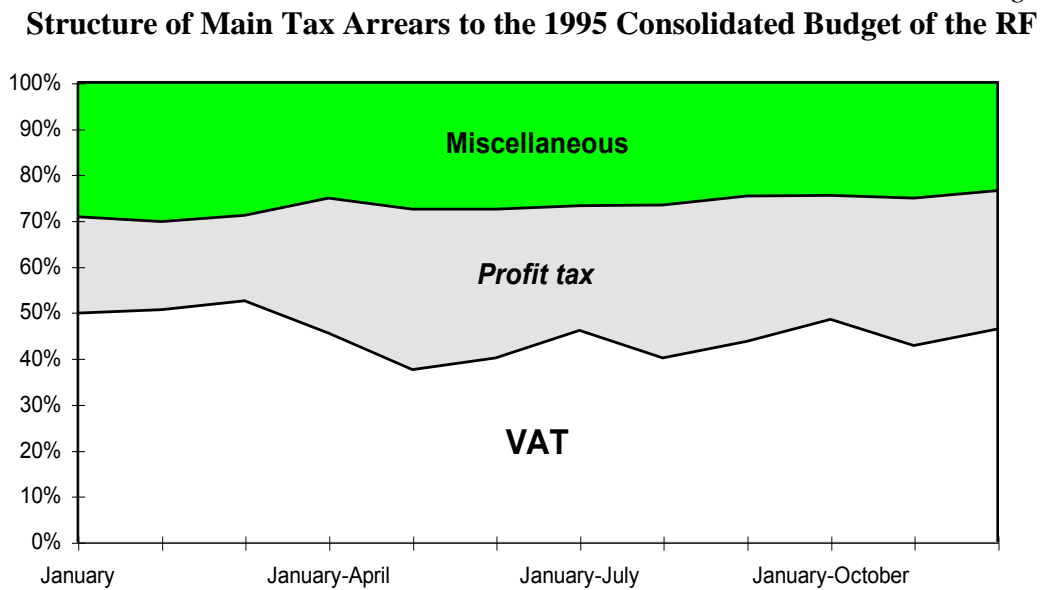


Fig. 2.10



Statistical Analysis of the Pattern of Tax Revenues

In this Section we have tried to determine, using formal methods, the existence of the dependence of the inflows of certain types of taxes upon a series of macroeconomy factors. For such factors we took GDP, the debtor indebtedness, the inflation, and some other ones. The study used the methods of the correlational-regressional analysis, based on the data by the RF Goskomstat and of the calculations by the authors. For the period for the study, we took the relatively stable, from the viewpoint of the legal changes, period of 1994 to 1995. The sum of the inflows for every tax on the monthly basis was taken as the explainable variable.

The indexes of GDP, debtor indebtedness, and tax revenues were deflated, because the monthly deflators of GDP by the consumer prices index accumulated from January 1992 were not available. When studying the inflows of the profit tax, we took for the tax basis not GDP on the whole, but GDP without VAT; moreover, we considered as a factor the deflated increase of the arrears to the Budget as for the profit tax.

The following dependence was obtained:

$$Y = 0.09X_1 + 0.0025X_2 - 2.69X_3 + 0.0004X_4 + 2.22$$

(2.1) (0.26) (-0.34) (2.21) (0.2)

$$R^2 = 0.38,$$

$$DW = 1.33,$$

$$F\text{-stat} = 2.9,$$

where Y are the deflated inflows of the profit tax,

X₁ is the deflated monthly GDP without VAT,

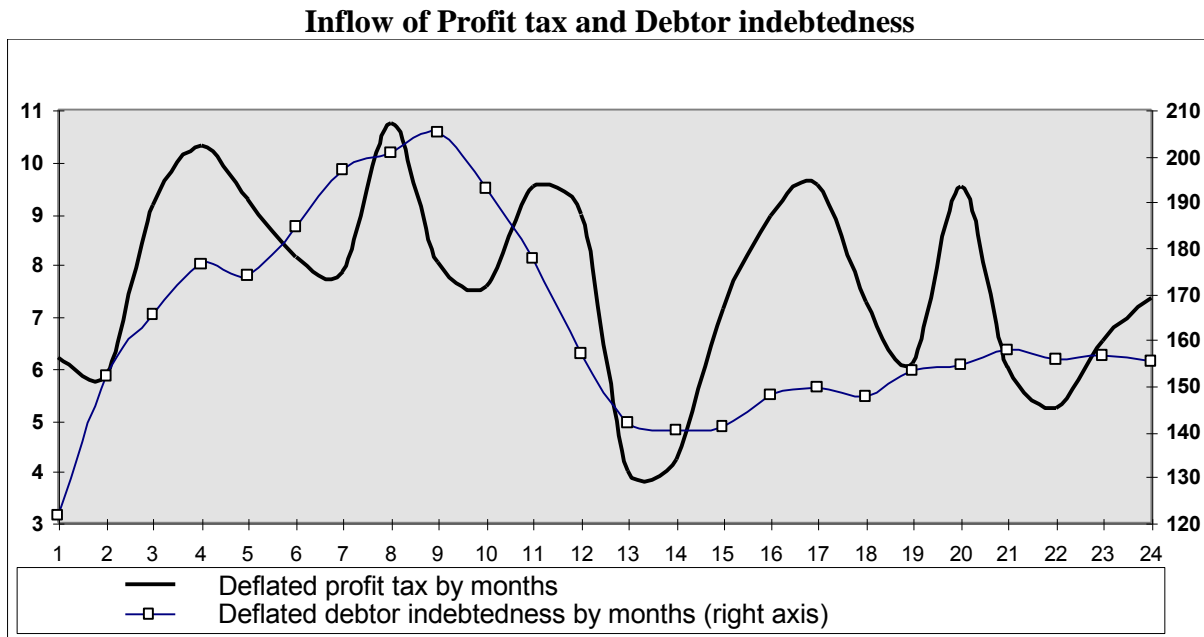
X₂ is the deflated accumulated debtor indebtedness,

X₃ is the price index by months, and

X₄ is the deflated increase of the arrears for the profit tax.

As it can be seen, these results cannot confirm the fact of the negative influence of the inflation on the value of the profit tax inflow. Theoretically, this may be explained, firstly, by the depreciation of the real volume of the debtor indebtedness during the period from the moment of shipment of the product and the income of the money to the Budget, and, secondly, by the depreciation of the real volume of a relevant arrears during the time of its existence. The effect of the inflation turns out to be statistically insignificant (t-stat X₃ = -0.34).

The effect of the debtor indebtedness is insignificant, as well (t-stat X₂ = -0.26); this is confirmed by its low correlation coefficient with the profit tax (0.3). Essentially, the growth of the debtor indebtedness has a negative effect on the inflows of the profit tax, because it reduces the taxable base. The diagram of the dynamics of the above indexes is shown at Fig. 2.11. The probable explanation of the absence of a reliable statistical dependence consists in the strong effect on the inflows of the profit tax of the seasonal factor and of the changes in the degree of strictness of the State policy as for the debtor indebtedness.



If the debtor indebtedness and the prices index are excluded, the parameters become better:

$$Y = 0.09X_1 + 0.0003X_2 - 1.01$$

(2.77) (-2.57) (0.3)

$$R^2 = 0.38,$$

$$DW = 1.3,$$

$$F\text{-stat} = 6.44,$$

where Y are the deflated inflows of the profit tax,

X_1 is the deflated monthly GDP without VAT, and

X_2 is the deflated increase of the arrears for the profit tax.

In our event, we have seen the growth of the reliability of the model (growth of the F-stat from 2.9 in the previous case up to 6.44 in this case). Besides, the growth of the significance of the factors at the indexes is obviously shown. Nevertheless, the low determination coefficient means a greater influence of other factors, besides the ones used, on the resulting variable.

It has already been shown, that, among these factors, a great role is played by the legislative changes, as well as the different seasonalities of different factors. To analyze the inflows of the VAT in 1994-1995 we used such explanatory factors as the dynamics of GDP (see Fig. 2.12), the inflation, and the growth of the arrears for the VAT.

The resulting regression equation is as follows:

$$Y = 0.06 X_1 + 12.61 X_2 - 0.09 X_3 - 13.95$$

(3.36) (2.81) (-0.32) (-2.46)

$$R^2 = 0.459,$$

$$DW = 1.92,$$

$$F\text{-stat} = 5.4,$$

where Y means the deflated inflows of the VAT,

X_1 means the deflated GDP by months,

X_2 means the monthly prices index, and

X_3 means the deflated growth of the arrears for the VAT.

Inflows of the VAT and GDP by months



The increase of the deflated arrears (from the essential point of view it must decrease significantly the tax revenues) turned out a statistically insignificant index. If it is eliminated from the model, the following results are gotten:

$$Y = 0.059 X_1 + 13.02 X_2 - 14.44$$

(3.44) (3.10) (2.70)

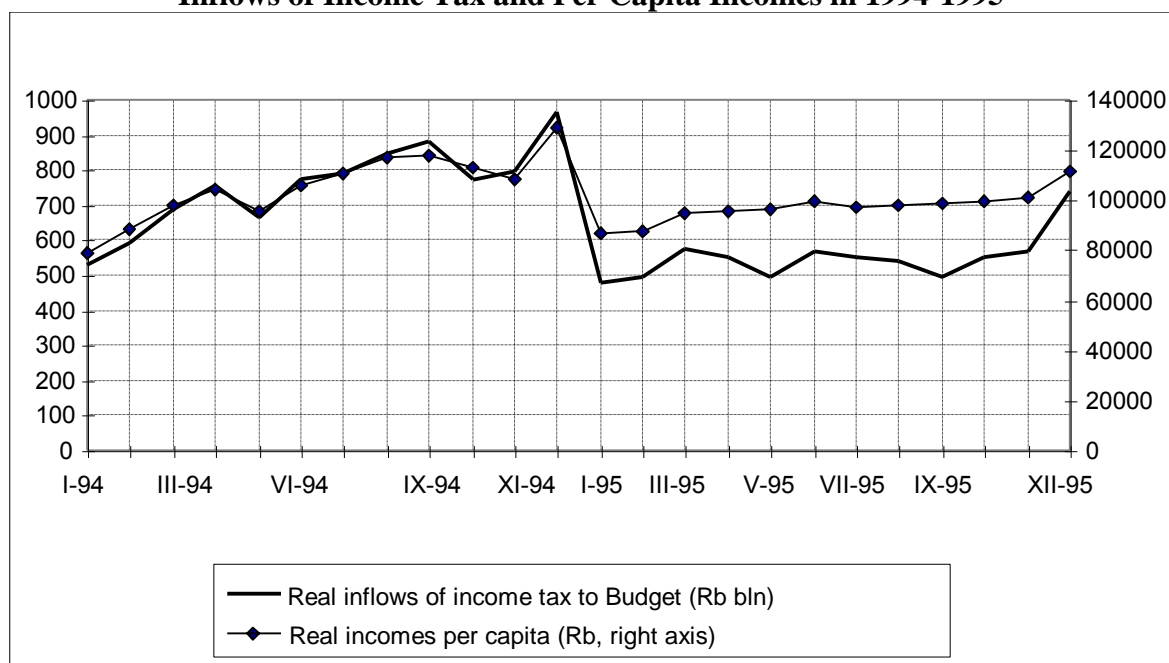
$R^2 = 0.456,$
 $DW = 1.88,$
 $F\text{-stat} = 8.38,$
 where Y means the deflated VAT inflows,
 X_1 -means the deflated GDP by months, and
 X_2 means the monthly price indexes.

If compared with the first variant, the characteristics of the model improved; this allows to believe it adequate. The above equation explains 46% of the variations of the value-added tax. One can also note that the coefficient at GDP equals, approximately, the average share of the VAT in GDP for the relevant period.

Beginning from 1995, the dependence of the VAT upon inflation changed from negative (in 1992) to positive. The above trend stayed effective for the last two years. To a certain extent, such a character of the dependence may be explained by the greater influence of the credit on the VAT depreciation during the time passing between the purchase of the goods by a tax payer and the moment of their offset with the tax liabilities. Nevertheless, this can hardly explain on the whole the predominance of such effect over the depreciation of the tax inflows due to the presence of the debtor indebtedness and arrears.

During the study of the inter-relations between the real inflows of the income tax and certain macro-economic indexes of 1994-1995, the index of the per capita real income was taken as the principal factor determining the dynamics of the inflows of the income tax (see Fig. 2.13).

Inflows of Income Tax and Per Capita Incomes in 1994-1995



The close links between these two indexes are due to the fact that the per capita income is, in essence, the basis for the assessment of the income tax.

In addition, we tried to reveal the dependence between the tax revenues and the degree of evasion from its payment. We used the share of the cash in the money aggregate M_2 as the indicator of the intensity of evasion from the payment of the income tax. As for the subject matter, this is explained by the dependence between the volume of the illegal (not accounted for the tax accountability) dealings and the needs of the economy in liquidity (see Fig. 2.14). Obviously, the effect of the share of M_0 in M_2 on the tax revenues must be negative.

The results of the regression analysis confirmed the initial assumptions:

$$Y = 196.49 + 0.01X_1 - 1614.3X_2$$

$$R^2 = 0.83,$$

$$F\text{-stat} = 52.46,$$

$$DW = 0.6,$$

where Y means the deflated inflows of the income tax to the Budget,

X_1 means the deflated per capita income, and

X_2 means the share of \dot{l}_0 in \dot{l}_2 .

The obtained high value of the determination coefficient determines the good explainability of the inflows of the income tax by the considered factors.

Further on, for a check-up, the hypothesis on the interrelation between the dynamics of the income tax and the inflation level was proposed (see Fig. 2.15).

After forming the regression, the extremely low determination coefficient (0.0003) was obtained; this means the absence of any relationship between the above variables.

This result was due, first of all, to the absence of a lag between the calculation and payment of the income tax; this tax is paid, mainly, from the source, thus eliminating the inflational depreciation of the arrears sum because it does not exist.

Fig. 2.14

Inflows of Income Tax and Share of M₀ in M₂ in 1994-1995

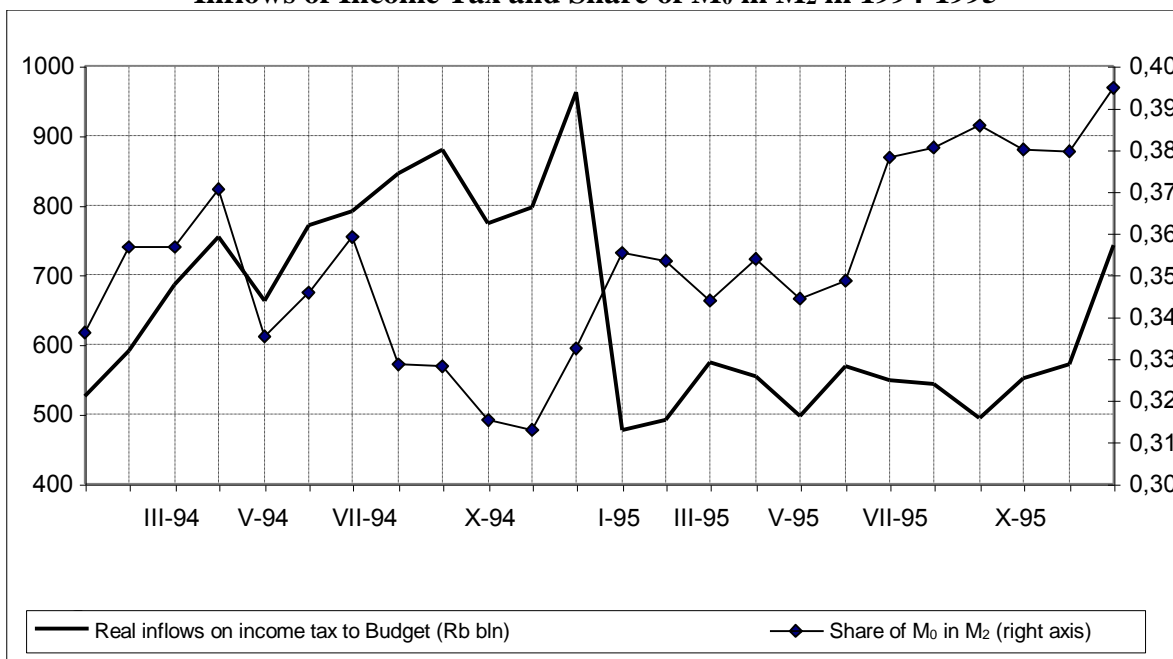
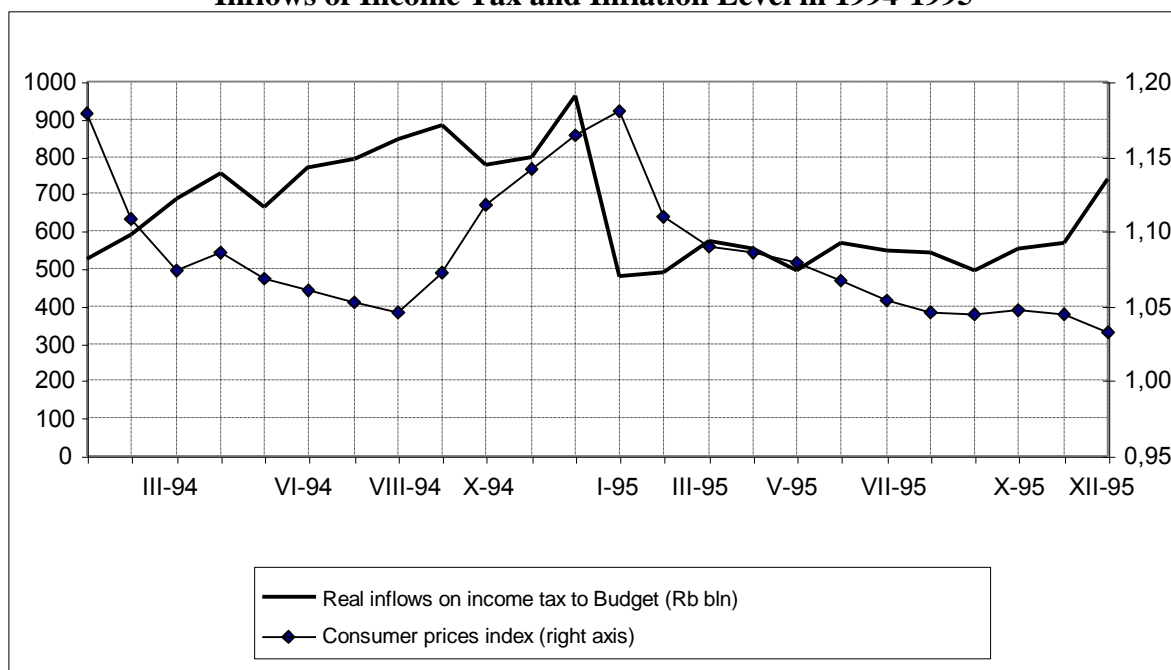


Fig. 2.15

Inflows of Income Tax and Inflation Level in 1994-1995



Regional Particularities of Budgetary Policy

The nineties are characterized by the obvious trend toward the growth of both the incomes and expenditures passing by the local budgets of the Federation subjects.

The share of incomes of the local budgets (taking into account the transfers) relative to the incomes of the Federal Budget was stably growing since 1992 to 1994 from 0.87 to 1.40, and only in 1995, it dropped sharply down to 1.04. A similar (on the whole) picture was observed with the expenditures, as well (growth from 0.59 in 1992 up to 0.88 in 1995 - in fact, contrary to the incomes, a drop was recorded in 1994 - without any collapse in 1995) (see Table 2.4).

Table 2.4

Incomes and Expenditures of Russia's Budgets in 1992-1995, Rb bln

	1992	1993	1994	1995
1. Local budgets				
1.1 Incomes of local budgets	2577	28616	110188	235186
1.2 Expenditures of local budgets	2307	27557	109071	241165
2. Federal Budget				
2.1 Incomes of Federal Budget	2969	21628	78851	226877
2.2 Expenditures of Federal Budget	3930	34368	145155	275570
3. Share of local budgets in Federal Budget				
3.1 Incomes(1.1 : 2.1)	0.87	1.32	1.40	1.04
3.2 Expenditures (1.2 : 2.2)	0.59	0.80	0.75	0.88

Notes: 1) The expenditures of the local budgets include the loans minus repayments.
 2) The incomes of the local budgets are reduced by the balance of the assets as of the beginning of the year.
 3) The expenditures on the repayment of the domestic State debt are included in the expenditures.

Taking into account the process of the real decrease of GDP in the nineties, and the fact that we did not account for the regional extra-budgetary incomes (due to the lack of information), it can be said that the decentralization of the Budget really took place in 1994, and has reached its maximum level. The 1995's decrease of the share of the local budgets was due, seemingly, to the reduction of the regional rates of the profit tax and income tax, the stricter practical implementation of the formula of the transfers to regions (in practice, this results in the lower share of the VAT revenues to be disposed of by the Federation subjects), allowing to centralize more significant volumes of the revenues.

We believe, that the creation of the Fund for Financial Support of Territories (for the regions suffering lack and extreme lack) having allowed to formalize somehow the process of the VAT sharing between the Federation and its subjects was a great achievement of the years 1994 and 1995. At the same time, the real transfers under the approved methodology, with the offset of the VATs and the grant by the Ministry of Finance of the VATs privileges for certain territories, did not allow to get out of the subjectivism when delimiting the authorities in what concerns the revenues. This practice stayed effective in 1995, as well, when, analyzing the share of the VAT revenues staying in regions one could encounter the "round" enough figures close to 30, 35, 40, or even 50 and more percent. For 1996, it is planned to introduce the new formula of transfers, but the preliminary calculations by the Ministry of Finance have shown that the volume of the assets to be transferred to territories will be even smaller than that calculated based on the older formula. Hence, a new methodology should be implemented (see below), which will be difficult enough, and we apprehend that regions will be, indeed, granted again privileged enough norms for the VAT (though this will be reflected in the reports on the budgets execution).

It should be noted that, on the whole, the budgetary relationships between the center and the Federation subjects are submitted, first of all, to the solution of the political, instead of fiscal, problems; this has shown itself in the process of making, in 1994-1995, the agreements with regions (mainly republics, e.g., Tataria, Bashkiria, Yakutia, Buriatia, etc.) on delimitation of authorities (at the end of 1995, the agreement was made with the Sverdlovsk region, the first agreement with a non-republic). Formally, these agreements fixed a series of privileges of this part of the regions as for the revenues and financing of the Federal expenditures (their universal practice is that the regions keep a share of the VAT and finance, instead, a share of the Federal programs), which breaks the principles of a unique approach to all the subjects. Indeed, the pragmatic method of construction of an asymmetric federation allowed to reduce conflicts with the regional elites, increased the share of the centralized assets, and ensured the financing of a series of Federal expenditures in the "problem" regions (though, taking into account the Chechen republic, it is, yet, early to evaluate the long-term vitality of an asymmetric federation).

In 1995, the main payers of taxes to the consolidated Budget of Russia were Moscow (16.8% of the revenues), the Khanty-Mansi Autonomous District (5.7%), the Moscow region (4.6%), St. Petersburg (3.9%), the Sverdlovsk region (3.6%), the Samara region (3%), republic Bashkiria (2.6%), and Krasnoyarsk region (2.6%); several other regions ensured 2.0% to 2.3% of the revenues (Nizhni Novgorod region, republic Tatarstan, Krasnodar region, Perm region, Cheliabinsk region,

Kemerovo region, Irkutsk region, and Yamal-Nenets autonomous district). Hence, 16 Federation subjects of 89 covered about 60% of all the Russian tax revenues. Moreover, the same regions were the main payers to the Federal Budget (except Tatarstan and Bashkiria (privileged in accordance with the agreements on delimitation of authorities) and Kemerovo region).

The analysis of distribution of the tax inflows to the regional and Federal budgets has shown that, in 1995, compared with 1994, the share of the tax revenues kept by regions (with rare exceptions) decreased by 2 to 6 percentage points. The sharpest changes were recorded in Karelia (95% and 67%, in 1994 and 1995, respectively) Tatarstan (84% and 77%), Bashkiria (87% and 74%); this confirms indirectly certain successes of the center in implementing the agreements with these republics. A special position is held by Yakutia which transfers practically no tax revenues to the Federal Budget; in exchange, it finances the Federal expenditures in its territory (Yakutia managed to fix in its agreement the situation it had managed to come to, unilaterally, in 1992 and 1993).

The conclusion may be made that the Federation subjects which keep about 50% to 57% (or less) of the total volume of the tax revenues are, without doubt, donors for other regions. According to this criterion, the donor regions are the above payers to the federal Budget, as well as republic Komi, Vladimir, Yaroslavl, Belgorod, and Tomsk regions. The similar criterion for the aid acceptor regions brings to 70% and more; these acceptor regions are small autonomous districts and the Jewish Autonomous region; republics Dagestan, Kabardino-Balkaria, Buriatia, Tuva, Khakassia, Mariy-El, Mordovia, Chuvashia; Arkhangelsk, Pskov, Kurgan, Kemerovo, Chita, Magadan, Kamchatka, Sakhalin, and Altay regions.

Reconstruction of Public finance System of 1995

Table 2.5 shows the reconstruction of incomes and expenditures of the State in 1995. For this the data on the execution of the State extra-budgetary funds (estimate based on the report on their execution for 9 months) were added to the report on the execution of the RF budgets of Tables 2.2 and 2.3, corrected by the estimate of the non-accounted expenditures for servicing the domestic debt (1.44% of GDP).

Table 2.5

Reconstruction of the RF State Revenues and Expenditures for 1995

	Republican Budget		Local budgets		Extra-budgetary funds		Consolidated Budget		
	Rb bln	% of GDP	Rb bln	% of GDP	Rb bln	% of GDP	Rb bln	% of GDP	% of Budget
I. TAX REVENUES									
1. Profits tax, income taxes	44245	2.7	109020	6.6			153264.7	9.2	26.8
1.1 Income tax from natural persons	3250	0.2	33178	2.0			36427.7	2.2	6.4
1.2 Profit tax of legal entities	40995	2.5	75842	4.6			116837.0	7.0	20.4
2. Allotments to social insurance funds					136600	8.2	136600	8.2	23.9
2.1 Employed					3323	0.2	3323	0.2	0.6
2.2 Employers					133278	8.0	133278	8.0	23.3
Pension fund					92445	5.6	92445	5.6	16.2
Social insurance fund					18207	1.1	18207	1.1	3.2
Employment fund					6640	0.4	6640	0.4	1.2
Social support fund					183	0.0	183	0.0	0.0
Mandatory medical insurance fund					15803	1.0	15803	1.0	2.8
3. Taxes on labor payment fund			4345	0.3			4345.2	0.3	0.8
4. Taxes on property	1018	0.1	18940	1.1			19957.9	1.2	3.5
4.1 Tax on property			15790	1.0			15790.5	1.0	2.8
4.2 Tax on land	187	0.0	3079	0.2			3265.6	0.2	0.6
4.3 Tax on transactions with securities	831	0.1	71	0.0			901.8	0.1	0.2
5. Domestic taxes on goods and services	99260	6.0	42393	2.6			141653	8.5	24.8
5.1 VAT	70704	4.3	24543	1.5			95246.7	5.7	16.7
5.2 Excise taxes	17682	1.1	6536	0.4			24217.7	1.5	4.2
5.3 Royalties for the use of mineral and natural resources	1174	0.1	5583	0.3			6756.2	0.4	1.2
5.4 Allotments for reproduction of feedstock basis	1683	0.1	604	0.0			2286.7	0.1	0.4
5.5 Special tax	7266	0.4	3618	0.2			10883.5	0.7	1.9
5.6 Other taxes on goods and services	753	0.0	1510	0.1			2262.1	0.1	0.4
6. Taxes on foreign trade	24155	1.5	29	0.0			24184	1.5	4.2

6.1 Import duty	8468	0.5	4	0.0			8473	0.5	1.5
6.2 Export duty	15685	0.9	24	0.0			15709	0.9	2.7
6.3 Other revenues from external economic activity	2	0.0					2	0.0	0.0
7. Other taxes	1785	0.1	14283	0.9			16068	1.0	2.8
8. Targeted Budget funds	14128	0.9	4041	0.2	2415	0.1	20584	1.2	3.6
TOTAL TAX REVENUES	184591	11.1	193050	11.6	139015	8.4	516656	31.1	90.4
II. NON-TAX REVENUES									
1. Central Bank profit	3475	0.2					3475	0.2	0.6
2. Exchange rate margin									
3. Other non-tax revenues	35403	2.1	40902	2.5			46991	2.8	8.2
incl. transfers and subventions	90	0.0	29224	1.8			ø	ø	
TOTAL NON-TAX REVENUES	38878	2.3	40902	2.5			50466	3.0	8.8
III. CAPITAL INCOMES									
1. Incomes from privatization	3408	0.2	1234	0.1			4641	0.3	0.8
TOTAL INCOMES	226877	13.7	235185	14.2	139015	8.4	571764	34.5	100.0
STATE EXPENDITURES AND LOANS MINUS REPAYMENT									
I. STATE EXPENDITURES									
1. General purpose State Services	4490	0.3	7419	0.4			11909	0.7	1.8
2. Defense	47553	2.9					47553	2.9	7.3
3. Support of law enforcement bodies	19194	1.2	6388	0.4			25581	1.5	3.9
4. Science	4801	0.3					4801	0.3	0.7
5. Social and public utility services	18649	1.1	108335	6.5	136600	8.2	263584	15.9	39.9
5.1 Education	8643	0.5	47818	2.9			56461	3.4	8.7
5.2 Culture and science	1123	0.1	5898	0.4			7021	0.4	1.1
5.3 Mass media	1644	0.1	746	0.0			2390	0.1	0.4
5.4 Public health and physical culture	3464	0.2	36946	2.2			40410	2.4	6.2
5.5 Social policy	3775	0.2	16927	1.0			20703	1.2	3.2
5.6 Social services from extra-budgetary funds					136600	8.2	136600	8.2	21.0
Pension fund					95767	5.8	95767	5.8	14.7
Social insurance fund					18207	1.1	18207	1.1	2.8
Employment fund					6640	0.4	6640	0.4	1.0
Social support of population fund					183	0.0	183	0.0	0.0
Compulsory medical insurance fund					15803	1.0	15803	1.0	2.4
6. State services to national economy	45441	2.7	101773	6.1	2415	0.1	149629	9.0	23.0
incl. from extra-budgetary funds	9243	0.6	2539.2	0.1	2415	0.1	14197	0.9	2.2
7. Other functions	137225	8.3	11367	0.7			119277	7.2	18.3
7.1 Other expenditures	37389	2.3	11277	0.7			48665	2.9	7.5
7.2 Expenditures on external economic activities	21492	1.3					21492	1.3	3.3
7.3 Expenditures on servicing the domestic debt	33522	2.0					33522	2.0	5.2
incl. servicing the GKO	24246	1.5					24246	1.5	3.7
7.4 Expenditures on servicing the external debt	15599	0.9					15599	0.9	2.4
7.5 Subventions to other levels of State administration	29224	1.8	90	0.0			ø	ø	ø
II. LOANS MINUS REPAYMENTS									
1. Budget loans	12188	0.7	5884	0.4			18071	1.1	2.8
incl. to other levels of State administration	667	0.0	90				757	0.0	0.1
2. State credits to foreign Governments	-2653	-0.2					-2653	-0.2	-0.4
3. Non-transferred incomes by Central Bank	5038	0.3					5038	0.3	0.8
4. Foreign credit resources granted to entities	8175	0.5					8175	0.5	1.3
5. Credit for conversion needs	169	0.0					169	0.0	0.0
6. Credit for investment needs	132	0.0					132	0.0	0.0
7. State credits to CIS countries	-585	0.0					-585	0.0	-0.1
TOTAL EXPENDITURES AND LOANS MINUS REPAID	299815	18.1	241165	14.5	139015	8.4	650681	39.2	100.0
INCOMES AND GRANTS minus EXPENDITURES AND LOANS MINUS REPAID	-72938.4	-4.4	-5980	-0.4	0	0.0	-78917	-4.8	
III. FINANCING									
1. Domestic financing									
1.1 Credits by RF Central Bank to finance the Budget deficit (net)	-1144.7	-0.1					-1145	-0.1	-1.5
1.2 Change of balances of Budget assets at bank accounts in rubles	-2376.4	-0.1	71	0.0			-2305	-0.1	-2.9
1.3 State short-term bonds (GKOs)	51751.5	3.1					51752	3.1	65.6
Mobilization of assets	115438.0	7.0					115438	7.0	146.3
Repayment of main debt	63686.5	3.8					63687	3.8	80.7
1.4 Saving loan (net)	1965.1	0.1					1965	0.1	2.5
1.5 Golden certificates (net)	-0.9	0.0					-1	0.0	0.0
1.6 State treasury bills (net)	-1501.6	-0.1					-1502	-0.1	-1.9
1.7 Treasury bonds (net)	-438.6	0.0					-439	0.0	-0.6
1.8 Other State securities (net)	-586.3	0.0	1059	0.1			507	0.0	0.6

1.9 Other domestic loans (net)	-92.8	0.0	4894	0.3			4767	0.3	6.0
TOTAL DOMESTIC FINANCING	47575.4	2.9	6024	0.4			53599	3.2	67.9
2. External financing									
2.1 Credits by international financial institutions (net)	29560.1	1.8					29560	1.8	37.5
2.2 Other foreign credits (net)	-6126.1	-0.4					-6126	-0.4	-7.8
2.3 Changes of balances of assets at bank accounts in foreign currency	1929.0	0.1	-45	0.0			1884	0.1	2.4
TOTAL Foreign FINANCING	25363.0	1.5	-45	0.0			25318	1.5	32.1
TOTAL FINANCING	72938.4	4.4	5979	0.4			78918	4.8	100.0
FOR INFORMATION: in 1995, GDP amounted to Rb1,659.2									

* Estimate

As it can be seen, when comparing Table 2.1 with Table 2.5, in 1995, the share of the mandatory tax withdrawals to GDP decreased further on, from 34.9% to 31.1%. This Share of the State expenditures also decreased, and amounted to 34.5% of GDP against 37.5% of GDP in 1994 (reduction by 8%). In 1995, the State expenditures and loans minus repayments reached 39.2% of GDP (against 47.5% of GDP in 1994; hence, the reduction by 17.5%). This reduction in the expenditures by 8 percentage points is formed by the reductions by 1.7 percentage points in the expenditures on defense (by 37%), by 0.4 percentage points of the expenditures on the law enforcement agencies (by 21%), by 0.4 percentage points of the expenditures on science (29%), by 2.6 percentage points of the expenditures on the social needs (by 14%), by 2.3 percentage points of the expenditures on the national economy (by 20%), and by 2 percentage points of the loans minus repayments (by 55%); at the same time, other expenditures grew by 1.4 percentage points.

1996 Draft Budget

For the first time during the years of the reforms, the 1996 Budget was approved by the State Duma before the beginning of the new fiscal year. Despite certain delays against the projected terms, the Government submitted the relevant draft to the State Duma well in advance (on 18 August 1995).

The Budget calculations supposed the continuation of the strict financial policy in 1996. The rates of growth of the money supply were to amount to 20-25% during the year. Herewith, the initial forecasts stated that, due to the reduction of the money circulation rate, the monthly inflation was to be limited to 1% to 1.2%, or annual 10% to 15%. According to the calculations by the Ministry for economy, the nominal volume of GDP was to amount to Rb2,100 trln, with its 1996's actual volume growth by 1%.

The Budget incomes were supposed to amount to 15.8% of GDP with the expenditures equaling 19.7% of GDP. The forecast supposed deficit was assumed as 3.9% of GDP. The deficit financing was supposed by the external (1.5% of GDP) and domestic (2.4% of GDP) loans. The main parameters of the draft Budget are shown in Table 2.9.

The program was realistic enough, though, the inflation rates (taking into account the 1995's dynamics) were underestimated.

With the purpose to correct the Budget, the Agreement Commission was established; the results of its work served to make relevant amendments to the draft Budget. The estimated inflation rate value was increased up to the monthly 1.9%, which can be considered a realistic value, based on the parameters of the draft monetary program for 1996 and the monetary policy effective in the second half of 1995. GDP value estimate was raised up to Rb2,300 trln.

On 15 November 1995, the State Duma - having had discussions with the Agreement Commission - approved, in the first reading, the Law "On the Federal Budget for 1996". The draft Law did not undergo any significant changes, if compared with the version submitted by the

Russian Government. Due to the corrections made, and the amendments to the Tax Laws approved by the Commission, the draft Budget increased the incomes approved in the first reading up to Rb347.2 trln (15.09% of GDP). The Budget expenditures of Rb435.37 trln (18.95% of GDP) were fixed based on the limit deficit value (3.85% of GDP). After this, the State Duma was to approve the itemization of the Federal Budget expenditures.

On 6 December 1995 the final version of the Russian 1996's Budget was approved. If compared with the first version of the draft Law, the expenditures on the social items, on the national economy, and on the defense were increased; at the same time, the expenditures on the State administration and the miscellaneous expenditures were reduced. On the whole, the approved 1996 Budget has no significant differences with the draft Budget submitted to the State Duma by the Government in August 1995. The Law has increased the value of the Budget incomes by Rb14.6 trln (0.6% of GDP): a significant share of this sum is to be formed by the taxes on foreign trade and inflows from the targeted Budget funds. The expenditures value was increased by Rb 21.3 trln (0.9% of GDP). More than a half of the above increase is formed by the expenditures of the targeted Budget funds. Besides, the value of the expenditures on the national economy grew significantly (by Rb7.9 trln). The expenditures on the social and defense programs were increased somehow, as well. The Budget deficit value was increased by Rb6.7 trln (0.3% of GDP).

Budget revenues. The Budget tax revenues amount to 82% (or 88% when taking into account the targeted Budget funds) of its inflows. The profit tax (2.4% of GDP), the VAT (5.5% of GDP), the excise taxes (1.9% of GDP), and the export-import duties (1.6% of GDP) remain the main sources of the tax revenues to the Federal Budget. On the whole, the tax revenues to the Budget amount to 12.3% of GDP (compared with the 10.3% of GDP in 1995).

Table 2.6

RF Draft Federal Budget for 1996

Parameters	Execution of 1995 Budget		Draft Budget submitted to State Duma on 30 August 1995		Draft Budget approved in first reading		Law promulgated on 6 December 1995		Deviations: Law promulgated against draft Law Rb trln
	Rb trln	% of GDP	Rb trln	% of GDP	Rb trln	% of GDP	Rb trln	% of GDP	
INCOMES									
Tax revenues; of them:	170.46	10.27	272.91	13.00	282.48	12.28	282.48	12.28	9.57
Profit tax	40.99	2.47	56.62	2.70	55.52	2.41	55.52	2.41	-1.10
Personal income tax	3.25	0.20	4.60	0.22	5.04	0.22	5.04	0.22	0.44
VAT	70.70	4.26	127.70	6.08	126.93	5.52	126.93	5.52	-0.78
Excise taxes	17.68	1.07	42.75	2.04	44.13	1.92	44.13	1.92	1.38
Special tax	7.27	0.44	1.15	0.05	1.15	0.05	1.15	0.05	0.00
Payments for use of natural resources	3.04	0.18	6.76	0.32	8.14	0.35	8.14	0.35	1.37
License duties on production and sale of alcoholic beverages	0.00		3.55	0.17	3.55	0.15	3.55	0.15	0.00
Tax on transactions with securities	0.83	0.05	0.40	0.02	0.00	0.00	0.00	0.00	-0.40
Taxes on foreign trade and foreign economic transactions	24.16	1.46	28.91	1.38	37.12	1.61	37.12	1.61	8.22
Other taxes, levies, and duties	2.54	0.15	0.46	0.02	0.91	0.04	0.91	0.04	0.44
Non-tax incomes	42.20	2.54	42.75	2.04	40.08	1.74	40.08	1.74	-2.68
Targeted Budget funds	0.00	0.00	13.13	0.63	24.65	1.07	24.65	1.07	11.52
Total Federal Budget revenues	228.19	13.75	332.57	15.84	347.20	15.10	347.20	15.10	14.63
OUTLAYS									
State administration	4.49	0.27	7.75	0.37	7.75	0.34	6.75	0.29	-1.00
International activities	21.49	1.30	28.02	1.33	28.02	1.22	28.04	1.22	0.02
National defense	47.55	2.87	78.97	3.76	78.97	3.43	80.19	3.49	1.21
Law enforcement and security support	19.19	1.16	39.67	1.89	39.67	1.72	37.36	1.62	-2.31
Fundamental research and support of scientific and technical developments	4.80	0.29	11.07	0.53	11.07	0.48	11.57	0.50	0.50
National economy, incl.:	36.20	2.18	65.10	3.10	65.10	2.83	72.96	3.17	7.86
Industry, power, construction	25.73	1.55	43.16	2.06	43.16	1.88	49.51	2.15	6.35
Rural economy and fishing	6.22	0.37	13.07	0.62	13.07	0.57	14.48	0.63	1.41
Protection of environment	1.34	0.08	2.06	0.10	2.06	0.09	2.13	0.09	0.07

Transport, telecommunications, informatics	0.46	0.03	0.96	0.05	0.96	0.04	0.96	0.04	0.00
Prevention and liquidation of consequences of Acts of God and force-major	2.44	0.15	5.85	0.28	5.85	0.25	5.88	0.26	0.03
Expenditures on social purposes, incl.:	18.65	1.12	39.25	1.87	39.25	1.71	40.36	1.75	1.10
Education	8.64	0.52	15.17	0.72	15.17	0.66	15.19	0.66	0.01
Culture, art, and mass media	2.77	0.17	4.75	0.23	4.75	0.21	5.10	0.22	0.35
Public health and physical culture	3.46	0.21	7.42	0.35	7.42	0.32	7.47	0.32	0.05
Social policy	3.78	0.23	11.90	0.57	11.90	0.52	12.59	0.55	0.69
Repayment and service of State debt	24.87	1.50	54.14	2.58	54.14	2.35	58.14	2.53	4.00
Replenishment of State stocks	15.62	0.94	10.00	0.48	10.00	0.43	10.00	0.43	0.00
Other expenditures, incl.:	82.70	4.98	65.48	3.12	67.32	2.93	63.68	2.77	-1.79
Financial aid to other levels of State power	29.22	1.76	54.71	2.61	54.71	2.38	54.63	2.38	-0.08
Expenditures of targeted Budget funds	14.06	0.85	13.13	0.63	13.13	0.57	26.71	1.16	13.58
Total outlays	275.57	16.61	414.42	19.73	435.75	18.95	435.75	18.95	21.33
Excess of expenditures over inflows	-48.69	-2.93	-81.85	-3.90	-88.55	-3.85	-88.55	-3.85	-6.70
FINANCING	48.69	2.93	81.85	3.90	88.55	3.85	88.55	3.85	6.70
Domestic financing	23.33	1.41	49.40	2.35	56.10	2.44	56.10	2.44	6.70
Foreign financing	25.36	1.53	32.45	1.55	32.45	1.41	32.45	1.41	0.00
GDP, Rb trln		1659.2		2100		2300		2300	

* For 1995, including the loans minus repayments that the draft Budget accounts for as separate items.

The draft Federal Budget actual inflows growth by 0.9% of GDP (compared with the 1995 Budget execution is explained by the growth of the tax revenues by 2% of GDP and a certain reduction of the inflows from the non-tax and targeted Budget funds. The growth of the tax revenues is due, mainly, to the growth of the VAT by 1.3% of GDP, the growth of the excise taxes by 0.8% of GDP, and the growth of the payments for the use of natural resources by 0.17% of GDP. At the same time, the reductions are expected of the revenues from the profit tax (by 0.1% of GDP) and from the special tax (by 0.4% of GDP).

In the Fall of 1995, together with the draft Budget, proposals as for changes in the taxation system were submitted to the State Duma. Some of these proposals were not approved: this reduced, of course, the projected 1996's inflows. It seems that, if one is based on the Rb2,300 trln forecast of GDP, the potential Budget revenues appear overestimated. This relates, first of all, to the revenues from the profit tax: the abolition of the tax on the over-normative labor payment will result in the lower tax revenues, compared with 1995, by at least 1% (by 0.22% according to the RF Ministry of Finance).

At the same time, the liquidation of certain privileges for the profit tax will hardly give more than the additional 0.2% of GDP (0.37% according to the RF Ministry of Finance). Additional revenues may result from the removal of the privileges for the *Gazprom* Company (the Government has already began such actions) which had not been accounted for by the draft Budget. If, in 1996, the order of the extrication from under the taxation of the stabilization fund could bring the additional 0.25% to 0.3% of GDP of the revenues from the profit tax. herewith, the half of it will be formed by the increased revenues - due to the elimination of the allotments to the stabilization fund amounting to 15% of the production cost (already implemented) - while the second half seems to result from the supposed abolition of the order of exception from the taxed profit of the incomes resulting from the difference between the export and domestic prices. Secondly, the VAT revenues volume had been overestimated: despite the removal of a number of privileges of the Spring 1995 and the change of the order of formation of the regions support funds, the growth of the VAT revenues can hardly be estimated as more than 1% of GDP. Thirdly, the almost 2-fold growth of the revenues from the excise taxes (up to 1.92% of GDP), even accounting for the grown excise tax rates for the crude oil and natural gas, need a serious organizational work.

Hence, the realistic estimate of the growth of the relevant revenues amounts to about 0.5% of GDP.

Of course, the today's conditions assure notable possibilities to increase the growth rate of the tax revenues by implementing the activities purposed to improve the taxes collection. If the Russian Ministry of Finance and Tax Police arrive to improve the control and to reduce sharply the number of the transactions with the unaccounted for cash a growth of the tax revenues for the main 6taxes may be supposed for 1996 already. The amount seems difficult to evaluate, but it seems that it will never result in more than 0.2% to 0.3% of GDP.

Thus, the growth of the 1996's tax revenues - in what concerns the main taxes - (compared with 1995), and accounting for the changes of the macro-economic situation (they suppose amendments to the tax Laws and a certain improvement of the taxes inflows) may amount to about 0.7% to 1% of GDP; nevertheless, this estimate is quite optimistic. Hence, under the conditions took into account when developing the draft, it seems improbable that the volume of the tax revenues to the Federal Budget will amount to more than 11% to 11.3% of GDP, in 1996.

In 1996, the inflows from the targeted Budget funds may amount to the supposed 1.07% of GDP. Eventually, the Budget inflows may be by 1.0% to 1.3% of GDP lesser than those supposed by the draft.

Budget outlays. When analyzing the projected Budget expenditures, first of all, the growth of the expenditures by 2.34% of GDP, compared with 1995, should be noted. Practically no one item of expenditures (except the items "International activities" and "Replenishment of State stocks") showed reduction of expenditures in real count.

The expenditures on the State administration grew by 0.02% of GDP (up to 0.29% of GDP).

The Law envisions the expenditures on defense of 3.49% of GDP. This figure is lower than the actual expenditures of 1994 (4.4% of GDP), but is by 0.62% of GDP, higher than that of 1995. As it has been noted more than once, in the short term no serious reduction of the defense expenditures is possible. But the necessity to reduce the defense expenditures in the medium term is quite obvious; moreover, in the situation of the defense reform and considerable reduction of the armed forces, this process will, inevitably, require a temporary growth of the defense expenditures.

Had the Law supposed the above measures, the growth of the defense expenditures whole have been quite validated. But the draft does not envision any acceleration of the reform start; moreover, the calculations envisioned the growth of the personnel of the armed forces by 230,000 persons. Hence, such decision will result in the continuing qualitative decay of the armed forces.

In 1995, the share of the expenditures on the law enforcement activities dropped to 1.16% of GDP (compared with the 1.8% of GDP in 1994). In the situation when the public order in the country is necessary, it is essential (just as in the case of the defense expenditures) to analyze in detail the structure of these expenditures, and, possibly, to increase the allocations. But the growth of the expenditures on the law enforcement activities by 0.46% of GDP (up to 1.62% of GDP) envisioned by the Budget Law does not seem well validated.

The Budget supposes that the expenditures on science will amount to 0.5% of GDP. During the period of 1993 to 1994, the share of the expenditures on science stabilized at this 0.5% level, which is, evidently, insufficient to support the normal functioning of the science sphere; moreover, in 1995, the financing of the scientific research made only 0.29% of GDP. As a result, to 1995, the total expenditures on the scientific research and civil purpose developments dropped almost 4-fold,

compared with the 1995 level. The envisioned by the new Law growth of the expenditures by 0.11% of GDP, compared with 1995, brings the level of financing of the expenditures on science to the level of 1994.

According to the Budget Law, the expenditures on the national economy are supposed to total 3.17% of GDP (2.18% of GDP in 1995). Herewith, the share of the State capital investments grows while the share of the grants decreases. To finance the industry, power, and construction, 2.15% of GDP are supposed to be allotted, which is by almost 40% more than in 1995. The main directions of spending of these assets are the State support of the base industries, reproduction of the mineral feedstock base, conversion of the defense industry, and construction.

The figures envisioned by the draft reflect the further reduction of the State expenditures on the support of the coal industry in real values. As for GDP, the expenditures under this item will drop from 0.48% of 1995 (as planned) down to 0.33% in 1996 (for comparison: the relevant values made 1.4% in 1993 and 0.9% in 1994). The share of the grants in the price per ton of coal will drop from 36.4% in 1995 to 24.2% in 1996. Hence, the parameters of the draft Budget reflect in the sufficient degree the process of reduction of the load on the Federal Budget by the grants on coal. At the same time, the change of the structure of the State support of the coal industry will not be sufficient: the expenditures on the sanitation of the unprofitable underground and open cast mines amount to only 21% of the total sum allotted to the industry.

According to the 1996 Law on the Budget, the State investments will make 1.45% in GDP; their share in its structure stays on the level of 1995. In the structure of use of the capital expenditures under this item, the share of the capital investments in the fixed assets will make about 18%, while the share of the capital transfers will amount to 82%.

The Budget Law contains absolutely no changes in the agrarian policy for 1996, though such changes are especially necessary¹. An important fact is the budget assumption to return, in 1996, the assets allotted in 1995 for the procurements to the federal Food Fund. The 1995's experience shows that the assets allotted on the return basis are not repaid in full volume.

In 1995, the grants to the animal breeding, at the rates of 1993, were included in the sum of the regional transfer and were used by the Federation subjects at their own discretion. This order, which became one of the factors instituting barriers in the inter-regional trade of the agricultural products and food, remains effective for 1996, as well. Besides, the efficiency of these grants, from the viewpoint of support to agricultural producers, is extremely low. The world practice shows that a higher efficiency is ensured not by direct grants to agricultural producers, but by enhancing the demand for their products. In the event of the meat and dairy products, these may be the federal programs of free lunches for schools, free catering in the hospitals for retreated persons, and other similar federal programs. In addition to that these programs not only carry a social charge, but, which is more important, they expand the demand for the produce of the agro-industrial complex. The main condition for such programs must be the purchase for them of exclusively domestic produce.

The Budget supposes, just as before, to use the tax on land for the activities of the Russian State Committee for Land, and in a growing proportion. We have noted more than once, that the concept of the tax on land needs to be reviewed. This tax must become local (even not regional), i.e., its level must be fixed exclusively by the local self-government authorities, and be centralized to the Federal Budget in the minimal, but equal for all the territories, proportion. The Federal authorities must fix the upper limit rates of the land tax, ensure the continuation of the already available

¹ The Section on the agrarian policy was written jointly with M. E. Serova

privileges on this tax, and its targeted use for the infrastructure and social arrangement of the territories. The activities of the Russian State Committee for Land must not be related with the volume of the accumulated tax on land, because this creates the interest of these bodies to hinder the formation of the private farms (the newly established private farms are released from the payment of the tax on land for the first five years).

The leasing fund which showed its extremely low efficiency in 1995 stays effective for 1996, as well. But its conservation in the planned volumes may have any sense only if the order of its use is changed. This fund must be reserved for the guarantees to the financial structures crediting the leasing operations in the rural economy. This will break the monopoly of the Russian Committee for Agriculture Procurement (Rosagrosnab), will become an incentive for formation of a normal market of the leasing services in the agro-industrial complex, will attract the commercial investment credit to the rural economy, and will improve the guarantees of return of the assets to the Budget.

The validation of the other expenditures items in the agro-industrial complex stays extremely poor, just as it was before. In particular, it is difficult to understand the sharp rise of the expenditures on compensation of the insurance payments to agricultural producers. With the reduction of the rate of compensation of the insurance payments from 50% to 25% and with the absence of any decisive proposals for additional stimulation of the insurance activities of agricultural producers, the Budget expenditures on the compensation grew, in 1995, 8-fold, compared with the actual level of 1994, and 31-fold, in accordance with the 1996 Budget.

Similarly, the issue of the grants on wool was badly developed. The expenditures are planned for purchase only, without analyzing the use of the feedstock purchased. If the wool is sold, some of the expenditures will return to the Budget. But if the feedstock purchased stays in the State stocks, the expenditures on servicing these stocks need to be planned. This gives large possibilities for an illegal use of the Budget assets.

The grants to the pedigreed stock breeding seem poorly validated, as well. The calculations give only the rates of grants per head of livestock and the number of the heads to which the grants relate. But the data on the available pedigreed livestock population are not accounted for. If really 330 thousand heads are to be supported, all the pedigree stock farms which receive direct grants from the Federal Budget for preservation of the domestic genetic fund of the livestock are to be named. Today the practice is such that the relevant grants are distributed by small portions among numerous livestock farms which are not real holders of the genetic potential of the Russian stock breeding; as a result, the efficiency of this targeted grant equals zero.

We do not think that the elite seeds growing is today a branch needing State grants. Lots of economies are engaged in the commercial elite seeds growing. Only the purchase of the imported hybrids of corn may be an exception.

Neither the 1995 Budget, nor the Law for 1996 show in an obvious manner the Budget loans to the agrarian sector in form of credit against goods. Nevertheless, in 1995, this item of expenditures amounted to almost Rb12 trln; this means that the real expenditures on the agro-industrial complex are almost twice higher than those clearly shown in the relevant item of the expenditures side of the Budget (the producers of the fuels and lubricants, and of the mineral fertilizers to be supplied to the rural economy were given the privilege of lower payments to the Budget). The same concept is fixed in the 1996 Budget.

The greatest lack of financing (as it has been shown when analyzing the Budget execution) is suffered by the expenditures on social purposes. Their value amounted, in 1995, to 1.12% of GDP (1.9% of GDP in 1994). The Law on Budget for 1996 envisions the increase of the expenditures on

social purposes up to 1.75% of GDP. The supposed growths of the expenditures are: from 0.25% of GDP to 0.66% of GDP on education; from 0.17% to 0.22% on culture, art, and mass media; from 0.21% to 0.32% on public health and physical culture; and from 0.23% to 0.55% on activities in the social policy. However, at such a growth, the expenditures on social purposes will be significantly lower than during the period of 1992 to 1994 (2.7% of GDP in 1992, 2.0% in 1993, and 1.9% in 1994). Their absolute value in a comparable expression will make less than a half of which was allotted for the social sphere from the Federal Budget in 1992.

The 1996 Law on Budget does not envision as expenditures the expenses on servicing the GKO's; neither does it envision the volumes of maturity payments on GKO's as financing (just as it was before). At the same time, the expenditures item includes the expenses on repayment of the domestic debt (0.6% of GDP), which need to be accounted for in the financing section. The growth of the expenses on the service and repayment of the State debt (in the Budget it amounts to 0.4% of GDP, compared with 1995) is, objectively, conditioned by the transfer to the Budget financing by borrowings in the domestic money market and the growth of the Russia's external debt. But this process has no relevant reflection in the Budget.

The Budget increases by 35% the expenditures on the assistance to the other levels of the State administration (from 1.76% of GDP in 1995 to 2.38% of GDP). It is known that, beginning from 1994, the mechanism of relationships between the Federal Budget and the budgets of subjects is based on the use of the uniform methodology of calculation of the financial assistance to the regional budgets from the special Fund for Financial Support; the latter is formed within the Federal Budget at the expense of 22% (in 1994; compare with 27% in 1995) of the federal share of the VAT.

In accordance with the Law on the Budget for 1994, the Fund for Financial Support of the subjects of the Russian Federation gave assistance to such subjects of the Russian Federation which had the per capita budget income for the preceding year lower than the average in the Russian Federation (Federation subjects needing assistance) and to such subjects for which the own incomes and the additional money received from the Federal Budget were insufficient to finance the current expenses (Federation subjects needing special assistance).

The main drawback of this approach was that the calculations of the average per capita income did not take into account the incomes of the regional extra-budgetary funds (including the hard currency funds). Besides, they were not corrected neither accounting for the use, in 1993, of the differentiated rate of the VAT, nor by the sum of the grants and credits from the Federal Budget (including for the targeted programs). The calculations of the transfers failed to take into account such strategic factor as the differentiation of the prices levels by regions. As a result, relatively higher grants were given to the southern regions at the expense of the northern ones, which is, obviously, against any logic. Numerous regions support the low prices level just due to the federal transfer payments allowing to finance subsidies.

The approach used in 1995 was, on the whole, similar. Herewith, as it has already been noted, the fact is important that the monthly statistics of the Ministry of Finance does not reflect the real volumes of the resources transferred from the Federal Budget to the local ones, because, in many cases, the Ministry of Finance decreases the sums of the transfers, increasing the share of the VAT kept by regions. This results in difficulties with the analysis of the real situation with the grants to local budgets.

The draft Budget for 1996 supposes certain changes of the order of formation of the fund for financial support of regions and of determination of the shares of individual regions in this fund. The fund for financial support of regions is supposed to be formed not by the allotments from the

VAT, but from the 15% of the sum of the tax revenues of the Federal Budget (with the exception of the sums of the 10% Personal income tax and the sums of the import duties).

It is supposed, that, just as in the preceding years, the financial assistance will be given to the regions with the annual budget income per capita lower than the average in Russia. The calculations of the budget incomes is based on the expected estimate of the 1995 revenues, taking into account the projections for 1996. To determine the regions needing special support, a new method, differing from the earlier one, is proposed. The regions needing special support will be considered such ones, in which, in 1996, the volume of the budget incomes plus transfers is insufficient to finance, in 1996, the budget expenditures (accounting for the capital investments). Herewith, the expenditures forecast is based on the current expenditures of the regions for 1991, taking into account the relevant deflator indexes and certain corrections.

Taking into account the two statuses of the regions, the above fund is split into the two parts from which the transfers are to be allotted to the regions needing support and to the regions needing special support. The proportions between the two parts of the fund are determined on the basis of the calculation (according to the 1996 data) of the sums of the money making the difference with the average per capita budget income by the regions needing support, and the sums of the money making the difference with the sums required to cover the current budget expenditures for all the regions needing special support. On this basis, the proportions between the two parts of the fund for 1996 were determined: 65.79% for the regions needing support and 34.21% for the regions needing special support. To determine the shares of individual regions, the relevant calculations are to be made.

For the regions needing support:

- the difference between the per capita budget income of the relevant region and the average per capita budget income of all the regions of Russia, as of the forecast for 1996, is to be determined;
- in the event the per capita budget income of the relevant region is lower than the average per capita budget income of all the regions of Russia, this difference is to be multiplied by the number of population of the relevant region. Further on, the result is to undergo the correction: for this the correction factor of the regional expenditures divided over the per capita population incomes and multiplied by 0.95 (without capital investments) is to be calculated. This factor is to be multiplied by the preceding sum of transfer.

Further on, the so calculated sums of the money making the differences with the average per capita budget incomes forecast for 1996 by all the regions of Russia are to be summed up by all the regions needing support. Further on, the shares of each region in the total sum of this money are to be determined. These shares are to be applied to the money actually received by the relevant part of the fund.

For the regions needing special support:

- the difference between the current budget expenditures (without capital investments) and the volume of the budget incomes, as of the forecast for 1996, is to be determined;
- further on, the sums of the money lacking to cover the above expenditures, are to be summed up by all the regions needing special support, and the share of every relevant region in the total sum of this money is to be determined. The results are considered the relevant shares of

the regions in the fund for financial support of regions and are to be applied to the money actually received by the relevant part of the fund.

We believe, that, when estimating the incomes of regions in 1996, a special attention should be paid to the potential revenues of the relevant budgets calculated banked upon the forecast taxation basis, the effective rates of the federal taxes, and the average (by Russia) rates of the regional and local taxes. This will create incentives for a more complete development of the local taxation systems.

The calculation of the transfer to a region needs also to take into account the ratio of the average Russian prices level to that of an individual region. The levels are to be calculated based on the prices of the representative set of goods, observed in regional and district centers, and used for the calculation of the aggregate price index on the consumer goods and services published by the RF Goskomstat.

Budget deficit. The Budget Law supposes the deficit of 3.85% of GDP. It supposes that the financing by the domestic borrowings will amount to Rb51.6 trln. The continuation of the practice to use, to finance the Budget deficit, the borrowings from the Russian financial market without direct credits by the Central Bank as sources of its coverage, needs an attentive planning of this process in order to change the structure of the domestic State debt for the benefit of the long-term borrowings. The external financing sources amount to Rb32.5 trln (this includes the sum of the supposed IMF credit of US\$3 bln). To the moment when this report was being written, the decision to grant to Russia the US\$102 bln EFF credit was practically made, during the visit of M. Camdessus, Manager of the IMF to Moscow. In 1996, Russia is to receive the first tranche of this credit, US\$4 bln.

Outlook on Public Finance for 1996

Current changes in tax laws. On 1 January 1996, critical amendments to the tax laws, approved in 1995, took force and effect. The Law “On Amendments and Supplements to the Law of the Russian Federation “On the Profit tax of Enterprises and Organizations””, of 25 April 1995, envisions to cancel, from 1 January 1996, the tax on the excess of the labor payment over the normalized value. The measures having the purpose to limit the growth of the labor payment, discussed during a long period, were not, yet, taken to the beginning of this year; hence, the, for the first time during the observed period, the new fiscal year begins without rationing the labor payment.

The Federal Law of 25 February 1995, “On the Special Tax from Enterprises, Institutions, and Organizations to Finance the Support of the Principal Branches of the National Economy of the RF and to Ensure the Stable Operation of the Entities of these Branches” envisions to cancel, from 1 January 1996, this special tax.

Just as during the preceding years, based on the Resolution of the Government of 25 November 1995, the fixed assets, as of 1 January 1996, are to be re-estimated in accordance either with the indexes published by the Goskomstat, or by a direct recalculation to the prices formed as of 1 January 1996.

On 8 December 1995, the Law “On the Simplified System of Taxation and Accountancy for the Small Enterprise Entities” was promulgated, after a long discussion. This Law ensures the possibility to substitute the complex of the taxes fixed by the relevant laws (except the customs payment, allotments to the extra-budgetary funds, State duties and license fees) by a unified tax on income or return (as the relevant administrations of the subjects of Federation may decide) of a

small enterprise or businessperson. The category of the small enterprises covers the ones which employ less than 15 persons.

Certain amendments have been made to the list of the VAT privileges, as well. The Law of 30 November 1995, releases from taxation, from 1 January 1996, the scientific research works; the production by editors, publishing houses, and printing offices, of the newspapers, magazines, and books relative to the education, science, and culture; and the turnovers relative to circulation of the mass media. The profit from the sale of the mass media products, as well as that from the sale of the books relative to the education, science, and culture will be tax-free, at the condition such profit is used for the investments relative to the principal activities.

An important factor of the taxation policy is the new prolongation (Resolution #1245 by the RF Government dated 18 December 1995) of the effectiveness of the temporary order of use of the money inflowing to the settlement (current) assets of enterprises before March 1996. After this term, an enterprise will be able to receive a postponement for the payments to the budget only upon having approved by the taxation authorities the schedule of repayment of the arrears before 1 January 1997. The Resolution envisions that the norm of reservation of the money for labor payment in all the money inflowing to the account of such entity will make either 10% or 20% for the debtors (in function of the initial norm, i.e., 30%, 40%, or 50%) before 1 March 1996.

In accordance with the Presidential decree dated 19 January 1996, the alternative order of registration of the debts of entities to the Budget was confirmed. In accordance with the above Decree, an entity will be able to receive a postponement for the payments to the budget at the condition that it pays, during the period from 1 April 1996 to 1 October 1996, half of the sum of the debt, in the equal, 5% of the total sum, shares every quarter-year, with the penalty of 30% annual. Further on, the order is envisioned of the repayment of the remaining debt during the next five years. The document has expanded the list of the privileged activities for small enterprises, added privileges for the 3rd and 4th years of functioning, if the revenue from the relevant activities amounts to not more than 90%; but the term of repayment of the privilege has been extended to 5 years.

On 1 January 1996, the Law # 227-FZ, "On Amendments and Supplements to the Law of the Russian Federation "On the Profit tax of Enterprises and Organizations"" of 31 December 1995, took force and effect. In accordance with the newly promulgated Law, among the Saving Bank (Sberbank) institutions, the branches at the level of the Federation subjects (territorial banks) become tax payers, in accordance with the summary balances.

Industrial, construction, and transport enterprises are considered small enterprises if the number of the persons employed does not exceed 100 (before the figure was 200). The criteria of consideration of an entity as a small entity (including the average number of personnel) are fixed by the Federal Law "On the State Support of the Small Enterprise in Russia".

An important change consists in the correction of the residual cost of the fixed assets and other property by the inflation index when determining the profit at its realization. This measure is intended to activate the renewal of the fixed assets and the replacement of the equipment to the entities which can use it more efficiently. The actual implementation of the above order will begin when the indexes, fixed by the RF Government begin being published. The gross profit accounted for at taxation includes the profit from the sale of land plots.

The Law includes, as well, the clause on compensation of the privileges on capital investments, in the events such privileges are implemented or transferred within the two years following the relevant grants.

Privileges for the profit tax as for the money entities receive have been instituted. They mean the absolution from taxation on profit of the free aid received from foreign States in accordance with the intergovernmental agreements, from foreign organizations for education, science, and culture development in Russia; the money transferred between the mother and subsidiary enterprises (with the above 50% share of participation in the statutory capital) within the limits of a same legal entity for the enhancement of the production and non-production bases, plus the property transferred to the consumer cooperation entities at the relevant decisions of their owners.

As for now, the incomes in foreign currencies are to be transferred into Russian rubles at the exchange rate to be fixed by the Russian Central Bank effective as of the date of determination of the revenue from the sale, in accordance with the accountancy policy of an individual entity. For comparison: before, the recalculation was made as of the date of the money inflow, notwithstanding the accountancy policy.

The taxed profit does not include any more the incomes from the State securities of the RF, of the RF subjects, nor of the local self-government bodies.

The decrease of the taxed sum by the sums of allotments to the reserve funds has been limited by the minimal sizes of the funds (to be fixed in accordance with the Law); such reduction is effective only at the condition of the targeted use, and within the limits of 50% of the taxed profit.

The results of the joint activities are to be accounted for by every partner when determining the taxable profit, every quarter-year.

The privileges for the capital investments relate to the profits intended not only to the financing of the capital investments and the bank credits for these purposes, but to the interests on such credits, including the shared participation, as well. The privileges relative to the development of the telecommunications and of the environment protection activities are, today, to be granted according to the general order.

The new Law has fixed a number of the privileges granted by the Presidential decree # 2270 of 22 December 1993, namely, the privileges for the profit to be allotted for the R&D works, to the Russian funds for fundamental studies and technology development, and to the replenishment of the life insurance reserves.

As for the Federal Budget, the taxation rate will amount to 8% for the banks granting credits to rural economies (50% at least) and the the insurers insuring the interests of the above entities (at least 50% of the insurance premiums).

On 14 July 1995, the State Duma approved the Law "On the Amendments to the Law "on Excise Taxes"". The new Law reduces somehow the list of the goods subject to the excise taxes; it reduces the competence of the Government as for fixing the excise taxes rates: this results from the fact that the new Law fixes the rates for the alcohol (60% to 90%), strong liquors (20% to 85%), beer and tobacco (20%), gasoline (20%), and passenger cars (5%). The new Law has introduced the offset order of calculation of the excise taxes for the use of the goods subject to the excise taxes when producing other products subject to the excise taxes; the new Law does, as well, put a new order to the payment of the excise taxes when importing products from the outside CIS countries, etc.

This draft Law was rejected by the Federation Council; on 12 August 1995, the State Duma did not manage to overcome the relevant veto. The situation saw its development not before than in February 1996. On 14 February 1996, the State Duma promulgated the Law "On the Excise Taxes" in the version developed jointly with representatives of the Federation Council.

The Law “On the Amendments and Supplements to the RF Law “on the Value-Added Tax”” was promulgated by the State Duma, in the third reading, on 5 December 1995. The new Law envisions to exclude from the number of the tax payers the natural persons engaged in the entrepreneurial activities. Moreover, the sums entrepreneurs receive as financial aid will be barred from the taxable turnover. In accordance with the new list of goods, the exported and re-exported goods; banking operations (except the collection operations); and R&D works executed by both the education and science entities. The new Law enhances the notion of the gold mining; neither does it release from taxation the enterprises of handicapped persons engaged in trading activities.

This Law was vetoed by the Russian President on 3 January 1996. The main reason for this was that the new Law did not envision either the privilege for the VAT in the housing construction, or the VAT release for the credits of foreign Governments and international financial institutions. On 21 February 1996, the new Law was approved by the State Duma in the version agreed upon with the President.

On 24 November 1995, the State Duma promulgated the Law on amendments and supplements to Article 6 of the Law “On the Personal income tax”. The new Law increases, from Rb10 mln up to Rb12 mln the value of the income taxed at the minimal rate. At the same time, the upper taxation rate was increased (beginning from the annual Rb48 mln), from 30% up to 35%. The draft was rejected by the Council of Federation on 9 December 1995. Nevertheless, on 21 February 1995, the State Duma defeated the veto of the Council of Federation.

The so-called “alcohol package of the normative documents includes 2 Presidential Decrees plus 6 Governmental resolutions; its purpose is to tighten the State control over the production, bottling, sales, and import of alcohol.

According to the RF Ministry of Finance, the measures envisioned by this package will result in the growth of the prices on alcoholic beverages by not more than 10% to 15%, while the supposed income of the Budget will amount, in 1996, to 1.5% to 2.0% of GDP. We think that such an estimate is too optimistic. Besides, a *sine qua non* for this is the distinct and complete implementation of all the above measures when tightening the control of the collection of the relevant taxes.

The important Resolution of the State Tax Service in the letter of 5 January 1996 “On Check of the Accuracy of Calculation of the Taxable Base by Organizations”, concerning the authorization to calculate taxes, in 1996, not only by the fact of dispatch of goods but by the fact of payment for it, as well, should be noted. At the same time, the accountancy of sale of goods has to be kept by the fact of their dispatch.

Outlook on evolution of the tax laws. On 12 July 1995, the amendments were made to the law on the bases of the taxation system “On the General Principles of Taxation and Levies in the Russian Federation”. This Law contains numerous serious enough amendments. The most important changes are the following:

- it introduces the norm, according to which, normative acts on taxation may be retroactive, if they envision specially such clause and at the condition improves the situation of tax payers;
- no taxes may be instituted which lead to discrimination of tax payers by territory or in function of the form of property, organizational and legal form of an entity, as well those limiting the travel, within the RF, of people, goods, transport, or financial assets. The taxes and levies instituted by the bodies of the Russian Federation subjects and by local authorities must not lead to the decrease of the incomes or growth of the expenditures of the Federal Budget;

- the limitation was introduced on the sizes of the regional (2% of the annual labor payment fund of entities) and local (5% of the annual labor payment fund of entities calculated on the base of the minimal labor payment) taxes. The taxes of the subjects of Federation are the following: the regional profit tax, the tax on property of organizations, and other taxes whose aggregate rate does not exceed the above limit. The local taxes include the tax on land, the tax on property of natural persons, the tax on heritage and gift, and the municipal taxes, whose aggregate rate does not exceed the above limit;

- the law introduces the notion of the levies which include the compulsory payments of single-time character, subject to payment to the budget of the relevant level when State authorities make legally significant actions for the benefit of a tax payer or grant to it certain rights (licenses);

- the delays or spreads of taxes payment are not included in privileges, but form separate notions. The order of their grants is regulated in sufficient detail; and

- the law envisions lower penalties for breach of the taxation laws, and limits the right of the State Tax Service to issue instruction on the enforcement of the tax laws.

The draft under consideration was rejected by the Council of Federation on 21 July 1995, and, from that moment, the State Duma did not make attempts to overcome the veto. Most probably, the draft will never be discussed again, because the Government has submitted to the State Duma the draft of the general part of the RF Tax Code which concerns the issues of the taxation system.

There exist three almost similar draft laws submitted, in the Fall 1995, by the Legislative Assemblies of the Orenburg and Perm regions, and the Murmansk region Duma. The essence is to let the Federation subjects keep in their budgets 50% of the export duty to develop their social spheres. The Ministry of Finance and the Ministry of economy gave negative opinions on this proposal.

In October 1995, the draft law "On Amendments and Supplements to the Law "On the Customs Tariff"" was submitted to the State Duma. The essence of it was to release from customs duties the goods imported within the limits of the credits granted to Russia by foreign states and international financial organizations. The above privilege was abolished, since 15 March 1995, by the Law "On Certain Issues of Grants of Privileges to Participants in External Economic Activities".

Among the possible changes in the taxation system, it should be noted that the conditions of the grant to Russia of the EEF credit by the International Monetary Fund suppose to cancel the export duties on gas (from 15 March) and on crude oil (from 1 July).

Forecast of evolution of the budget situation in 1996. The estimate below of this budget is based on the scenario in which the Government maintains the tight financial policy. The inflation forecast for this model was made on the basis of the auto-regressional model developed in the IET (see V. Mau, S. Sinelnikov-Murylev, and G. Trofimov "Alternatives of Economic Policy and Problems of Inflation", *Problems of Economy*, # 12, 1995) using the actual data on the inflation in the preceding month and the dynamics of the money supply during the preceding six months.

When making the forecast, we were based on the index of growth of the money supply assumed by the "Main Directions of the Money Policy for 1996", and equal to 2.9% to 3.35 monthly (43% annual, taking into account the actual decrease in M_2 in January and the planned growth of M_2 in February (by 5%) and in March (by 4.1%)). These parameters differ significantly from those on which the budget calculations were based (25% of increase in M_2 in 1996). The "Main Directions of

the Monetary Policy for 1996” do not suppose the growth of the real demand for money in 1996. This condition does not seem all realistic. Of course, one can hardly forecast the growth of the demand for money in the first half-year, under the serious political instability. However, if, after the Presidential elections, the successive course of economic reforms and political stabilization continue, then, based on the 1994-1995 experience, one can forecast at least a 5% growth of demand for money in the second half of 1996.

This, assuming the 43% growth of M_2 in 1996 and the 5% growth of the demand for money, we have calculated the 1996's inflation level of 40%, or 2.8% monthly. Based on this inflation level, and the condition that the decrease of the actual GDP stops (as assumed by the budget calculations), our estimate of GDP for 1996 amounts to Rb2,800 trln which is Rb500 trln higher than the one taken into account by the Law on the Budget.

As it has already been noted when analyzing the Budget, the realistic estimate of the tax revenues for 1996 is the value equaling about 11.2% of GDP. This means the possibility to execute the Budget with the Rb310 trln of the tax revenues, Rb30 trln of the targeted budget funds revenues, and Rb40 trln of the non-tax incomes envisioned by the Law. Hence, even with the inflation higher than envisioned by the draft Law, the revenues may amount to about Rb380 trln, i.e., by Rb30 trln (1.1% of GDP) higher than the Law assumes in absolute figures.

But the above inflation level determines the necessity to indexate, during the year 1996, at least, such State expenditures as the labor payment to the persons employed in the Budget-supported branches, stipends, grants to the Pension Fund, etc. Besides, one should have in mind that the Presidential elections to be held in the beginning of the Summer 1996 will, inevitably, lead to a number of populist decisions. The correspondent growth of the Budget expenditures will be, the most probably, higher than the excess of the forecast expenditures over the value fixed by the Law.

The above is confirmed by the number of the expenditure decisions made in January and February and not accounted for in the 1996 Budget. These are the measures to restore the Chechnia (Rb16 trln), the Laws “On the Increase of the Minimal Pensions and the Order of Indexation and Recalculation of the State Pensions” (Rb15.8 trln) and “On the Increase of the Minimal Labor Payment” (Rb11.5 trln, including Rb4.2 trln from the federal Budget), both promulgated on 7 February. Additional allotments for the defense, the coal industry, and the repayment of the Budget debenture in the labor payment were declared. In accordance with the preliminary estimates, these measures will require additional Rb35 to 40 trln, not accounted for in the Federal Budget for 1996.

Such escalation of the expenditures decisions will, in 1996, inevitably, lead to certain difficulties with the Budget execution; these difficulties will be similar to those of 1995, when the greater than envisioned incomes turned out, nevertheless, insufficient to cover the growing Budget expenditures.

The Budget situation of 1996 may change radically enough if the Government shows a sufficient political will in developing and implementing the already approved measures with the purpose to improve the taxes collection. If the Ministry of Finance and the Russian Taxation Service manage to improve the control, reduce strongly the transactions using the non accounted for cash, a significant growth of the tax revenues may be supposed for 1996. (The above estimates take into account the growth of the tax revenues by 0.2% to 0.3% of GDP).

It should be emphasized again that the scenario of the events is based on the assumption that, in 1996, the tight budgetary and monetary policies are effective. The alternative scenarios, which may be put into life if communist or nationalist forces take power, are discussed in the section dealing with the monetary policy.

2.2 Monetary Policy

Outlines of Monetary Program

In 1995, the reduction in the average monthly inflation rates from the 1994's 10.2% down to 4% was declared the target of the monetary policy. The Program by the Government and Central Bank was based on the assumed growth of the money supply by the average monthly 4.2%. This Program was agreed upon with the International Monetary Fund when granting to Russia the stand-by credit of US\$6.4 bln. The main parameters were fixed by the Joint Declaration of the RF Government and the Central Bank on the economic policy for 1995. To control the growth of money supply, the monthly limitations on the growth of the net internal assets of the crediting bodies, as well as the limits of the net claims to the Government were fixed. The accumulation of the net internal assets was limited to 88% to the end of 1995. The Program determined the dynamics of the external assets of the Central Bank by the targeted indexes of the growth of the net international reserves.

The monetary program envisioned to refuse the use of the direct credits from the Central Bank to finance the Federal Budget deficit.

Only the short-term credit to cover the cash gap in the first quarter-year, not exceeding Rb3.5 trln. The Budget deficit in rubles was supposed to be covered, mainly, by selling State securities. In accordance with the Program, the credits to commercial banks were to be granted only at the market basis, at the sales rate. The rate for refinancing of commercial banks was not supposed to be lower than the relevant rate of the interbank market.

The 1995's financial stabilization program did not envision any fixed ruble exchange rate or any obligations as for its dynamics. (Though, the smooth revaluation of the ruble by 8% in the first half-year with its slow devaluation by 4% in the second half-year were envisioned).

Hence, the initial choice was made, for the orthodox stabilization based on the control over the money supply, without the use of the standard mechanism of nominal anchor (by fixing the exchange rate). This approach is more flexible, and it had a good validation in the situation of the Russian financial markets at the end of 1994.

First of all, after the inflation burst of the end of 1994, having resulted in a series of speculative attacks on the ruble, the gross hard currency reserves of the Central Bank dropped to the crucially low level of US\$1.5 bln (as of the end of January 1995). To that moment, the Government had to carry out the forced sharp devaluation of the ruble. This measure could have allowed to replenish rapidly the external reserves, but it would also have exacerbated the already high inflation. Nevertheless, judging by the experience of the currency crisis of October 1994, this measure could have led, with a high probability, to the dismissal of the Government.

Secondly, the fixation of the exchange rate was impossible due to the lack of trust in the monetary program of the Government. At the beginning of 1995, it was not yet clear to what extent would it be devoted to the declared policy. Any attempt to come back to the practice of the inflationary financing of the Budget deficit at a fixed exchange rate would have meant the complete fiasco of the economic policy of the Government. Hence, strict enough measures by the Government and Central Bank in the first quarter-year were necessary to solve finally, in February, the issue of the IMF credit and to make the monetary problem real.

Main Features of Financial Stabilization Process in 1995

Anti-inflation policy measures. From the very beginning of 1995, the policy of the Central Bank followed the strict directions of the monetary program. The growth of the monetary aggregates decreased sharply. In the first quarter-year, the growth of the monetary base made 4%, while the net internal assets grew by 2.3% and M₂ grew by 9.7% (see Table 2.7). The Central Bank did not credit the Government above the volume envisioned by the monetary program. Nevertheless, it purchased short-term bonds of the Government within the limits for the growth of the net internal assets. In the first six months, the growth of the net internal assets made only 19%, while the limits fixed by the monetary program were 35% for the same period. This tightness of the internal crediting policy had its sense. First of all, it was necessary to demonstrate the adherence of the Government and Central Bank to the course for reduction of the inflation. Secondly, a certain basis was being created to increase the net internal assets in the second half-year. Thirdly, the expansion of the monetary base due to the accumulation of the external reserves by the Central Bank, not envisioned by the program, was somehow compensated.

During 1995, the actually prohibiting rate of refinancing was effective. As Fig. 2.16 shows, it exceeded significantly, practically all the time, the INSTAR rate of actual transactions with one-day credits, and, from mid-March to the end of the year it exceeded the average weighed yield on GKO's. The aggregate volume of the sales credits granted by the Central Bank to commercial banks made only Rb538 billion during the whole year, or 0.33% of GDP. Neither the mechanism of the bills rediscount, nor the crediting of commercial banks under collaterals envisioned in the program for 1995 were introduced. By this, the Central Bank actually rejected the influence on the short-term interest rate of the money market by the discount window. This narrowed somehow its possibilities for moves in the Summer and Fall when the results of the tight crediting policy became obvious.

Despite the measures taken, the inflation stayed, during the first six months of the year, at a high enough level, above 10% monthly. This is explained by the consequences of the crediting expansion of 1994, the seasonal growth of the consumer expenses, the growth of the prices on the power media, and the issue for circulation of the treasury bonds at the end of 1994. A certain role was played by the higher inflation expectations induced by the threat of a sharp devaluation of the ruble at the beginning of the year. On the whole, in the first quarter-year, the situation of the currency market was determined by the significant speculative demand for the currency resources. As for the policy of a smooth devaluation of the ruble, that the Central Bank maintained from January to April never had any stabilizing effect on the inflation process.

In April, the Central Bank made the decision to expand the basis of the mandatory reserves for commercial banks, having introduced the reserves for the fixed deposits and hard currency accounts. The meaning of the increase of the reserve allotments consisted, seemingly, in trying to attenuate the effect of the credit multiplier growth resulting from the expansion of the ruble deposits and the expected for activation of the financial markets.

Table 2.7

Monthly parameters of monetary policy in 1995

	Monetary base ¹	M2	Net internal assets ²	Net international reserves ³	US dollar exchange rate	Average weighed yield on GKO and OFZs	Interest rate on three-month inter-bank credits	Inflation rate
	Rb trln	Rb trln	Rb trln	Rb trln	Rb/US\$	% annual	% annual	%
January	44.0	93.8	40.5	3.5	4048	217.6	363.1	17.8
February	47.6	101.9	42.0	5.6	4473	256.0	385.6	11.0
March	49.9	107.3	40.8	9.1	4897	220.6	334.5	8.9
April	57.3	123.2	46.0	11.3	5100	187.2	245.1	8.5
May	64.0	138.2	44.2	19.8	4995	145.6	199.5	7.9
June	73.7	156.6	47.5	26.2	4538	111.5	121.1	6.7
July	81.6	165.0	55.1	26.5	4415	84.2	121.2	5.4
August	86.1	173.8	59.5	26.6	4447	124.9	173.1	4.6
September	89.3	179.7	63.8	25.5	4508	156.7	102.9	4.5
October	90.7	184.2	62.5	28.2	4504	103.7	81.1	4.7
November	95.4	195.2	70.7	24.7	4580	93.4	82.5	4.5
December	103.8	213.8	76.5	27.3	4640	86.7	82.5	3.2

¹ cash outside banking system and minimal reserve requirements by ruble deposits (acc. to IMF);

² difference between monetary base and volume of net international reserves of monetary and crediting bodies (acc. to IMF);

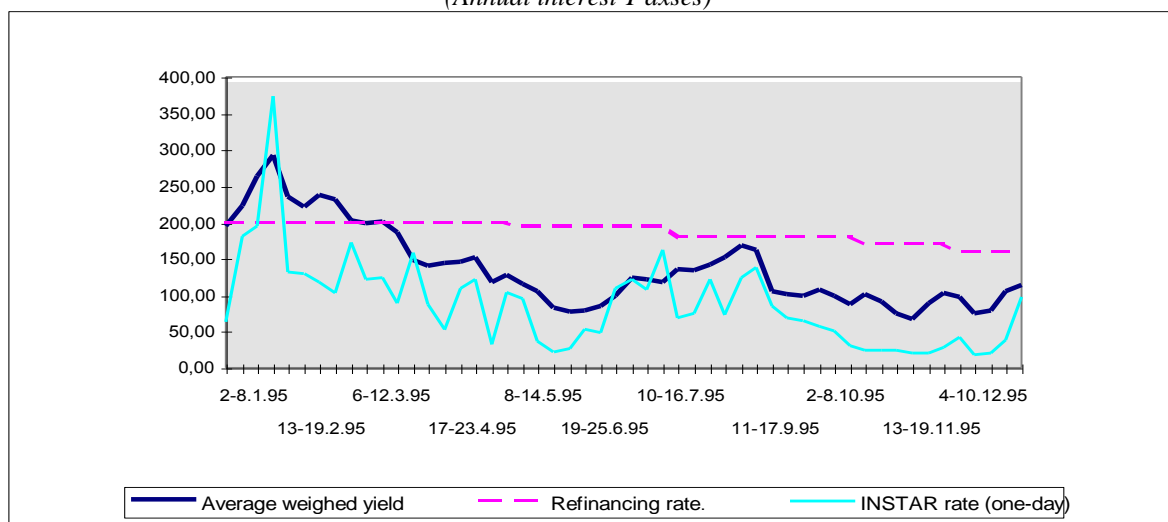
³ difference between foreign reserve assets and liabilities of the RF Central Bank and Government, including net short-term liabilities of the Vnesheconombank or any other institution acting in behalf of the Government (estimated at the exchange rate Rb3,350 per US dollar) (acc. to IMF);

⁴ average weighed (by the volume of sales) yield on GKO and OFZs at the secondary market.

Fig. 2.16

Interest rates in 1995

(Annual interest Y axes)



The increase of the mean reserves norm supplemented, in a certain sense, the strict self-limitation of the Central Bank on the volumes of refinancing of commercial banks. At the beginning of the year, the money multiplier grew from 2.04 up to 2.13 and stayed at about that level till the second half-year. In August, it dropped down to 2.02, this value remaining stable till the end of the year.

The tightening of the reserve policy was confronted by the banking community. In the conditions of the remaining high enough inflation the growth of the reserve allotments means an additional tax load on commercial banks. This circumstance resulted, inevitably, in that banks selected more risky

directions of crediting, which made one of the causes of the banking crisis which began in August. Indeed, there would have been no necessity in the tightening of the Central Bank's reserve requirements to commercial banks should the Central Bank have selected the most rational policy of accumulation of the hard currency reserves (see below).

The deceleration of the money supply growth which took place in the first quarter-year resulted in the reduction of the real offer of money. This is a consequence of such phenomenon as the inflation inertia.

The inflation inertia is explained by the relative rigidity of the commodities prices. Even under a high inflation they cannot change as rapidly as desired. The inertia of the monthly dynamics of the consumer prices is reflected by the simple auto-regressional model of the following form:

$$\pi_t = a\pi_{t-1} + bm_{t-6,t-1} + \varepsilon_t,$$

where π_t is the inflation in the month T,

$m_{t-6,t-1}$ is the average rate of growth of the money supply in the preceding half-year, and

ε_t is the random variable reflecting the influence of the inflation expectations and non-monetary factors.

The estimates of the regression parameters ($a = 0.68$, $B = 0.36$) were obtained based on the corrected data on the dynamics of the consumer price index and money stock M_2 from January 1992 to December 1995. The multiple regression factor $R^2 = 0.85$, the t-statistics value equal 8.4 for the parameter a and 3.9 for the parameter b.

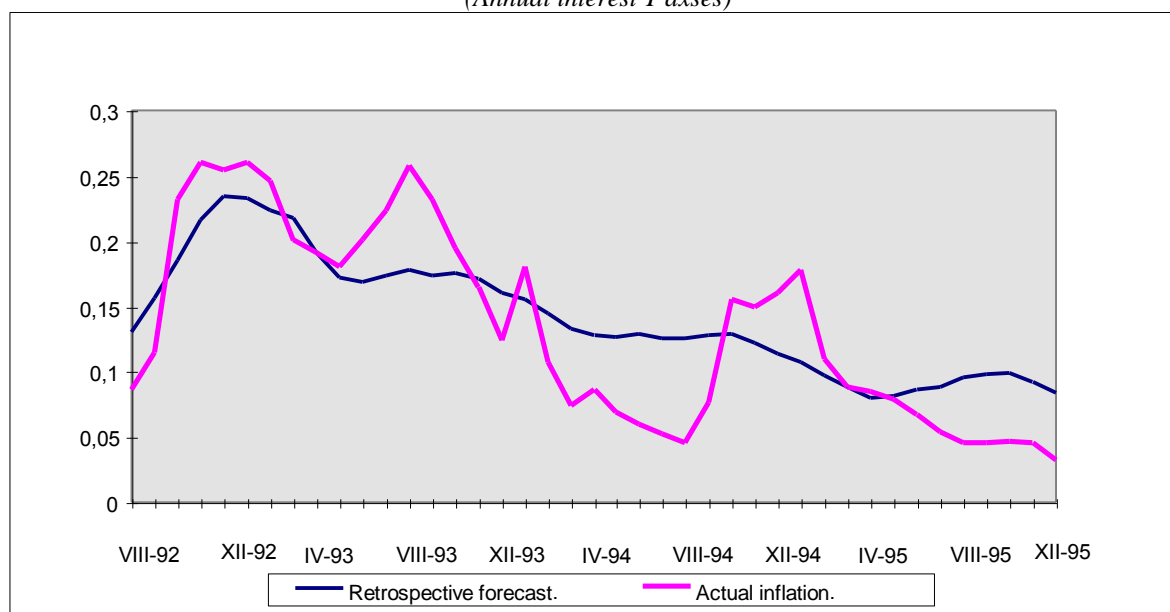
This model reflects well the trend of inflation from 1992 to 1995. This is well shown at Fig. 2.17 showing the actual and estimated rates of inflation from July 1992 to January 1996. The estimated inflation (retrospective forecast) was calculated by the formula:

$$\pi_t = 0.68\pi_{t-1} + 0.36m_{t-6,t-1}$$

For the actual monthly augmentations of the money supply. The retrospective forecast models the inflation dynamics based on the quantitative theory, taking into account the inertia of prices. The closeness of the sum of the regression factors to one reflects the attribute of the money neutrality in the long-term order. The deviations of the actual inflation from the retrospective forecast are explained by the changes of the inflation expectations and the effect of the non-monetary factors, not accounted for in an apparent form. These deviations may be due to the dynamics of the exchange rate, the leaps of prices for the basic resources, the fluctuations in the economic policies, etc.

Retrospective forecast and actual inflation in 1995

(Annual interest Y axes)



As Fig. 2.18 shows, the reduction of the actual volume of the money stock (M_2) began since Fall 1994, which resulted in a sharp growth of the interest rates of the money market to the beginning of 1995. The average weighed yield on GKO's reached the monthly level of 14% at the end of January (see Fig. 2.16) and dropped down to 10% to the end of March (See Table 2.10). Nevertheless, to the end of the first quarter-year, the yield on the ruble assets grew in relation to that of the hard currency assets. This was to result in the lower demand for dollars and a relevant drop of the dollar exchange rate. However, the uncertainty as of the future policy remained in the first quarter-year. Besides, as it has already been said, the Central Bank continued, in the first quarter-year, a targeted policy of the ruble devaluation. Before the joint declaration of the Central Bank and the Government, this policy was, to a certain extent, validated by the lack of the hard currency reserves in the Central Bank and the remaining threat of new speculative attacks.

Were the expectations of all the participants of the financial markets more rational, allowing to foresee the consequences of the policy of the Government and the Central Bank, the structure of the portfolios of economic agents would have been changed for the benefit of the ruble assets in March already. Nevertheless, certain market indicators show that, in many events, the decisions are made on the basis of the adaptive expectations based on extrapolation forecasts. The dynamics of the currency forwards (source: "Monetary Reports", Brigitte Granville, January 1996) from December 1994 to November 1995 shows that the attitude toward the Governmental policy changed radically only in May, after the moment when the US dollar rate began falling (see Fig. 2.19).

It should be noted that the closed-end currency contracts had reflected well, before the ruble corridor was introduced, the inflation expectations, because they had been based on the extrapolation of the current prices growth and took into account the possibilities of a real growth of the ruble rate poorly. The data on the time structure of the interest rates also confirm the inertial of the inflation expectations.

Indeed, till the end of April, the market agents did not take fully into account the consequences of the financial stabilization which had begun. In the conditions of the strongly "dollarized" economy, banks continued to keep significant hard currency assets. In general, the restructuring of the bank portfolios is slowed down due to the poor development of the financial institutions and derived financial instruments.

Fig. 2.18

Actual money supply in December 1993 prices
(Rb trln Y axes)

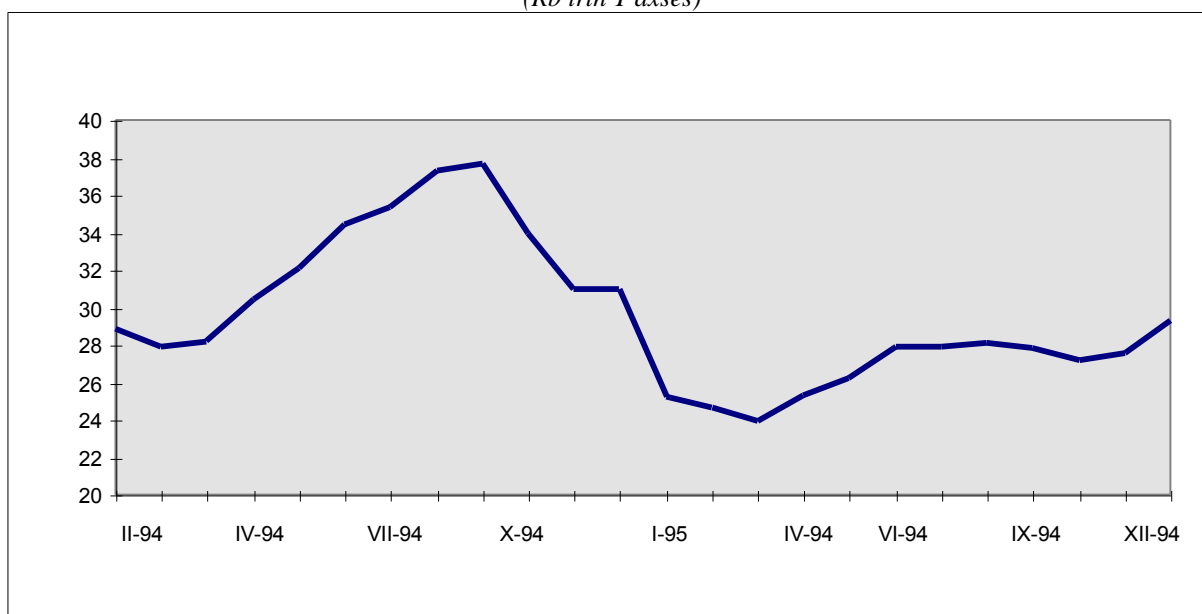
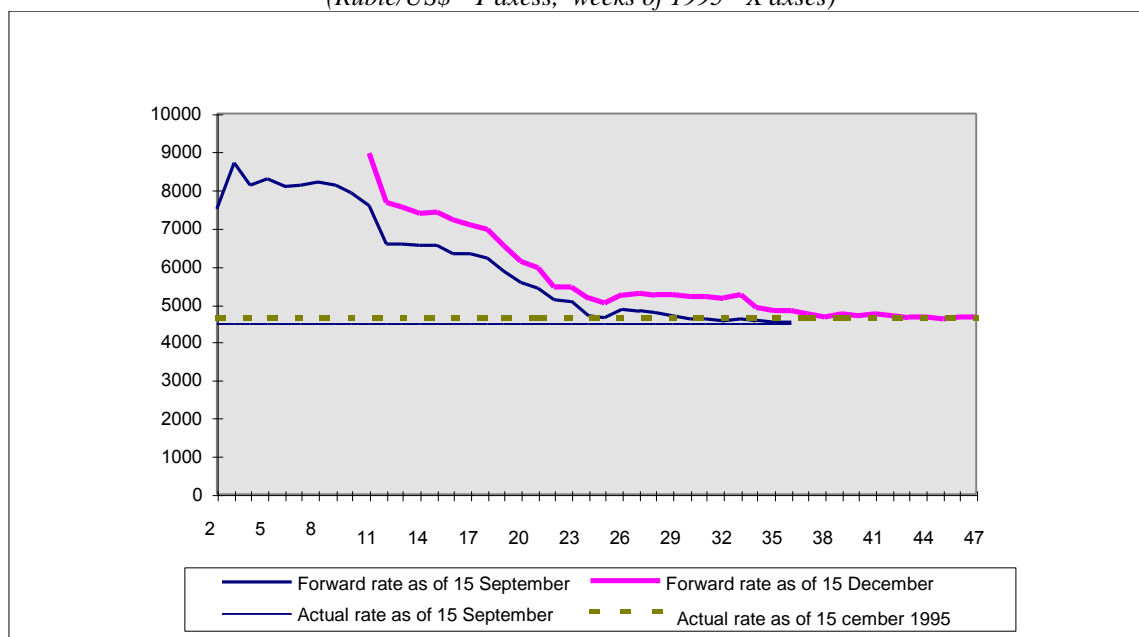


Fig. 2.19

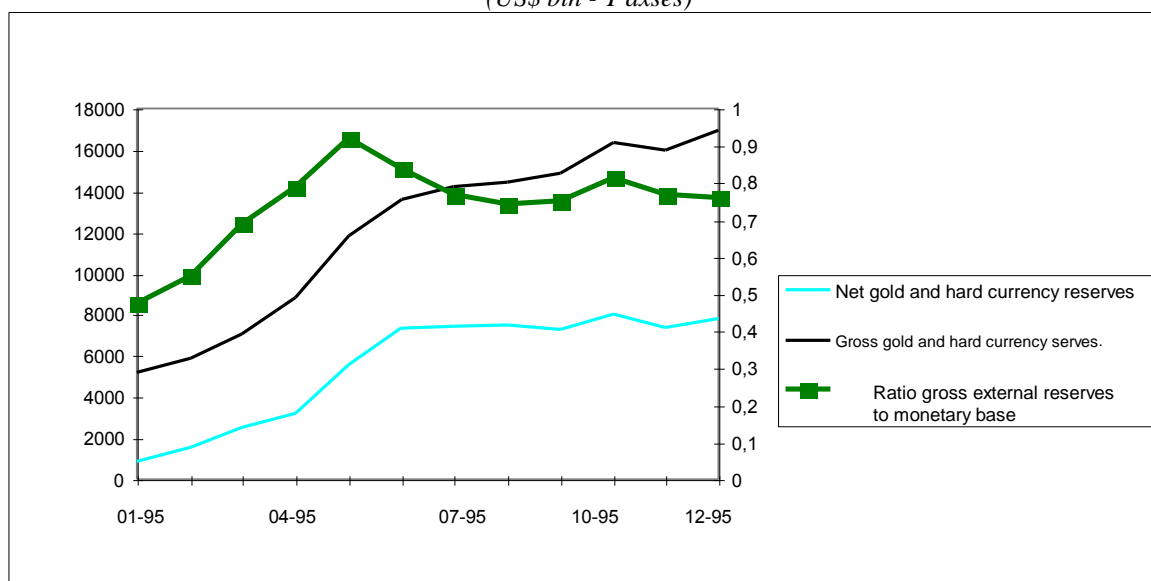
Dynamics of forward rates of US dollar
(Ruble/US\$ - Y axes, weeks of 1995 - X axes)



The problem of trust in the anti-inflation policy explains the inertia of expectations and the slow reaction of financial institutions only in part. On its merits, the attitude toward the intentions and possibilities of the authorities was to change radically after the IMF's decision to support the monetary program, made at the end of February. The currency policy of the first four months of the year played a disorienting role. In January and February the smooth devaluation of the ruble had good reasons, but in March and April it became inconsistent with the measures aimed to limit the money offer. The Central Bank determined the change of the expectations and began to increase intensively its currency reserves, increasing uniformly the US dollar exchange rate. The only significance of such policy was to boost preventively the US dollar rate foreseeing the further strengthening of the ruble. Fig. 2.20 illustrates the dynamics of growth of the external reserves of the Central Bank (the data were taken from the IEA report "The Lost Chance", Moscow, 1996). Most of the currency reserves were purchased by the Central Bank just in May and June.

Currency reserves of Government and Central Bank

(US\$ bln - Y axes)



The February to May increase of the US dollar exchange rate constrained the restructuring of the financial portfolios and resulted in a forced growth of the actual offer of the ruble mass. This reduced the interest rates at the money market and strengthened the ruble devaluation expectations. Nevertheless, the growth of the actual demand for the ruble surpluses from the participants of the financial markets, which agrees with the anti-inflation policy and the high ruble interest rate, arrived after the acquisition of large currency reserves by the central Bank. The demand for rubles was growing with the decrease of the US dollar rate and slowdown of the inflation resulting from the tight measures taken at the beginning of the year. Hence, the dynamics of the money supply (see Fig. 2.18) were determined, in the first four months of the year, mainly by the changes of the money offer by the Central Bank and the rigidity of the prices; further on, the dynamics were determined by the changes of the demand for money, first of all, from the financial markets.

Due to the artificial growth of the US dollar rate, the Central Bank purchased, in March to May, more than US\$5 bln. The net external reserves grew from the US\$1 bln at the beginning of February to US\$3.2 bln at the beginning of May. In the second quarter-year, the growth of the monetary base made 48% instead of the 15% assumed by the money program. During the same period, the money supply grew by 46%, while the supposed growth made the same 15% (see Table 2.10).

The accumulation itself of such a sum of external reserves matched perfectly the purposes of the financial stabilization because it ensured the stability of the currency market in the second half of 1995. Here one should not overestimate the absolute amount of the reserves accumulated by the Central Bank. Fig. 2.20 shows the dynamics of the ratio of the gross gold and hard currency reserves to the monetary base. It amounted to 48% in January, reached its maximal value, 92%, in May, and decreased to 76% in June. It stayed at about this level till the end of the year. For comparison, in Mexico, during the period before the currency crisis of 1994, the ratio of the gross external reserves to the money supply exceeded one. Hence, it does not seem rightful to speak of a significant excessive accumulation of the hard currency by the Central Bank in the first half of 1995.

Similarly, it does not seem rightful to overestimate the inflation effect from the accumulation of the currency reserves. As confirmed by the model above, the dynamics of the money supply determines only the inflation trend. The deviations from the trend are tied, in a great extent, with the changes of the inflation expectations. In particular, in the fourth quarter-year, the actual inflation was much lower than the values forecast using simple monetarist models. This effect is explained

by the reduction of the inflation expectations in the second half-year, due to a higher trust in the policy of the Government and Central Bank. The secure of the ruble stock by the currency reserves should be understood in such sense, that its release does not create conditions for unsecured emission in the following months due to the necessity to indexate the incomes. Instead of this, at unfavorable changes of the political situation, the getaway of the investors from the ruble assets should result in a contraction of the ruble market by redemption of the issued ruble mass (with continuing tight monetary policy). This also favors the inflation expectations and levels the inflational consequences of the accelerated accumulation of the currency reserves.

However, if the Central Bank had not executed a purposeful devaluation after the approval of the monetary program, the decrease of the US dollar rate could have begun in March already. In this case, the growth of the currency reserves would have been going on on the background of an attack against the dollar. It needs to be taken into account that, in April and May, the Central Bank had no competitors in the money market, capable to ensure a significant speculative demand for US dollars. It did not use at full extent its actually monopolistic situation in the currency market and did not play for decrease in a profitable way. If the psychology of the financial markets had been taken into account, the discharge of the dollars could have been incited and the reduction of its rate could have been stopped, using mass purchases, at any level much lower than the actual Rb4,500 per dollar. This would have allowed the central Bank to accumulate, to May, the sufficient currency reserves, but at a significantly lower rate than it happened in March and April. In such case, the growth of the money supplt in the second quarter-year could also have been much lower than the actual 46%. Our estimates show that a similar growth of the currency reserves could have been obtained by increasing M_2 by 30% to 45%. However, at such scenario, it was important to prevent the dollar rate fluctuations, to stop its reduction, and prevent the back speculative surge. In such situation, a logical solution of the market stabilization problem would have been to introduce the ruble corridor a month before the actual date, i.e., at the beginning of June.

It is also possible that, at a better thought out policy of accumulation of external reserves, there would have been no necessity to tighten the reserve requirements for commercial banks. According to our estimates, the increase of the norm of the reserve allotments, beginning from May, blocked the additional expansion of M_2 in 1995 by not more than Rb10 trln. This is much lower than the additional money stock issued for purchase of hard currency in March and April due to the unfavorable for the Central Bank exchange rate difference.

The intensive Spring accumulation by the Central Bank of the external reserves did not result in the expected inflation surge in the second half-year. Nevertheless, it could have been done more efficiently for the Central Bank itself, with a lower level of inflation and lesser losses for the banking system. The working balances of commercial banks at the correspondent accounts in the Central Bank grew by almost 50% in the second quarter-year and dropped by 25% in the third quarter-year. Here, the growth of the balances resulted from the growth of the mandatory reserve allotments, while the July's reduction was due to the sharp drop of the excessive reserves of commercial banks. This demonstrates the excessive tightness of the Central Bank's reserve policy.

In the second half-year, the growth of the net international reserves slowed down, coming to 4.2%. For the contrary, the net internal assets grew by 61%. These are due, in a great extent, to the expansion of GKO's in the second quarter-year resulting in their more active purchase by the Central Bank on the open market (see below).

It should be noted that the monetary program was corrected, accounting for the unforecast growth of the monetary base in the first quarter-year. For all that, the initial limit of the net internal assets growth for the year was exceeded insignificantly (see Table 2.10).

The introduction of the ruble corridor stabilized the currency market and influenced the attenuation of the inflation expectations in the Fall. Hence, in the second half-year, the mechanism of the nominal anchor functioned. Such stabilization of the inflation expectations would not have been possible without the anti-inflation measures of the first half-year, such as the tight policy of the internal crediting and accumulation of the sufficient currency reserves. Table 2.10 shows the balances of the year as for the main nominal macroeconomic indexes.

Currency policy. When evaluating the currency policy of the Central Bank before the introduction of the ruble corridor, it should be contemplated that the real rate of the ruble increased, during the whole year, by 76.5% (for comparison: in 1994, the real rate of the ruble increased by only 14%, and in the first quarter of 1995 it increased by only 4.4%). Initially, the macroeconomic program was oriented toward the policy of a stable or slowly growing real rate of the ruble. However, the growth of the real yield on the ruble assets and the changes of the expectations in the second quarter-year brought to a wild process of de-dollarization of the economy and a growing offer of hard currency. As a result, in May, the Government and the Central Bank faced a new choice: either to continue the accumulation of the currency reserves, maintaining the nominal exchange rate at the level above Rb5,000, or, in order to control the monetary base, limit their growth at the expense of a lower US dollar exchange rate. In May, the reduction of the US dollar exchange rate resulted in the change of expectations of the main mass of the small holders of dollar assets, giving an additional motivation to the rate reduction in June.

In order to ensure, under the beginning de-dollarization of the economy, the stability of the real ruble exchange rate, the Central Bank would have had to breach the milestones of the monetary program. The growth of the monetary base at the expense of growth of the external reserves does not contradict the main goals of the IMF in what concerns the net internal assets. However, they do not agree neither with the main purpose of the stabilization which is to reduce the prices growth rates (whose growth brings, for the other hand, to the growth of the real exchange rate of the ruble), nor with the requirement of the IMF to limit the currency interventions with the operations aimed at smoothening the rate fluctuations.

This is why the Central Bank refused, in May, to continue the policy of increase of the currency reserves at a scale sufficient to stabilize the real rate of the ruble, and why, in May and June, the nominal rate of the Russian currency grew significantly. This growth and the drop of the interest rates in the money market resulted in a slowdown of the economy de-dollarization process to the beginning of July.

The currency reserves of the monetary authorities increased, to the end of the first half-year, to US\$13 bln (see Fig. 2.20). In the first half-year, the accumulation of the currency reserves resulted in the additional growth of the monetary base, in accordance with the current rate, to about Rb15 trln exceed of the fixed milestones (see Table 2.10). The actual refusal of the Central Bank to implement active measures, provoked the reduction of the US dollar exchange rate by 12% in May and June 1995 (see Fig. 2.21). The above allowed to the central Bank to restrict the growth of the monetary base by about 60% in the first half-year. The continuity of a fixed ruble exchange rate in June would have required a much more significant growth of the monetary base to the end of the first half-year, with a much sharper drop of the interest rates. Such monetary expansion could not have helped to effect the Fall's inflation.

Hence, the drop of the nominal US dollar rate in May and June should be considered as a compromise policy, conditioned by the high degree of "dollarization" of the economy and the actually existing mobility of the capital flows. The main issue is the compromise between the slowdown of the inflation rates and the stability of the dynamics of the real course of the ruble. The draft monetary program for 1996 formulated, already, this compromise in an obvious form, because

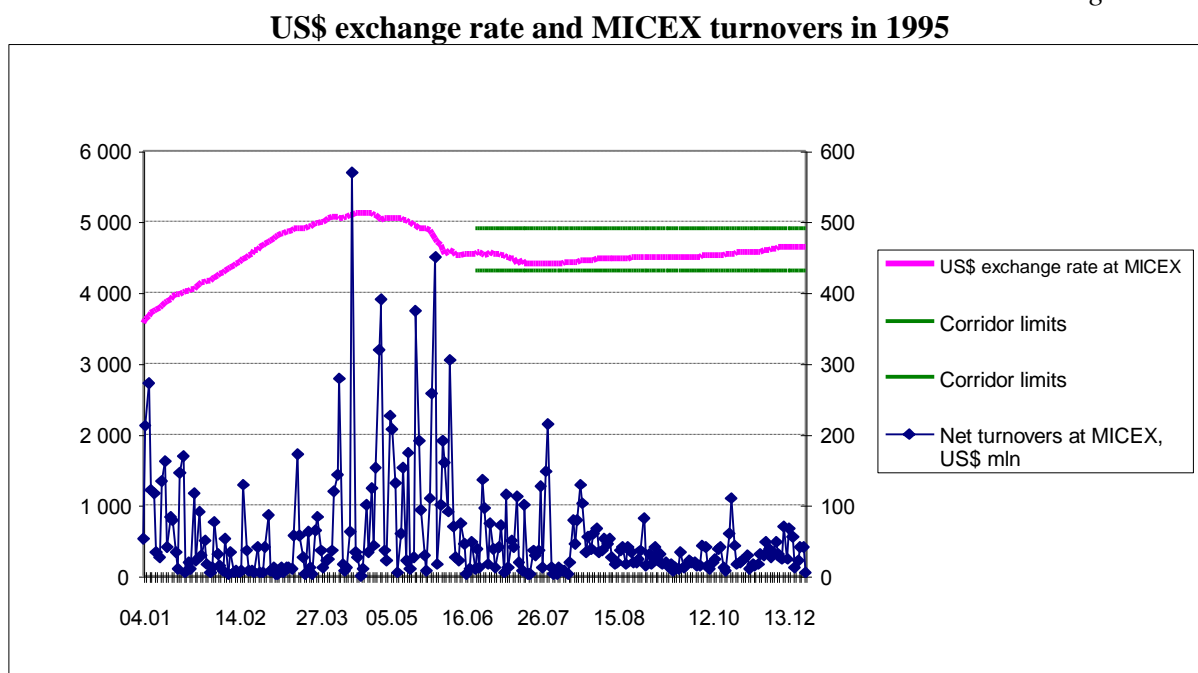
the coordination of the ruble exchange rate with the inflation and the support of a stable payment balance had been declared the purposes of the currency policy.

The limitation of the growth of the monetary base was also favored by the lowering of the banks' limits of the open currency position by 30%, the decision to increase the norm of the mandatory reserve allotments, and the introduction of the reservation norm for the currency deposits. What is important, is that the US dollar exchange rate was stabilizing simultaneously with the lowering of the interest rates of the financial market, which had a positive effect on the lowering of the inflation expectations.

Our estimate of the currency policy of the central Bank is based on the hypothesis that the growth of the monetary base due to the external reserves is less inflational than the one due to the net internal assets. Proceeding from the assumption that the main role in the US dollar drop of May and June was played by the financial markets, not the population, hence, the growth of the monetary base was due to the reduction of the least liquid items of the Central Bank's balance. This is confirmed by the grown multiplier and grown bank assets at the correspondent accounts in the second quarter. Such alteration of the money supply structure leads to a slowdown of the money circulation rate and is accompanied by a not so significant rise of the prices level. The point is that a significant part of the balances was used to service the transactions in the financial markets, first of all, in the State bonds market, and was not a threat to the commodities markets. The expansion of GKO's and OFZ's in the second half-year contributed in an even greater slowdown of the money circulation rate.

Hence, the Central Bank could have prevented such a significant growth of the real ruble exchange rate, had the external reserves been accumulated uniformly during the year. A controlled slow devaluation, coordinated with the inflation dynamics and answering the interests of the money supply growth could have had a certain stabilizing effect on the inflation expectations.

Fig. 2.21



This variant of the currency policy could have been implemented from the beginning of May, after the inevitable decrease of the US\$ exchange rate lower than the one actually happened. The insignificant growth of the net internal assets in the first half-year had a sanitation effect on the situation of the financial markets of the second half-year. Hence, the security of a significant share of the monetary base by the foreign currency assets of the Central Bank (84% to the end of the first

half-year and 75% to the end of 1995) would have favored, with a stable and forecastable currency policy, the reduction of the inflation expectations.

The growth of the real exchange rate of the ruble did not have any negative effect on the export operations (see Section 5.3). The annual volume of the export to the outside CIS countries grew by 25%, compared with 1994, while the import from these countries grew by 12.5%. Herewith, the growth of the net export has been due to other factors, and does not mean that the growth of the real ruble exchange rate will not have a negative effect on the real sector.

Firstly, the improvement of the external trade position of Russia in the past year is analogous to the effect of the J-curve of the trade balance. Due to the prices lag, the revaluation of the ruble in the real expression does not lead to an immediate reduction of the net export; moreover, it even improves the trade balance for a certain period. According to a number of experts, in 1996, a reduction of production of certain goods, whose shares in the world market is significant, i.e., non-ferrous metals, will take place. In contrast to the crude oil and natural gas, the change of the real exchange rate of the ruble for these groups has a serious influence on the production dynamics. As for the Russian share of the crude oil in the international market, it is not high, and its export has practically no effect on the world prices. Due to the above, and also due to the problem of the non-payments in the domestic market, the production of the power media is not elastic to the prices proportions of the external market.

Secondly, it is necessary to account for the so-called effect of “bridgehead” or effect of hysteresis”: after having gotten to the domestic market, foreign competitors do not cede their niches even at more favorable for domestic producers price ratios.

Thirdly, the growth of the real exchange rate before the economic ascent begins, brings to higher labor remuneration prices and to the partly loss of the relative Russian advantage in the world trade.

Fourthly, the strengthening of the ruble (not supported by such fundamental factors as the growth of GDP, labor productivity, production investments, etc.) will lead, sooner or later, to a devaluation, which will have a negative effect on the inflation expectations.

The introduction, on 5 July 1995, of the ruble corridor within the limits of 4,300 to 4,900 rubles per US dollar determined, in many aspects, the macro-economic situation of the second half-year. This measure was logically resulting from the situation in the financial markets, formed to the middle of the year. From February 1995, the Central Bank permitted absolutely unvalidated fluctuations of the exchange rate showing the absence of any strategic goals of the currency policy. The ruble corridor allowed to eliminate the indefinite character of the changes of the US dollar exchange rate and favored a higher trust in the monetary policy. The continuation of the policy of the unregulated controlled float could have resulted in a further disbalance of the currency market.

the introduction of the ruble corridor allowed to the central Bank to control more efficiency the money supply. This was especially important in the situation when the short-term interest rates of the money market did not play the role of an instrument of the Central Bank’s policy, and, hence, did not influence the demand for money. Under the conditions of the ruble corridor, the central Bank managed to reduce sharply the amounts of the currency interventions aimed to stabilize the US dollar exchange rate. The stabilization was “automatic” due to the fact that the fixed limits of the corridor reduced to zero the speculative activities. The data on the volumes of sales at the currency exchange during the year (see Fig. 2.21) reflect the fact that, in the second half-year, the US dollar stopped playing the role of a speculative asset.

Expansion of offer of GKO's. To the beginning of 1995, the value of outstanding GKO's on the market amounted to Rb11 trln, or 1% of GDP. To the end of the first half-year, the volume of GKO's/OFZ's market grew to Rb36 trln by par value; to the end of 1996, the value of these bonds grew to Rb73 trln, or 4.5% of GDP. The dynamics of the par value and deflated cost of the unpaid for liabilities is shown at Fig. 2.22.

It can be seen that the beginning of the expansion of the real offer of GKO's fell on June and July. This is due to the significant volumes of redemption; hence, the initial profit of the Budget at the initial sales was insignificant. Nevertheless, just in July, the significant yield growth on GKO's took place which results directly from the growth of their issue under the conditions of the limited liquidity of the financial markets.

The official purpose of the internal debt control policy consisted in expanding the medium-term maturity of the State securities. As of the beginning of 1995, this term was 50 days. The issue of the coupon bonds of the OFZ Federal Loan bonds allowed to extend the average maturity date up to 70 days as of the middle of the year, while to the end of the year the maturity date reached 70 to 100 days. At the same time, the average maturity date of GKO's reached 80 days for a very short period in May 1995, having dropped to 65 to 70 days afterwards. It is evident that the further extension of GKO's/OFZ's duration is yet difficult because of the continuing uncertainty of the further State policy; hence, it is a too expensive activity.

Fig. 2.22

GKO's/OFZ's Market and State debt
(Rb bln Y axes)

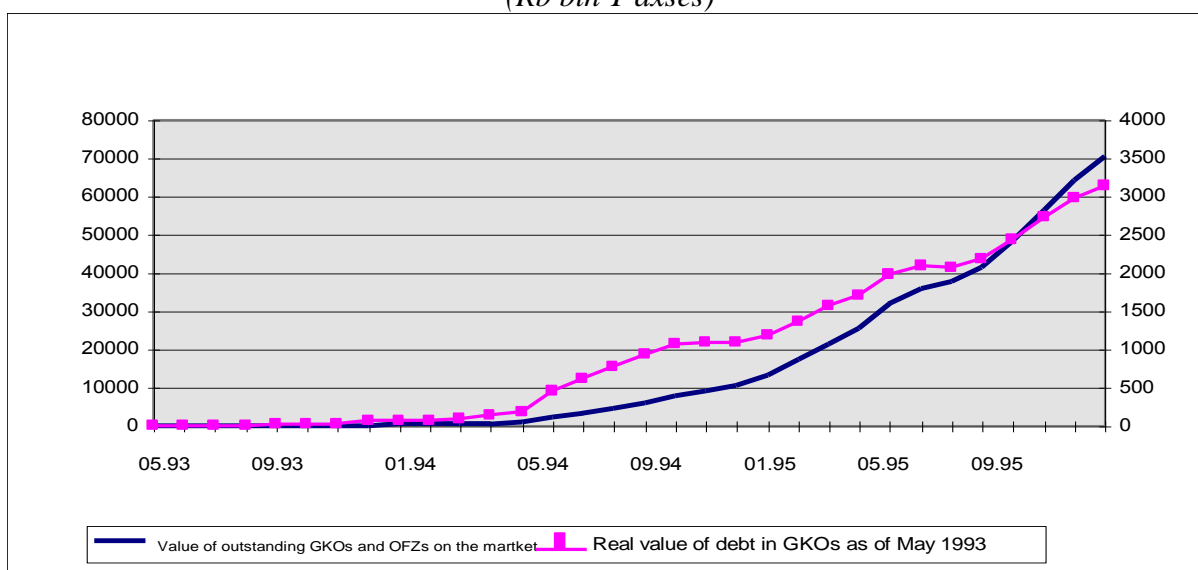
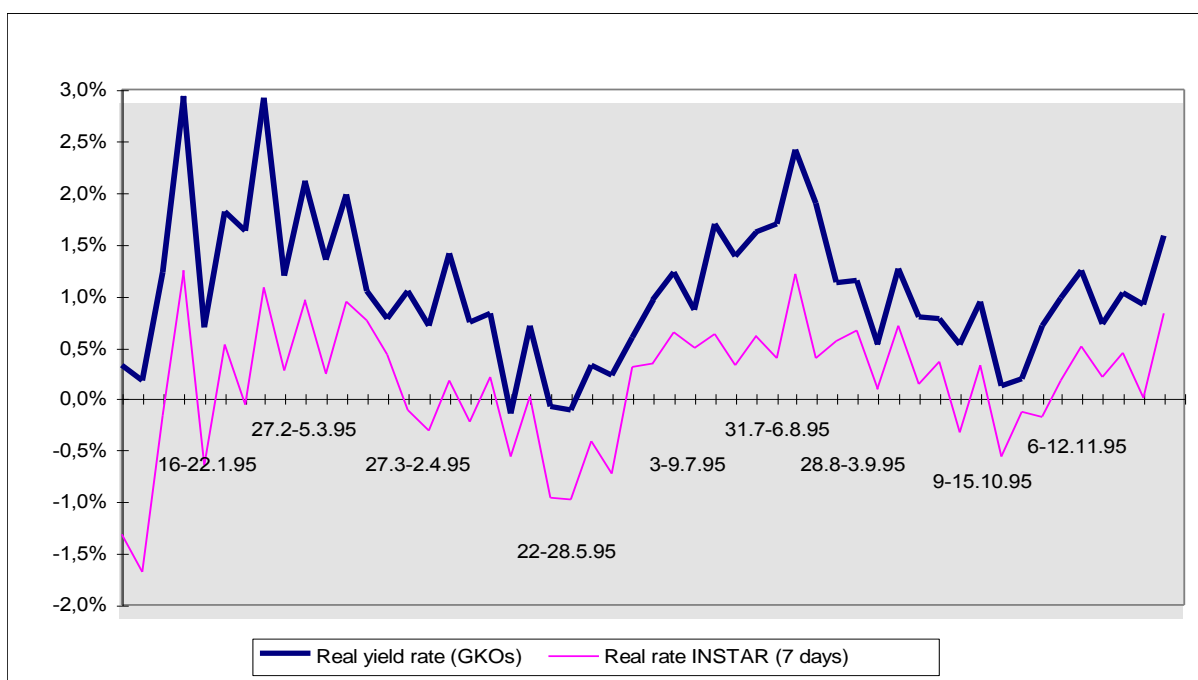


Fig. 2.23

Real yield rates: 3-month GKO's and INSTAR (7 days)
(%, monthly - Y axes)



Judging by the dynamics of the net internal assets, the activity of the Central Bank in the secondary market of GKO was not so high in the first half-year. The purchases by the Central Bank on the open market became more visible in the second half-year, which is indirectly confirmed by the intensive growth of the net internal assets from July. According to our estimates, the shares of the portfolio of the State bonds in their total volume amounted to 10% at the beginning of the year, and about 20% at the end of the year. Nevertheless, the real yields on GKO/OFZs were relatively high in the second half-year. This can be seen at Fig. 2.23 which shows the dynamics of the real average weighed yield on the three-months GKO and the dynamics of the real averaged rates for the actual interbank credits (INSTAR, 7 days). The July's outburst of the yield on GKO stopped the natural process of reduction of the ruble interest rates which had begun at the end of the first quarter-year (see Fig. 2.16).

It is necessary to take into account that the anti-inflation policy has a double effect on the borrowing instruments market. The decrease of the inflation rates is reflected in the decrease of the profitability with a certain lag. At the same time, in the conditions of the insufficient liquidity of the financial market, the growth of the issue of GKO pushes the profitability level up. As a result, in 1995, the profitabilities were reducing slower than the inflation. This was the cause for the growth of the real cost of the State debt servicing in the second half-year, which continues to influence the possibilities of mobilization of assets to the Federal Budget in the first quarter of 1996.

As our econometric estimates show, the inflation and the volumes of new issues are statistically significant factors, determining the dynamics of the yield on GKO. The evaluation of the dependence between the aggregated profitabilities and the advancing smoothed gliding average rates of inflation and the rates of real issuing of GKO yields the following results. The growth of the deflated value of outstanding GKO by 1% leads to the yield growth by 0.2 to 0.3%. The growth of the monthly inflation by 1% yields growth by 0.5% to 0.6%.

Hence, the changes of the rates of inflation are more significant factors than the changes of the real value of outstanding GKO. The significative influence of the issuing on GKO yield should be understood as the result of the effect of the limited liquidity, supplementing the fundamental Fischer's factors (inflation and temporary preferences)¹. The limited liquidity of the Russian financial markets in the second half of 1995 was conditioned by the monetary policy followed since

¹ This point of view was formulated in: Lucas, R. "Liquidity and interest rates", *Journal of Economic Theory*, Vol. 50, 1990, pp. 237-264.

January, and conserving its tightness, despite the accumulation of the external reserves by the Central Bank.

From here it follows that the restrictions on the liquidity for GKO market needed to be softened. In order to avoid increasing, in this case, the volume of the net internal assets, it was reasonable to open the market for non-residents as early as at the end of the Summer 1995. At that moment, the political risks were absent, and the declaration by the Central Bank on the introduction of the ruble corridor practically eliminated the currency risk, as well. Hence, the situation was dealing with the risk-less high investment yields in the liquid assets, which was to attract foreign investors.

It should be noted that the expansion of GKO offer, effective since 1995, does not mean that the monetary authorities follow the way of construction of a State debt pyramid. Generally speaking, the exponential growth of the real internal debt is all admissible in the conditions of financial stabilization. Indeed, during the first two years of existence of GKO market, the deflated cost of the unpaid for bonds was changing following the trajectory looking like an exponent. Herewith, at the stage of development of the internal debt instruments, the logistic curve, too, describes well the similar dynamics. Initially, it has practically no differences with an exponent, but then it is stabilized. At least several more years are needed to make more or less validated conclusions on the real trend of the domestic debt.

Banking crisis. The August crisis of the interbank credit market became more than the greatest problem for the banks in 1995: it was a certain factor signaling that the macro-economic conditions of functioning of the monetary and crediting institutions had changed. The sources of the crisis lie in different planes, but all of them are significant and interrelated.

The interbank credit market was born under the conditions of high inflation, high exchange rate of the US dollar, and injections of cheap money in the economy. The close links between the banks, and the interest in a rapid restructuring of the balances allowed to develop swiftly the infrastructure of this market. The problem of non-repayment of debts was partly offset by inflation whose level ensured the stable depreciation of the credits granted. The interbank market gave the possibility of multiple prolongations of the credits. The interbank credit market ensured a significant growth of the customer crediting, which resulted inevitably, in the growth of the volume of the non-repaid credits and extension of the investment terms.

Under the conditions of the soft inflationary policy of 1992-1995, most banks did not at all get into such issues as the coordinated control of assets and liabilities, evaluation of the credit, interest rate, or currency risks. A negative role in the making of unvalidated decisions was played by the cross-ownership, when large customers of commercial banks owned large blocks of their shares of stock and influenced the decisions on crediting. When speaking of the low efficiency of the banking system, the extremely high level of salaries and unvalidated expenditures of the banks, relative to the absence of strict budgetary limitations, should be mentioned.

The beginning of the implementation of the 1995's monetary program became the critical moment in the evolution of the banking sector. The introduction of the ruble corridor reduced abruptly the yield on the speculative transactions with foreign currencies. This effected, inevitably, the profitability levels of the banks accustomed to operations with cheap money. Some of them faced practically bad debts, which was well enough known in the interbank credits market. Beginning already from July, persistent rumors circulated on the insolvency of the banks which had been considered reliable before.

Nevertheless, the trigger effect belonged to the decision by the Central Bank, made just before the banking crisis, to extend the effectiveness of the ruble corridor up to the end of 1995. It is clear,

that some banks expected a revision of the currency policy after 1 October and counted upon additional profits from either speculative attacks or arbitral bargains.

Should the Central Bank have failed to declare beforehand the continuation of the ruble corridor, the banking crisis would have surged, most probably, at the end of September. It would have been caused by the agitation in the interbank credits market induced by the expectations of revision of the corridor limits and by the acute lack of the ruble assets.

The crisis was foreseen, but few people expected it in August. The interbank credits market collapsed on 24 August, when more than 150 banks did not manage to strike their balances. The index of the weekly circulation dropped from Rb6,526 bln, as of 23 August, down to Rb297 bln, as of 6 September. To support the liquidity, banks began selling State securities, of which a significant share was purchased by the Central Bank. Further on, the Central Bank was selling GKO/OFZs to solvent banks. This prevented the collapse of the quotations and allowed to distribute, in a rational manner, the liquidity among the banks.

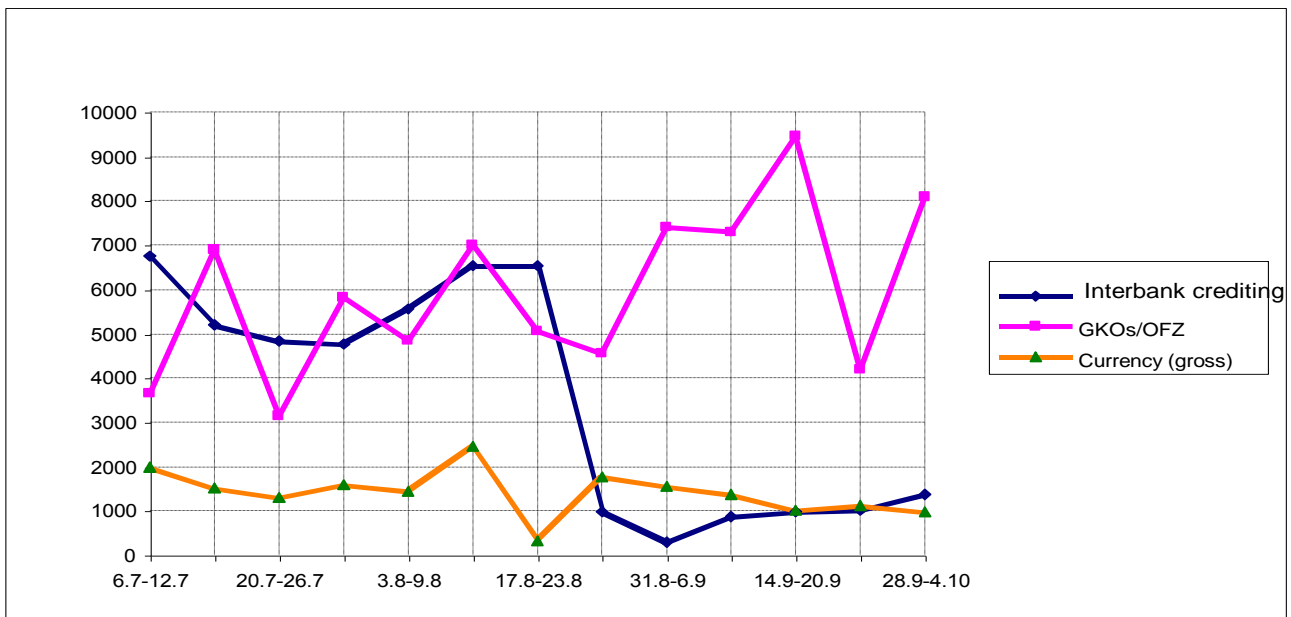
The weekly turnover of GKO/OFZs market grew from Rb4,564 bln, as of 30 August, up to Rb9,443 bln, as of 20 September (see Fig. 2.24). The crisis was the easiest for the banks with significant stocks of the customers' money and "prudent" structures of the assets (such banks were rare enough, due to the above reasons).

The crisis resulted in an especially fierce competition of different banks. One cannot say that the "black Thursday" was initiated by large banks, but, at a certain moment, they stopped granting money, and this concerned smaller and medium-size banks whose reputations could not be doubted. The separation of interests, sometimes detrimental for the current profitability, aggravating the relationships between banks. The conflict affected also the Association of Russian Banks, because these groups aspired for a change of representation in the Association for their benefit. The struggle, despite the variety of its manifestations, was reduced to the new redistribution of the banking clientele and reflected the intensified competition.

To the beginning of 1996, the interbank market did not, yet overcome the crisis. The remaining tension is, somehow, conditioned by the conflicts between banks around the December's collateral sales. Personal relationships between the banks managements remain the determinant factors when making bargains. The exit of the interbank crediting from the crisis is closely linked with the sanitation of the banking system, which may be reached by a tighter surveillance of the banking activities and a perfected mechanism of the bankruptcy and sanitation.

Fig. 2.24

Turnovers of markets: interbank credits, GKO/OFZs, and currency (gross)
(Rb bln Y axes)



Variants of 1996 Monetary Policy

The policy of the consecutive financial stabilization of the Russian economy yielded real results in 1995. An intensive reduction of the inflation processes showed itself, the exchange rate of the national currency stabilized, the currency reserves of the Central Bank grew. This section discusses the scenario forecasts of the monetary situation in Russian in 1996. For this we have used the modification of the above inflation model, taking into consideration the effect of the US dollar exchange rate as indicator of the inflation expectations (section 2.1 uses the model with the exogenous determination of the dynamics of the demand for money).

Below, we will consider the three possible scenarios of evolution of the monetary sphere situation. The first one is based on the milestones of the uniform State monetary policy for 1996. These milestones assume the further reduction of the money supply growth rates (they are planned for the level of 2.9% to 3.3% monthly); the remaining stable money circulation rate; the stop of the recession of the real GDP (with the nominal GDP of Rb2,300 trln); and the growth of the US dollar exchange rate by about 17% in 1996. The official forecasts of inflation, corresponding to the above growth of the money supply, amount to about 1.9%. The approved Budget Law proceeds from similar parameters of the monetary policy; besides, these parameters are coordinated with the IMF when granting to Russia the three-year EFF credit of US\$10.2 bln (US\$4 bln in 1996).

Our estimates show that, at such initial data, the average monthly rates of prices growth will be higher than 1.9%, amounting to about 3% monthly, i.e., 40% to 43% on the whole for the year (see Fig. 2.25, Fig. 2.26, and Table 2.8).

Fig. 2.25

Scenario # 1

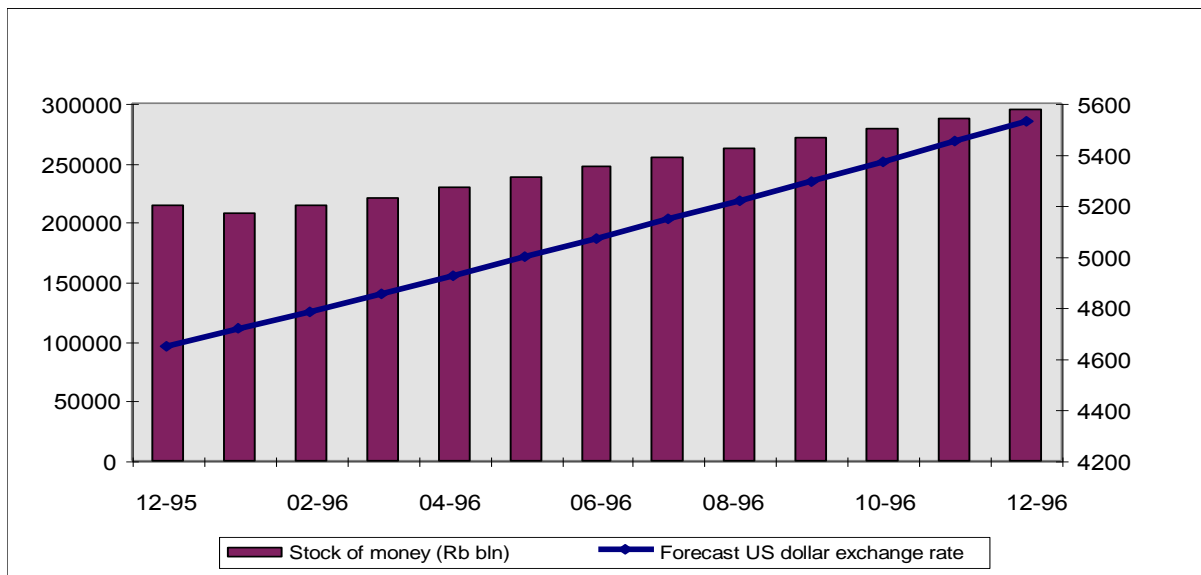
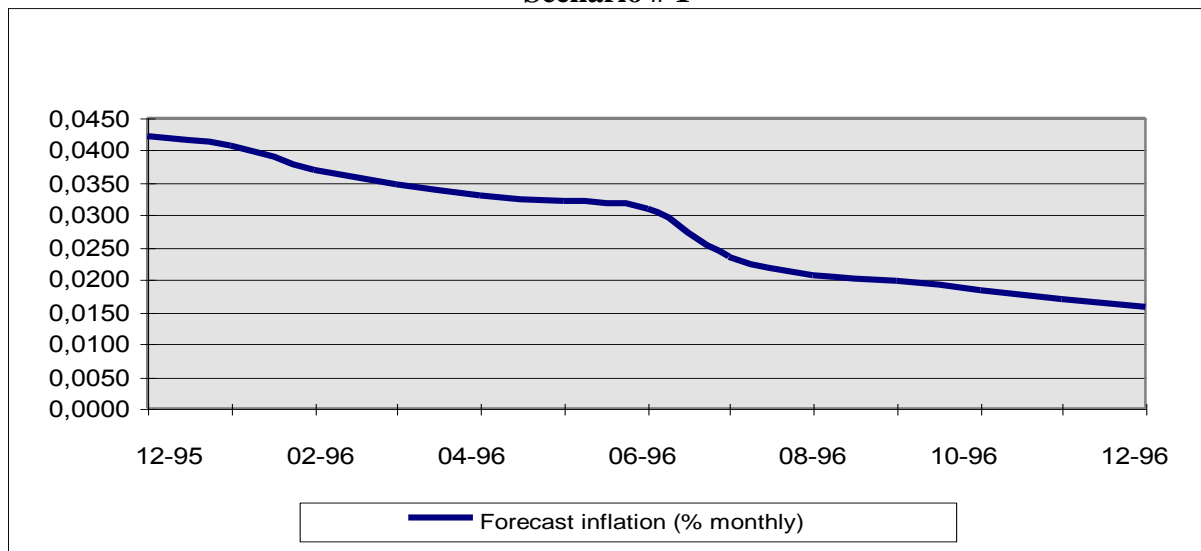


Fig. 2.26

Scenario # 1



The high enough level of inflation, corresponding to the strategy implemented by the today's Government is, to a certain extent, limit from the point of view of completion of the financial stabilization in 1995-1996. Its excess will contradict the mission of creating the conditions for the future economic growth in Russia.

The Presidential elections split the year into two periods. If the victory of the pro-reformist forces is supposed, the nearest months will be the most vague due to the high political risks.

Table 2.8

Macroeconomic indicators according to Scenario # 1

	Exchange rate as of the end of the month (Rb/US\$)*	M ₂ (Rb bln)*	Index of actual prices growth rate during the month	Mean geometric of the monthly rates of growth of M ₂ during the preceding six months	Forecast according to Scenario # 1
January 1992	230	1054	2.450		
February	139	1204	0.380		
March	160	1369	0.300		
April	144	1506	0.220		
May	128	1641	0.120		
June	113	2093	0.186		
July	144	2668	0.110		
August	205	3422	0.090	0.142	0.113
September	254	4515	0.107	0.190	0.145
October	398	5722	0.231	0.220	0.209
November	447	6038	0.261	0.249	0.271
December	415	6400	0.255	0.243	0.285

January 1993	572	7187	0.260	0.205	0.282
February	593	7782	0.246	0.180	0.262
March	684	8913	0.197	0.147	0.223
April	823	11063	0.191	0.120	0.198
May	1024	13460	0.179	0.116	0.201
June	1060	15765	0.201	0.143	0.190
July	987	18482	0.224	0.162	0.181
August	992	21121	0.258	0.170	0.170
September	1169	21771	0.232	0.181	0.164
October	1184	24554	0.195	0.160	0.143
November	1231	26788	0.164	0.142	0.127
December	1241	32601	0.124	0.122	0.117
January 1994	1548	33980	0.180	0.129	0.126
February	1659	36439	0.110	0.107	0.121
March	1753	39550	0.069	0.095	0.117
April	1832	46401	0.086	0.105	0.117
May	1916	52253	0.072	0.112	0.122
June	1989	59414	0.055	0.118	0.114
July	2060	64363	0.050	0.105	0.105
August	2197	70970	0.042	0.112	0.102
September	2633	77063	0.076	0.118	0.109
October	3975	80359	0.156	0.118	0.137
November	3234	84348	0.135	0.096	0.133
December	3550	97800	0.164	0.083	0.131
January 1995	4048	93800	0.178	0.087	0.135
February	4473	101900	0.110	0.065	0.127
March	4899	107300	0.089	0.062	0.103
April	5130	123200	0.085	0.057	0.102
May	4990	138200	0.079	0.074	0.098
June	4539	156600	0.067	0.086	0.085
July	4445	165000	0.054	0.082	0.069
August	4447	173800	0.046	0.099	0.059
September	4499	179700	0.045	0.093	0.050
October	4504	184200	0.047	0.090	0.045
November	4581	195200	0.045	0.069	0.043
December	4645	213800	0.032	0.059	0.042
January 1996	4734	208455	0.041	0.053	0.041
February	4818	214709	0.030	0.040	0.037
March	4855	221150		0.036	0.035
April	4926	227563		0.035	0.033
May	4998	234163		0.036	0.032
June	5070	240953		0.031	0.030
July	5144	247941		0.020	0.027
August	5220	255131		0.020	0.025
September	5296	262530		0.029	0.026
October	5373	270143		0.029	0.026
November	5452	277978		0.029	0.026
December	5531	286039		0.029	0.027

* The data on the M2 and inflation up to January 1996 and on US dollar exchange rate up to February 1996 are actual.

Certain moments characteristic for the evolution of the financial markets situation in the first half-year may be accentuated.

Firstly, it seems difficult enough for that the State to mobilize enough assets to finance the Budget at the expense of GKO/OFZs, because the demand for the long-term share, i.e., OFZs and six-month GKO may drop due to the high political uncertainty.

The cost of servicing of this share of securities with the increased yield rate may face the Finance Ministry with the issue of expediency of sale of the "long-dated" securities before the elections. In such situation the RF Ministry of Finance will need to find an acceptable compromise between the problem of reduction of the cost of servicing of the State securities and the support of the market attractiveness and stability.

Secondly, it is quite logical to suppose, in April and May, the process of the dollarization of the economy, opposite to the events of the Spring and Summer 1995, will take place, with this or that intensity.

The economic agents, expecting the devaluation after the Presidential elections, will be transferring their assets from the ruble to the hard currency form. First of all, it deals with the most liquid assets, such as deposits and GKO's.

The currency stocks of the Central Bank seem sufficient to protect the ruble against the attacks possible before the Presidential elections. It seems evident, that Russian banks lack the potential to disbalance the currency market and bring to a sharp drop of the ruble rate.

Herewith, the massive sale of the securities in May and June may lead GKO's market to serious problems. When waiting for the June elections, the participants of the financial markets will split into the group willing to risk and the group unwilling to risk. The first group may include those who believe that, when investing into the ruble assets, the exchange rate risk is low enough, and, besides, that at any course of events, the repayments and coupon payments with the State securities will be made in full volume. The second group expects, with a high probability, significant changes in the exchange rate policy, taking into account the possibility of a sharp devaluation of the ruble. They evaluate seriously the consequences of the changes in the procedure of repayment of the State securities and of a partial depreciation of the State bonds due to the return to the inflationist policy. The tactics of the prudent investors will consist in the gradual sale of the State securities to convert the received ruble assets into hard currencies. The participants of the market which are sure of the stability of the monetary and exchange rate policies will purchase the securities at low prices and receive their premium for risk in form of high profitability.

The policy of the RF Central Bank will be determined by the strive to reach different goals. For the one hand, the support of the stability of the State securities market and support of their profitability at the level acceptable for the Ministry of finance will require to expand the purchase of GKO's/OFZ's on the open market. For the other hand, the fixed parameters of the monetary program limit the volumes of such operations. As it seems that, in May and June, the market will be characterized by the high elasticity of the offer price, the Central Bank should not purchase expensive bonds beforehand, in order to support the quotations and going ahead of their mass sale. Herewith, in the event investors leave in mass GKO's/OFZ's market, and the prices collapse, the market will need to be supported by intensive purchases. In such event, the Central Bank will minimize the volumes of the money issue, though the Ministry of finance will have to agree for new issues under a high interest rate.

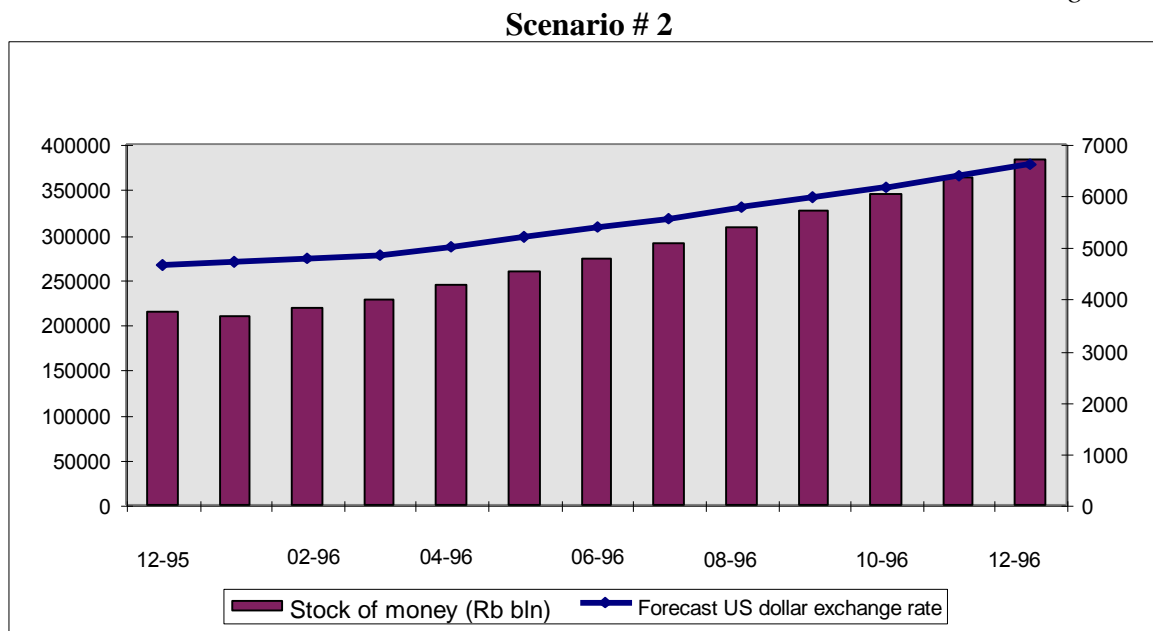
The second scenario we consider is based on the assumption that some of the electoral promises of Boris Yeltsin and socially-targeted initiatives of the State Duma are put into life. The implementation of the expenditures decisions made will require about Rb40 trln of additional annual expenditures not accounted for in the Budget (see Section 2.1). This will mean the growth of the Budget deficit from 3.9% of GDP to 5.4% of GDP. Within the framework of this scenario, we assume that the elections will be won by a responsible enough politician, inclined, on the whole, to continue the course on the reforms deepening.

The insignificant, at first sight, increase of the Budget expenditures will, in reality, mean a serious change of the macroeconomic policy. The matter is that the additional volume of the internal borrowings at the level of 1.5% of GDP (Rb40 to 45 trln, at GDP, according to the Budget forecasts, of Rb2,800 trln) will not be able, at our opinion, to be supported with the existing State securities market. In the event of such softening of the Budget policy, an additional, not envisioned by the

Budget policy, money issue by the Central Bank, i.e., in form of purchase of the State securities in the open market.

Based on this, in 1996, the increase of the money supply will make not the 40% (2.9% monthly), but 80%, i.e., about 5% monthly. We suppose that the acceleration of the rate growth will make about 40% annual. As a result, the inflation in 1996 will make a little more than 4.5% monthly, or about 70% for the whole year (see Fig. 2.27, Fig. 2.28, Table 2.9).

Fig. 2.27



In practice, this variant of the economic policy will mean the inevitable and expedient systematic indexation of the incomes and other nominal parameters in accordance with the prices growth, and this will mean the transition to the permanent inflation of 80% to 100% annual rate.

Theoretically, the high probability of the transition to the permanent inflation is based on the thesis on the rigidity (inflational character) of the prices and of the pricing policy of entities in the transitional period. This very factor, which showed itself obviously in 1995, hinders the efficiency of the monetarist stabilization measures which give a low yield in the short-term outlook. As a result, the stabilization requires a strong political will. In the contrary event, the transition will take place to the permanent inflation with a systematic indexation of incomes.

Fig. 2.28

Scenario # 2

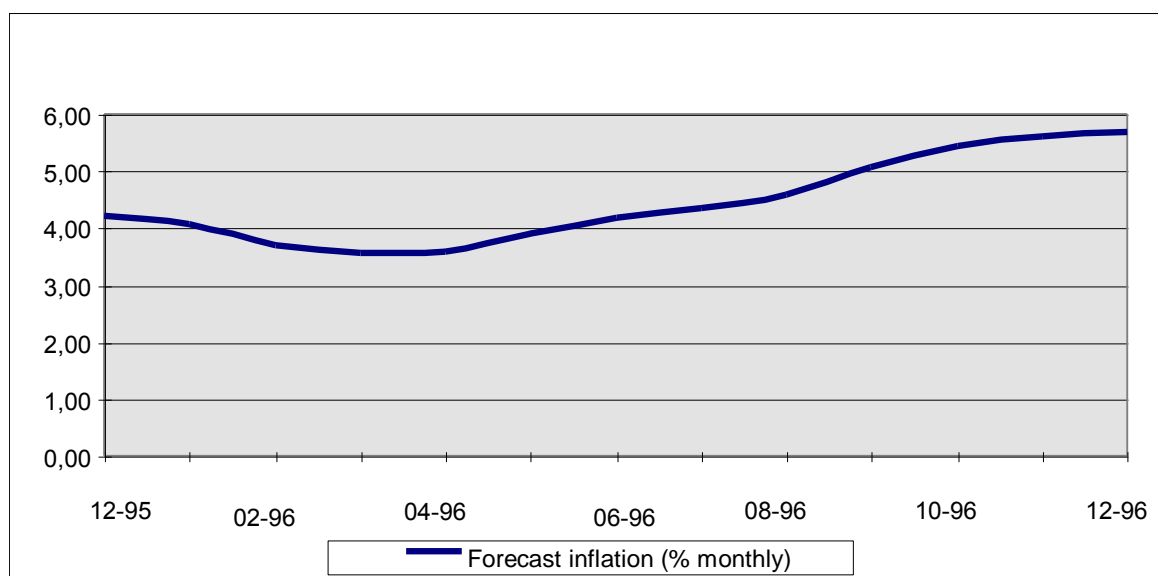


Table 2.9

Macroeconomic indicators according to Scenario # 2

	Exchange rate as of the end of the month (Rb/US\$)*	M ₂ (Rb bln)*	Index of actual prices growth rate during the month	Mean geometric of the monthly rates of growth of M ₂ during the preceding six months	Forecast according to Scenario # 2
January 1996	4734	208455	0.041	0.053	0.041
February	4818	218878	0.030	0.040	0.037
March	4855	227852		0.039	0.035
April	5025	243801		0.040	0.036
May	5200	258429		0.048	0.039
June	5383	273935		0.048	0.042
July	5571	289002		0.042	0.043
August	5766	307787		0.043	0.046
September	5968	326254		0.058	0.051
October	6177	344198		0.062	0.054
November	6393	363129		0.059	0.056
December	6616	383101		0.058	0.057

* The data on M₂ and inflation up to January 1996 and on US dollar exchange rate in January and February 1996 are actual.

It should be noted, that, when considering this variant of the moderately populist policy, we ignored at least the following two significant circumstances: first of all, it seems unlikely that the recession of the real GDP will stop in the described macroeconomic conditions; and, secondly, a real reduction of the borrowings, both internal and external, may be expected. Any breach of the parameters of the monetary policy agreed upon with the IMF will result in the suspension of the EFF credit grant and in more complicated relationships with the creditors of Russia.

For the third scenario of the political events we assume that, before the Presidential elections, the today's opposition is unable to secure the implementation of the decisions completely destroying the outlining stabilization. In the other words, the approved Budget for 1996 will be put into life, and the monetary program agreed upon with the IMF will be continued. Nevertheless, in accordance with this scenario, after the elections, the situation will further on change to the worse: the new President of the procommunist and/or national-patriot orientation will replace the Government, and the Duma, supporting the President, will begin promulgating the laws changing radically the economic policy. In order to illustrate the possible consequences of such change of orientation, suppose the realization of only some (and in the minimal variant) decisions inherent for the rhetoric of the communist and national-patriot leaders.

The most probable is that, among the priority measures in the pricing policy will be the freezing of the prices for the main foodstuffs. We assumed, that the prices would be fixed for about one third of the goods of the retail trade. Hence, at the average monthly inflation which, in accordance with

the forecast based on this and the following assumptions, will attain 10% to 11%, in the second half-year, the volume of the grants required to support the stable prices level will amount to about Rb35 trln.

Seemingly, the second decision in the prices regulation field will be the fixed prices on the products of the basic industries: the fuel industry and the power industry. The communists will use this method to struggle against the so-called “inflation of expenses”. The volume of the grants from the Budget required for this will amount to about Rb30 trln.

As for the currency policy, the most probable is the introduction of the multiple exchange rates with their fixation. Such decision will, inevitably, result in the necessity to subsidize the exchange rate for exporters. At the condition that the real exchange rate used for export stays on the uniform level, conserving the incomes of the exporters on the level of the Summer 1996, the grants of about Rb25 trln will be needed. The grants aimed to conserve the stable internal prices on the imported food and equipment will require Rb25 trln.

In addition to these measures, we should assume the growth of the defense expenditures by at least 1.5% of GDP, and the growth of the expenditures on the national economy (mainly on the investments in and grants to the unprofitable entities and to the rural economy) by 2% of GDP. Of course, the escalation of the expenditures decisions will not be limited by the Federal level; hence, the growth of the expenditures on assistance to the regional budgets by 1% of GDP has to be assumed. As a result, the deficit of the Federal budget will amount to 12% of GDP.

It seems improbable that, within the limits of the new economic policy, the internal and external borrowings in the envisioned volumes (except the Central Bank credits) can be conserved as sources for financing of the deficit in the second half-year. Hence, for the second half of 1996, the monetarizable share of the deficit will amount to about Rb300 trln or about 9% to 10% of the annual GDP (the estimated GDP is Rb3,200 bln). This means that, in the second half-year, M_2 will grow by 250% (average monthly rate of 23%).

On the whole for the year of 1996, the money stock will increase by 320% (average monthly rate of 13%). We supposed the rates of growth of the US dollar exchange rate equal to 90% (see Fig. 2.29, Fig. 2.30, Table 2.10).

Fig. 2.29

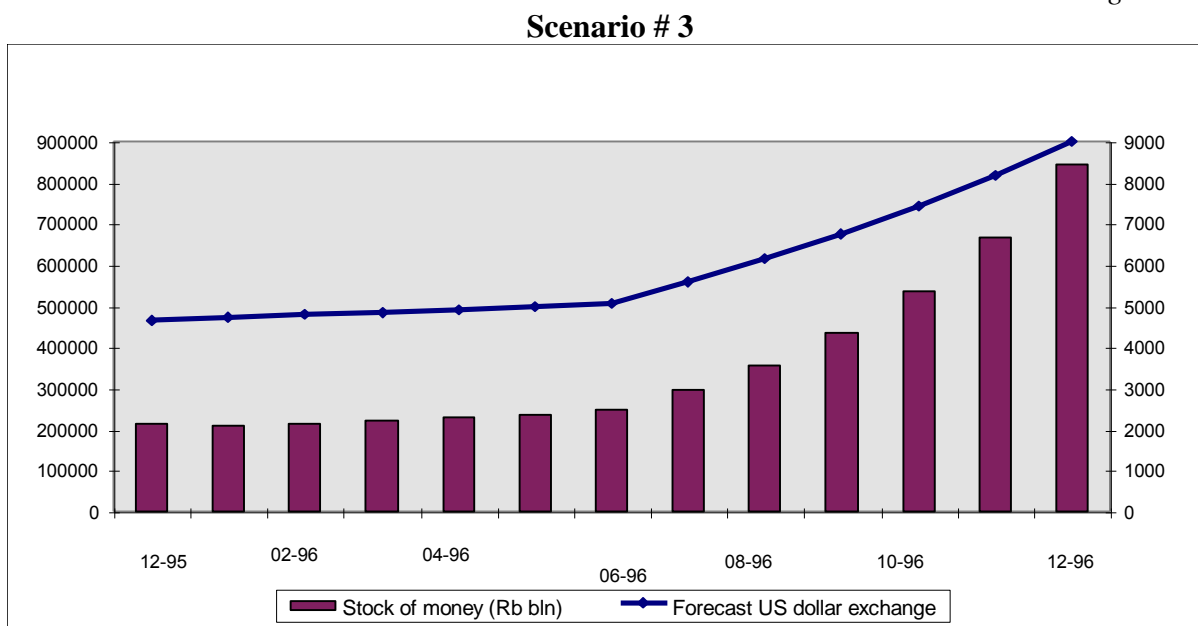
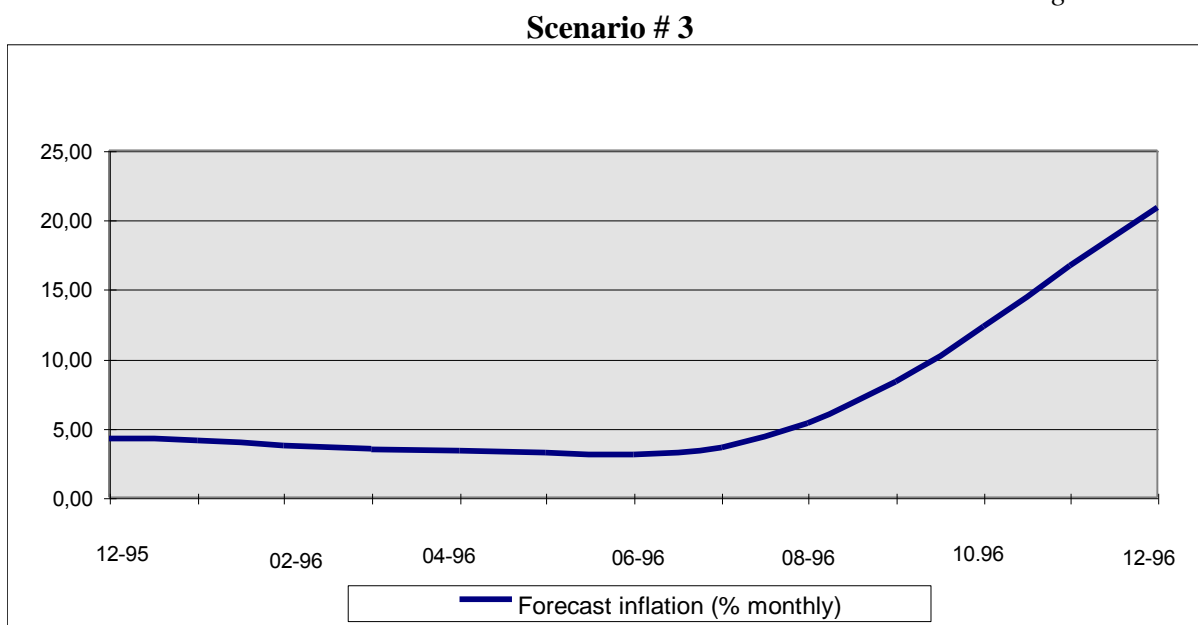


Fig. 2.30



Under these conditions, and in accordance with the model described above, the inflation of the second half of 1996 will make up about 85%, or the average monthly 10.8% with the acceleration from 3.6% of July to 21% of December. On the whole for the year, the inflation will amount to about 130% (see Fig. 2.30).

Herewith, we assume the sharp enough reduction of the demand for money, beginning in July and growing in the Summer and Fall of 1996. On the whole, in July to December, the demand for the real money will be reduced by about 10% to 12%, in accordance with our estimates. Then, taking into account the inertia of prices, the inflation splash will be postponed till 1997. Hence, the new power will, for some time, use the fruits of the stabilization policy of 1995-96, increasing the Budget expenditures at a relatively low inflation.

Macroeconomic indicators according to Scenario # 3

	Exchange rate as of the end of the month (Rb/US\$)*	M ₂ (Rb bln)*	Index of actual prices growth rate during the month	Mean geometric of the monthly rates of growth of M ₂ during the preceding six months	Forecast according to Scenario # 2
January 1996	4734	208455	0.041	0.053	0.041
February	4818	214709	0.030	0.040	0.037
March	4855	221150		0.036	0.035
April	4926	228890		0.035	0.033
May	4998	238046		0.037	0.032
June	5070	247568		0.034	0.031
July	5578	297081		0.025	0.036
August	6135	356497		0.051	0.054
September	6749	434927		0.088	0.084
October	7424	534960		0.119	0.123
November	8166	668700		0.152	0.167
December	8983	842562		0.188	0.209

* The data on the M₂ and inflation up to January 1996 and on US dollar exchange rate in January and February 1996 are actual.

2.3 State Securities

For the first time in the Russian history, the State Budget for 1995 used the principle of financing of the Budget deficit using the Central Bank credits, supported by the significant growth of importance of the domestic borrowings. Herewith, more than half of the Budget deficit (about Rb36 trln) was supposed to be covered by the market sale of securities, mostly GKO's. Due to the gradual removal from circulation of promissory notes (KO's) an additional issuing load was transferred to the short-term bonds.

As the Budget deficit turned out much lower (65.34% of the planned one), even the corrected Budget plan for mobilization of assets was also unfulfilled by 28%. In accordance with the preliminary data, the sale of the securities (without treasury bonds) brought to the treasury about Rb26 trln, which makes about 1.6% of GDP. The market of the State securities, whose value reached, as of the beginning of 1996, Rb121.4 trln (or 7.3% of GDP), became the most powerful financial market of Russia.

The State bonds were the main direction of financial investments, characterized, during the whole year, by the high yields, liquidity, and reliability. In the conditions of the banking crisis and lack of directions for efficient placement of assets, they played the main dumping role, having neutralized somehow the "system" financial markets.

The year 1995 saw the surge and rapid development of the two new promising types of the State bonds with the variable coupon interest and the maturity over one year: these were the Federal Loan Bonds (OFZs), circulating in the same system as GKO's in the non-cash form, and the bearer bonds of the State Saving Loan (OGSZs), intended, mainly, for natural persons. The implementation of the project relative to the issuing of the new gold certificates was postponed, because the procedures of the secondary circulation of these securities had not been worked out as they should.

At the same time, the plans (agreed upon with the IMF) of reduction of issuing and removal from circulation of the quasi-money - promissory notes - were not implemented completely.

Nevertheless, judging by the results of the year, the sums paid out in redeeming old promissory notes exceeded the sums they had mobilized. It seems that the issuing of these securities will be continued in their today's or somehow altered form.

The domestic currency loan bonds continue staying outside the sphere of the direct interest of both main categories of the potential investors and of the issuer who has come to no progress in organizing the secondary market of these securities. In such conditions, the planned issue of the additional tranches of the domestic loan under the market procedure may become much more expensive for the treasury.

The hyper-developed sector of the State borrowings is typical for the countries undergoing the dynamic market transformations (in particular, this was typical for most Latin American countries). Despite the fact that, judging by the world measures, the domestic debt of the Russian Federation, legalized by market instruments, remains small enough, compared with the GDP, its further growth, with the conservation of the growth rates formed during the last years, will, inevitably, lead to the problems relative to the trust in the issuer and its budgetary policy. The long ago critical problem of liberalization of the conditions of purchase of the state securities by the risk-sensitive foreign investors should be taken into account, as well. Due to the above, the smallest doubt of the market participants in the solvency of the State may bring to the consequences disastrous for the Budget (and the domestic financial markets).

GKOz and OFZs

As of the end of 1995, Rb72.5 trln worth of outstanding GKOz and OFZs were on the market. Compared with the beginning of 1995, the market grew more than 7-fold. Herewith, despite the fact that the first issue of OFZs took place only in June, they amounted to about 11% of the total market.

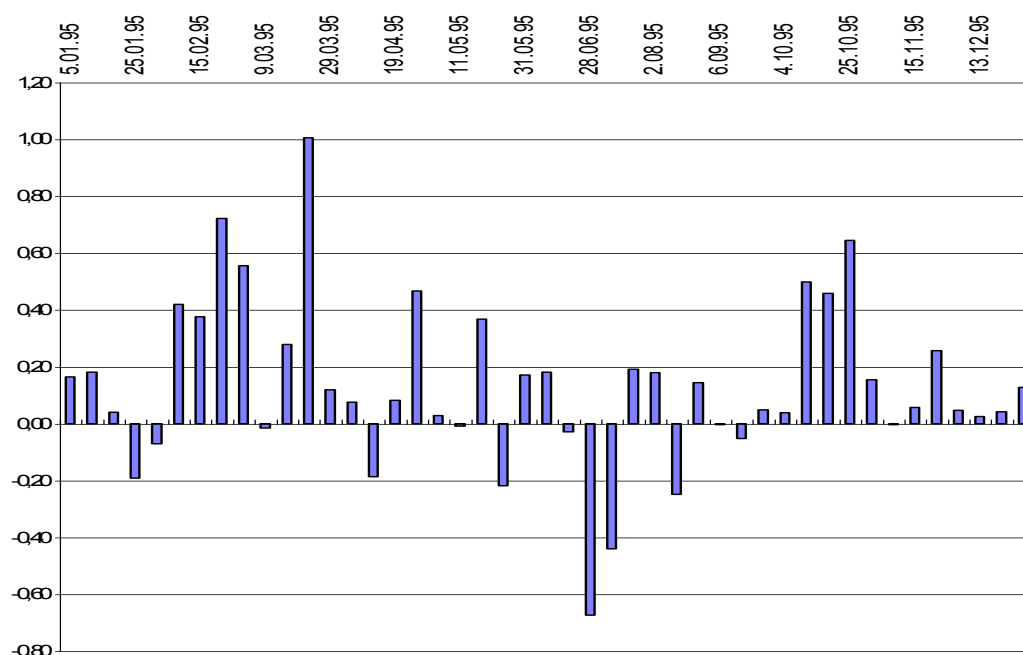
During the first half of 1995, 45 sales of GKOz, including 31 sales of those of the three-month term 11 sales of those of the six-month term, and 3 those of the one-year term issues were carried out, plus 9 sales of OFZs.

During 1995:

- more than Rb72 trln worth of GKOz and four more than Rb2 trln worth of OFZs were redeemed;
- the declared sales value of issuing made up RB156.45 trln on GKOz and Rb13 trln on OFZs;
- the aggregate demand for GKOz purchase at public sales amounted to the Rb168.43 trln (par value) having exceeded the offer by less than 8%, while the demand for OFZs made up Rb8.56 trln which was by almost 35% less than the offer; and
- the sales allowed to sell RB134.17 trln worth of GKOz (par value) which made up 85.75% of the offered value. This allowed to mobilize to the Budget about Rb10.28 trln (hence, the efficiency of mobilization of assets in primary auctions made up a little more than 7.6%). As for OFZs, Rb5.5 trln of them were sold (42.3% of the declared value of issue). It is evident, that investors were, on the whole, more prudent with the medium-term bonds, partly because of their novelty, and, partly, because of the non-standard mechanism of determination of the income.

The demand to offer ratio at GKOz and OFZs sales underwent serious changes during 1995 (see Fig. 2.31).

Deficit (-) and excess of demand over offer (+) at GKO/OFZs sales in 1995



In 1996, the Central Bank adopted the new instruments of the financial policy, linked with GKO/OFZs market. In accordance with the instructions of the Ministry of finance, the Central Bank began selling in the secondary market the bonds not sold at public sales; at the end of the year, it began the before term repayment of these bonds.

The sales became, finally, instruments of re-financing of the indebtedness formed earlier; the main share of the assets is mobilized to the Budget by additional issues. During 1995, Rb18.8 trln worth of additional bonds were placed, which amounts to 13.5% of the cost sold at public sales.

One of the positive results of the additional placement was a certain stabilization of the yield on the secondary market of GKOs purchased at public sales (see Fig. 2.32).

Nevertheless, the arbitral possibilities still remain in effect: this parameter made, in 1995, 484.33% (here and below, we show the yield without accounting for the tax privileges).

The inevitable cost for the transfer to the additional distribution (before term repayment) is the high informational complexity of GKO/OFZs market, and of the budgetary policy on the whole.

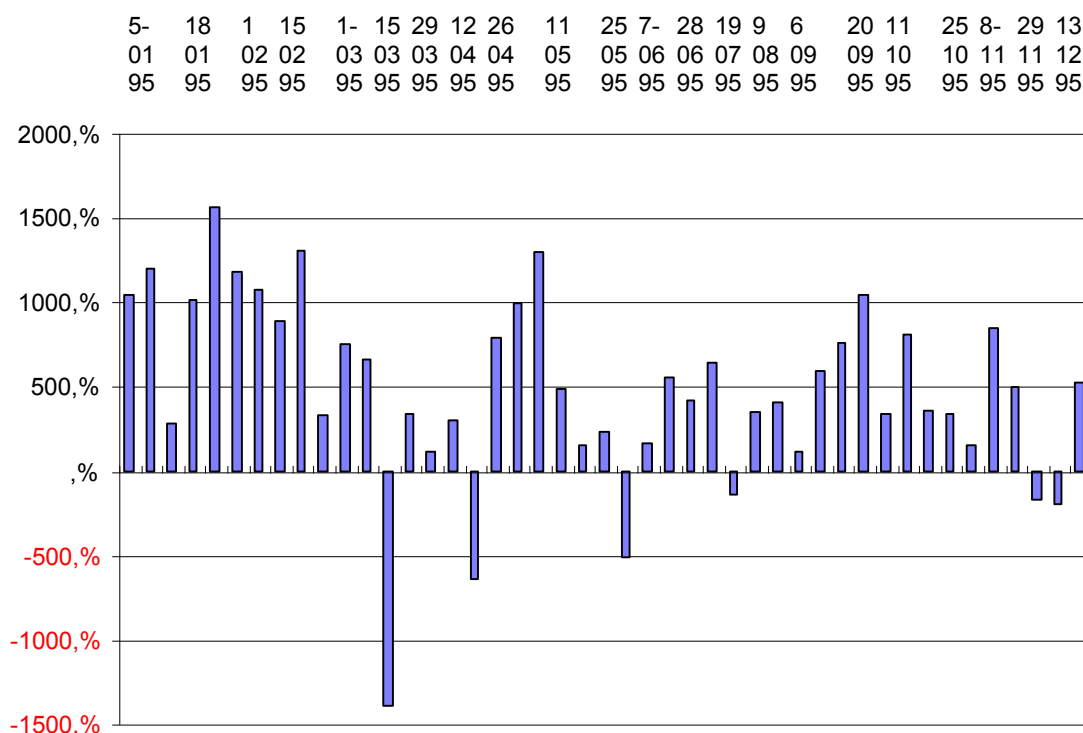
As a result, it becomes almost impossible to evaluate the integral efficiency of the mobilization of assets to the Budget, because the Government borrows money for different terms and for indefinite interests (within the limits of the market prices as of the day of the additional distribution).

In 1995, the circle of bidders working in the market was stably expanding. The number of the authorized dealers at the three sites trading within the framework of the system approached twelve dozens, with the number of their customers exceeding 2,600 (for comparison: in August 1994, about 1,500 entities took part in the trade, with 60 brokers). The average shares of the customers' assets at the sales reached 42.7% for GKOs (compare with the 33.83% for 1993-94) and 42.7% for OFZs. To the end of 1995, as a result of the solution of the inter-regional settlements problem, new trading sites were opened in Novosibirsk and St. Petersburg (10 October and 19 December, respectively).

However, the share of these sites in the total turnover of the primary and secondary markets does not, yet, exceed 3%, despite of the optimistic forecasts of experts.

Fig. 2.32

Resale yield on bonds purchased at public sales the next day*

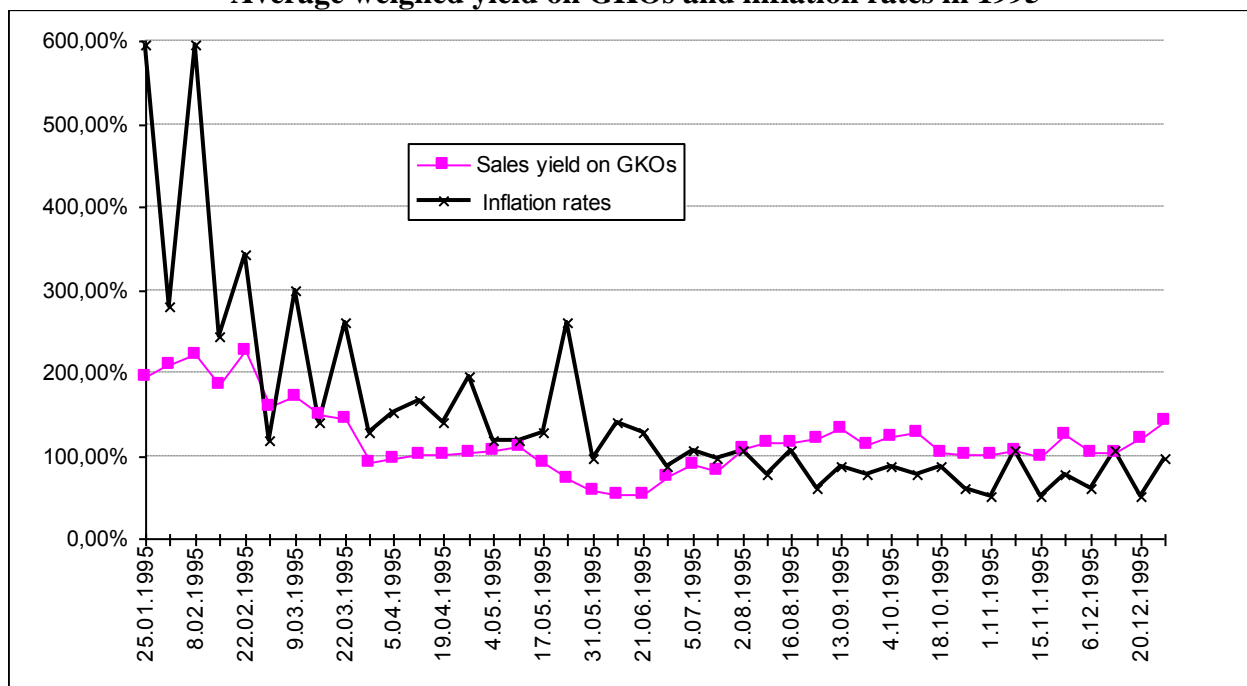


* when calculating the indexes, it was supposed that the bonds had been purchased at the mean weighed sales price and sold at the closing price of the first trading session after the sales.

For the moment being, the macro-economic significance of GKO/OFZs market is steadily growing. This concerns not only the volumes, but the qualitative parameters, as well. In particular, after the August collapse of the interbank crediting market, the yield rates of GKO/OFZs market became the most representative rates in the Russian economy. High yields on GKOs served one of the tools to hold the US dollar within the limits of the currency corridor, to increase the real exchange rate of the ruble, and to de-dollarize partly the financial sector in Russia.

Yield dynamics of GKOs market underwent drastic shifts during 1995. In Spring, the discount rates of the market were steadily decreasing, and, to the end of May-beginning of June, the yield came to the values minimal for all the time of existence of this market, having met the level of support determined by the fundamental, first of all, inflational, factors. However, while, in the first half-year, the discount rates were lower than the inflation level, there happened an outbreak in the third quarter-year: the yields of GKOs exceeded steadily the current inflation rates (see Fig. 2.33).

Average weighed yield on GKO's and inflation rates in 1995



In addition to the stabilization and the inflation decrease, this picture also shows the passive sales policy of the issuer. When setting up the issuing schedule, the Ministry of finance was often based on the current needs of the Budget financing, ignoring both the market evolution outlooks, and the most probable inflation scenarios (including its own forecast). Moreover, according to A. Chubais, the First Vice-Prime Minister, after the Summer-Fall crisis of the interbank credits market, authorities used GKO's market to refinance the banking system of Russia. This policy resulted in the higher real cost of the debt servicing in the second half-year.

By and by, the plans of the further issuing of GKO's may become less and less dependent on the voluntary decisions of the monetary authorities; at the same time, the schedule of the liabilities of repayment of the bonds will augment its significance. The participants of the market understand this quite well, and, hence, offer underestimated prices at GKO's sales relative to the repayments. Hence, such sales are much more strenuous for the issuer. The Ministry of Finance has to use actively the right to fix the sort-out price with the redemption of a certain share of the issued securities by the Central Bank, ensured by the conditions of GKO's issuing.

On the whole, in 1995, more than one third (33.45%) of the claimed for demand, which could have been satisfied, was sorted out. This means the underestimated prices of a significant part of the applications, the "professionalism" of the dealers following an aggressive strategy at the sales. The same is confirmed by the "twin-peak" form of distribution of the applications submitted to certain sales (theoretically, without a preliminary arrangement, such distribution should be unimodal). The issuer has, often, to follow the desires of the bonds' purchasers, because the issuer has no more the possibility to expose the cost of the debt to the inflational erosion due to the liabilities taken in the sphere of the monetary policy.

As a result, the real (deflowered) cost of the debt passed by GKO's grows following the rates described by the quadratic function (see Fig. 2.34).

If the real cost of servicing of the State indebtedness calculated using the actual volumes of GKO's issues in 1995, is detracted, it becomes positive; moreover, it is higher than the average value for the whole period of existence of the market (39.6% and 29%, respectively). However, in the

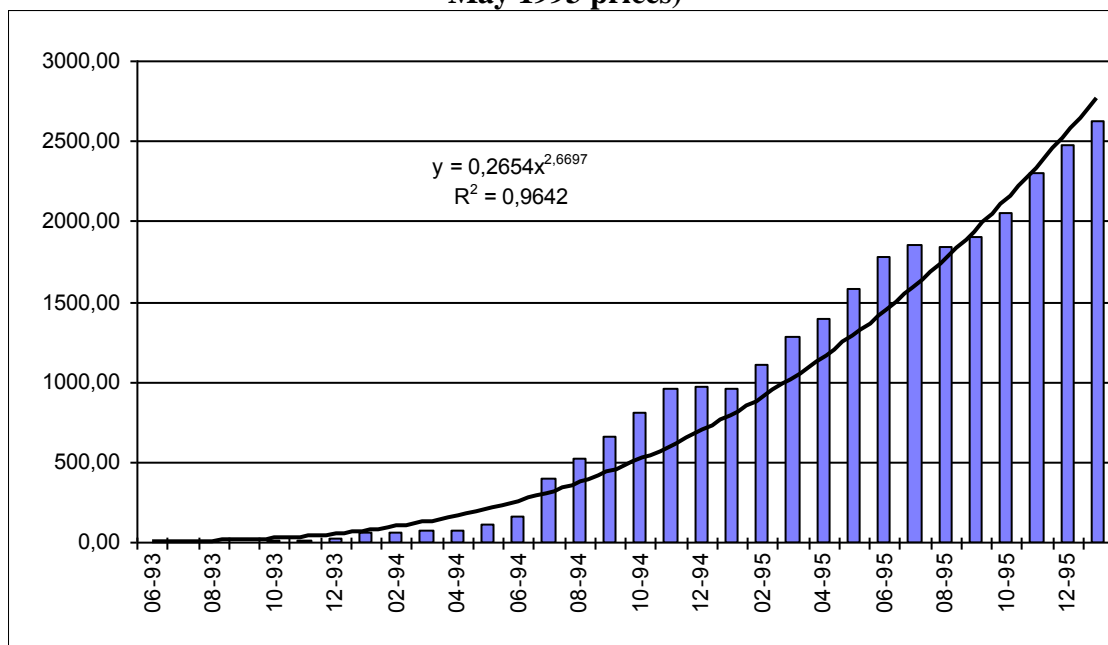
years 1993 and 1994, the mean real cost of the debt was negative. The ex ante nominal rates for GKO, despite the guarantees on these securities, were often higher than the other interest rates in the economy, including the interest rates on more risky transactions.

The growth of the real cost of the debt servicing is also dangerous due to its indirect effect, i.e., it has the increasing effect on all the interest rates in the economy, both by the mechanism of mobilization of the borrowed assets for the bonds purchase, and from the viewpoint of the change of the opportunity costs of investors. This influence is even more significant as greater volumes of the State bonds are issued for circulation.

It is no secret, that, in order to control the currency exchange rates and to mobilize one-time large sums, the Central Bank and the Ministry of Finance had, more than once, artificially increased the yield on GKO. Under the conditions of the industrial recession and of the crisis of the investment sphere, the State uses its “safety margin” and overplays private investors as borrowers.

Fig. 2.34

Real (deflated by the index of consumer prices) value of domestic debt in GKO market (in May 1993 prices)



The excessive attractiveness of the State bonds market leads to the extremely unfavorable effect of the “extrusion” of the investments in the real (production) sector of the economy with the relatively lower potential of reliability and lower domestic yield. Hence, there exists one more unpleasant consequence of the high yield and investment quality of GKO: it is the slowdown of the evolution of the assets market values. Indeed, GKO stay, yet, beyond competition: Russia hasn’t, yet gotten the bonds of the private sector which overcome the State bonds, if judged by the combination of the main investment characteristics.

There exists one more problem of the State bonds: the short-term character of the indebtedness. In June, to implement the policy of extension of the terms of the circulating debts, the Ministry of finance began distributing the medium-term bonds of the federal loan with the floating coupon dividend (OFZs).

According to the reckonings of the Finance Ministry, these bonds were to become the main instruments for borrowings in the nearest time, displacing GKO from the main roles. The issuer wanted to solve, with the help of the Federal loan bonds, the two priority problems: to reduce the cost of mobilization of assets to the Budget and to extend the terms of the State debt. Indeed, under

the conditions of the general reduction of the interest rates, the borrowing of money for long term, with a fixed interest rate, turns out unprofitable. The reduction of the charges is supported by the tying the every quarter-year coupon payments for the medium-term bonds to the current yields of GKO's secondary market; this allows to avoid paying to the purchasers the bonuses for the inflational (interest) risk above the interest rate determined by the fundamental factors.

One of the main advantages of OFZs relates to the absence of the necessity of the relatively frequent refinancing, which is characteristic for the assets circulated by investing in the consecutive issues of GKO's. At the same time, as the coupon interest is linked to the current yield of GKO's market, the efficiency of the investments in OFZs must be, at least, comparable with the efficiency of a sequence of short-term investments. Nevertheless, the risk on dividend on the formally long-term bonds is practically identical to the one on the three-month GKO's due to the variable dividend on the coupons. Besides, during the initial period, the Ministry of finance, interested in attracting investors to the new instrument, deliberately increased the yield of OFZs coupons in comparison with GKO's of the comparable maturities. This had the inevitable effect on the sales policy and on the conditions of the Central Bank operations in the secondary market. In particular, the additional placement of OFZs were more massive, in the relative expression, than those of GKO's: during the year, almost half of the total volume of OFZs came to the market by additional placement; as for GKO's, the relevant parameter made a little more than 19%.

The strategy of the Ministry of finance aimed to extend the horizon of the indebtedness, the average weighed maturity of GKO's/OFZs (the "duration", in the terms of the Central Bank specialists) was steadily growing during 1995; to the end of the year it reached the level of about 100 days against the about 52 days at the beginning of the year.

State saving loan bonds

One of the main difficulties in implementing the plans of issuing the State bonds was the fact that the expansion of the debt was to be simultaneous with the tight policy of the monetary compression. As a result, to the mid-95 the country had practically no more large reserves of the free assets of the resident legal entities, not engaged in crediting the Government (this is confirmed by the extremely small turnovers of the newly opened regional sites, which, for the first time, gave the possibility to invest in GKO's/OFZs for numerous structures). Hence, the intention of the Government to turn to the money of the population, which, according to various estimates, keeps up to US\$10 bln "at home", seemed quite logical.

As the formed structure of the trade in GKO's/OFZs is not intended for serving a large number of small investors, the decision to issue the special loan - the bearer's coupon bonds - for the population seemed quite valid. The conditions of their issue suppose the convenient par values (Rb100,000 and Rb500,000), the one year maturity, and the every quarter-year payment of the floating coupon interests which are, just as for OFZs, tied to the yields of the secondary market of GKO's. The secondary distribution of the bonds was planned to be carried out by the dealer banks and treasury bodies.

In 1995, three tranches of the saving loan, Rb1 trln worth each, were issued (ends of September, October, and November). The sale of the first tranche was, on the whole, successful; this encouraged the Government to accelerate the further issues (initially, they were planned for every quarter-year). Nevertheless, the distribution of the next tranches met the lack of demand, despite the fact that the Ministry of finance fixed a bonus to the already high enough interests on the first coupon of the bonds. Thus, according to the estimates, only 18% of the declared volume of the third tranche were sold.

It seems that the relative failure of the market distribution of the saving bonds tranches was due to the following reasons.

First of all, no publicity campaign consistent with the scale of the event was organized. The first tranche was distributed among the investors as if by force of inertia, because the information on the preparation for issue of the State bonds for the population had been discussed by the mass media long enough. Nevertheless, this turned out insufficient to distribute the next tranches. The unknown, on the whole, form of savings, and the anxiety as for the poorly developed procedure of the payments on coupons played their roles.

Secondly, the Federal treasury bodies could not, on the whole, solve the problem of the bonds distribution.

Thirdly, the secondary market of the saving bonds is, yet, poorly developed, and this discourages, first of all, large investors. The average bank margin between the purchase and sale prices is very high (between 1% and 1.5%), while the turnovers of the exchange market at several sites (Russian exchange, St. Petersburg stock exchange, Tiumen-Moscow *Hermes* exchange, Central Russian universal exchange) did not exceed several billion rubles daily, in 1995.

Initially, numerous investors were aware of the technical risk of delay of the payments of the coupon interests. However, the first coupon for the first tranche of the bonds was paid by the Sberbank offices at the end of December, without the expected difficulties; moreover, for the owners of the large parcels of the saving bonds, a special procedure of the payments on the coupons was organized. This improved the trust in the saving bonds as financial instruments. Nevertheless, the results of the first issues do not allow for the conclusion that the population has become active in financing the Budget. According to a number of estimates, despite the introduced minimal quotas of sale of the saving bonds by the authorized entities (not less than 90% of the bonds purchased from the issuer were to be sold within 60 days), the greater share of the issue stayed in the banking sector of the economy. According to certain experts, the money of private persons make not more than one third of the Rb2 trln mobilized to the Budget by the sale of the saving bonds.

Promissory notes (KOs)

The issue of promissory notes had the double initial purpose: to work out the non-issue procedure of compensation of the non-payments in the industrial sector and to postpone the financing of a part of the current credit liabilities. Nevertheless, as the practice showed, KOs are “almost money”; hence, they circulated swifter than the other components of the money stock. The danger of losing control over the growth of the money stock, the non-market character of KOs distribution, and dividends badly coordinated with the realities of the market situation (40% p.a.) brought to serious objections of the IMF. Under the pressure of the international financial institutions, the Government committed to remove gradually KOs from circulation.

One more significative drawback of KOs was that they favored indirectly the redistribution of the product from the real sector of the economy to the financial one (first of all banks) and from regions to the capital. The decision on the non-centralized development of the market within the framework of several authorized depositories (their number reached 30) led to the informational asymmetry and to the exclusive situation of a limited number of operators. The issuer did not manage to transfer the transactions with KOs to a unique “neutral” depository in order to create a well organized and open information market.

The instability of the economic situation, the drawbacks in the organization of circulation, and the vague outlook on KOs as financial instruments did not favor the improvement of the market liquidity, even under the conditions of “de-dollarization” and escape from the risky investments.

Besides, the availability of alternatives of the end use of these instruments (mutual settlements for goods and services, repayment, and exchange against tax privileges) led to the market segmentation and differences in the price dynamics of its sectors in function of the formal maturities.

The securities with the maturity of one month and less were, mainly, instruments for the short-term speculations, being close substitutes of GKO and reacting vividly on the changes in the yields of this market. KO with longer maturity dates were, in a higher degree, used as portfolio investments and as means to obtain tax privileges (about two thirds of KO were used in this form).

KO make the cheapest form of borrowing to cover the Budget deficit, and, hence, despite the obligations before the IMF, their issuing continued at a high rate in 1995. As a result, the year plans of KO issuing and redemptions were highly exceeded (by 42% and 22%, respectively), while the balance mobilization-redemption, though negative, taking into account the tax privileges, was fulfilled only by one fifth, compared with the goal milestones (Rb1.3 trln). As the dependence of the Budget upon KO became quite significant these last years, it seems that their issuing will be continued in this or that form.

In particular, the issuing from the mid-95 of the short-term KO (with the up to 30 days maturity-date) intended exclusively for tax releases, and for which the endorsement within the framework of the depository circulation was not compulsory, became a certain compromise solution of the Finance Ministry. It is planned to introduce a new instrument to circulate within the framework of a centralized depository, with the floating yield rate, dependent upon GKO/OFZs market situation. In this event, the increase of the cost of the State debt servicing is inevitable; at the same time, as of the beginning of 1996, more than Rb7 trln worth of outstanding KO stayed on the market.

Domestic hard currency loan bonds (OVVZs)

The domestic hard currency loan bonds take a special place in the Russian financial market. They are more complex to analyze than many other instruments. The reason for this is that, being State borrowing instruments, circulating inside the country, they cannot be describes based exclusively on the domestic market parameters. The quotations of the Vnesheconombank bonds are, from time to time, significantly influenced by the external factors, relative to the situation of the sovereign debts of other nations (first of all, those under development) and to the negotiations concerning the external debt of Russia. There is no doubt that a great role is played by the fact that Russia does not have any official rating of a borrower. Besides, additional uncertainty comes from the permanent changes of the market participants' structure, i.e., foreign and domestic investors. Of course, these groups of "bidders" are characterized by different temporary preferences, inclination to risk, and other important parameters.

Despite the significance of the volume parameters (US\$7.6 bln par value worth of outstanding bonds are on the market, and the weekly turnover of the market amounts to about US\$3 bln) the trade in the OVVZs stays, exclusively, the over-the-counter one, without, practically, any control by the State. In 1995, the, seemingly, most important attempt to organize a secondary market of the OVVZs on the basis of the MICEX, failed.

The most important among the domestic specialists of the market are such banks as Vneshtorgbank, MFK-Moscow Partners, Alba-Alliance, Avtobank, Eurofinance, Neftekhimbank, Indosuez Capital, New Alliance, Deutsche Morgan Grenfell, and Moscow Narodny Bank. Despite the growth of the share of the domestic participants, it is thought that foreign financial structures continue being main agents therein.

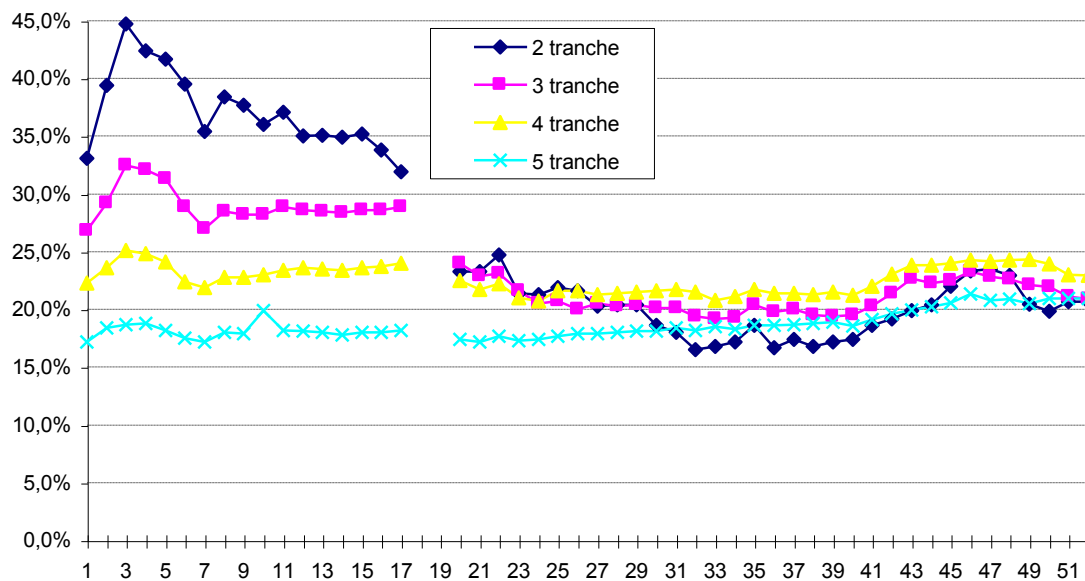
As of the OVVZs market, the following events were the principal ones in 1995:

- the “Mexican” crisis of the beginning of the year, having initiated the sharp growth of the yield on bonds, and the outflow of the foreign investors’ capital;
- the timely, about US\$230 mln worth, dividends paid by the Finance Ministry on the coupon, on 14 May 1995, having improved the trust in the bonds;
- the August crisis of the interbank crediting having resulted in the temporary breach of trust between operators. Natural consequences of this were the reduction of the turnover and the reduction of the market liquidity; and
- the agreements on the restructuration of the external indebtedness of Russia with the London and Paris Clubs; this quenched the negative perception by the participants of the market of the results of the elections to the State Duma.

Until 1995, one of the peculiarities of the OVVZ bonds consisted in that, practically during the whole period of their market circulation, the yields of the earlier tranches were higher than the ones of the latter tranches. In the other words, the shape of the decreasing curve of yield of the OVVZs was inverse to the traditional one of that of the temporary interest rate structure. The breakdown occurred only in May 1995, after the payment on the coupon, when the maturity of the second tranche, the most profitable for the moment being, was less than one year. Hence, the portfolio status of this security was revised: it was transferred to the status of the short-term conservative investments. The turnovers for the second tranche decreased immediately, and the yield began decreasing (see Fig. 2.35). The role of the main game instrument was taken by the third tranche, while the fourth tranche became the most profitable among the bonds of the market of the countries under development.

Fig. 2.35

Yield pattern on domestic hard currency loan for 1995*



* no transactions on the bonds were made before the dividends payment on the coupon

In 1995, one more factor for supporting the yield of the later tranches of the bonds formed (anyway, it became profitable for Russian investors), i.e., the currency policy of the Russian Government. The growth of the real ruble to US dollar (which serves to express the par value of the OVZs) exchange rate increased the requirements to the nominal yields of these instruments.

As a result, despite the serious achievements at the negotiations on the restructuring of the external debt, and despite the implementation of the Governmental stabilization program, the December yield of the fourth tranche came back to that of January, while the yield of the fifth tranche even grew somehow. The diagram below shows that the yields of all the tranches have become more and more similar; to the end of 1995, they got in the 20% to 25% p.a. corridor.

2.4 Interest Rates and Money Markets

In 1995, the continuation of the money contraction policy during the whole year 1995 became the main factor determining the processes in the money market. At the same time, the monetary authorities did not manage to come to a strict enforcement of growth constraints of money supply in circulation. The effects of the currency policy of the RF Government and Central Bank resulted in complex transformations of the money supply, on the whole (understood broadly, as a multi-currency aggregate): the relatively low liquidity assets in US dollars were being frozen in form decentralized reserves, and the more “hot” rubles of the currency interventions were being thrown to the market.

Issuing of quasi-money, the treasury bonds circulating faster than other money aggregates, played its role, as well. Hence, it is no surprise that the attenuation of the inflation processes was slower than initially expected.

One more particularity of 1995 should be noted: the crediting market and the interest rate market were practically uncontrolled by the monetary authorities. For the one hand, the effect of the refinancing rate on the interest rates level had lost all of its importance: in contrast with the world practice, the Central Bank rate fixes not the lower limit of interest, but the upper one. The

refinancing of the banking system with the help of the credits sales did not have visible effects either on the market volumes or on the formation of the interest rates level indicators formation in the money market. At the same time, the transactions in the open market had, first of all, fiscal purposes, while the finer methods of control of the interest rates (report transactions with State securities, lombard crediting, deposit transactions) were not included in the Central Bank's instruments.

When, at last, in the Fall, the breakdown of the inflation dynamics was reached, the normal continuation of the stabilization processes was breached by the institutional crisis of the banking sector of the economy. The Government had only one way out, namely, refinancing the banking system at the expense of the securities market; this market absorbed a significant share of the resources having circulated before in the inter-bank system and directed to the real sector of the economy. Hence, despite the seemingly positive results of the year, certain negative moments allow to speak of the crisis of the country's monetary resources.

The officially published by the Central Bank monthly statistical data on the volumes of crediting of the economy (entities, organizations, and other banks) by banks, and on the deposits of legal entities and natural persons in 1995 are shown in Table 2.13.

The shares of the own assets of enterprises in their circulating assets had always been relatively small, hence, the credit is irreplaceable as the short-term regulator of the liquidity. As, due to a series of reasons, the issuing of securities inside the country is unprofitable for most firms, the need in the investment credits is also very high. The Central Bank estimated the need of the economy in the credit resources, as for the beginning of 1996, at the level of Rb170 trln, i.e., about 1.5-fold more than the volumes reached.

In order to have the possibility to analyze deeper the current situation, we deflated the data shown in the Table by the consumer price index of the RF Goskomstat (see Fig. 2.36).

The real volumes of the economy crediting by commercial banks during the period under consideration were constantly decreasing; the decrease during the year made about 30%. Of course, these events cannot be fully attributed to the consequences of the Governmental policy of the money shrinkage, because the money crediting dropped significantly relative to the volume of the banks depository base, as well (see Fig. 2.37).

During the same period, the deposits of enterprises in the real expression decreased, as well, though, much slower than the credits, while the sum of the deposits by the population was steadily growing. In the other words, the banks are playing their role of intermediaries in the money market less and less efficiently: the monetary crisis is obvious.

Table 2.11

Volumes of crediting and deposits in banks in January to November 1995, Rb bln.

Date	Credits		Deposits			
	to entities	to banks	of legal entities	of natural persons	in Sberbank	in commercial banks
01.01.95	63964.5	9059.8	4499.7	25939.0	15204.3	10734.7
01.02.95	68143.7	8609.9	4814.8	30506.8	18654.7	11852.1
01.03.95	72783.2	10414.5	5565.3	33286.0	20261.3	13024.7
01.04.95	78843.9	13106.0	5949.3	36356.2	22035.5	14320.7
01.05.95	91929.4	17043.6	6693.6	40535.2	24373.6	16161.6
01.06.95	85424.6	21012.2	7853.3	45441.9	27169.1	18272.8
01.07.95	83613.3	23814.3	7534.3	50993.2	30169.3	20823.9
01.08.95	86648.5	21612.9	8275.2	54097.2	32108.4	21988.8
01.09.95	91425.7	14876.0	8355.6	56230.3	33921.8	22308.5
01.10.95	92526.0	13141.0	8631.9	58602.2	36069.5	22532.7
01.11.95	93077.1	13949.4	8659.7	61507.6	38689.7	22817.9

Date	Real volumes						Inflation
	Credit		Deposits				
	to entities	to banks	of legal entities	of natural persons	in Sberbank	in commercial banks	
01.01.95	1	1	1	1	1	1	1.178
01.02.95	0.90436	0.80674	0.90834	0.99838	1.04154	0.93762	1.11
01.03.95	0.87021	0.87913	0.94588	0.98139	1.01914	0.92792	1.089
01.04.95	0.86563	1.01591	0.92851	0.98430	1.01779	0.93687	1.085
01.05.95	0.82904	1.21763	0.96283	1.01147	1.03759	0.97447	1.079
01.06.95	0.80112	1.39125	1.04697	1.05089	1.07192	1.02110	1.067
01.07.95	0.73489	1.47777	0.94134	1.10522	1.11554	1.09059	1.055
01.08.95	0.72187	1.27125	0.98001	1.11137	1.12535	1.09156	1.046
01.09.95	0.72187	0.83651	0.94601	1.10439	1.13662	1.05873	1.045
01.10.95	0.70520	0.70713	0.93521	1.10141	1.15654	1.02332	1.047
01.11.95	0.67756	0.71693	0.89610				

Fig. 2.36

Dynamics of real (deflated) (100% as of 1 January 1995)

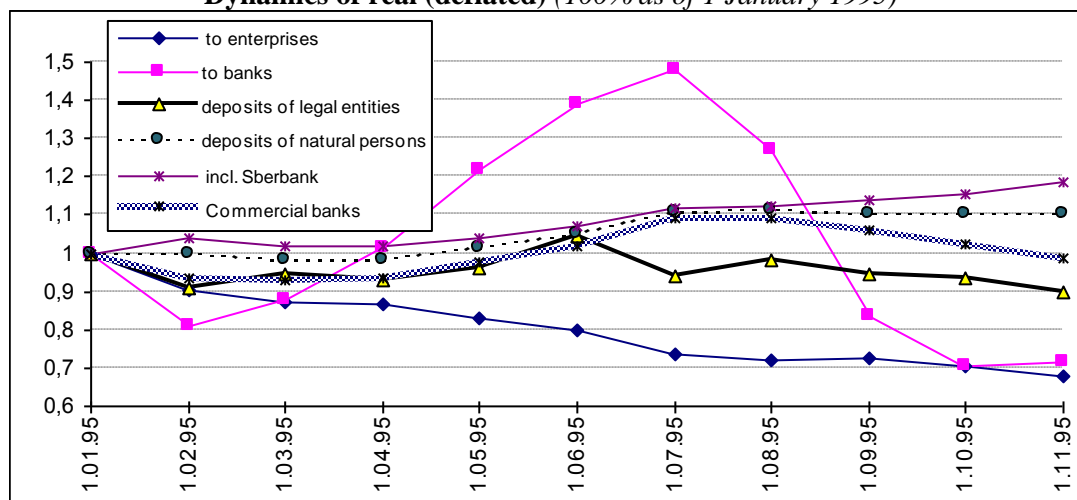
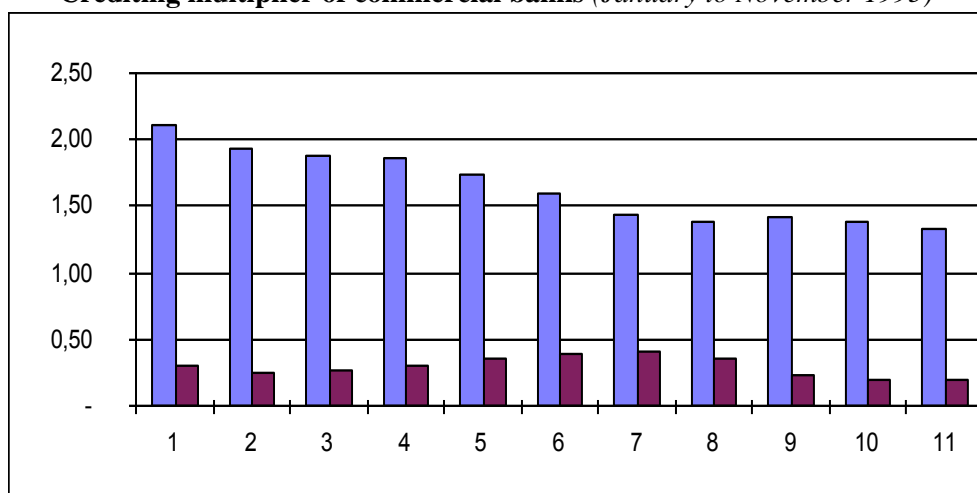


Fig. 2.37

Crediting multiplier of commercial banks (January to November 1995)*



* calculated as volume of credits granted per ruble of deposits of population and legal entities in commercial banks.

Of course, the activities of the Government aimed at mobilizing money on the domestic debt market played their role; this had a visible increasing effect on the real interest rates. However, this was not the only cause of the crisis. Thus, the general reduction of the interest rates observed during 1995 in no way encouraged the growth of the real volumes of crediting, despite the traditional logic. As there are no reasons to think that the demand level is insufficient, one has to recognize that banking structures use the quantitative rationing of credits. The current crisis situation of the market cannot be mastered by only macroeconomic activities: the necessity has surged of a series of efficient reformations at the micro-level; these reformations should be linked, first of all, with the institutions of bankruptcy, the rights of property, the control over the State-owned sector of the economy, etc.

On the whole, the situation on the money market can be clearly divided into the two periods: before and after the August crisis of the Moscow interbank credits market.

Pre-crisis period

Before the Fall 1995, the interbank credits market formed the main system of organized trade in money resources which purchaser used for various purposes. To the Summer 1995, its turnovers exceeded one trillion rubles, supporting a very high degree of liquidity; hence, the quotations of the interbank credits interest rates for different terms (from overnight to three months) were considered the most representative as the “money prices”.

Despite the relative uniformity of the interbank credits market, and the unified conditions of most transactions, different segments of the market may be separated, from the point of view of the temporal characteristics of the loans granted. The structural behaviors of the interest rates on the different terms transactions are, in many aspects, due to the particularities of the use of the money mobilized.

The interbank credits of over than one-month term are the most related to the situation of the real sector of the economy. These are, first of all, the three-month loans: this was the maximal term of the regularly quoted credits.

The general level of the market interest rates on the three-month interbank credits underwent the most dramatic changes in 1995 (see Fig. 2.38). For comparison, the same Figure shows the dynamics of the market interest rate of 1994. One can see, first of all, the parallel character of the changes of the interest rates (the correlation factor is 0.85); this reflects, first of all, the seasonal character of the inflation processes which would be broken, for the first time, only in Fall 1995. However, in 1995, the general level of the interest rates was, on the whole, by 30% to 50% annual lower; at the same time, the accumulated inflation rates for the first halves of these two years were practically the same (about 70% to 75%).

This fact reflects the lower inflation expectations in 1995: in contrast with 1994, the credits market “believed” in the slowdown of the inflation rates. An additional confirmation of this is the fact that, in the structure formed in Summer, the interest rates on the three-month credits were the lowest.

For the other hand, the credits for several days terms are, mainly, of the “conjuncture” character; hence, the relevant interest rates depend, in a great extent, on the situation of the currency market and the availability of other short-term arbitral possibilities.

Another important function of these transactions relates to the control, by banks, over the liquidity of the balances. Just the loans of the short-term range always prevailed in the general mass of the interbank credits, forming a significant share of the total volume of transactions.

A special role in the market belongs to the overnight credits (nevertheless, it should be noted, that some of the credits quoted as the one-day ones are, essentially, renewable revolving credits). All the other short-term rates (up to one week) are, mainly, related to the rate of the overnight credit and depend upon it directly, due to the fact that these instruments are very close substitutes. As a rule, all these credits were some more expensive than the overnight ones.

Both in 1993, and during almost the whole 1994, the foreign currency market served the main direction of application of the resources mobilized. Indeed, the simple enough transaction of the “purchase of inter-bank credits - purchase of US dollars - back conversion in rubles - repayment of credit” type, arbitral profit could be obtained during long periods of time. Thus, in June to December 1995, the average daily rate of growth of the US dollar exchange rate made 142.24%, in the yearly expression, while the nominal average interest rate on the overnight credits was almost two-fold lower, namely, 74.96%. It should be noted that, in contrast with the rates of growth of the US dollar exchange rate, the nominal interest rates are always positive. Before the “black Tuesday”, the correlation between these rates and the US dollar exchange rate growth was high enough, making 0.44, but, after in October 1994, the pre-depositing of the money allotted to purchase hard currency was introduced, this dependence became insignificant. The inter-relation between the demand for foreign currency in the exchange market and the recorded volumes of transactions with the overnight credits became much lesser (according to the INSTAR sampling).

After the arbitral possibilities in the currency market disappeared, banks began mobilizing credits, mainly, for transactions with GKO: e.g., the resale of these bonds purchased for the mean weighed price at a distribution sale, gave at the next secondary sales in 1995, in average, about 800% annual (taking into account the tax privileges. Hence, the short-term inter-bank rates grew more, as a rule, during the ordinary sales for distribution of these bonds (see Fig. 2.39).

Fig. 2.38

Interest rates on three-month bank credits in January to August 1995 (week)

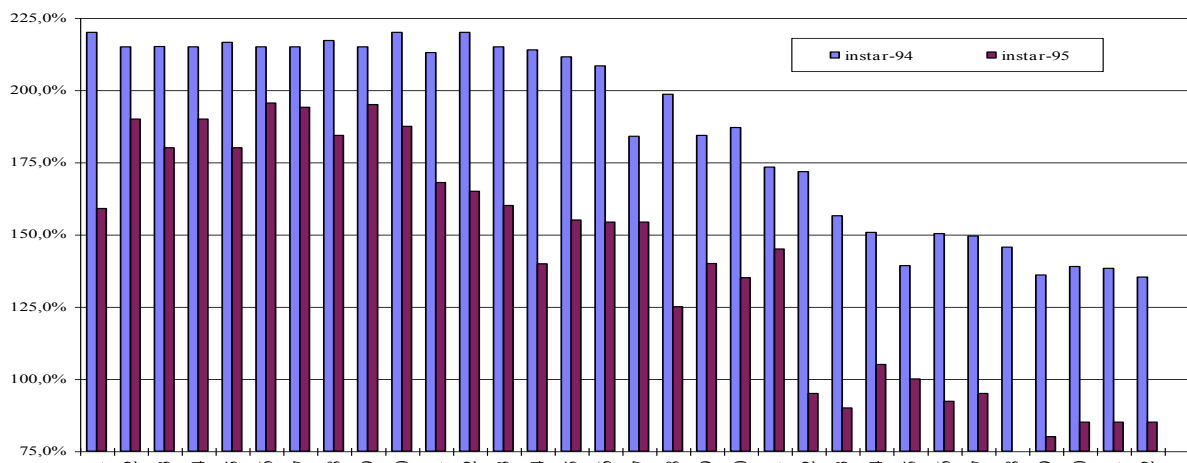
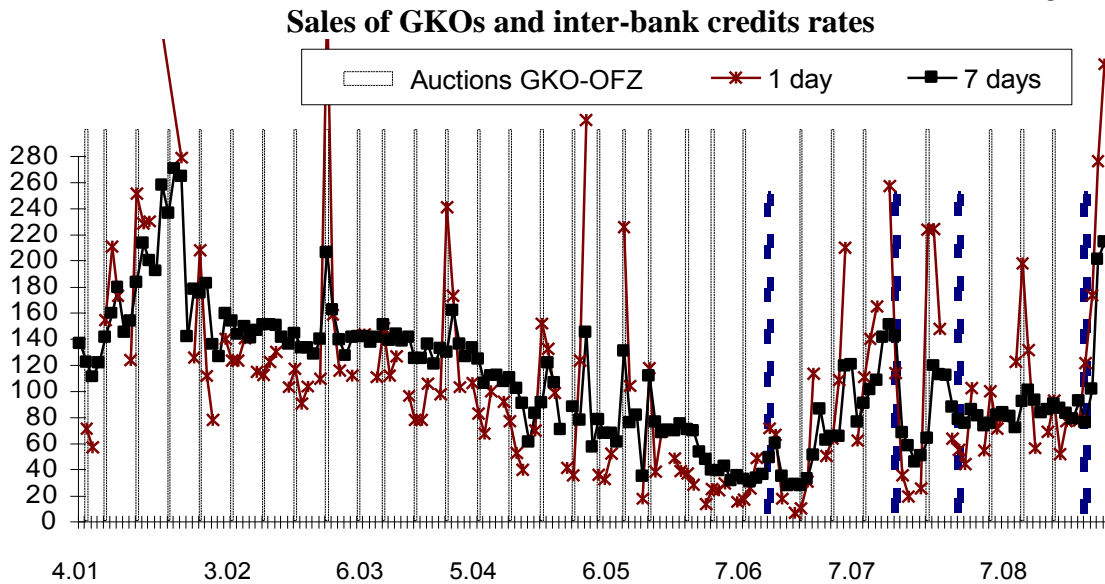


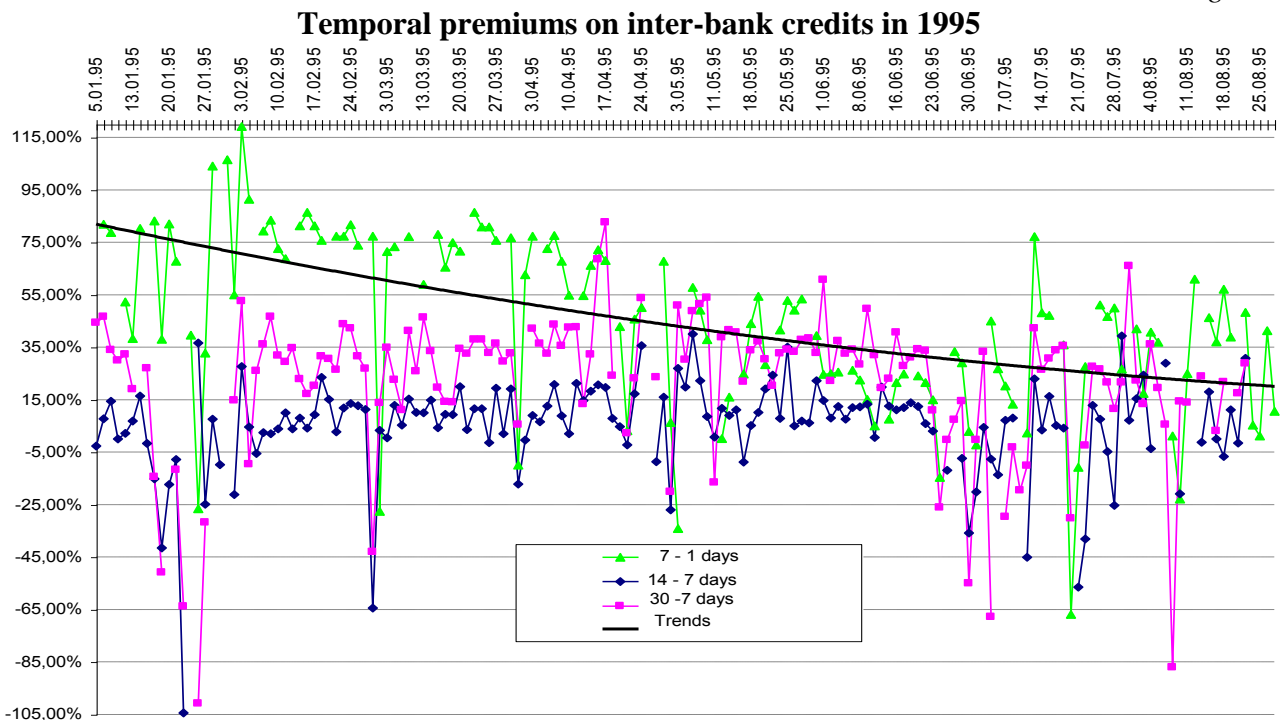
Fig. 2.39



One of the main reasons for the popularity of the overnight loans among the purchasers consists in that, for a long time, they had stayed relatively inexpensive not only on the background of the efficiency of the arbitral operations, but also if compared with the longer terms credits. In order to show this, let us use the apparatus of the temporal structure of the interest rates, calculating the current values of the premiums for the risks on different terms credits. The current premium for the risk (liquidity), or the temporal premium is, in such event, construed as the additional percentage the creditor obtains for the longer term of grant of the liquid assets to a borrower, compared with a sequence of shorter term credits.

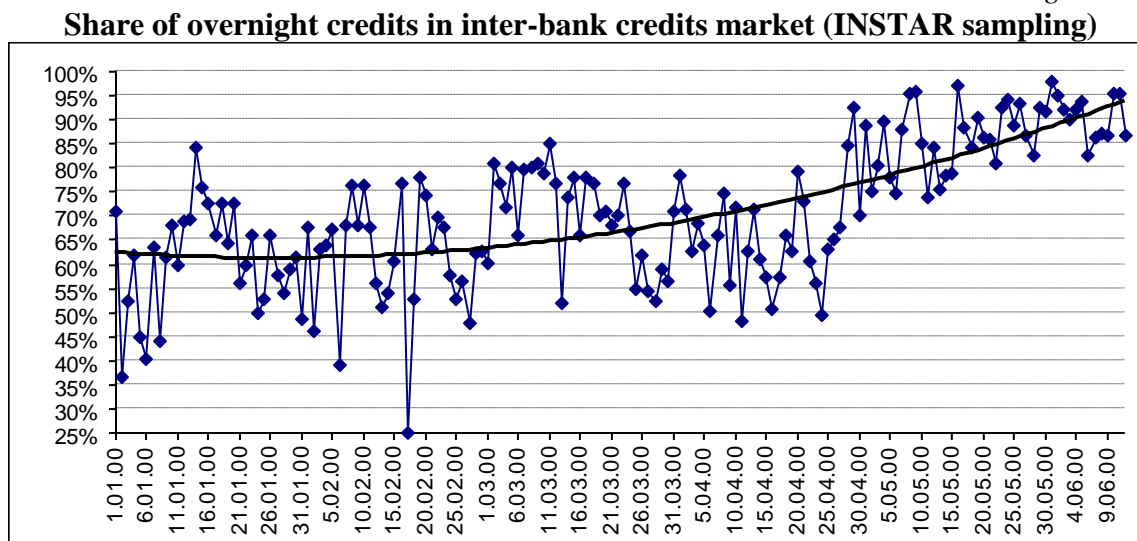
When composing the diagram (see Fig. 2.40) it was supposed, that an overnight credit may be turned over five times during one week, and a week term credit may be turned over, respectively, four times a month. The diagram shows all the temporal premiums in the yearly expression.

Fig. 2.40



Together with the certain advantages for the purchasers, the overnight credits became attractive for the sellers as well, due to the “liquidity preference”. The amounts of the temporal premiums were insufficient to overcome the unwillingness of the creditors to make long-term contracts in the conditions of financial instability. Thus, the consensus had been reached between the sellers and purchasers of the inter-bank credits, which resulted in the unproportional growth of the overnight crediting volumes (see Fig. 2.41). To the end of June, the overnight bargains amounted to over 90% of the market turnover, while from May to December 1994 they covered a little more than a half of the trading volumes.

Fig. 2.41



But soon, it became evident that both the sellers and the purchasers had failed with their expectations, based on the extrapolation of the existing trends. As for the purchasers, they received, instead of the expected stably cheap resources, the extremely short-term liabilities with the weekly changing floating interest rate. Under the conditions of expiration of the arbitral possibilities, it became a significant source of financing of the long-term (for the Russian realities) projects, most of which had been designed for a not so often corrected interest rate.

At the same time, the intensity of fluctuations of the interest rate on the overnight credits grew visibly: in 1995, its standard deviation from the mean values grew, compared with 1994, more than twice (86.12% and 37.71%, respectively). But even this is not the main thing. The usual margin between the rates on the “long-term” and “short-term” transactions actually disappeared. As Fig. 2.40 shows, the premium for the risk on the week credit, compared with the one on the overnight credit, was dropping steadily, with the stability of all the other main market temporal rates of the inter-bank credits market. In the other words, this means that the overnight credits became visibly more expensive, in relation to all the other main market rates, and the borrowers faced inevitable problems.

The sellers of the overnight inter-bank credits received, in their turn, only an “illusion of the liquidity”, because it turned out difficult to stop the effectiveness of the once granted revolver credits and to withdraw the money from the market even at local problems. Of course, under the other equal conditions, a shorter term investment is more liquid, but, regretfully, only in this case. The febrile borrowing in order to mend holes raised the rates on the short term money even more. At the end of the end, the epidemics of the non-repayments surged, and the trade turnover dropped many-fold. The crisis of trust resulted in that the main suppliers of the assets either left the market, or revised sharply the crediting limits, agreeing to make bargains only with the most reliable counter-agents.

Post-crisis situation

The collapse of August 1995 in the Moscow inter-bank credits market, and the banking crisis that followed soon after, are the key moments in the change of the risk perception by the main economic

subjects. Aware of the possible non-repayments, lots of banks openly declared the assets redistribution from the crediting portfolio to the State securities market. The population, the second best net creditor, also showed the capacity to learn: in Fall, the unprecedented leap of the investments in the had currency cash and the convincing victory of the formally safe deposits in the saving banks over the deposits in commercial banks were recorded. If, at the beginning of the summer, the assets were distributed between them about equally, to the end of the year, 90% of the deposits were in the Sberbank. The tightening of the State control over the latter logically continued this trend.

This period of time includes, also, the breakdown of the trend in the dynamics of the granted interbank credits: after the speculative peak of the middle of the year, the crediting volumes decreased sharply back to the “normal” level, determined by the situation in the real sector of the economy and the situation of the assets-liabilities flows of the financial sector. The terms of the bargains made were, as before, concentrated in the short-term part of the terms range. Moreover, even the one-month term credits began quoting quite irregularly, and the interbank credits for longer terms stopped being granted at all. A certain revival of the market was observed, as before, within the periods of GKO/OFZs sales.

At the same time, despite the great reduction of the interbank credits market turnovers, and that the demand for liquidity had in no way decreased, the interest rates continue staying at a very low level. Lots of experts explain it by the monopolization of the market by large-scale operators. Out interpretation is much simpler: the banking structures possessing free money use the strict rationing of the credit: they grant loans to only a limited circle of the most reliable borrowers and refuse, at the same time, to make bargains at any price if they have slightest doubts in the solvency of a counterpart. It is not for nothing, that the statistics showed the growth of the free balances at the correspondent accounts of banks: the latter did have to have recourse to this, though not the most efficient, way of controlling the liquidity. Moreover, a significant share of the losses of the banks was due just to the loss of the instantaneous liquidity and the lack of possibilities to compensate for the temporary shortage of resources in the market.

The loss by the interbank credits market of its former importance, combined with the absence of the centralized indicators of the interest rates, resulted in that the center of gravity when forming the interest rates shifted to the market of GKO/OFZs. Despite a certain growth of demand for these securities, the need to satisfy the needs in financing the State Budget deficit was, inevitably, leading to fixation of the real, high, interest rates in the economy.

2.5 Finances of Entities

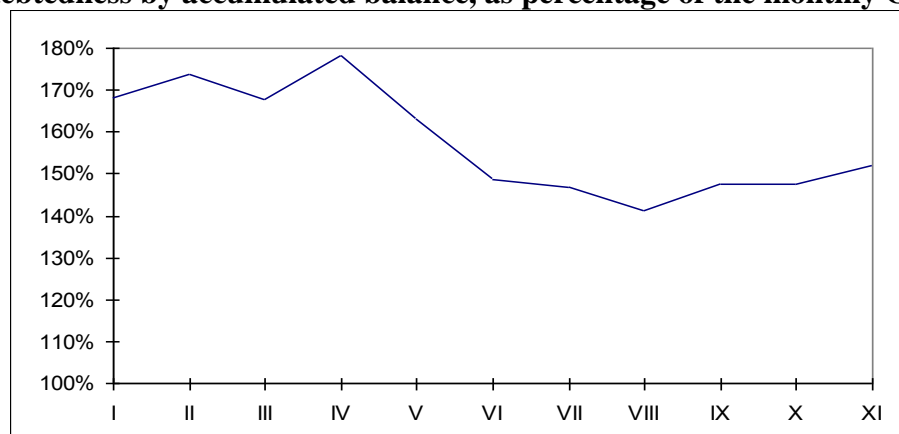
The analysis of the financial situations of Russian enterprises, of the situations with their payments and settlements in 1995, shows the obvious continuation of the tendencies which had shown themselves in 1994. A significant share of the profit, despite its general 3-fold growth, compared with 1994, remained inflational. The dynamics, by months and by quarters-year, of the indexes of the physical production volume and of the profit depend upon each other very feebly. During the first six months of 1995, the dynamics of the profit followed, yet, the dynamics of the production volume - in the second half of 1995, this dependence became much less obvious (see Table 2.12). The absence of a stiff interconnection is, also, seen in the finished industrial products price index to the profit dynamics ratio. During 1995, the price index varied, compared with the relevant periods of 1994, within the limits of 340% to 350%, being stable enough, while the profit dynamics was of the traditional bond-wise character. The profit of the first quarter of 1995 made, already, 371%, compared with that of the first quarter of 1994.

On the basis of the data shown in Table 2.12, one can see the general picture of the trends of the changes of the financial situation of Russian enterprises.

These trends prove that the Russian industry stays highly sensitive to the effects of the external conjunctural and institutional factors. This manifests itself in the situation of the financial assets, payments, and mutual settlements of Russian enterprises. Any stable interdependence between GDP and the indexes, by months and by quarters-year of the arrears and total debtor indebtedness of the industrial, construction, rural economy, and transport entities is absent, as well. The decrease, in the middle of the year, of the total debtor indebtedness to GDP ratio was caused, obviously, by institutional reasons.

Fig. 2.42

Debtor indebtedness by accumulated balance, as percentage of the monthly GDP (months)



The activation, in the second half of 1995, of the Government's struggle against bad debtors made lots of entities to intensify their work with debtors; this resulted in an improvement of the debtor indebtedness collection. The small growth of the debtor indebtedness of the end of the year was, most probably, of a temporary character and due to the end of the financial year. Had the Government have continued, in 1996, the policy of the pressure on the non-payers, the fixation of the decrease trend in the dynamics of the indebtedness could have been expected. However, the personnel replacements in the Government may hamper this.

The sensitivity of the indebtedness factor to the effects of the external factors can be seen when the parameters of 1994 and 1995 are compared. It is known that the first half of 1994 was characterized by the temporary stabilization of the settlements and the reduction of the both delayed

total and debtor indebtednesses to GDP ratio. This led to the illusion of surmounting the non-payments crisis: the growth of the indebtedness to the end of the year was explained by the short-term effect of the factor of the financial year end, and its further reduction was forecast for the beginning of 1995.

Fig. 2.43

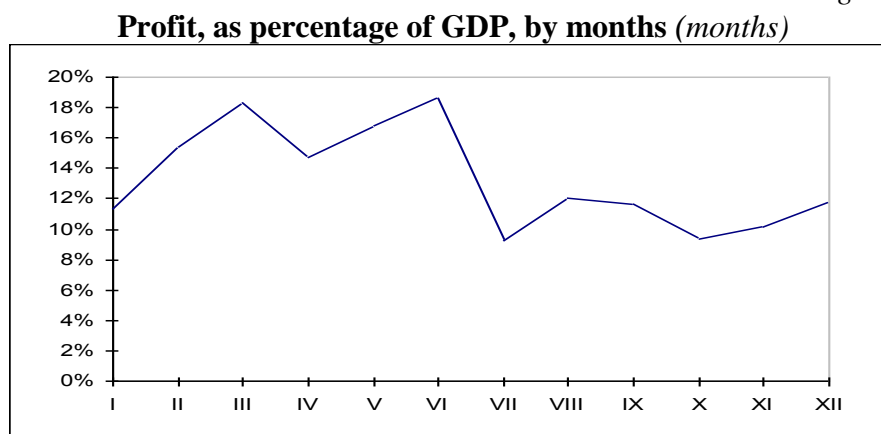


Table 2.12

Main financial parameters of Russian entities, Rb trln

	months											
	I	II	III	IV	V	VI	VII	VII	IX	X	XI	XII
Monthly GDP, Rb bln	78200	82800	94100	101000	120300	139200	154100	169000	172000	178000	181300	189200
Profit, Rb bln	8847	12799	17221	14911	20236	25966	14244	20332	20072	16577	18312	22164
- % of GDP	11.3	15.45	18.3	14.76	16.82	18.65	9.24	12.03	11.66	9.31	10.1	
Debtor indebtedness, accumulated balance, Rb trln	131.4	144.0	158.0	179.97	195.98	206.78	226.27	238.55	253.94	262.86	275.84	
Total indebtedness in arrears												
- % to the preceding month	110	110	107	114	108	109	111	108	107	107	107	
- % of GDP	129	134	128	132	122	114	113	113	119	123	130	
Debtor indebtedness in arrears												
- % of the preceding month	105	107	107	111	107	107	107	108	106	103	106	
- % of GDP	113	91	97	95	96	90	92	95	92	85	87	
Debtor indebtedness in arrears as of the end of the period	84.2	89.9	95.9	106.2	113.7	121.4	130.2	140.5	148.7	153.2	162.3	165.5
Incl.:												
- sellers' indebtedness	73.4	78.9	81.1	91.6	97	105.0	110.8	122.3	129.6	133.4	142.2	146.9
- incl.: indebtedness on bills of exchange receivable	0.2	1.8	0.4	0.5	0.5	0.5	0.6	0.7	0.5	0.6	0.6	0.6
- indebtedness of State customers for payment for supplied products	7.3	6.5	6.2	6.7	6.3	7.0	7.2	7.9	8.3	87	8.2	7.5
Of the total over three-month maturity indebtedness in arrears:												
Creditor's indebtedness in arrears, as of the end of the period	99.0	109.1	115.9	132.1	142.6	155.5	173.1	187.4	201.4	216.2	232.8	238.9
Incl.:												
- indebtedness to suppliers	55.0	59.4	63.0	68.1	75.7	83.3	90.0	97.0	103.9	111.2	119.2	122.3
- incl.:	0.1	0.3	0.2	0.2	0.2	0.2	0.1	0.2	0.3	0.2	0.3	0.2

indebtedness on bills payable												
- indebtedness for payments to Budget	20	22.6	25.1	31	33.8	35.6	40.9	45.9	48.5	54.0	57.1	57.4
- indebtedness for payments to State out-Budget funds	4.8	5.5	5.8	7.0	8.1	8.8	9.9	10.6	11.7	14.1	16.1	17.6
From the total over three-month maturity indebtedness	59.3	65.1	71.0	79.4	84.0	95.7	104.7	111.8	125.7	138.0	149.9	150.9

According to Goskomstat.

This forecast was confirmed, in relation to the arrears of the debtor indebtedness. Beginning from February 1995, its ratio to GDP never exceeded 97%, while in October it made only 85%. As for the total arrears of the indebtedness, from the beginning of 1995, its ratio to GDP stably exceeded the 120% mark. Only at the beginning of the year, the decrease of this index became visible, under the effect of the institutional factors.

Nevertheless, the stabilization of the arrears of the debtor indebtedness does not, yet, give valid reasons to speak of any termination or attenuation of the non-payments crisis. Neither are these reasons given by the surging stability of the arrears structure.

Already to the mid-94 the trend toward stabilization of the internal proportions in the structure of the arrears of the creditor's indebtedness showed itself. Thus, the share of the delayed debt to the suppliers stabilized at the level of about 60%, while the share of the indebtedness for the payments to the Budget stabilized at the level of about 15% to 20% of the total indebtedness. In 1995, this trend continued, but, already, at another qualitative level: the share of the delayed debt to the suppliers decreased by about 00%, while the share of the indebtedness for the payments to the Budget increased by about 3% to 5%. Specialists construed this trend as a stabilization of the settlement relationships, resulting from the improvement of the settlements mechanism. The integrated analysis of the situation confirms the fact of stabilization of the settlements, but its causes will be much more clear if the structures of the channels of sale of individual groups of goods are analyzed.

For example, the petroleum products, forming the commodities group with the greatest mass of non-payments, show an obvious trend of sale by direct contacts. In 1995, compared with 1994, the shares of the sales by direct contacts grew by 12% for the gasoline, by 9% for the diesel fuel, and by 10% for the fuel oil. This reflects the general trend of growth of the "wild clearing" within the frameworks of cartel agreements (chains of mutual offsets, financial and industrial groups).

The formation of such links stabilizes the settlements themselves. An indirect confirmation of the fact that the indebtedness before the suppliers "settles down" in the clearing chains is the growth of the share of the other creditor's indebtedness in the structure of the indebtedness in arrears which reflects, as a rule, the offsetting activities.

Another confirmation of the new stability of the settlements, within the framework of the cartel agreements, is the slower circulation of both the debtor's and the creditor's indebtedness. According to the RF Goskomstat, the mean term of settlement of the creditor's indebtedness made 75 days in the first quarter-year, having increased to 85 days in the second quarter-year. The relevant medium terms of settlement of the debtor indebtedness made 63 and 69 days. This trend is quite explainable from the point of view of the evolution of the mutual settlements and direct links schemes. Usually, the rules of mutual settlements separate certain commodities items and the relevant debts. This means, that the indebtedness structure forms two stable enough groups of debts: the one for the goods taking part in the mutual settlements, and the one for the goods sold as they are. This results in that one part of the indebtedness conserves its variable character, while the other part acquires the

conventionally permanent character. And this circulation of the conventionally permanent indebtedness by the mutual settlements channels results in the growth of the turnover terms.

The barter, non-liquid, character of the mutual settlements also effects the requirements in the circulating capital. The formation of the money assets turns out dependent on the share of the goods used for the mutual settlements in the gross production volumes of entities. The growth of this share is directly proportional to the degrees of participation of entities in the mutual settlements. If such participation shares grow (as it happened in 1995) the share of sale as it is, i.e., for cash, drops. This results, inevitably, in the worse cash positions, and, hence, lower solvencies. It was just in 1995, when this tendency showed itself fully. During 1995, the ratio of the money assets to the indebtedness in arrears to suppliers was stably decreasing, from 25% at the beginning of the year, down to 14% in November. Nevertheless, we believe that this does not demonstrate any worsened situations of entities: to the contrary, this shows that they had acquired certain stabilities within the framework of cartel agreements.