

*INSTITUTE FOR THE ECONOMY  
IN TRANSITION*

***RUSSIAN  
ECONOMY  
IN 1997***

**TRENDS AND  
PERSPECTIVES**

# Part 1

## Economic and political outlook: 1997

Proceeding on from the political and economic situation which has taken shape by the end of 1996, one could have presumed that 1997 would signify a possibility for creating a big “window of opportunity” situation<sup>1</sup>. In such a situation, with the State Duma suppressed (not interested in a decisive opposition) and using the trust of President the “team government” would have a chance to elaborate and pursue a consistent economic programme, regardless of as to what extent the intended measures were popular.

By early 1997 the problem of macroeconomic stability is shifted to the background. The inflation dynamics, drop in GKO yields, positive dynamics of the social indicators demonstrate that with the ongoing problem of the budgetary crisis, the main reason for inhibition of the start of economic growth lays in the institutional sphere.

The interest of the opposition majority in the State Duma in the continuation of the stagnant economic crisis, on the one hand, and the coalition composition of the government which was a result of the post- election

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<sup>1</sup> Such a first “window of opportunity” was in place between late 1991- early 1992

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compromise between the executive power and business, on the other hand, have entailed a political dead- lock situation. In such a situation clearly shown diversified private interests affect the pursuance of a consistent economic policy.

As of early 1997 there were two scenarios of the further development of the situation which seemed fairly probable. The first variant- to overcome the current situation and intensify the process of reforms by undertaking decisive steps aimed at overcoming the budgetary crisis, restructuring natural monopolies, social sphere, etc. The other scenario- to drift to the oligarchic development, in which a stable crisis at the end would grant a victory to the opposition, or a non- democratic development of the situation.

In such conditions, by spring the necessity to make a transition from the “government of coalition” to the “government of team”<sup>2</sup> has matured. The formation of the renewed government terminated the suspended situation of political uncertainty and assisted to creating political preconditions for economic growth.

A major challenge, strategically important in light of the prospects of this country’s economic growth, which the new government faced at that moment became the problem of overcoming the budgetary crisis.

One can single out a number of reasons which caused the budgetary crisis in Russia as an economic post- stabilisation crisis on the threshold of the start of growth:

*Firstly*, with the current tax system deteriorating, the crisis in the government revenues was intensified by a lack of the inflationary tax.

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<sup>2</sup> For details, see: “Rossiyskaya Ekonomika v I polugodii 1997 g. Tendencii i Prespectivy.” IET, 1997

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*Secondly*, the delayed structural reform in the budgetary sphere has determined the crisis in public spending. The cuts in public spending, consequently, has had affected heavily the social protection system, branches of non- production sphere, and armed forces. Should the government have refused to resolve the problems of reforming the budgetary sector in 1997, the budgetary crisis could have become increasingly steady and politically dangerous.

In order to have a balanced budget, the government was undertaking measures in some directions.

*In the first place*, proceeding on from the fact that it was the tax collection problem which had become a main factor of a significant growth in the budgetary deficit and the government's dependence on domestic borrowings, the renewed government launched a serious struggle for increasing the budgetary revenues. The government focused on the following basic measures: introduction of changes in the order and sequence of tax collection and financing of spending, restructuring and securitisation of enterprises' arrears to the budget. The Tax Code submitted to the State Duma is also aimed at enhancement of fairness and neutrality of the current tax system at the expense of a reduction in a number of benefits, and struggle against tax evasion.

*Secondly*, an increase of the efficiency of the budgetary spending was provided in the package of documents on social, housing and military reforms.

*Thirdly*, some measures were undertaken with regard to overcoming the arrears crisis at the expense of the reform of the price and tariff system: in particular, the reform comprised signing a number of Decrees and Resolutions on restructuring natural monopolies.

Finally, *in the fourth place*, the first half 1997 signified a new stage of the struggle against corruption. The core novelty of that stage was that for the

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first time the authorities' measures were aimed at rather stopping the opportunity of an abuse through elaboration of clear rules of the game than only at investigation and penalties.<sup>3</sup>

The measures undertaken by the government, especially in the field of increasing the tax revenues were evidently painful to representatives of the powerful economic interests groups.

The character of privatisation changes. Given that between 1992- 1995 privatisation was clearly aimed at social and political objectives, in 1997 an evident shift was made towards fulfilling fiscal tasks ( Table 61).

The "clearing" of the executive power from representatives of specific business groups is also attributed to that period of time. In other words, the "team government's" coming to power in spring 1997 signified a new stage in this country's political and economic development. The core content of that stage was the state's self- separation from business, separation of the national interests from private ones.

A number of factors have assisted to the government's freedom of manoeuvre. The reaching of financial stabilisation and growth in investors' trust, in the first place, and a specific stage of the electoral cycle as the other factor unquestionably played a crucial part in this respect. However, there was a third factor which became characteristic of 1997.

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<sup>3</sup> The former direction is represented, for example, by the Presidential Decree of 8 April 1997 "On Prior Measures On Prevention of Corruption and Reduction in Budgetary Spending in Course of Organisation of Procurements for the State Needs", the President's instruction ( in the Presidential Address) to the Ministry of Finance to activate the treasury system of execution of the Federal budget in 1998 at a full rate, and the measures on regulating natural monopolies. At the same time assignment of new control functions and proxies to the Ministry of Interior ( transfer of State Tax Service, Tax Police, Customs and the Currency and Export Control Service under the jurisdiction of the Ministry of Interior) and the stirring campaign with regard to submission of tax declarations accompanied with discussions generated by the mass- media around the declared sums was a sign of practising the traditional approach.

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Between 1995- 1996 the major structural problem was the division of the Russian economy ( primarily, its industry) into two large sectors: on the one hand, there are export- orientated industry branches which are interested in macroeconomic stability, open ( to the external world) economy, minimum government regulation of their economic performance. On the other hand, there are import- substituting industry branches ( or, more specifically, potentially import- substituting branches)- those sectors which suffered at most from the market liberalisation because of their lower competitiveness. Those import- substituting industry branches claimed for protectionism, state investment and “cheap money”. The qualitatively new feature of 1997 when compared to 1995- 1996 became an overcoming of bi-polarity and formation of several types of economic agents whose interests happen to be in a complex interaction.

The analysis of the ongoing structural shifts allows to single out four groups of industry branches, depending on their specifics and parameters of economic policy required for their steady development.

*In the first place*, raw material and energy industry branches which are mostly export- orientated among industry branches. Their position practically exclusively depends on the global price level for the respective kinds of products and on this country’s type of economic regime. These industry branches are interested in a liberal economic system, absence of protectionism, and macroeconomic stability as a precondition for an efficient investment activity.

*Secondly*, there are the industry branches exporting “intermediary products”- primarily, ferrous and non- ferrous metallurgy, chemistry and petrochemical industry, and producers of exported military and technical goods. Similar to the first group, their common position depends on the same factors, but with one more factor to add- prices for natural monopolists’

products and services. An increase in those prices would undermine an efficiency of the export of intermediary goods.

*In the third place*, the producers of goods being competitive in the domestic market: those are machine building and metalworking, a part of chemistry, medical and microbiological ( especially production of medicinals) sectors, flour- grinding, feeder- making, food industry branches. For them, the national currency's stability ( as a factor of the domestic demand stability), high real Rouble rate ( as a factor counteracting imports) and restricting natural monopolies are of a crucial importance. As for the protectionist policy, it makes a certain sense for these industry branches, but it is not as much crucial for their development, while for a number of those branches ( which require import assembly parts and equipment) a protectionism is contra-indicated.

Finally, *in the fourth place*, there are those sectors of the national economy which are incapable of adjusting themselves to the market competition conditions and require state support ( and government regulation), cheap financial resources, "protection of the domestic producer" for their development. Such industry sectors as some machine- building sub-branches, light industry may be attributed to that group.

Obviously clearly expressed anti-market priorities are characteristic of enterprises of the fourth group. All the other groups, in one way or another, manage to find their place in the open market economy.

The ongoing structural shifts in the Russian economy have a direct impact on both the balance of forces among the influential interest groups and the Federal authorities' possibility to influence social and economic processes, i.e. they may cause serious political implications.

It results, first of all, in the weakening of anti- market groups which are the basis for the leftist parties. Proceeding on from that, one may forecast an

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alleviation of the social tension and gradual clearing the political elite from advocates of the orthodox import- substituting policy ( cheap credits, high import tariffs, profit redistribution from the export industry branches to machine building, tough regulation). Thus, for instance, the changes which have happened in the government for the last two year testify to this fact rather convincingly.

In such a situation the government could take additional chances for pursuing a course which would be independent from single interest groups and to a higher extent meet the actual national interests<sup>4</sup>.

In mid-1997, however, the crisis in the government programme became notable- particularly, the State Duma decline in the package of social bills, and the executive power was not sufficiently insistent in implementing the consistently reformist policy ( drop in tax collection, refusal from undertaking tough measures against non- payers who did not wish to restructure their debts to the budget, lack of specific measures aimed at restructuring public spending, etc.). Since the beginning of the year one could observe a gradual reduction in the amount of tax arrears to the Federal budget which was a result from the measures undertaken by the government. However, by early May the overall amount of indebtedness to the Federal budget grew at the expense of new non- payments and made up a. 82.5 trln. Roubles. In all, regardless of some rise in

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<sup>4</sup> The overcoming of the bipolar structure, complication of the system of current economic interests in the society terminates the situation in which the executive power had to choose between one or another party of the conflict who sought for the support. Now the government has a possibility to attract a support on the part of broader coalitions and at the same time to use contradicting interests of single groups in its own favour. ( For example, keeping a general liberal regime, to toughen its control over natural monopolies' performance, which could have been impossible because of the political reasons, since the support of anti-market, antiliberal group would have been required. Another example- to use the conflicts among financial groups which are interested in developing different industry branches for its own (the executive power's ) favour.



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collection of the budgetary revenues, in the first half 1997 the initial plan of budgetary revenues was fulfilled only at 64%

( according to the estimates of the RF Ministry of Finance). In spite of the fact that the spending part of the budget was executed at 68%, the actual spending was growing, and the actual under-financing rate made up 31% of the overall amount of the intended budgetary spending.

One may single out several reasons for the crisis of the programme.

*Firstly*, the aspiration of the opposition majority in the Duma to keep the stagnant economic crisis has been underestimated. At the same time in 1997 a new facet of the regional problem manifested itself most clearly. The elections in the Russian regions- parts of the Federation- held between 1996- early 1997 have resulted in a growth of the regional authorities' responsibility before the regions' population and in the regions' increasing sovereignty from the Federal centre, since the majority of governors turned from appointed into elected heads of their regions. At the same time, as the situation in Primorsky Krai showed, the Federal centre has failed to find efficient levers of control over the regional authorities<sup>5</sup>

*Secondly*, the struggle of the new interest groups for control over the government has also become a reason for the crisis of the government's programme. Finally, *thirdly*, the crisis was caused by conflicts within the government.

The tender on a sale of the stake of joint- stock company "Svyazinvest" held in 1997 and the political scandals caused by that have given a negative

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<sup>5</sup> In such a situation, the Federal centre attempted to encourage the confrontation between the regional authorities and the authorities of a lower ( municipal) level. The Council on Local Self- Governance was established. The discussion on the budgetary federalism problems ( including the adoption of the Law on local self- governance) and transparency of financial flows has had a new spur.

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sign to investors. As a result of the weakening government's positions, investors, primarily foreign ones, have revised their view on prospects of a start of economic growth in 1997. The hopes for a start of a fast economic growth in Russia in 1997 have not been justified.

The prospects of growth were also stricken by the global financial crisis, and in this point two issues are crucial:

On the one hand, in spite of the fact that the anti-crisis measures were painful, they were undertaken on time and were rather consistent, and the government, together with the Central bank, has managed to keep the macroeconomic situation in this country under control. Apart from anything else, that became the government's demonstration of its grown independence from the powerful economic interest groups, to many of which the monetary authorities' actions should have had rather painful consequences.

The efficiency of the undertaken measures allowed to prevent the Rouble destabilisation, while such a devaluation took place in the majority of emerging market economies, including relatively stable European post-communist states. Hence, Russia still remains one of the two countries of the analogous investment rating which have not had their national currency dropped.

The demonstration of efficiency of the monetary authorities' policy in the conditions of the remaining turbulence in the global currency and stock markets has resulted in strengthened position of the economic block of the government, both within the Cabinet and in the dialogue with the legislative power. At the same time the struggle among the business groups for control over the government intensified, too.

On the other hand, in this connection the government's resoluteness in keeping the national currency's stable rate is becoming of a crucial significance for the prospects of economic growth in this country. Any refusal from such a

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course may be equal to a retreat to the situation observed prior to the financial stabilisation, with the characteristic problems of inflationary expectations, lack of investment, etc.

In general terms, reckoning up 1997, one may single out the following issues:

Some progress is observed in respect to a number of directions related to pursuing the social and economic policy, which manifested itself in specific indices and positive economic shifts. One should especially note the following directions:

*First of all*, the economic growth is in place in a number of industry branches and in the general dynamics of GDP. However, it is rather clearly observed structural shifts, especially in industry, than the economic growth itself, which are important ( Table 14).

In 1997 main points of growth became the enterprises focused on meeting the domestic demand, i.e. those which successfully compete with foreign producers in the domestic market. It is worth noting that the process began to develop without introducing any protectionist measures or administrative exclusion of foreign competitors. The ongoing processes are first of all related to a reactivating of the domestic demand ( as a result of macroeconomic stabilisation) and enterprises' ( especially their owners' and management's) adjustment to market environment.

Thus, Russia is passing by the politically dangerous conflict between export- orientated and import- substituting sectors of the national economy, which should assist to the stabilisation of the general political situation and provide the government with greater opportunities of pursuance an optimal economic policy.

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*Secondly*, the process of separating the spheres of activity of state and business has clearly intensified. The Federal authorities undertook important steps aimed at alleviating their dependence on the entrepreneurial institutions and various interest groups. That, consequently, caused a number of sharp political conflicts which, apparently, should also continue to occur in 1998. It is privatisation and the problems of ownership rights related to that which will still be a core issue of the future conflicts.

*In the third place*, the government has managed to significantly reduce the impact on the part of the main destabilising factor in the social sphere noted as of early 1997- back wages and pension debts. In summer the government paid off its debts to pensioners, by autumn the back wages were paid off to the army, and by the New Year holidays the government transferred to the regions the resources necessary for paying off the Federal back wages to those employed in “the budgetary sphere”. The resolution of that and a number of other problems has resulted in a notable drop (after March) in a strike fever. Between April- December the number of strikes, number of participants in them and labour time waist because of strikes proved to be significantly inferior to the respective indices reported during the first three months of 1997.

*In the fourth place*, the government succeeded in elaboration and offering the legislative power a number of real and sound reforms which were specific and technological actions. Those were, first of all, the Tax Code, Budget Code, a package of social reforms, concept of the pension reform, proposals on healthcare reform.

In spite of the fact that due to certain political reasons the majority of the aforementioned documents were not officially approved by the Duma, the elaboration of such documents is extremely important, since it laid the grounds

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for resolving those sharp problems in the future. In other words, the executive power now has rather a clear picture of what to do in the respective spheres.

*In the fifth place*, in course of a significant part of 1997 the authorities were capable of providing recovery and maintenance of the monetary and credit system's stability ( Tables 1 and 2). In 1997 the inflation rate in this country was lower compared to the "advanced" post- communist countries, including Poland.

*In the sixth place*, last year was signified with the accession of Russia to the Paris and London Clubs. In 1997 the Russian securities market was recognised as the most intensively emerging market world-wide.

Finally, *in the seventh place*, some changes to a better has manifested themselves in a whole number of social indicators, including life expectation, crime rate, etc.

Naturally, not all of the problems have been resolved and, furthermore, not all of them were resolved consistently. Among the executive power's major failures one can specifically single out the following defeats:

1) Tax collection. Although in 1997 the decline in the government share in GDP slowed down sharply, the process still continues ( Table 14). The respective index for Russia currently is lower compared to not only the majority of other post- communist states but even the US government share in GDP.

2) The enterprises' mutual arrears continued to grow, although their growth rate slowed down.

3) The budget deficit is still on the level which is dangerous from the economic growth standpoint( with the GDP monetisation being low, chances for borrowing in the domestic market are also rather low).

4) The government has being very amorphous while dealing with natural monopolies regulation.

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The core task of the government in 1998 will be the pursuance of the course launched in 1997 and, specifically, intensification of the consistency of implemented measures. The reasons for such tasks are rather evident. The year of 1997 became, in a sense, the first year of the economy's post-stabilisation development. Inflation was suppressed, and the budgetary problems and problems of incentives to economic growth have moved to the forefront. Such problems require a long time, and in any case (even if the political situation were extremely favourable, and that was not the case in 1997) one will need to go beyond a one-year frame.

It seems possible to single out the following key issues in the economic policy for 1998, which might be regarded as indicators of the steadiness of the government's course.

*Firstly*, such an indicator should become prevention a possibility of reactivating the Federal budget's back wages and pension debts. Such debts both destabilise the economic situation and undermine the government's political positions and put that in a self-justifying position. Objectively, such a situation is extremely beneficial to Opposition, including representatives of that in the State Duma. The Duma, following its political and populist considerations, would be inclined to making decisions which will result in a groundless growth in budgetary expenditures. Hence, in such a situation the Duma would be able to demonstrate its "closeness to the ordinary people" and at the same time undermine the executive power's position.

*Secondly*, the government should aspire to impose constraints on and struggle against other sources of the debts growth in the national economy.

One step in this direction was made- the decision taken by the Constitutional Court concerning the order of priority with regard to recovery of debts to the budget (Article 855). The crucial point in this matter is that in

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reality the preferential position of the obligations by salaries and wages encourages the growth in back wages ( since such an approach allows to not pay taxes).

The other step which the government will have to make is to increase the responsibility of management corpse for creating back wages. In contrast to 1992, for example, the current situation in which enterprises operate but ship their products on credit is a clear signal of tax evasion. Summing up, should back wages appear, they would call for the law enforcement bodies' interference.

*The third* indicator will be resolving the tax problems. Strictly speaking, at this point one should single out two groups of issues which are closely related to each other, but far from being similar in light of implementation of a practical policy. The government's resoluteness in collecting current tax payments, debts restructuring<sup>6</sup> as a first step, and, secondly, getting the Tax Code approved by the Federal Assembly would allow to clean off the economic field from the prior years' stratification and regulate the tax system in order to stop its degradation and not allow a renewal of the tax arrears growth in the future.

The efficiency of resolving the budgetary problem will be also shown by two indicators as follows: an adoption of the package of "social" legislation allowing to " lift the burden" from the budget and create an actual system of guarantees and incentives ( *the fourth indicator*) and regulation of financial flows in the regions, providing the transparency of the consolidated budget's flows ( *the fifth indicator*).

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<sup>6</sup> Keeping the current situation unchanged does more harm compared to defects of any restructuring scheme which by itself may not be a perfect concept.

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Finally, *the sixth indicator* may become continuation of and increase in the measures on strengthening the government's control over the natural monopolies' activities. First of all, the government must provide a transparency of the natural monopolies' financial flows formation of their investment policy, and rationalising their tariff policy.

An important political lesson of 1997 will be a realisation of the fact that during the painful stage of overcoming depression and beginning of growth the Duma is not interested in a sharp confrontation, hence it is a necessary but not sufficient condition for creating a "window of opportunity" situation. The current stage is a period during which actual variants of perspective development, structuring of economic interests and, therefore, intensification of the struggle among the business groups for the control over the government's activities are shaping up. That is why a real implementation of the policy of the post-stabilisation stage of economic reform (social, ownership, budgetary transformations) is possible only in the conditions of the agreed Cupertino between the executive and legislative branches of power. In this sense one may interpret the situation as follows: at the present stage the "window of opportunity" creates not a team government, but some "state of team".

At the same time such factors as the Duma's dependence upon the electorate and, in compliance to the Constitution, its inability to have a real effect on the government policy by themselves cause a trend to the Duma's self-separating from the government's activities. The forthcoming parliamentary election, strengthening of the interest groups' pressure allow, in light of the present situation, to assume that the opposition majority in the Duma will become increasingly aggressive. At the same time the government's



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position in its dialogue with the Duma in the situation of depressive growth<sup>7</sup> would tend to weaken.

Proceeding on from the above, an intensification of the confrontation between the executive and legislative branches of power seems probable. At the same time it may well happen that between early 1998 - the first half of the year the “government of team” would erode and it would be drifting to a coalition government. Such government would be coalition not from the viewpoint of its ministers’ membership in different parties, but in terms of their representation of different interest groups. On the other hand, hence, the forthcoming parliamentary elections are becoming of a crucial importance for the destiny of the Russian reforms.

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<sup>7</sup> One may also note the factors which impose constraints on capital inflow to Russia. They are related to such reasons as the further intensification of the Asian financial crisis, drop in the credit rating of a number of the Russia’ largest companies and the peril of a drop in this country’s investment rating. In addition to that, the government’s activities are blocked and it is incapable of demonstrating its readiness to make and implement many decisions, especially those in the institutional sphere.

# Part 2

## Monetary and budget spheres

### 2.1 Monetary policy

#### Monetary policy outlook for 1997

In 1997 the government continued to implement a consistent tight monetary policy initiated in 1995. Main reasons which explained the significant reduction in the inflation rate in 1996-1997 were: control over the money supply in the framework of the co-ordinated with IMF monetary programme and some reduction in the budget deficit at the expense of cuts in the budget outlays.

During the first half of 1997, the growth of the money supply amounted to 27.6 per cent, of the money stock  $M_2$  – 24 per cent. By the beginning of July, the volume of money stock reached Rb 364 trillion or more than 15 per cent of the annual GDP. The ratio of the high-powered money to  $M_2$  somewhat declined compared with its 1996 level and came to 37.6 per cent by the middle of 1997. The ratio of the monetary base  $M_2$  went up reaching 45.9 per cent by the beginning of July.

Increment of the monetary base for the whole of 1997 constituted 25.7 per cent which corresponds to a monthly average increment of 1.92 per cent, the high-powered money in circulation  $M_0$  – 32.0 per cent (2.34 per cent on average per month), the money stock  $M_2$  – 28.6 per cent (2.12 per cent on average per month) (Table 1). This reflects a reduction in the money multiplier from 2.4 by the end of January 1997 down to 2.31 by the end of December 1997 (Fig. 1). Increment in the real money stock amounted to 15.8 per cent (Fig. 2).

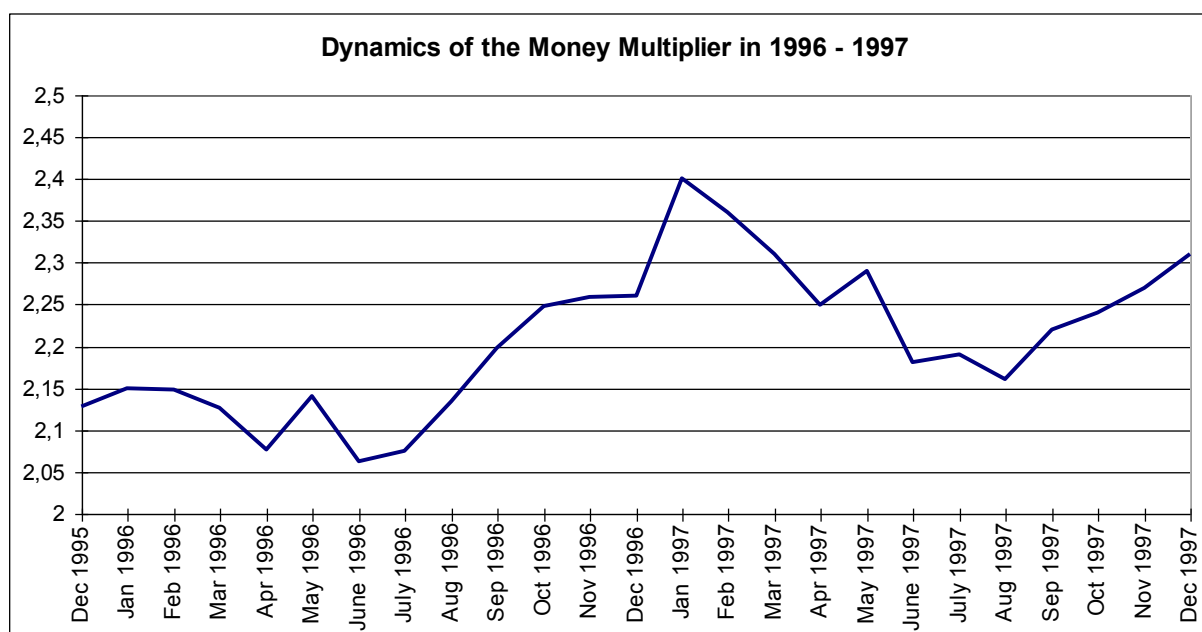
Table 1.

1996 – 1997	$M_0$ (by end of month)		Money stock $M_2$ (by end of month)		Monetary base (by end of month)		Money multiplier
	Rb trillion	change in per cent	Rb trillion	Change in per cent	Rb trillion	change in per cent	$M_2/\text{ДБ}$
Dec.	103,8	8,35	295,2	4,57	130,9	4,72	2,26
Jan.	96,3	-7,23	297,4	0,75	123,9	-5,35	2,40
Feb.	102,0	5,92	307,6	3,43	130,2	5,08	2,36
March	105,2	3,14	315,0	2,41	136,3	4,69	2,31
April	115,2	9,51	328,4	4,25	145,7	6,90	2,25
May	120,4	4,51	339,4	3,35	148,2	1,72	2,29
June	136,8	13,62	363,8	7,19	167,0	12,69	2,18
July	140,3	2,56	375,5	3,22	171,4	2,63	2,19
Aug.	141,6	0,93	377,7	0,59	174,7	1,93	2,16
Sept.	134,8	-4,80	376,2	-0,40	169,8	-2,80	2,22
Oct.	135,7	0,67	382,3	1,62	170,4	0,35	2,24
Nov.	128,7	-5,16	371,1	-2,93	163,8	-3,87	2,27
Dec.	137,0	6,45	379,5	2,26	164,5	0,43	2,31

In 1997 the monetary base was growing mainly at the expense of an increase in the official external reserves (Fig. 3). For the first half of 1997, the CBR's gross assets grew from Rb 130.9 trillion up to Rb 167 trillion, i.e. by 27.6 per cent. In the second half-year, they have practically remained unchanged (reduction constituted 1.5 per cent). Net internal assets (NIA) of the monetary authorities were changing unevenly during that period. From the beginning of the year their value declined by 0.6 per cent, reaching by the beginning of May Rb 122.2 trillion worth. For the first nine months of 1997, the value of NIA have not practically changed (reduction constituted 1.6 per cent). However, at the end of the year, in the circumstances of the financial markets crisis, the Central Bank carried out a massive acquisition of the state bonds. For

the second half-year, they have grown by 33.08 per cent. The growth of the monetary base in the first half-year occurred mostly at the expense of an increase of the official internal assets in the second quarter-year. Net external reserves of the CBR in the first half of 1997 grew from US\$1.7 bn up to US\$10.6 bn, i.e. by 517 per cent. From June to December they declined by about 62 per cent.

*Figure 1*



Accumulation of the external reserves in the first half of 1997 and increasing pressure on the rouble by buying a bull was caused not so much by a positive Russia's trade balance (precisely in 1997 there appeared a trend toward its decline. In the circumstances of the largest positive 1996 balance, NIR never reached such record volumes), but by an inflow of foreign capital to Russian financial markets, first of all, to the GKO market and by the process of de-dollarisation, i.e. substitution of the part of assets in foreign currency with the assets nominated in roubles.

Figure 2

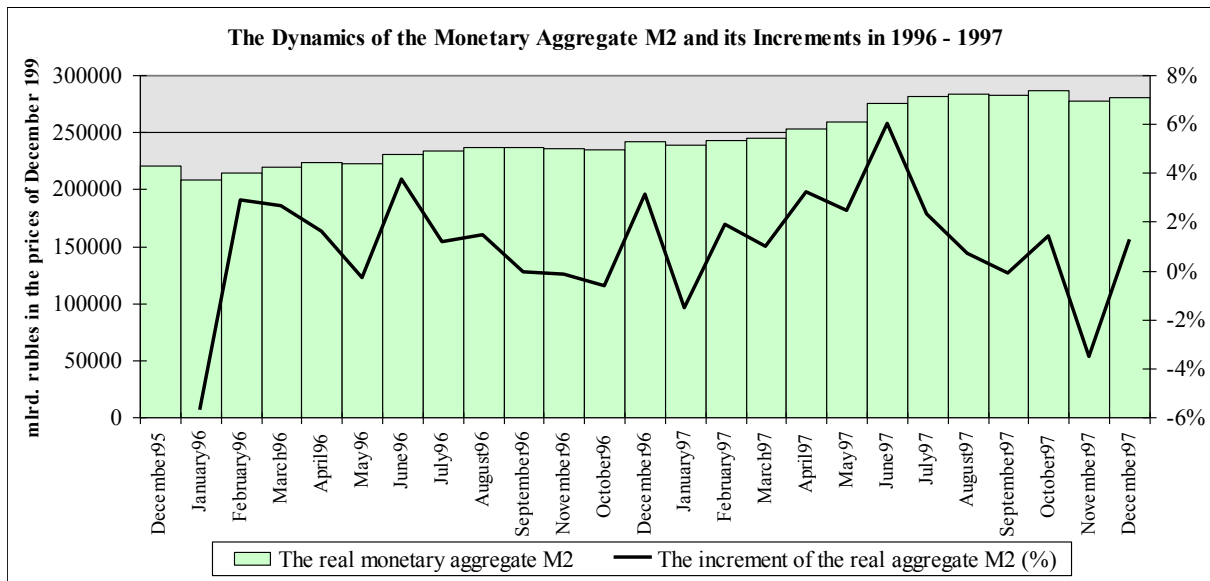
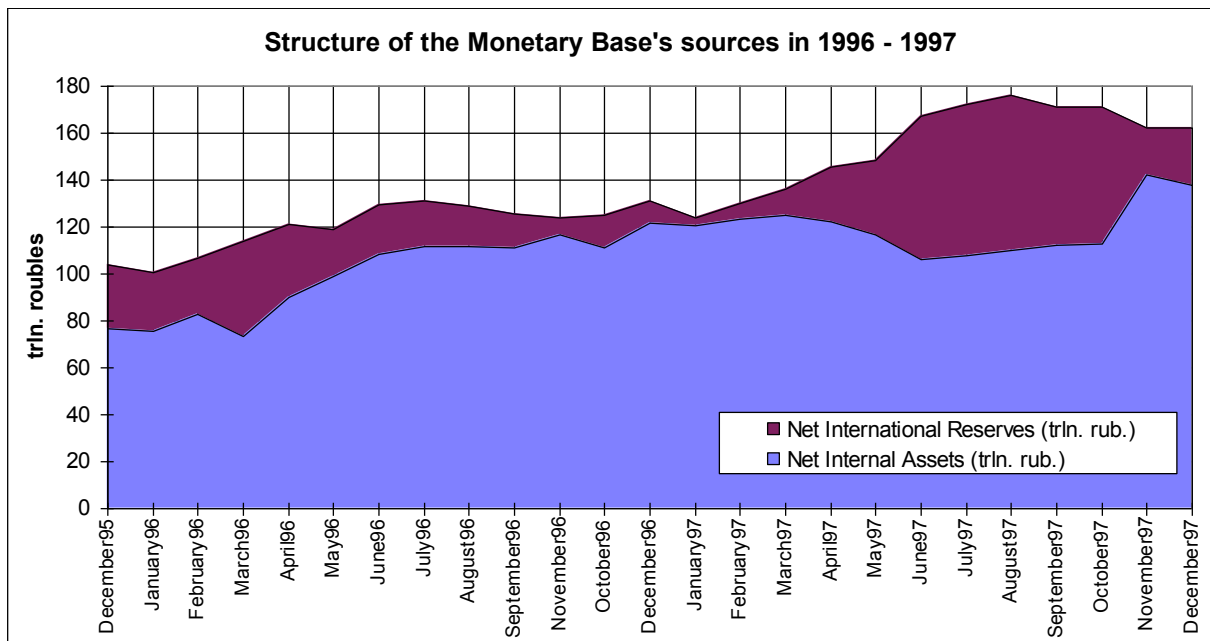
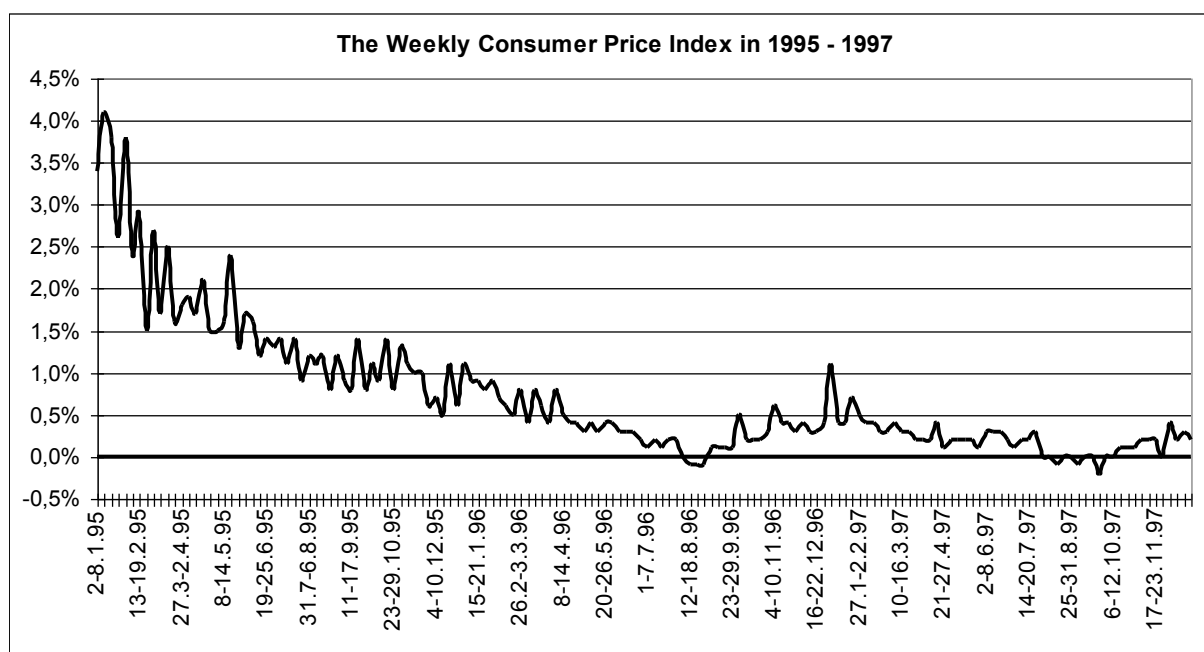


Figure 3



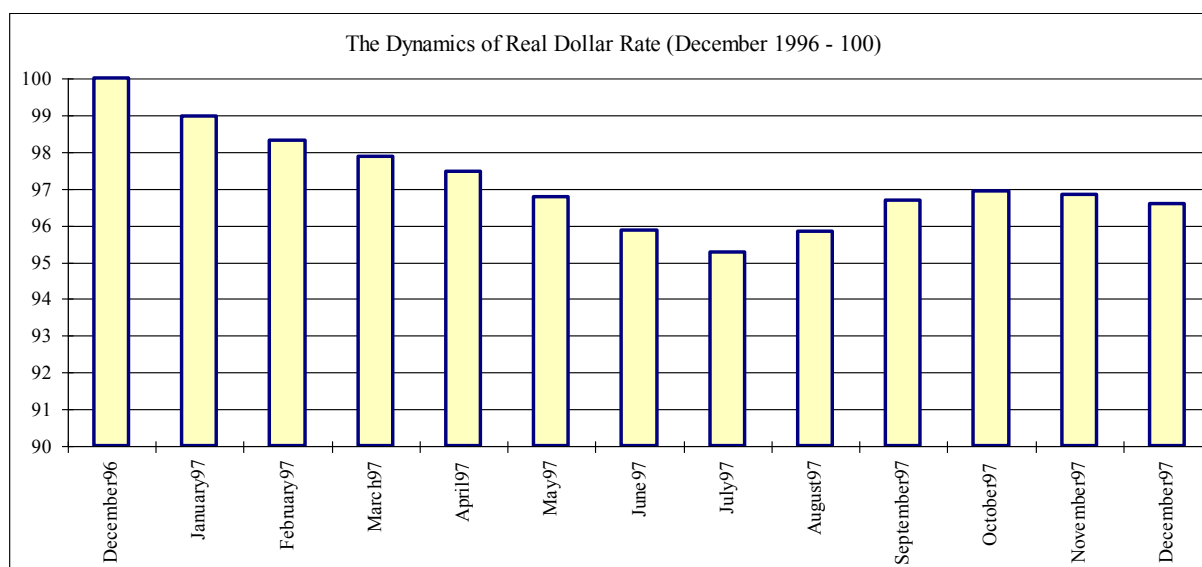
A massive inflow of the foreign capital to the market of state debt obligations becomes a contradictory (that contradiction became evident during the autumn financial crisis when non-residents started to withdraw their assets from the GKO market) factor of the financial stabilisation. According to the data of the balance of payments, investment of non-residents in the Federal government bonds in 1996 increased by more than US\$7 bn worth. Such a

dramatic increase in supply have contributed to a fast decline in interest rates, slowing down increasing expenditure on the state debt service. However, in the circumstances of instability in the international financial markets, exodus of cautious investors from the markets of the developing countries, from Russia in particular, can result in serious crisis in the circumstances of once-only sale of packets of state bonds and attack on the national currency.

*Figure 4*

Inflation in 1997 consistently declined. If in January 1997, the rate of consumer prices constituted 2.3 per cent per month, then in the second-quarter, it declined to about one per cent per month and to the end of the year practically, it did not surpass that level (Fig. 4). In the first half-year, the price increment constituted 8.6 per cent which was somewhat above the targets enshrined in the monetary programme for the year 1997. In the second half-year, inflation declined to 2.3 per cent (4.6 per cent annual). During the year, the consumer prices increased by 11 per cent.

Figure 5



Constant lagging of the inflation rate behind the stock of money growth which corresponds to the growth of remonetisation of the economy, has been taking place since 1995, when as a result of the stabilisation measures, the demand for money went upwards. In 1996 the volume of the real money stock increased by 9.6 per cent and in 1997--already by 15.8 per cent. Decline in the inflation rate in 1997 has also resulted in the growth of the real exchange rate of the national currency. For the first six months of 1997, the real exchange rate of the rouble with relation to the dollar increased by 4.14 per cent (Fig. 5). During the second half-year, the real exchange rate of the rouble declined by about one percentage point of its June level and for the whole of 1997 in went up by 3.0 per cent<sup>8</sup>.

<sup>8</sup> It should be noted that the level of mobility of international financial flows have increased considerably after the elections and a removal in June 1996 of restriction on the rouble convertibility on current operations. This fact has placed before the 1997 currency policy new problems similar to those faced by some developing countries. Sensibility to political events and certain "herd instinct" characteristic of the Western investors poses a threat of speculative attacks unmotivated by the fundamental factors (so called self developing currency crisis). That is why, accumulation of considerable amount of currency reserves (23.8 bn dollars for the end of June was quite justified. Ratio of currency reserves of CBR to the monetary base increased from 7.26 per cent by the end of 1996 up to 36.5 per cent by June 1997 and declined to 34.9 per cent by October.

By July 1997, it became obvious that the securities market has been overheating. That was caused by the fact that the investors have overestimated the stability of the political situation and the ability of the government to push forward the economic reforms and overcome the fiscal crisis. However, by the middle of the year, the crisis of the reform policy became evident. It manifested itself in the fact that the State Duma had rejected a set of proposed social draft laws, in the growth of the opposition to the reforms inside the executive power. In particular, it was noted in the latent confrontation between the government and the president's administration, inconsistency of the government policy (refusal to adopt strict measures to the budget debtors, lack of real enforcing measures for the debtors, lack of real measures designed to restructure the budget outlays, etc.). Among the reasons for that crisis are: the interest of the opposition majority in the Duma to preserve the economic crisis, readiness of some groups in the executive power to collude with the opposition, "quiet" opposition to the reforms by a number of elected governors of the Federation subjects in relation to whom the central authorities have no adequate means of influence<sup>9</sup>, attempts of the influential interest groups to place the government under their control.

Increasing pressure exerted on the reformist wing of the government, weakening of its position as a result of large-scale political scandals which have brought about a change in investors estimates, first of all, foreign ones, of the prospects about the future economic development. That has brought about a decline in demand for the Russian corporate equity which resulted in a sharp adjustment of the stock market. The first round took place at the end of August,

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<sup>9</sup> In such situation Centre tried to stimulate a confrontation between regional authorities and municipal administrations. The Council on local self-government has been created. The problem of fiscal federalism has received a new impetus (including enacting of the Law of self-government), transparency of financial flows.



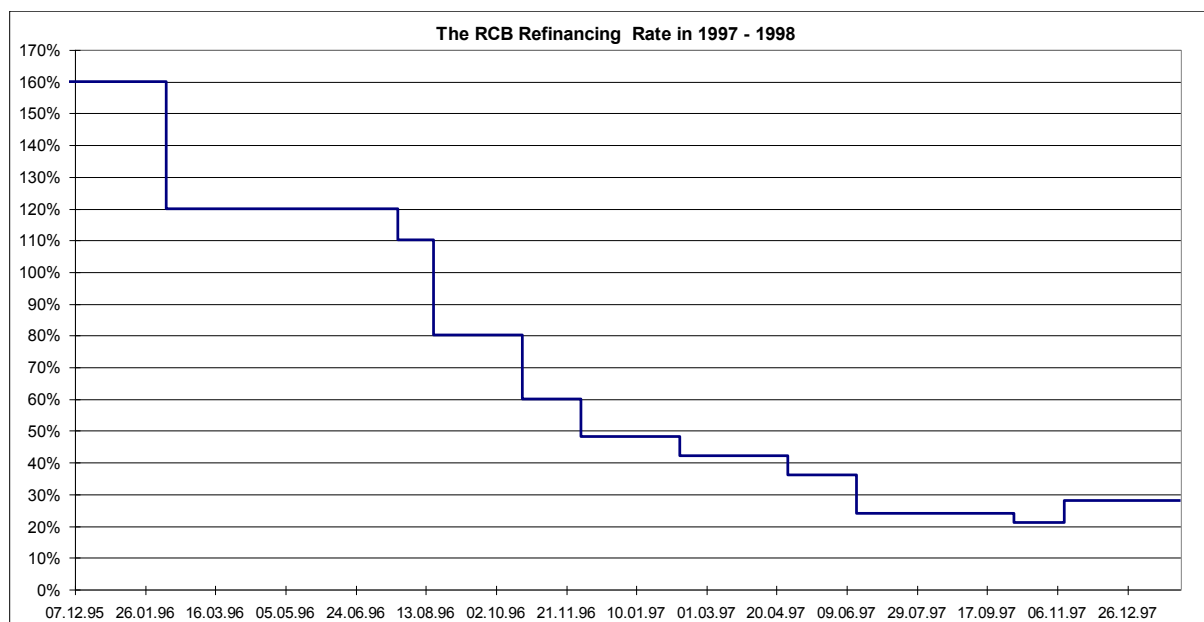
i.e. before the autumn financial crisis occurred. Simultaneously, there started a growth of demand on currency assets and the growth of CBR's currency reserves sharply slowed down. Reduction of net external reserves at the end of 1997 forced a wide circle of investors to apprehend for the stability of the currency policy and macroeconomic course of the Russian government as a whole. These fears have strengthened aspirations of the foreign investors acting in the Russian stock market and GKO-OFZ market to obtain their profit at a stable dollar exchange rate.

In 1997 the Central Bank of Russia continued implementing policy of flexible maintenance of liquidity through the "discount window" in the framework of tight control over the increment of the money stock. In particular, the policy of placing custody credits against securities granted on GKO's on a fixed interest rate was continued. "Discount window" gradually becomes a dominant channel for maintaining the required liquidity ratio of the banking system. Average weighted interest rate on custody credits against securities during the first half of 1997 was substantially less than the CBR's refinancing rate. The latter constituted in February - April 42 per cent and was decreased on April 28 down to 36 per cent, on June 16 - to 24 per cent, and on October 6 - to 21 per cent. On May 1, 1997, the Central Bank changed norms for required reserve ratio for the commercial banks on rouble and currency deposits. In particular, the reserve ratio was lowered on rouble checkable deposits and time deposits for 30 days from 16 per cent down to 14 per cent (20 per cent in June 1996), on deposits from 31 to 90 days - from 13 per cent down to 11 per cent, from 91 days and longer - from 10 per cent down to 8 per cent. The reserve ratio on the banks foreign currency liabilities was raised from 5 per cent to 6 per cent. These measures were designed to converge the required reserve ratio on

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foreign exchange and rouble deposits. Note that the reduction in the reserve ratio was taking place simultaneously with the revision of the refinancing rate and reduction in custody credit rates.

*Figure 6*



Crisis on the international financial markets which broke out in October was provoked by the devaluation of currencies of the south-east Asia countries and led to a significant destabilisation of Russia's financial markets. In those circumstances, the Central Bank of Russia imposed a number of measures designed to avert speculative runs on the rouble and support the state securities market. A decision was taken to raise the refinancing rate from 11 November 1997 from 21 per cent to 28 per cent (Fig. 6). Moreover, the required reserve ratio on foreign currency deposits was raised from 6 per cent to 9 per cent and rates on custody credits were reduced down to 22 per cent annual for the period of up to 7 days, to 25 per cent for the period of between 8 – 14 days, and to 28 per cent for a period of between 15 – 30 days.

The imposed measures allowed to avert the rouble devaluation which was fraught with catastrophic consequences for the whole Russian finance system.

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***External causes for the Russian financial markets crisis***

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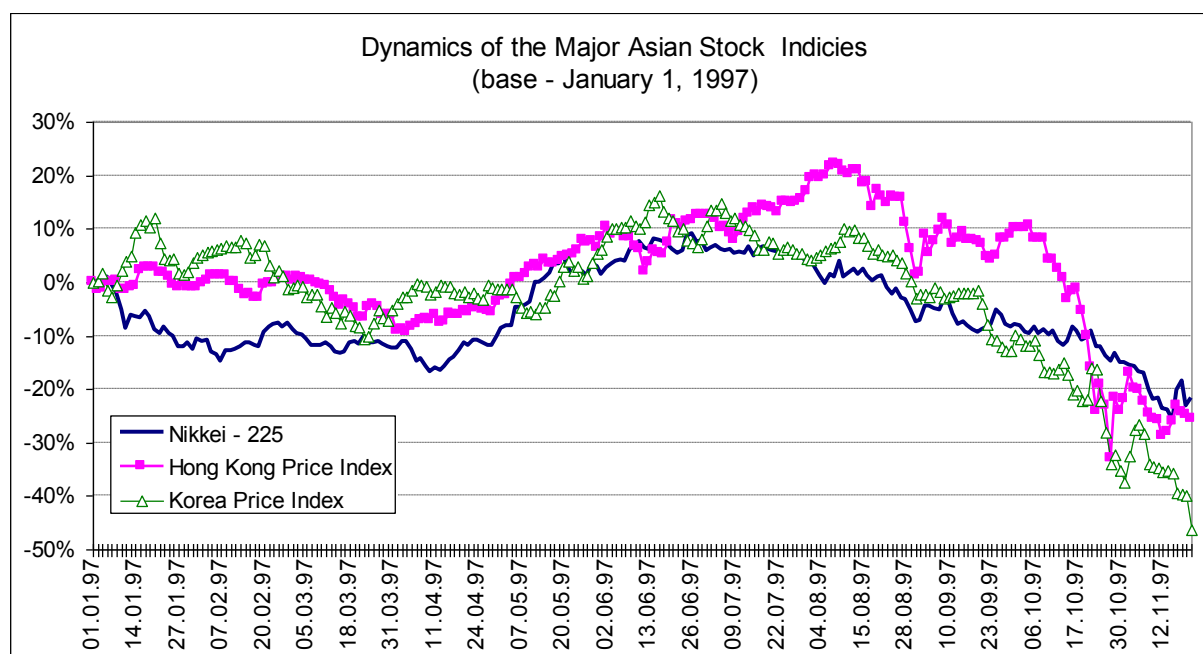
*During the whole of 1997, the situation of the world currency and stock markets remained quite unstable. For example, growth of Japanese stock market index from April till June 1997 led to an increase of capital inflows to Japan which already in May resulted in the growth of Yen exchange rate with respect to the US dollar by 12 per cent.*

*Dramatic for developed economy increase in the exchange rate of the national currency considerably undermined competitive advantages of the majority of Japanese companies. In circumstances of the export-oriented economy that means a decline in the average profit rate of companies. That is why, in the second half-year growth of the stock market index changed for reverse. For example, from August to December the fall of the Tokyo stock exchange Nikkei - 225 index amounted to about 30 per cent.*

*Price movement through time for the shares of the Japanese companies have influenced the economic outlook of the whole Asian region. Figure 7 shows that Hong-Kong and South Korea stock exchange indexes were behaving similarly. For example, coefficient ratio of Japanese and Korean stock exchange indexes made up 0.88 for the period from January to November 1997.*

*The change in the Hong-Kong status in mid-1997 determined a higher level of fluctuations on its stock exchange. Financial problems experienced by a number of largest local companies and banks together with an uncertain political outlook considerably raised the investment risks. Precisely the change in the status of Hong-Kong became a parting point for revaluation of the assets on world markets. General price decline from 7 August 1997 till mid-December in the stock market of Hong-Kong made up about 45 per cent.*

Figure 7



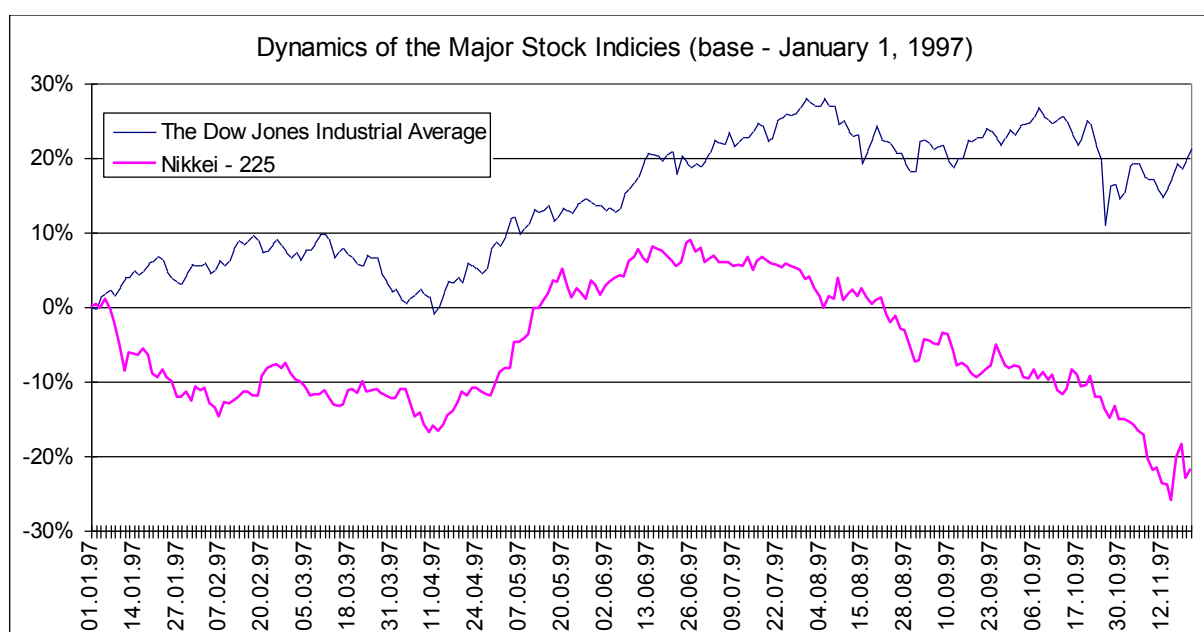
*Note: here and further on, the index rates for 1.01.1997 are taken as benchmarks. Figures 7,8 and 9 show increment rates in absolute value.*

*The fall of the stock exchange index in Hong-Kong, Japan and other Asian countries accompanied with the devaluation of national currencies put in question expectation for further economic growth in USA which has close trade and financial ties with that region (Fig. 8). Moreover, the outflow of capital from the developing markets started, and on October 28 the crisis reached all stock markets world-wide. In particular, on October 28 the Dow Jones Industrial Average fell by 554.51 points (decline constituted 7.18 per cent) down to 7160.9.*

*Such sharp reaction of the US stock market to the changes in the Asian region was unlikely half-year before the aforementioned events. However, continued from April to August growth of the Dow Jones Industrial Average guaranteed mainly by price increase of the technology-intensive companies have already ended. By autumn 1997, many observers started to evaluate the existing level of quotations as overvalued due to increased inflationary*

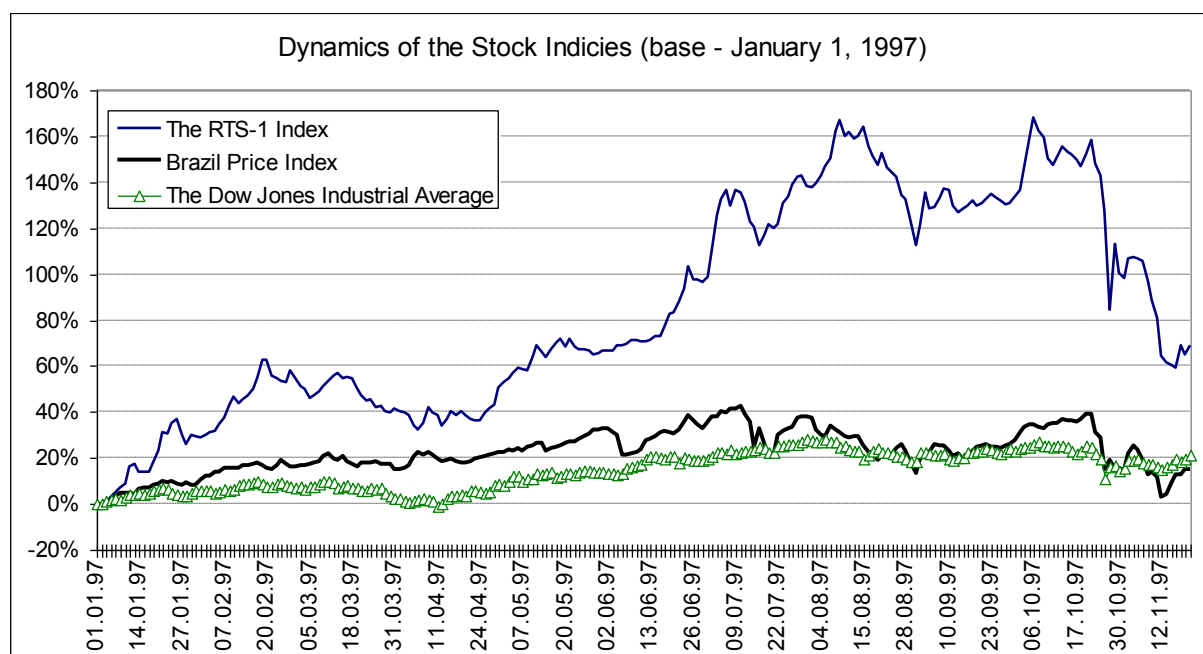
*expectations in the US. Intention of the Federal Reserve Board to increase the interest rate with the first signs of inflation made many global funds risk managers to redistribute the investment portfolio in favour of an increased share of the European bonds. Demand on shares of the European companies grew from the second half of 1996 till August 1997. Moreover, the fall of quotations on shares in the European stock markets was less noticeable than in Asia and USA.*

Figure 8



*The redistribution of capitals on the world scale was caused not only by a desire to withdraw money from the risky markets, but by the speculative interests as well. Large international investment funds which dominate the majority of the developing markets have organised a co-ordinated play a bull which have resulted in the fall of the stock exchanges indexes by the volumes close to the Hong-Kong volumes.*

Figure 9



*Such reaction of the large Western investment funds is explained, mainly, by their aspiration to avoid the Mexican variant of the financial crisis. The Mexican crisis in December 1994 was caused by different factors. Among them, one should identify especially the rapid increase in the external debt which had reached 7.4 per cent of the overall external debt of all countries with developing markets (US\$1.6 trillion)<sup>10</sup>. Nevertheless, the financial crisis scheme remained unchanged: massive outflow of the external capital poses a threat for the devaluation of the national currency and the foreign institutional investors active on the internal market strive to sell their assets in a given country and fix obtained profits. That way, the crisis is spreading to all segments of the financial market.*

*Precisely this explains significant post-crisis adjustment of the prices for shares resulting from a large number of transactions. As an example of such situation, we can analyse dynamics of indexes of two countries with similar*

<sup>10</sup> Keppler M., Lechner M. *Emerging Markets: Research, Strategies and Benchmarks*. Chicago, 1997, p. 78

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*credit ratings. Nevertheless, as can be seen from Figure 9, despite similar credit ratings of both countries, the Russian stock exchange is less stable and less liquid than the Brazilian one.*

The measures introduced by the Central Bank were, to a certain extent, justified and allowed to avert the development of crisis processes. In contrast with the majority of countries who suffered from the crisis, Russia managed to avoid a combination of interest rates growth and devaluation of the national currency. When there exist macroeconomic conditions for undermining the currency market--inflationary money supply, negative balance for the current transactions, low currency reserves, bank crisis, etc.--the currency crisis is inevitable. When speculative runs start which are caused by such fundamental factors, it is impossible to change anything. Any attempts aimed at strengthening regulation over the currency market only result in the growth of the illegal outflows of capital.

In Russia, fortunately, these fundamental causes have not reached the critical mass. The macroeconomic situation in Russia in 1997 by itself could not provoke the currency crisis. The monetary policy was not inflationary despite a considerable growth of the money stock. The latter was dictated by an increase in demand and was supported by growing gold and currency reserves. The position of Russia in the external credit market has somewhat improved. The currency policy was allowing to maintain the justified price proportions of the external trade turnover. The Central Bank measures aimed at prudential regulation of the banking system have contributed to a reduction of the possibility for a new banking crisis in case the stock market collapses.

Theoretically, the Central Bank of Russia had at its disposal a rather wide choice of possible anti-crisis measures: 1) maintaining control over the currency market, refusing to take any adjustment measures in the GKO market,

thus allowing this market to adjust to a new equilibrium itself with a higher interest rate; 2) devalue the rouble by 20-30 per cent, thus averting a sharp increase in GKO yield; 3) increase the interest rates, thus preserving the existing currency policy; 4) carry out partial devaluation supplemented by an increase in the interest rates; 5) formally refusing to take any measures directed at changing the interest rate and the exchange rate, to provoke the collapse of the stock market to the level of May 1997, thus reducing a potential demand for the currency from non-residents who wish to leave the stock market and strengthen, at the same time, GKO-OFZ market.

However, all measures which envisaged any devaluation of the rouble were politically and economically unacceptable. Attempts of direct and indirect manipulation with the rate of government and corporate equities, being politically acceptable, were extremely risky.

Evaluating the CBR's decision envisaged at increasing the refinancing rate, one should take into consideration, on the one hand, that by that moment many countries, who were involved in the crisis, had already raised the interest rates, and that measure became the main instrument in competition between the monetary authorities of different countries for international capital. On the other hand, the increase of the refinancing rate, which entailed the growth of the interest rate in the government securities market, has provoked a redistribution in favour of the state securities market assets at the expense of the stock market, thus exacerbating its collapse.

The fact that the banking system suffers considerable unanticipated losses becomes the main consequence of the financial crisis<sup>11</sup>. A significant part of bank assets, which previously guaranteed high profits, constituted instruments

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<sup>11</sup> Note that worsening financial situation of many financial groups became an important reason for the autumn increased struggle for the political influence which also destabilised the political situation in Russia.



which were mostly devaluated as a result of the financial crisis: corporate shares, GKO-OFZ, European bonds, internal currency bonds, debts to the London club. At the same time, shortage of liquidity which became acute during the crisis forces the banks to increase the supply of the devaluating assets which increased the decline of the corresponding quotations. All that has brought about the first sings of the banking crisis: a number of banks failed to honour obligations on payment and supply of securities. There were demands for advance payment on the contracts in the financial markets.

In relation to that, drafting of the new monetary policy should include a higher possibility for a banking crisis. It should be noted, that in December 1997, the Central Bank of Russia stressed its intention to increase the choice of the applied monetary instruments which refer to short-term crediting of the commercial banks. In particular, it envisaged to start offering the banks different types of secured credits. As a collateral for the CBR's credits, government bonds included in the Custody list are accepted. Market value of such bonds adjusted by the correction factor set by the Central Bank will represent a credit limit for a working day. In addition to the already existing custody credits against securities, the Central Bank of Russia is planning to extent intraday transaction credits and day crediting on custody of securities blocked on the DEPO bank accounts.

### **Inflation forecast for 1998**

*Given forecast is based on the following premises. First, parameters for the growth rates of the money stock  $M_2$  (they are within the limits of 1.7 per cent-2.2 per cent of monthly increment; 22 per cent and 30 per cent annual correspondingly) fixed by the Joint Declaration of the RF Government and the Central Bank in **Main directions for the single state monetary policy for 1998***

will be maintained. Second, increment of the real GDP is envisaged at 1per cent .

This forecast model is based on the regressive equation of the following type:

$$p_t = c + a_0 p_{t-2} + a_1 \sum_{i=0}^n w_i m_{t-i} + a_2 Y_t + \varepsilon_t,$$

where  $w_i = b_0 + b_1 i + b_2 i^2 + b_3 i^3$  – polinome weight,

$p_t$  – weekly change of consumer prices  $t$ ,

$m_t$  – decimal log of a monthly change of the money stock rate M2, evenly spread over the weeks of a corresponding month,

$Y_t$  – monthly change rate of the real GDP, evenly spread over the weeks of a corresponding month,

$c$  – intersept,  $\varepsilon_t$  – the residuals of regression,

$n$  – lag depth, equal 47 weeks,  $i$  – lag number.

Table 2 shows the statistical estimates of the given regression equation. Figure 10 gives distribution of the increment rates of the money stock.

Table 2.

Variable	Coefficient	Standard error	t-statistics	Level of significance
Intersept	0,000728	0,000431	1,688416	0,0948
$p_{t-2}$	0,220639	0,085855	2,569899	0,0118
$Y_t$	-0,011744	0,002789	-4,210157	0,0001
Zero degree of polinome	-0,003735	0,001479	-2,524706	0,0134
First degree of polinome	0,000741	0,000194	3,811825	0,0003
Second degree of polinome	0,0000302	0,00000751	4,026371	0,0001
Thrid degree of polinome	-0,00000203	0,000000512	-3,966668	0,0001
Number of observations	96	Number of freedom degrees	89	
$R^2$	0,742873	F- statistics	42,85534	
fixed $R^2$	0,725538	Level of significance F-statistics	0,000000	
Standard error	0,001460	Sum of square residuals	0,000190	

According to the given forecast compiled with the help of that model, the consumer prices will grow by 9.8-10.3 per cent in 1998. Figure 8 shows that the first six months of 1998 will be more inflationary. For example, according to

*the first scenario, the increment of the consumer prices for the first half year will constitute 8 per cent, and according to the second scenario--7.6 per cent.*

Figure 10

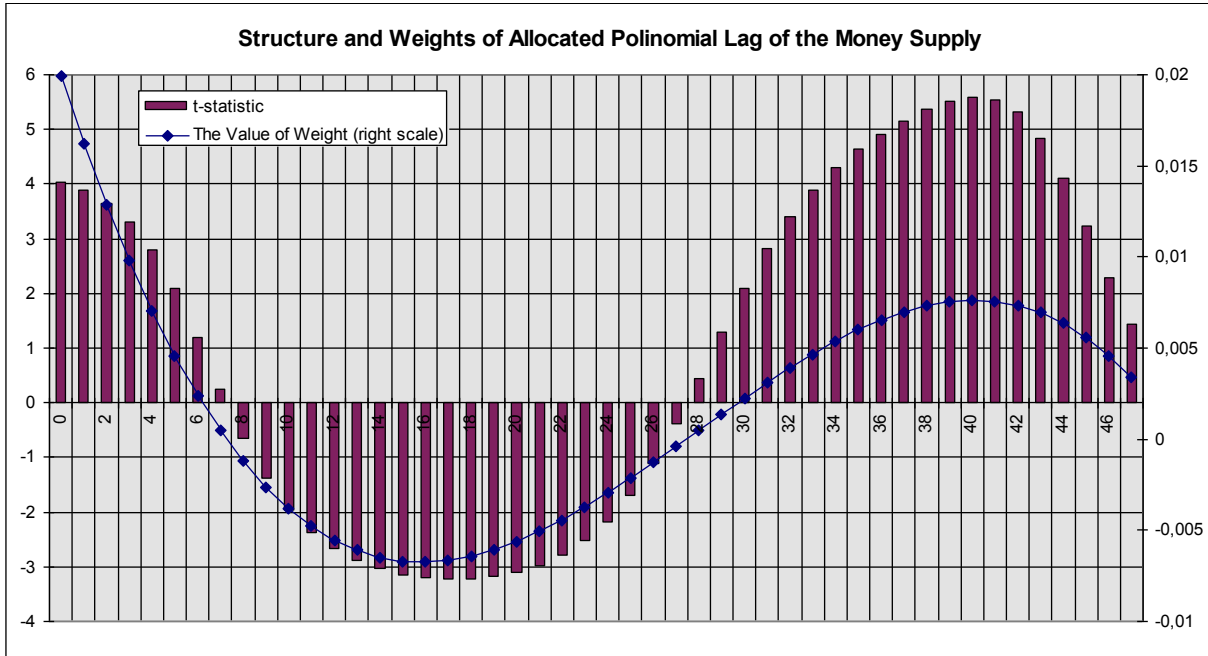
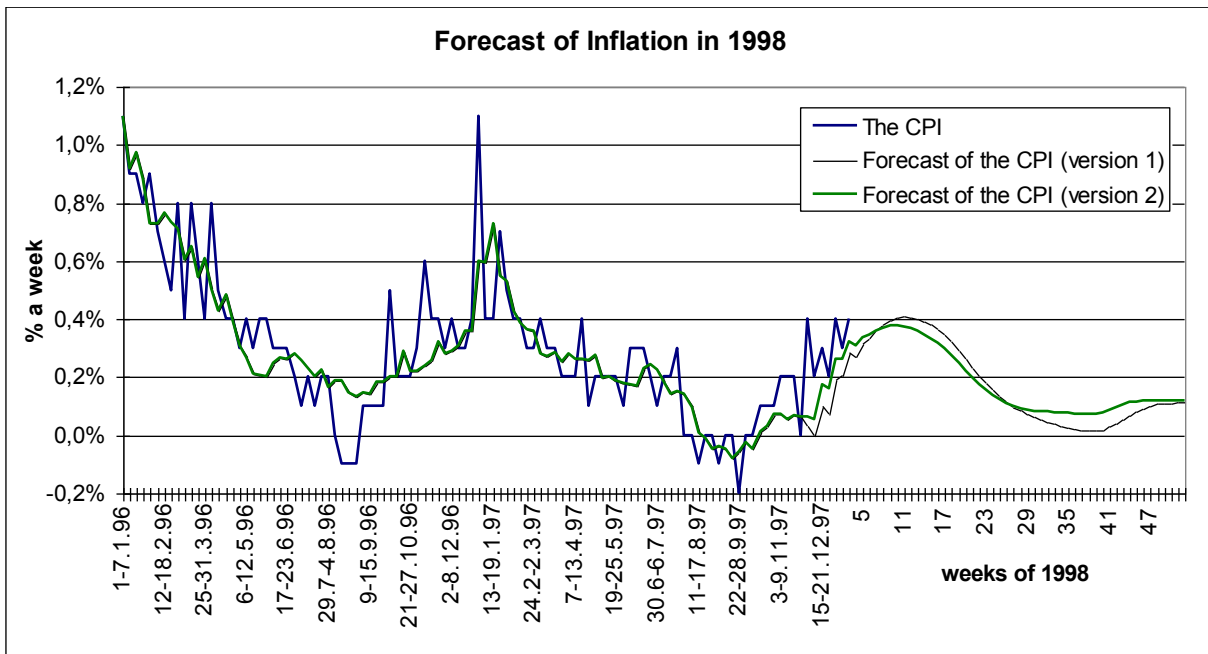


Figure 11



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## 2.2 State Securities market

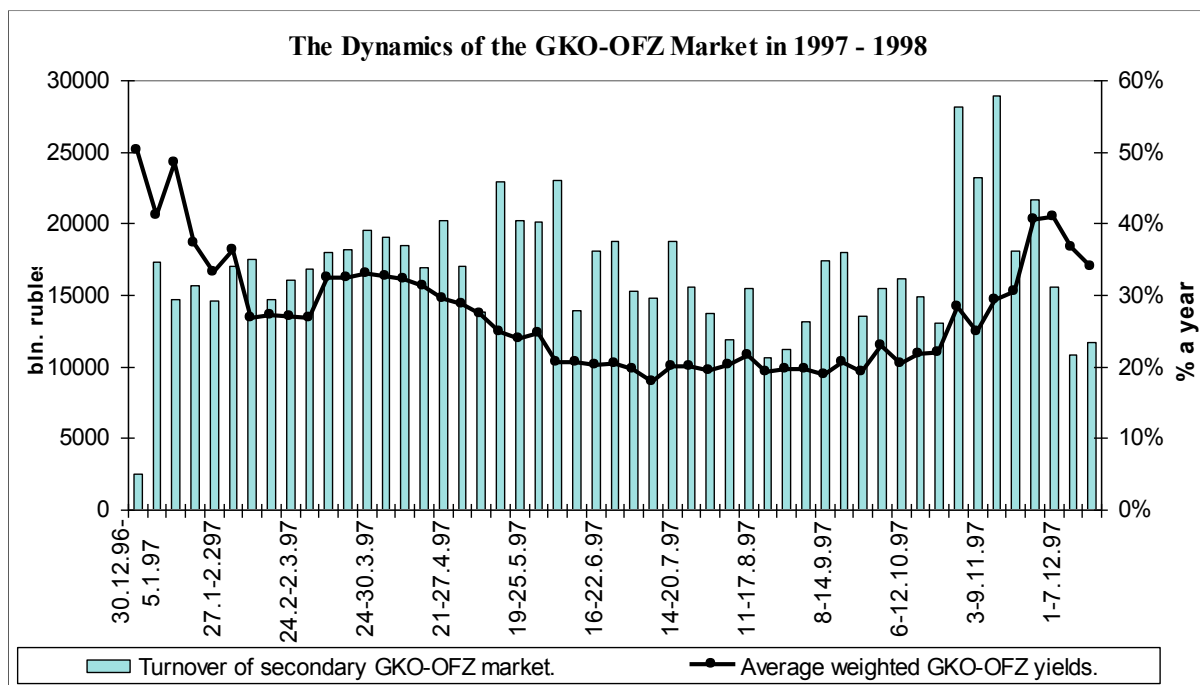
Nominal volume of the state internal debt accumulated in the GKO-OFZs increased by about 52 per cent over 1997. The par value of the outstanding state bonds on the internal market constituted by mid-December Rb 346.55 trillion or 13.9 per cent of GDP. For the same period, the stock of GKOs and OFZs placement amounted to Rb 438.4 trillion worth. The sale of the state bonds allowed to raise Rb 378.2 trillion.

During practically the whole year, right up to the autumn, there was a steady decline in the GKOs-OFZs yield. Consequently, the cost of the state debt service nominated in roubles has declined (Fig. 12).

In March 1997 the second issue of the Russian Eurobonds in the volume of DM2 bln worth with a seven-year maturity at 9 per cent interest rate (the first issue of eurobonds to the tune of US\$1 bn worth with a five-year maturity and 9.25 per cent yield took place in November last year). At the end of June, the government of Russia launched eurobonds with a ten-year maturity to the total of US\$2 bn worth. The volume of subscribers outnumbered twofold the volume of the offer. Limit on the emission was dictated by the limitations imposed on the external borrowing for the current year. Yields on the new tranche of eurobonds somewhat increased reaching 10.5 per cent annual. However, taking into consideration an increase in duration period and the emission volume such an increase is considered insignificant. In October 1997, the government of Russia additionally placed US\$400 mn in the third tranche. All that testified about the growing interest which foreign investors showed toward the Russian financial markets and also placed trust in the governmental economic policy before the financial crisis. However, changes in political outlook linked with the summer privatisation auctions and the autumn scandals which took place in the higher echelons of power have resulted in the crisis of trustworthiness in the

government policy. These events coincided with the financial crisis which most negatively reflected on bond yields.

Figure 12

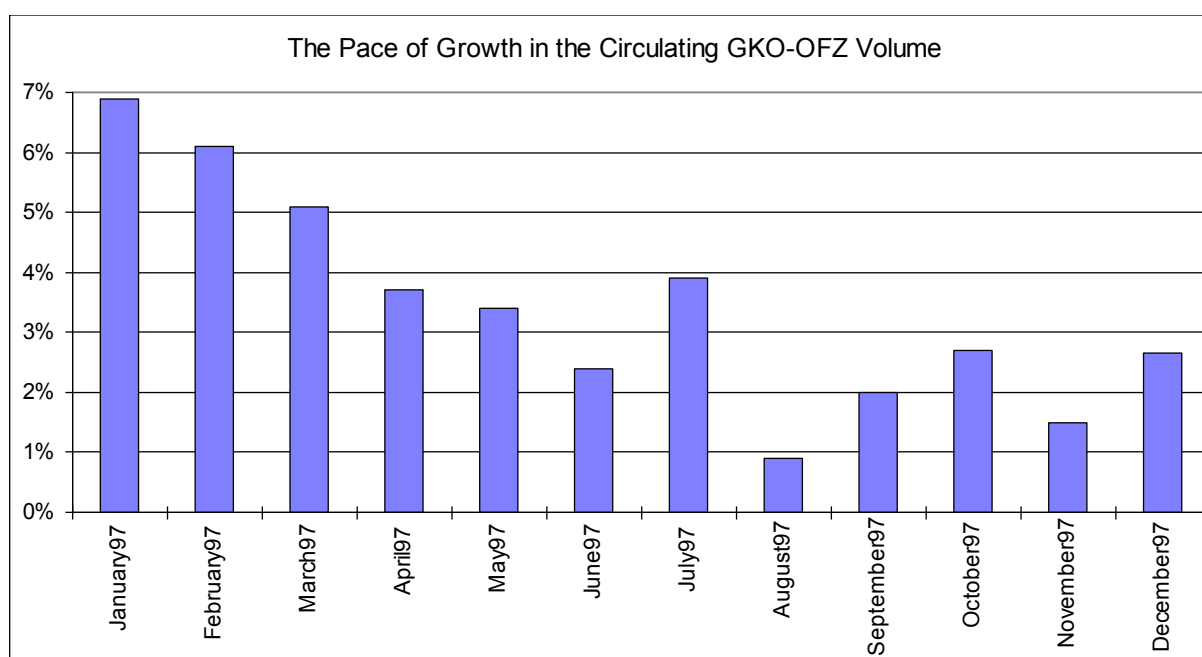


In the first half of 1997, investors interest toward the municipal and regional bonds have substantially increased due to the general decline in GKO-OFZs yields. In the first-quarter, those securities did not belong to high yielding instruments. Moreover, in June MICEX started to trade in "agrarian" bonds with 1, 2 and 3 year maturity. These bonds represented debt restructuring of the subjects of the RF to the government of Russia accumulated for the commodities credits granted by the Ministry of Finance in 1996. Overall volume of that debt amounts to Rb 9.1 trillion old roubles.

Stabilisation of the internal debt dynamics has permitted the Ministry of Finance of the RF to implement consistently one of the main objectives of managing the debt, i.e. maximum prolongation of the duration periods for the state bonds. By the end of 1997, average duration period of GKO-OFZs constituted about 280 days, while at the beginning of 1996--105 days. Issuance of the new series of the OFZs and, in particular, with fixed coupon as well as

rescheduling on 15 March 1997 of the Ministry of Finance's debt to the Central Bank into 13 new OFZs tranches with duration term between 4 and 8 years have contributed to longer maturity periods. Prolongation of the duration periods for bonds diminishes the risk profile of increasing costs for the state debt service, allowing the government to anticipate better the corresponding expenditure in budget drafts and decrease the increment rates for the issuance of the new GKO-OFZs (Fig.13)<sup>12</sup>

*Figure 13*



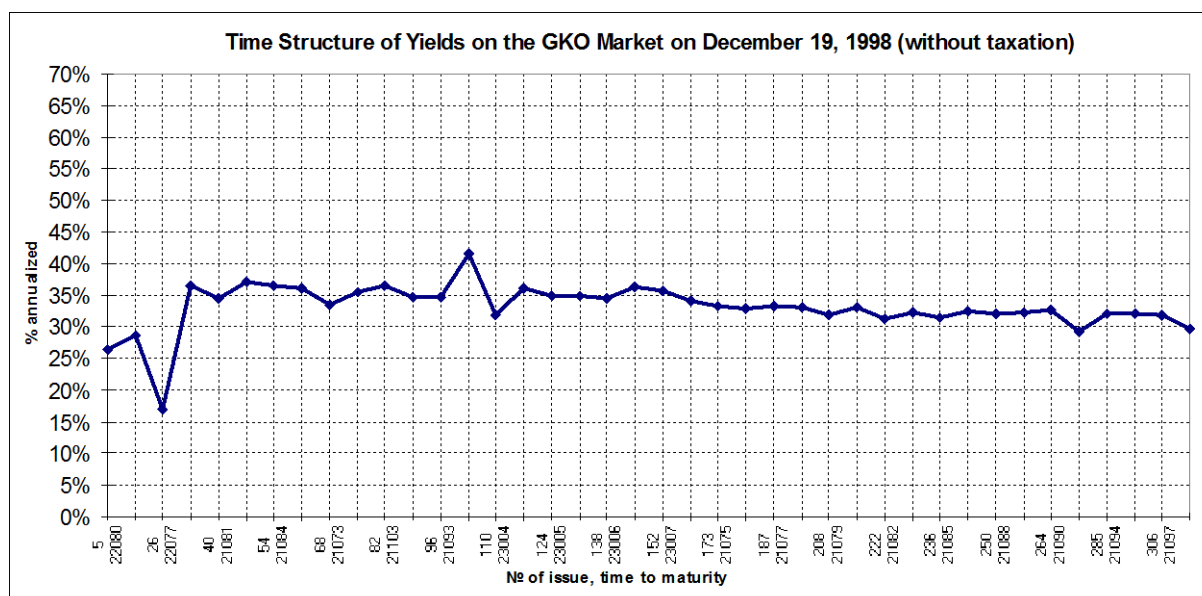
Besides the increased duration of the government bonds, the lack of significant difference between the yields on short-term papers and long-term papers testified about a high degree of trust in the monetary policy pursued by the Government and the Central Bank of Russia.

Crisis on the world financial markets together with the worsened political situation in Russia have resulted in the trend change on the GKO-OFZs market. From November 1997, there was a steady growth of the state debt

<sup>12</sup> If at the beginning of 1997, with the same yields monthly growth rates of the outstanding GKO-OFZs constituted over 5 per cent, then in November-December they were between 2

service (Fig. 12). Nevertheless, the yield growth has brought about an increase in the transactions volume on the market. It seems that many investors considered the yield rate of 32-35 per cent annual as sufficient one for the near future.

Figure 14



Yield increase on the state bonds in the internal market have resulted in a decline of quotations on the Russian eurobonds. At the same time, quotation for all other Russian bonds (for example, debt to the London club, VEB bonds) have dropped. This, understandably, decreases possibility for effective government borrowing on the external market in the near future.

Nevertheless, the temporary structure of yields on internal papers demonstrates that in the given market with a high degree of probability, there will be relative normalisation of the situation. Lack of significant differences between yields on the sort-term state bonds (a few days) and the long-term ones (about one year) can be understood as expectations for further reduction in inflation and the interest rates in the market by mid-1998 (Fig. 14).

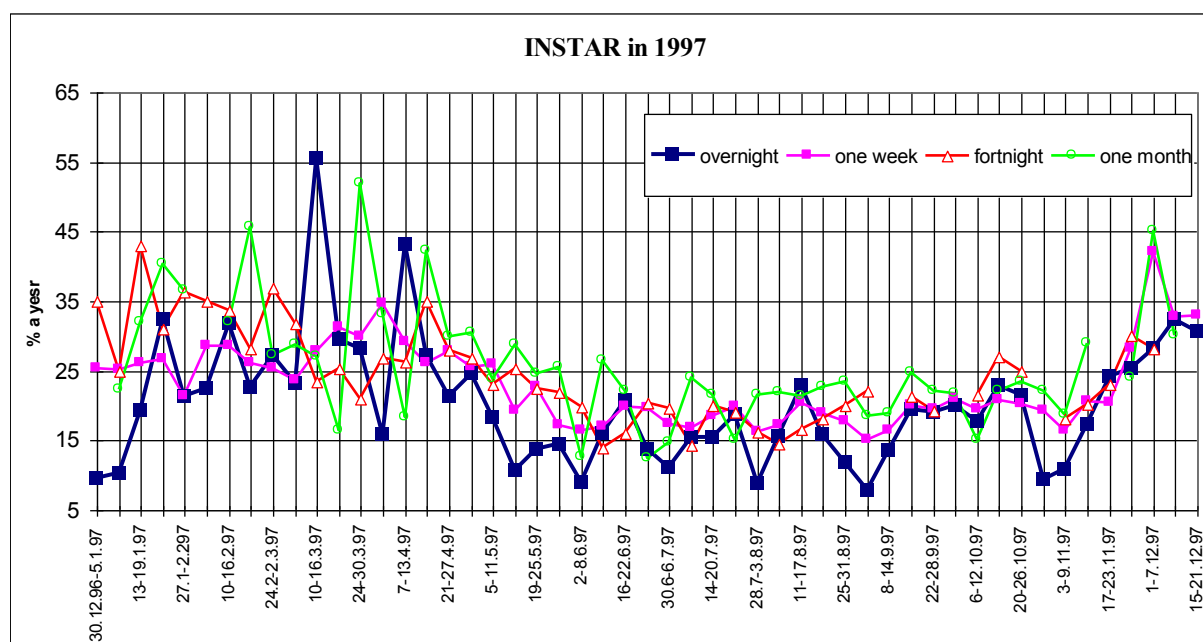
Growth of the yields rate in the state securities market in November-December 1997 led to an increase in the share of GKO-OFZs in the structure of the majority of the investment portfolios. However, the scale of this process is being weakened by a general decline in capital inflow in the Russian financial markets from foreign investors.

In case the government does not substantially increase the volumes of borrowing, then due to an increase in debt service in 1998, there will appear favourable conditions for the development of the corporate equity market. Nevertheless, in Russia at present, there are no securities backed by real assets of large corporations which little depend on the volume of currency reserves and the policy of the Central Bank.

### 2.3. Interbank Credits Market

In 1997 decline in the inflation rates, yield fluctuations on the state bonds and the level of liquidity for the whole banking system determined the dynamics of the credit rates in the interbank rouble market (Fig. 15).

Figure 15





In January-April 1997 the interbank rouble market demonstrated significant fluctuations in the credit rates with different maturity. Average rate level for the given period constituted 25-30 per cent annual. From May, following the decline in the yields rate in the state securities market (Fig. 12), average credits interest declined to 15-20 per cent annual.

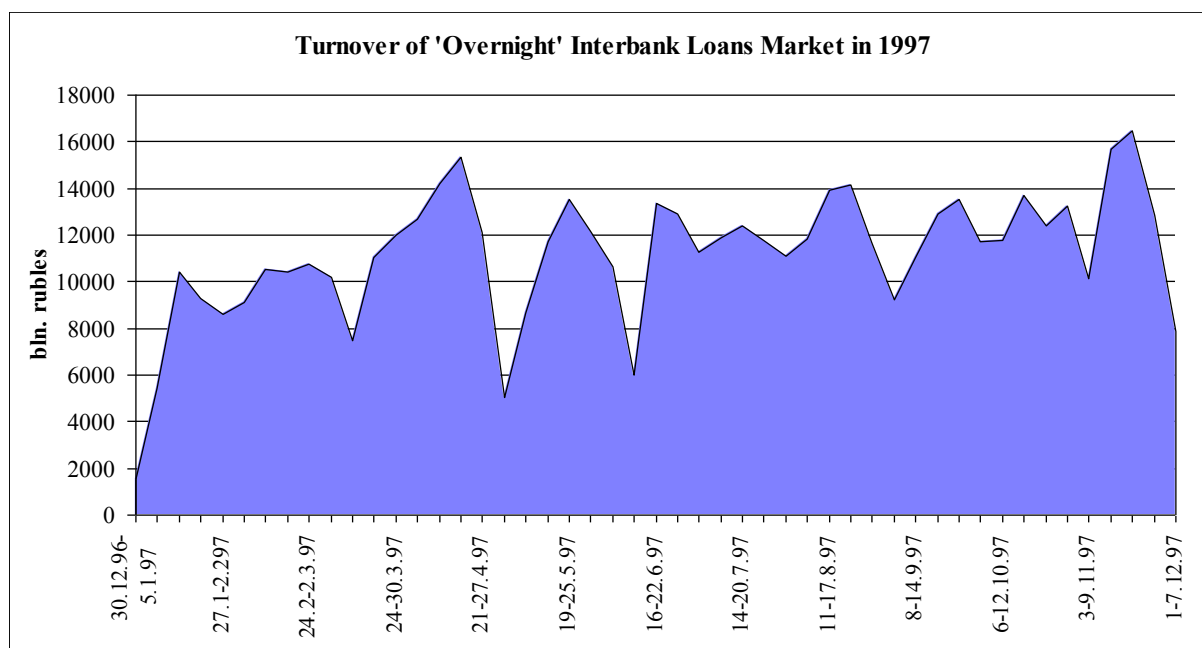
The crisis of the financial markets has led to considerable adjustments in the interbank credits market. The interest rate on the prevailing one-day credits rose from 12 per cent-17 per cent annual up to 30 per cent annual by the beginning of December. Among reasons for such dramatic interest rates increase, one should identify the effect of the "put-off crisis" on the GKO-OFZ market and the decline in the level of mutual trust in relations between the commercial banks. The latter have suffered considerable losses as a result of devaluation of a large part of their assets represented by the state bonds and corporate equity.

Despite the December increase in the interest rates and the closure of the credit limits by a number of large banks, it is important to note that there was no banking crisis in 1997. The market turnover was gradually growing and reached in March-November the volume of RB 13-15 roubles worth per week (Fig. 16) which was considerably larger (in constant prices) than the turnover of the interbank credit market before the interbank crisis of 1995 as well as the turnover of the secondary GKOs-OFZs market by the end of 1997 (Table 3). On the whole, the annual volume of the granted interbank one-day credits surpassed Rb 700 trillion. Their share in 1997 constituted 60-65 per cent of the overall volume of market transactions.

Implementation by the Central Bank of Russia of the mechanism for transactions REPO and widening of the possibilities for granting custody credits against securities have produced a stabilising effect on the interbank rouble

credits market. However, so far one-day credits are prevailing in the market. It is connected, to a considerable extent, with the shaken financial stability by the end of the year of a number of large commercial banks and the closure of the limit for mutual crediting.

*Figure 16*

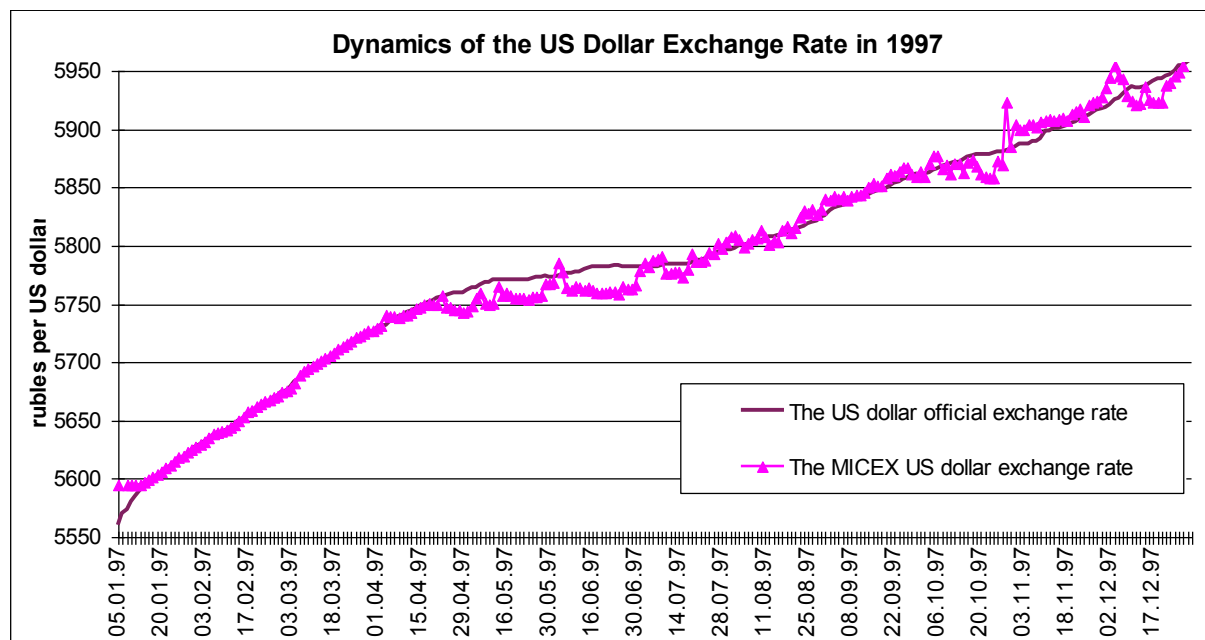


## 2.4. Currency Policy

In the first quarter of 1997, the official and market dollar exchange rate grew steadily by about the same pace 0.6 per cent-0.7 per cent per month (or 7 per cent-8 per cent annualised). At the beginning of the second quarter, the market quotations started to lag behind the official ones. In April, the dollar posted 0.3 per cent up on MICEX (3.6 per cent annual), and on the interbank over-the-counter market fell by 0.4 per cent. In May-June, the growth of the official rate practically stopped. However, in July the dollar rate was growing by a high pace. Overall increment in the official and the market dollar exchange rate in the first half-year constituted correspondingly 4 per cent and 3 per cent. In the second half-year the dollar growth rates declined. On the whole, over the

second half-year both the official and the market dollar rate grew by about 3 per cent (Fig. 17).

*Figure 17*



During the first eight months of 1997, movement trough time of the dollar rate was connected not only with seasonal growth of the export earnings but with the favourable marcoeconomic situation. In the circumstances of an increased capital inflow, the Central Bank was forced to support the dollar rate maintaining the targets enshrined in the monetary programme.

However, beginning with mid-autumn of 1997, the situation has been changing dramatically. Destabilisation of the political situation in Russia together with the international financial crisis have caused a massive capital outflow effected by the non-residents from the financial markets. Repatriation of the profit obtained from the state securities market has determined the increase of demand for dollars. In these circumstances, the priority of the Central Bank consisted in the preservation of the rouble exchange rate. Any sharp changes in the rouble rate, could have led to the Mexican variant of the course of events, when devaluation of the national currency dramatically

strengthened the wish of the non-residents to convert their financial assets into hard currency. In those circumstances, on 10 November 1997 the Central Bank of Russia announced targeted parameters of the currency policy for the years 1998-2000 (See above). Those parameters defined its stability and continuity and at the same time gave large freedom of movement for the implementation of the currency policy, in particular, with respect to widening of the currency corridor. The pace of growth of the currency rate as before will be looked at as the main indicator influencing both the inflation rate and the conditions for attracting investments and economic recovery.

## 2.5. Stock Market

One can single out several periods in dynamic of the Russian stock market in 1997. *First* - from January till the beginning of March - was characterised of the market surge which attracted significant capital stock of foreign and domestic investors. It resulted in the quotation growth for the majority of shares (IET stock market price index<sup>13</sup> grew by 24 January by 52.9 per cent) and a sharp increase in the volumes of transactions (Fig 18). Average yield of the market by 20 February amounted (sales results on RTS-1) to 25 per cent per month. However, in the last decade of the month, the stock market

<sup>13</sup> IET stock market price index reflects average weighted, in the volumes of real transactions on RTS, yield of the market portfolio (1.01.1996 = 1). Index is being calculated on all shares on sale on RTS independently of their share in the overall volume of sales and frequency of transactions.

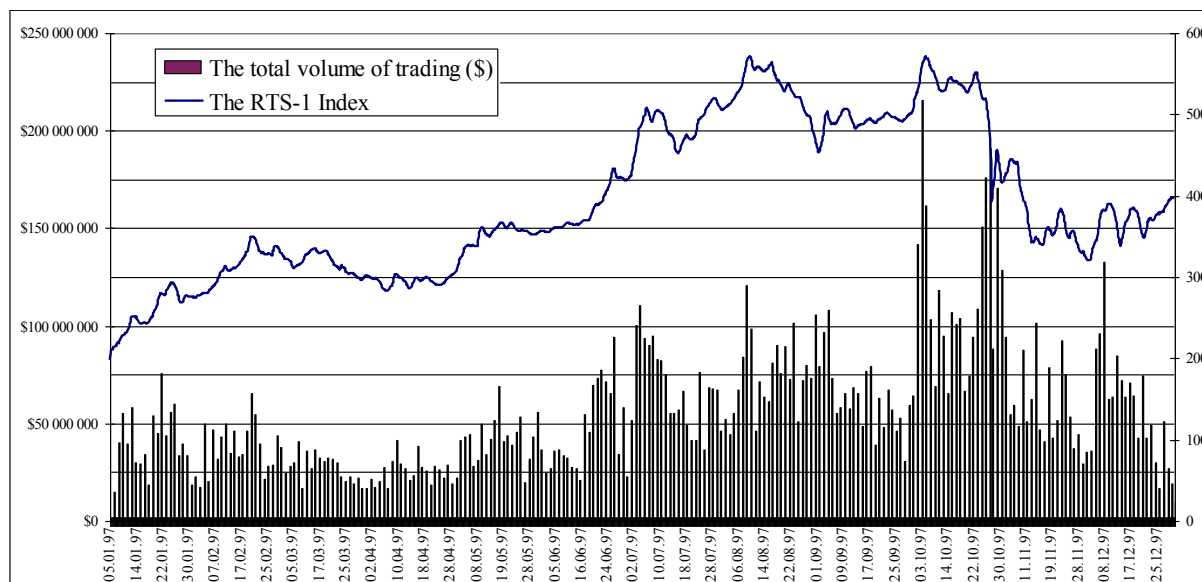
Formula for calculating the index:

$$I_t = I_{t-1} \cdot \sum_{i=1}^n \left( \frac{P_{i,t} \cdot V_{i,t}}{P_{i,0} \cdot V_{\Sigma,t}} \right),$$

where  $I_t$  – index for a day  $t$ ,  $n$  – number of shares on sale on RTS-1,  $P_{i,t}$  – price of  $i$  share for a day  $t$ ,  $V_{i,t}$  – volume of transactions for  $i$  share for a day  $t$ ,  $P_{i,0}$  – price of  $i$  share on 1 January 1996 (of its first appearance on RTS-1),  $V_{\Sigma,t}$  – aggregate volume of transactions on RTS-1 for day  $t$ .

index started to decline (technical "price adjustment" after a month and a half of an uninterrupted growth).

Figure 18



During the *second period* (March-April 1997) the activity of the stock market fell noticeably. Day sales volumes on RTS-2 did not surpass US\$35-45 mn (against US\$55-65 mn during the first period). That was linked with the price drop after two months of growth and possibly with the reaction of part of the non-residents to the government reorganisation. The level of stock price achieved during the first two months of the year turned out to be overevaluated in order to be able to attract new capital stock on the market.

The end of April defines the beginning of the *third period* which lasted to the beginning of August. The activity of the stock market at that time went up substantially (Fig. 18). Daily sales volumes on RTS-1 amounted to US\$45-65 mn in May, US\$60-90 mn in June, and US\$100-120 mn in July-August which surpassed the scale of the first recovery. A decisive role was played by the inflow of new capital stock to the market after the of Western companies managers had determined the investment limits. Quotation growth on the

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Russian stock market was taking place against the background of the general increase of activity on world stock markets.

In July, the dynamics of trade operations was influenced by a reduction in state bonds yields and attempts of the Russian government to lower the volume of the budget arrears which attracted to the market rouble assets from the Russian commercial banks and investment companies. The start of the restructuring of corporate arrears, launching of new auctions for the sale of packets of shares fixed in the Federal ownership have increased potential attractiveness of Russian companies for strategic investors, both domestic and foreign.

The beginning of the *fourth period* fell on the first half of August. From 8 August there started a gradual decline in the prices on the blue chips. Price adjustment was determined by a significant fall in the American stock indexes as well as by the fact that investors placed less trust in the government's policy, their desire to minimise political risks. RTS-1 turnover remained high due to intensive sale of shares by foreign investors. Russian companies and banks having entered onto the stock exchange in an anticipation of its growth with simultaneous decline of GKO-OFZs yields could not manage to maintain the share prices at the achieved level.

In September there was a certain stabilisation of the majority of quotations, however a general market outlook was rather stagnant. As before, the trend for American and Russian stock exchange indexes remained well corrected<sup>14</sup>.

The beginning of the *fifth period* is closely linked with the crisis on the world stock exchanges. Active participation of the foreign capital on the

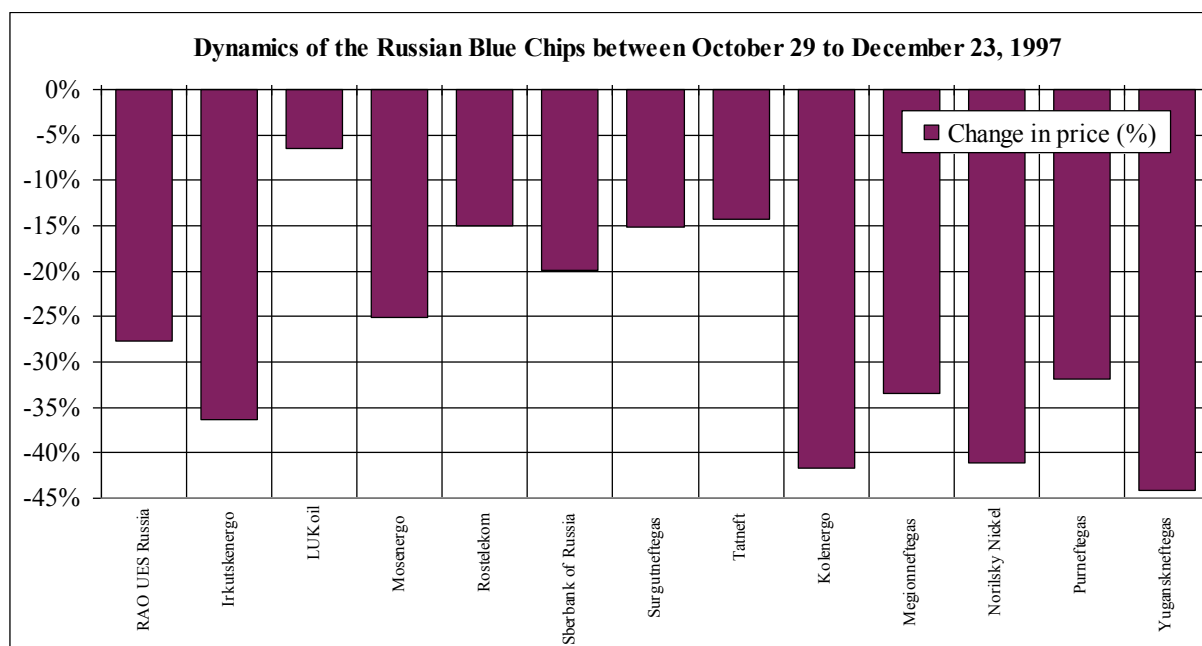
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<sup>14</sup> Foreign investors, by redistributing funds among different developing markets, exert noticeable influence on RTS-1 outlook. However, the following of many stock exchange operators to the Dow Jones index brought about the effects of "self-fulfilling expectations".

Russian financial markets determined the scale and structure of the crisis which started on 23 October 1997. Following the October world financial crisis, the Russian stock market demonstrated a significant fall of quotations in November 1997 (Fig. 18).

Main reason for such dramatic fall of prices on Russian shares consists in the withdrawal of funds by Western investors. Predominance of the non-residents' capital stock and the absence of significant barriers for the repatriation of the profit obtained on the Russian stock market, in the circumstances of continuing post-crisis adjustment on the stock market of Europe and USA, have determined further fall of the quotations for the Russian shares. From 24 October (pre-crisis level) to 19 December the RTS-1 index dropped by 31.4 per cent. On the whole, from 6 October (maximum index value--571.7) to 19 December the drop constituted 37.8 per cent which significantly surpassed the drop of the majority of American and European stock market indexes.

*Figure 19*



The highest reduction in quotations among first rate shares from the end of October 1997, was registered on papers of Kolegergo, Norilsk Nickel, Unified Energy Systems of Russia, Irkutsk Energo, Megionneftegas, Sberbank of Russia and Rostelecom (Fig. 19).

In 1997 the Russian stock market continued to be characterised by a high level of concentration. Papers of the seven major corporations constituted 70 per cent of the overall volumes of trade during the mentioned period (Fig. 20).

Figure 20

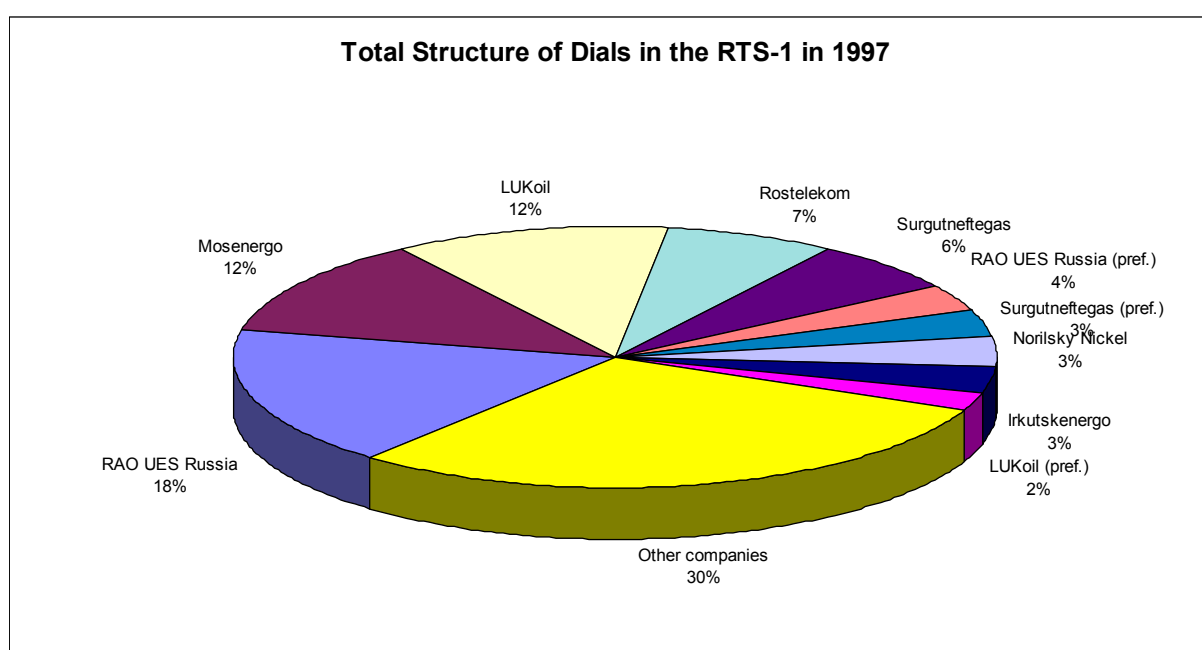


Table 3

### Financial Markets Indicators in 1997

	May	June	July	August	September	October	Novemb.	December
Monthly inflation	0,9%	1,1%	0,9%	-0,1%	-0,3%	0,2%	0,6%	1,0%
Calculated annual inflation by a given month' trend	11,4%	14,03%	11,4%	-1,2%	-3,54%	2,43%	7,44%	12,68%
CB RF refinancing rate	36%	24%	24%	24%	24%	21%	28%	28%
GKO auction quotation (by end of month)	27,26%	18,64%	18,84%	18,75%	18,44%	19,91%	28,20%	33,55%
OFZ auction quotation (by end of month)	35,58%	25,84%	24,63%	18,17%	17,91%	18,81%	25,67%	25,67%
OGSZ auction quotation (by end of month)	34,61%	20,42%	18,22%	18,22%	18,22%	19,00%	19,00%	19,00%
GKO redemption yield (per cent annual) with maturity periods:								
less than 1 month	22,00%	17,84%	17,68%	17,5%	19,27%	21,49%	14,45%	30,98%
1-3 months	24,13%	19,61%	17,49%	18,5%	19,52%	19,71%	23,00%	36,19%
3-6 months	28,24%	21,69%	18,93%	18,5%	18,57%	18,44%	24,93%	31,94%
average rate on outstanding issues	26,65%	20,28%	18,28%	18%	18,99%	19,60%	22,37%	33,82%
outstanding OFZ average redemption yield (per cent annual)	35,4%	31,5%	27,1%	27,5%	28,38%	21,67%	30,82%	36,29%



	May	June	July	August	September	October	Novemb.	December
GKO-OFZ market turnover per month (Rb bn)	77011	82445	71841,6	60000	–	81660	91882	52488
IBC-INSTAR rate (per cent annual by the end of month) on credits for:								
1 day	7,71%	15,13%	8,97%	7,5%	26,81%	6,57%	21,47%	36,13%
1 week	9,90%	20,34%	19,51%	16%	20,74%	20,45%	25,88%	33,93%
2 weeks	16,75%	21,04%	16%	15%	17,00%	25,00%	30,00%	36,00%
1 month	22,13%	20,00%	23%	23%	21,00%	22,00%	24,00%	28,00%
IBC market turnover per month (Rb bn)	67535	74768	78821,8	95000	88843	100262	109866	83258
USD rate by end of month on MICEX (Rb)	5773	5782	5798	5827	5860	5887	5917	5960
DM rate by end of month on MICEX (Rb)	3394	3352	3160	3250	3327	3414	3457	3361
USD average monthly growth rate by trend (per cent annual)	2,32%	1,89%	3,37%	6,17%	7,23%	5,67%	6,29%	9,08%
DM average monthly growth rate by trend (% annual)	22,1%	-1,24%	-46,68%	40,07%	50,82%	36,31%	-14,38%	1,56%
USD and DM aggregate monthly gross turnover on MICEX (Rb bn)	1956	1700	1713,8	2050	2183	3077	4099	10234
Monthly stock market turnover on RTS (USD mn):	804,0	948,74	1575,16	1600	1398	2693	926	1240

## 2.6. Budgetary Policy

### 2.6.1. Budget execution

**Budget revenues.** 1997 was characterised by further development of the fiscal crisis (Tables 4 and 5). The first quarter of 1997 was characterised by record low volumes of tax receipts even taking into consideration seasonal drop in revenues. For example, in January the tax receipts into the Federal budget amounted to 5.7 per cent of GDP. That is about one per cent of GDP less than a corresponding indicator for 1996. On the whole, by the end of the quarter, tax receipts into the Federal budget reached the level which was equal to its 1996 level (7.5 per cent of GDP). Such drop in the tax payments at the beginning of the year, to a great extent, is explained by objective economic and not subjective reasons. Among them are: inability of the government formed in August 1996 to take decisive measures toward cutting budget arrears, lack of any measures designed to fight the arrears growth, pushing forward the tax reform.

In the second quarter, after the government reshuffle which indicated transition towards a stringent tax policy, the level of tax receipts had noticeably increased and even reached the level of 9.2 per cent of GDP for the first five



	1996	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
1. Revenues from public property and activity	0,4	0,3	0,6	0,5	0,4	0,5	0,4	0,4	0,41	0,45	0,5	0,4	0,43
2. Proceeds from the sale of the public property	0,1	0,8	0,6	0,4	0,3	0,3	0,3	0,4	0,65	0,59	0,7	0,7	0,87
3. Proceeds from the sale of the government inventories	0,8	0,0	0,4	0,2	0,2	0,1	0,2	0,2	0,20	0,18	0,2	0,2	0,20
4. Proceeds from the foreign economic activity	0,7	0,2	0,2	0,4	0,4	0,3	0,3	0,0	0,01	0,01	0,0	0,2	0,32
5. Other non-tax revenues	0,4	0,4	0,3	0,3	0,3	0,4	0,4	0,7	0,8	0,8	0,7	0,5	0,45
<b>TOTAL: NON-TAX REVENUES</b>	<b>2,6</b>	<b>1,8</b>	<b>2,1</b>	<b>2,0</b>	<b>1,7</b>	<b>1,7</b>	<b>1,7</b>	<b>1,8</b>	<b>2,05</b>	<b>2,00</b>	<b>2,1</b>	<b>2,0</b>	<b>2,39</b>
REVENUES FROM TARGETED BUDGETARY AND EXTRA-BUDGETARY FUNDS	1,3	0,6	0,5	0,6	0,7	0,8	1,0	1,0	1,62	1,63	1,7	1,8	1,95
Payments into budgetary targeted funds ( - )	0,1	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,04	0,03	0,0	0,0	0,04
<b>TOTAL REVENUES</b>	<b>24,8</b>	<b>15,3</b>	<b>16,8</b>	<b>18,6</b>	<b>20,8</b>	<b>22,2</b>	<b>22,1</b>	<b>22,2</b>	<b>22,97</b>	<b>22,93</b>	<b>23,2</b>	<b>23,4</b>	<b>25,71</b>
<b>OUTLAYS</b>													
1. State administration	0,8	0,6	0,6	0,7	0,8	0,8	0,8	0,9	0,92	0,94	1,0	1,0	1,07
2. International activities	1,2	0,4	0,3	0,6	0,7	0,7	0,7	0,7	0,30	0,29	0,3	0,3	0,31
3. National defence	2,8	1,6	2,1	2,9	3,1	3,3	2,8	2,8	2,95	2,94	2,9	2,8	2,98
4. Law enforcement and government security	1,7	1,6	1,6	2,0	2,0	2,1	2,0	1,9	1,87	1,94	2,1	2,0	2,15
5. Fundamental research	0,3	0,1	0,1	0,2	0,3	0,3	0,3	0,4	0,38	0,36	0,4	0,4	0,38
6. Services to national economy	7,9	3,9	4,3	5,3	5,9	6,2	6,2	6,5	6,70	6,91	7,0	7,0	8,17
7. Social services	8,4	5,5	6,8	8,0	8,5	8,8	9,3	9,2	8,99	8,83	8,8	8,7	9,51
8. State debt service	2,0	1,2	1,8	1,9	1,9	1,9	1,7	1,7	1,64	1,48	1,4	1,5	1,55
9. Replenishment of state inventories and reserves	0,4	0,1	0,1	0,2	0,3	0,2	0,2	0,2	0,19	0,33	0,4	0,4	0,36
10. Expenditure of state targeted budgetary funds	0,9	0,5	0,4	0,4	0,4	0,5	0,5	0,5	1,08	1,12	1,1	1,3	1,30
11. Other expenditures	1,5	0,8	0,8	0,9	1,1	1,1	1,2	1,2	1,48	1,32	1,4	1,3	1,47
<b>TOTAL EXPENDITURES</b>	<b>27,8</b>	<b>16,3</b>	<b>19,1</b>	<b>23,1</b>	<b>24,9</b>	<b>25,9</b>	<b>25,8</b>	<b>26,0</b>	<b>26,51</b>	<b>26,46</b>	<b>26,6</b>	<b>26,6</b>	<b>29,24</b>
<b>CREDITS MINUS REPAYMENTS</b>	<b>1,1</b>	<b>1,9</b>	<b>1,0</b>	<b>0,4</b>	<b>0,4</b>	<b>0,3</b>	<b>1,0</b>	<b>0,8</b>	<b>0,62</b>	<b>0,45</b>	<b>0,4</b>	<b>0,4</b>	<b>0,25</b>
1. Budgetary loans	0,8	0,2	0,1	0,1	0,2	0,2	0,9	0,7	0,62	0,47	0,4	0,4	0,47
2. State credits to CIS countries	-0,1	0,0	0,0	-0,1	0,0	0,0	0,0	0,0	-0,06	-0,08	-0,1	-0,1	-0,07
3. State credits to foreign governments	-0,2	-0,1	-0,1	-0,1	-0,1	-0,1	-0,1	-0,1	-0,14	-0,12	-0,1	-0,2	-0,16
4. Foreign credit resources granted to enterprises and organisations	0,6	0,6	0,4	0,0	0,0	0,0	0,0	0,0	-0,01	0,02	0,0	0,0	0,02
5. Amount of CBR revenues not transferred	0,1	1,3	0,6	0,4	0,3	0,2	0,2	0,2	0,21	0,15	0,1	0,2	0,00
<b>TOTAL: EXPENDITURES AND LOANS MINUS REPAYMENTS</b>	<b>28,9</b>	<b>18,2</b>	<b>20,1</b>	<b>23,5</b>	<b>25,3</b>	<b>26,2</b>	<b>26,8</b>	<b>26,8</b>	<b>27,13</b>	<b>26,91</b>	<b>27,0</b>	<b>27,0</b>	<b>29,49</b>
<b>SURPLUS OF REVENUES OVER EXPENSES MINUS REPAYMENTS</b>	<b>-4,2</b>	<b>-2,9</b>	<b>-3,3</b>	<b>-4,9</b>	<b>-4,5</b>	<b>-4,0</b>	<b>-4,7</b>	<b>-4,6</b>	<b>-4,16</b>	<b>-3,99</b>	<b>-3,8</b>	<b>-3,6</b>	<b>-3,78</b>
<b>OVERALL FINANCING</b>													
1. Domestic financing													
1.1. CBR credits for financing the budget deficit	0,0	-0,3	-0,1	-0,1	-0,1	-0,1	0,0	0,0	-0,03	-0,03	0,0	0,0	-0,02
1.2. Change in the residuals of the budgetary funds on bank rouble accounts	0,2	0,3	-0,9	-0,6	-0,6	-0,8	-0,9	-0,5	-0,61	-0,53	-0,5	-0,4	-0,53
1.3. State short-term bonds	1,7	1,4	1,9	2,4	2,0	1,9	1,9	1,9	1,78	1,66	1,6	1,4	1,36
1.4. Savings loan	0,3	0,0	0,2	0,2	0,3	0,2	0,3	0,3	0,24	0,21	0,2	0,2	0,19
1.5. Treasury bills	-0,3	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,00	0,00	0,0	0,0	0,00
1.6. Other state securities	0,1	0,0	0,1	0,3	0,2	0,2	0,4	0,3	0,32	0,26	0,2	0,2	0,27
1.8. Other internal loans	0,5	0,9	0,9	0,9	0,8	0,6	0,6	0,5	0,45	0,40	0,4	0,4	0,53
<b>TOTAL: DOMESTIC FINANCING</b>	<b>2,7</b>	<b>2,4</b>	<b>2,1</b>	<b>3,0</b>	<b>2,6</b>	<b>2,1</b>	<b>2,1</b>	<b>2,4</b>	<b>2,15</b>	<b>1,98</b>	<b>1,9</b>	<b>1,8</b>	<b>1,80</b>
2. Foreign financing													
2.1. International financial organisations credits	1,0	0,2	1,0	0,6	0,5	0,8	1,1	0,9	0,82	0,92	0,8	0,8	0,93
2.2. Foreign governments, foreign commercial banks and firms credits to the Russian Federation	0,5	0,4	0,2	1,3	1,3	1,1	1,5	1,3	1,23	1,12	1,1	1,1	1,07
<b>TOTAL: FOREIGN FINANCING</b>	<b>1,5</b>	<b>0,5</b>	<b>1,2</b>	<b>1,9</b>	<b>1,8</b>	<b>1,9</b>	<b>2,6</b>	<b>2,2</b>	<b>2,03</b>	<b>2,02</b>	<b>1,9</b>	<b>1,8</b>	<b>1,99</b>
<b>OVERALL: TOTAL FINANCING</b>	<b>4,2</b>	<b>2,9</b>	<b>3,3</b>	<b>4,9</b>	<b>4,4</b>	<b>4,0</b>	<b>4,7</b>	<b>4,6</b>	<b>4,18</b>	<b>4,00</b>	<b>3,8</b>	<b>3,6</b>	<b>3,79</b>
<b>Note: expenses on GKO-OFFZ service</b>	<b>0,4</b>	<b>2,92</b>	<b>3,2</b>	<b>3,2</b>	<b>3,3</b>	<b>3,2</b>	<b>3,0</b>	<b>2,86</b>	<b>2,71</b>	<b>2,57</b>	<b>2,50</b>	<b>2,38</b>	<b>2,65</b>
<b>Budget deficit (with net debt service on</b>	<b>4,5</b>	<b>5,8</b>	<b>6,6</b>	<b>8,1</b>	<b>7,8</b>	<b>7,2</b>	<b>7,7</b>	<b>7,43</b>	<b>6,88</b>	<b>6,56</b>	<b>6,32</b>	<b>5,98</b>	<b>6,44</b>



	1996	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
1. Domestic financing													
1.1. CBR credits to finance budget deficit	0,0	-0,3	-0,1	-0,1	-0,1	-0,1	0,0	-0,04	-0,03	-0,03	0,0	0,0	-0,02
1.2. Change in the budget residuals on the bank rouble accounts	0,2	0,0	-1,1	-0,5	-0,4	-0,4	-0,7	-0,26	-0,28	-0,25	-0,2	-0,2	-0,36
1.3. State short-term bonds	1,7	1,4	1,9	2,4	2,0	1,9	1,9	1,87	1,78	1,66	1,6	1,4	1,36
1.4. Savings loan	0,3	0,0	0,2	0,2	0,3	0,2	0,3	0,28	0,24	0,21	0,3	0,2	0,19
<b>OVERALL: DOMESTIC FINANCING</b>	<b>1,8</b>	<b>1,2</b>	<b>0,9</b>	<b>1,9</b>	<b>1,8</b>	<b>1,7</b>	<b>1,5</b>	<b>1,89</b>	<b>1,74</b>	<b>1,59</b>	<b>1,6</b>	<b>1,5</b>	<b>1,23</b>
2. Foreign financing													
2.1. International financial organisations credits	1,0	0,2	1,0	0,6	0,5	0,8	1,1	0,94	0,82	0,92	0,8	0,8	0,93
2.2. Foreign governments, foreign commercial banks and firms credits transferred to the Russian Federation	0,5	0,4	0,2	1,3	1,3	1,1	1,5	1,28	1,23	1,12	1,2	1,1	1,07
<b>OVERALL: FOREIGN FINANCING</b>	<b>1,5</b>	<b>0,5</b>	<b>1,2</b>	<b>1,9</b>	<b>1,8</b>	<b>1,9</b>	<b>2,6</b>	<b>2,22</b>	<b>2,05</b>	<b>2,04</b>	<b>2,0</b>	<b>1,8</b>	<b>2,00</b>
<b>TOTAL: GENERAL FINANCING</b>	<b>3,3</b>	<b>1,7</b>	<b>2,1</b>	<b>3,8</b>	<b>3,7</b>	<b>3,5</b>	<b>4,1</b>	<b>4,11</b>	<b>3,79</b>	<b>3,63</b>	<b>3,6</b>	<b>3,3</b>	<b>3,23</b>

**Tax arrears.** Positive trend characterising the first half of 1997 consisted in the gradual reduction, since March, in the volume of budgetary tax arrears. Movement through time of the real volume of arrears into the Federal budget is given in Table 3. Main explanation for that movement trough time characterising enterprises arrears to the Budget consisted in tough position of the government in the spring of 1997 and its persistent fight against non-payments which have resulted in sharp growth of not only the volume of repaid arrears but of the collected volume of current taxes due. Table 8 shows that the first half-year was characterised by growth over time of current tax receipts (tax receipts minus repayment of arrears). March indicators stand aside due to the change of government and start of the more decisive measures designed at increasing tax revenues into the Federal budget.

However, in July there was a significant decline in current tax receipts and increase in arrears which continued during autumn 1997. We think that one of the reasons for such decline consists in the understanding by the economic agents of the softening of the government's attitude towards tax defaulters. Softening of the government's position manifested itself in the absence of any tough actions with respect to the defaulters who refused to restructure their accrued debts according to the Government's resolution No.254 of 5 March 1997, adoption of the Resolution No.928 of 4 July 1997, which was later partly revoked, which envisaged very lenient schedule for debt repayments to the

budget (including the debt of the budget organisations) and tax arrears in the fuel and energy complex and the decision to write off arrears on fines and penalties, etc. On the whole, in 1997 the Government adopted less than a dozen resolutions dealing with the restructuring of the enterprises' debts to the budget.

In the second half-year, the volume of arrears was constantly growing in real terms. Overall real growth of the volume of arrears during June-November constituted nearly 50 per cent. Only by the end of the year, owing to the offset money payments, it became possible to reduce the volume of arrears by about 7 per cent in real terms.

Table 6

**Tax arrears to the Federal budget  
(December 1996 prices) in 1997 (Rb bn)**

ARREARS	1996	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Overall	70533	78117	80414	77192	75198	75328	73875	84143	90838	95809	102877	109947	103551
Total deflated arrears	57886	62669	63559	60169	58035	57617	55891	63091	68247	72199	77370	82194	76647
Total arrears in per cent of monthly GDP	31,3	38,8	39,9	37,8	40,2	40,4	37,5	37,90	39,30	39,11	42,87	44,51	40,61
Changes in arrears, total (per cent).		8,3	1,4	-5,3	-3,5	-0,7	-2,9	12,9	8,2	5,8	7,2	6,2	-6,7per cent
On VAT	42058	49481	51419	49764	47864	48662	49167	55559	59110	62772	69088	73671	71032
Arrears on VAT deflated	34517	39696	40641	38790	36940	37220	37197	41659	44410	47303	51959	55075	52577
Change of arrears on VAT (per cent)		15,0	2,4	-4,6	-4,8	0,8	-0,1	12,0	6,6	6,5	9,8	6,0	-4,5per cent
On profit tax	9218	8935	9126	8575	10131	10908	10530	11354	13418	13361	13058	15257	13964
Arrears on profit tax (deflated)	7566	7168	7213	6684	7819	8344	7966	8514	10081	10068	9821	11406	10336
Change of arrears on profit tax (per cent)		-5,3	0,6	-7,3	17,0	6,7	-4,5	6,9	18,4	-0,1	-2,5	16,1	-9,4per cent

Movement through time of the arrears to the consolidated budget (Table 7) is similar to the dynamics of the arrears to the federal budget and, to a large extent, is being explained by the same factors. Compared with the beginning of the year, by December 1997 the real volume of arrears increased by 27 per cent.

In 1997 offset payments of tax arrears and budget liabilities were carried out by way of "reversed" offset payment which started from the enterprises paying their tax arrears and not from the government arrears as it was done

earlier. Despite the fact that with the help of the offset payments, about 25 per cent of the tax revenues have been collected, that type of budget execution itself and insufficiently clear organisation of the offset payments permanently led to a reduction in the tax discipline when taxpayers in view of the pending offset tax arrears for the budget ones wanted to increase the volume of arrears by cutting current tax payments.

Table 7.

**Tax arrears to the consolidated budget  
(in December 1996 prices) in 1997 (Rb trillion)**

AAREARS	1996	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Overall	128,2	138,9	140,2	136,1	151,9	166,6	159,7	163,3	179,5	180,2	185,2	204,5	181,8
Total arrears (deflated)	105,2	111,4	110,8	106,1	117,3	127,4	120,8	122,4	134,9	135,8	139,2	152,9	134,6
Total arrears in per cent of monthly GDP	57,0	69,1	70,1	66,7	74,1	80,5	74,3	73,6	76,73	73,56	77,1	82,8	71,3
Change of arrears and total (per cent).		5,9per cent	-0,6per cent	-4,2per cent	10,5per cent	8,7per cent	-5,2per cent	1,3per cent	10,2per cent	0,7per cent	2,5per cent	9,8per cent	-12,0per cent
VAT arrears	55,8	66,2	68,7	67,1	69,6	73,3	73,0	77,3	81,4	84,5	91,4	96,7	91,2
VAT arrears (deflated)	45,8	53,1	54,3	52,3	53,7	56,1	55,2	57,9	61,2	63,7	68,8	72,3	67,5
VAT arrears (per cent)		16,0per cent	2,1per cent	-3,6per cent	2,6per cent	4,4per cent	-1,5per cent	4,9per cent	5,5per cent	4,1per cent	8,0per cent	5,2per cent	-6,7per cent
Profit tax arrears	20,7	20,7	20,9	19,9	25,9	29,2	28,2	26,8	31,2	29,8	28,2	32,9	27,8
Profit tax arrears (deflated)	17,0	16,6	16,5	15,5	20,0	22,4	21,4	20,1	23,4	22,4	21,2	24,7	20,6
Change of the profit tax arrears (per cent)		-2,4per cent	-0,8per cent	-5,8per cent	28,8per cent	11,8per cent	-4,6per cent	-5,8per cent	16,4per cent	-4,2per cent	-5,6per cent	16,5per cent	-16,5per cent

Table 8

**Tax receipts to the federal budget in 1997  
(in Rb bn)**

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Accrued tax receipts	10000	23499	46995	75794	97079	123924	141234	159240	173032	190775	206260	249532
of which: payments of arrears since the beginning of year	1005	2824	10498	19427	28976	37403	42895	45681	51690	56379	61078	69609
Tax receipts by month	10000	13499	23496	28799	21285	26845	17310	12600	13792	17743	15485	43272
of which: by month payments of arrears	1005	1819	7674	8929	9549	8427	5492	2786	6009	4689	4699	8531
Current payments	8995	11680	15822	19870	11736	18418	11818	9814	7783	13054	10786	34741
Change of current payments rates		29,8per cent	35,5per cent	25,6per cent	-40,9per cent	56,9per cent	-35,8per cent	-17,0per cent	-20,7per cent	67,7per cent	-17,4per cent	222per cent
Current payments in per cent to monthly GDP	4,5	5,8	7,8	9,7	5,7	8,6	5,3	4,2	3,2	5,4	4,4	13,6
Monthly GDP (Rb trillion)	201	200	204	205	207	215	222	234	245	240	247	255

Decision to reduce quotas on the access to the oil pipeline for the government export needs and distribution of these quotas among the enterprises-debtors on condition of their repayment of arrears to the budget, played a positive role in maintaining the volume of tax receipts. On July 8 the President of the RF signed a Decree "On Measures Designed to Reduce Arrears of Oil-producing Enterprises on Their Payments to the Federal Budget and Government Extrabudgetary Funds". That Decree envisaged a receipt by oil-producing enterprises of quotas for oil exports through the pipeline system. On September 2, 1997, the Government of the Russian Federation adopted Resolution No.1130 "On Distribution On Additional Volumes of Oil Transportation For Export". By that resolution additional capacity in the oil pipeline for export were distributed from 1 October 1997 as part of the total capacity in the oil pipeline for export among oil-producing companies in proportion to their aggregate volumes of production. Aforesaid quota increase on oil exports for the oil-producing enterprises have been taken at the expense of the intermediaries who exported crude in order to finance federal government's needs. At the same time, additional capacity volumes of oil shipments for export were granted to the oil-producing companies for a five year period independently of the change in the overall capacity volume of crude exports by those oil-producing enterprises under the guarantees of the oil-producing companies to timely payments in 1997 and repayment of accrued taxes by 1 January 1998 to the federal budget and state extra-budgetary funds. According to the calculations done by the State Tax Service, that measure allowed to obtain about Rb 16 trillion of accrued and current payments in 1997.

On December 8, 1997, the Temporary Extraordinary Commission set to enforce the taxpayer discipline, took a decision to arrest the property of the Omsk oil-refinery, which is part of the oil company Sibneft, and of Angarsk



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petrochemical company, which is part of Sidanko, in view of their accrued taxes to the federal budget. According to the data of the State Tax Service, the debt of the Omsk oil-refinery to the federal budget constituted Rb 525 bn, and of the Angarsk petrochemical plant--Rb 766 bn. The alternative scenario for the solution of that problem envisaged bankruptcy procedure which was disadvantageous to the state because according to the acting in 1997 bankruptcy legislation, their debts would have been frozen for a year and a half. On December 17 the emergency meeting of the Temporary Extraordinary Commission (VChK) those enterprises were given a chance to repay debts to the budget. Omsk oil refinery has paid all its arrears before the dead line. Angarsk petro-chemical company has not obeyed the VChK decision. By that decision the tax administrations had the right to demand the debts repayment from the mother company Sidanko. Further development of the events and a possible transfer of that decision on to the other important debtors will serve as an indicator for the availability of political will in the sphere of the budget revenue implementation.

**Financing of the budget outlays.** In the first quarter, there was some reduction in financing of the federal budget outlays compared with 1996 which was predetermined by a drastic fall of its revenues. Owing to an improvement of the revenue side of the budget in the second quarter of 1997, the government managed to increase considerably the volume of public expenditure (from 7.3 per cent of GDP in January up to 13.4 per cent of GDP in June). The biggest growth was observed with respect to the "social services" which is explained by the government's wish to honour its obligations on repaying the wage arrears in the budget sphere.

Inability to fully finance the outlays became a reason for the budget sequestration. Such suggestion was submitted by the government to the Duma

in the form of a draft law on 30 April 1997. In that draft the government proposed to cut the budget expenditure by Rb 108 trillion or by 3.96 per cent of forecast GDP (Rb 2,727 bn) because of the budget revenue shortfalls. The idea was to cut some expenditure items by 50 per cent and the most important ones-- by 30 per cent. Moreover, the government proposed to reduce the number of "protected" items. However, the Duma refused to enact the draft bill during its spring session but the Ministry of Finance began to follow the targets of sequestration in real life.

The budgeted expenditures were executed in the first half-year at the volume of 68 per cent without the sequestration. Real expenditures increased on average by 1 per cent of GDP a month during the half-year. It resulted in a 30 per cent shortfall in the overall volume of planned budgeted expenditures without sequestration. Expenditures and loans minus repayments to the federal budget constituted 14.4 per cent of GDP for the six months of 1997. Expenditures of the consolidated budget in the same item--26.8 per cent of GDP.

In the second half-year, the dynamics of the execution of the expenditure part of the federal budget was dubbing the dynamics of revenues and was remaining at the stable level of 13-14 per cent of GDP. Significant increase in expenditures on administration by 0.36 per cent of GDP should be noted (compared with 0.2 per cent of GDP in the first half-year) and a reduction in expenditures on the international activities down to 0.31 per cent of GDP in December (compared with 0.6-0.7 per cent of GDP in the middle of the year). During the whole year, the federal budget expenditures (by the Ministry of Finance methodology) constituted 15.3 per cent of GDP.

**Budget deficit.** During the whole of 1997, indicators of the budget deficit surpassed the legislatively fixed target. For the first quarter of 1997, the federal

budget was executed with the deficit amounting to Rb 23.3 trillion (by the Ministry of Finance methodology) or 3.8 per cent of GDP (29.4 per cent of the overall sum of the budget expenditures in the first quarter) when the maximum budget deficit was set at 3.5 per cent of GDP (18.01 per cent of the expenditures volume). The volume of the domestic deficit financing amounted to 1.9 per cent of GDP in the first quarter. The volume of the foreign budget deficit financing amounted to the tune of 1.9 per cent of GDP.

By the results of half-year, the federal budget deficit (by the Ministry of Finance methodology) constituted 4.1 per cent of GDP which was by 0.6 per cent of GDP more than the target. In the second half-year, there was a significant decrease in the budget deficit down to 3.23 per cent of GDP which was linked with a considerable (up to 12.1 per cent of GDP in December compared with 10.8 per cent of GDP in November) growth of budget revenues. Thus, the volume of the budget deficit turned out to be less than the target of 3.5 per cent.

As was aforesaid, the financial crisis resulted in a dramatic growth of the public debt service. That fact did not significantly influence the 1997 federal budget execution. However, the world financial crisis will undoubtedly bring negative results in 1998.

Table 9

### The reconstruction of the 1997 budget

	Republican budget		Local budgets		Extra-budgetary funds*		Consolidated budget		
	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	per cent budget
REVENUES									
1. Income tax, tax on profit	35650,3	1,3	142825,0	5,3			178475,4	6,7	19,1
1.1. Profit tax	33144,9	1,2	69040,5	2,6			102185,4	3,8	11,0
1.2. Personal income tax	1746,9	0,1	73370,3	2,7			75117,2	2,8	8,1
1.3. Other taxes on income and profit	758,5	0,0	414,3	0,0			1172,8	0,0	0,1
2. Payroll tax	0,0	0,0	9147,1	0,3			9147,1	0,3	1,0
3. Taxes on goods and services	171356,0	6,4	73759,5	2,8			245115,5	9,2	26,3
3.1. VAT of goods produced on the territory of the Russian Federation and services	88572,1	3,3	53815,8	2,0			142387,9	5,3	15,3

	Republican budget		Local budgets		Extra-budgetary funds*		Consolidated budget		
	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	per cent budget
3.2. VAT on goods imported on the territory of the Russian Federation	28541,8	1,1	0,0	0,0			28541,8	1,1	3,1
3.3. Axcises	50399,4	1,9	12423,6	0,5			62823,0	2,3	6,7
including: oil, gas condensate	33438,0	1,3		0,0			33438,0	1,3	3,6
3.4. Special tax designed to support major sectors of the economy	820,3	0,0	898,3	0,0			1718,6	0,1	0,2
3.5. Other taxes on goods and services	3022,4	0,1	6621,8	0,2			9644,2	0,4	1,0
4. Taxes on property	582,0	0,0	46930,4	1,8			47512,3	1,8	5,1
4.1. Tax on transactions with securities	582,0	0,0	-3,7	0,0			578,2	0,0	0,1
4.2 Other taxes on property			46934,1	1,8			46934,1	1,8	5,0
5. Payments for the use of natural resources	6999,7	0,3	28609,7	1,1			35609,3	1,3	3,8
5.1. Payment for subsoil	3212,8	0,1	11926,4	0,4			15139,1	0,6	1,6
5.2. Payments for reproduction of minerals	2497,1	0,1	6897,0	0,3			9394,1	0,4	1,0
5.3. Land taxes and rent	1070,5	0,0	8365,5	0,3			9436,0	0,4	1,0
5.4. Other payments for the use of natural resources	219,4	0,0	1420,7	0,1			1640,1	0,1	0,2
6. Taxes on foreign trade and foreign economic operations	27815,1	1,0	0,1	0,0			27815,2	1,0	3,0
6.1. Import duties	26589,8	1,0		0,0			26589,8	1,0	2,9
6.2. Other import duties	0,0	0,0	0,1	0,0			0,1	0,0	0,0
6.3. Export dues	1225,3	0,0		0,0			1225,3	0,0	0,1
7. Other taxes, levies and duties	1144,7	0,0	27716,8	1,0			28861,5	1,1	3,1
8. Contributions to the social security funds					203564,3	7,6	203564,3	7,6	21,8
8.1. Employed					5194,6	0,2	5194,6	0,2	0,6
8.2. Employees					198369,7	7,4	198369,7	7,4	21,3
Pension fund					145449,4	5,4	145449,4	5,4	15,6
Social security fund					28131,8	1,1	28131,8	1,1	3,0
Employment fund					7627,8	0,3	7627,8	0,3	0,8
Social assistance fund					0,0	0,0	0,0	0,0	0,0
CMI fund and territorial CMI funds					17082,2	0,6	17082,2	0,6	1,8
Territorial DF					78,4	0,0			
9. Other extra-budgetary funds					990,2	0,0	990,2	0,0	0,1
TOTAL TAXES AND PAYMENTS	243547,8	9,1	328988,6	12,3	204554,5	7,6	777090,9	29,1	83,3
NON-TAX REVENUE								0,0	0,0
1. Revenue from state property and activity	6746,1	0,3	4804,5	0,2			11550,6	0,4	1,2
1.1. Transfer of CBR earnings	1985,0	0,1					1985,0	0,1	0,2
1.2. Other types of earnings from state property and activity	4761,1	0,2					4761,1	0,2	0,5
2. Proceeds from the sale of public property	18767,7	0,7	4542,8	0,0			23310,5	0,9	2,5
3. Proceeds from the sale of the public inventories	5341,3	0,2		0,0			5341,3	0,2	0,6
4. Proceeds from the sale of land and non-material assets	13,6	0,0	175,4	0,0			189,0	0,0	0,0
5. Penalties	205,4	0,0	913,1	0,4	7796,8	0,3	8915,3	0,3	1,0
6. Revenue from foreign economic activities	8547,3	0,3	24,3	0,0			8571,6	0,3	0,9
7. Other non-tax revenue	2086,0	0,1	9978,0	0,4			12063,9	0,5	1,3
8 Transfers from other level governments	105,0	0,0	49903,4	1,9	37325,4	1,4	x	x	
8.1. Dotations	0,0	0,0	3345,9	0,1	37325,4	1,4	x	x	
of which: from the federal budget					31849,9	1,2			
of which: from the local budgets					5475,5	0,2			
8.2. Subventions	0,0	0,0	2400,0	0,1			x	x	
8.3. Funds transferred in mutual payments	105,0	0,0	11499,4	0,4			x	x	
8.4. Transfers	0,0	0,0	23088,2	0,9			x	x	

	Republican budget		Local budgets		Extra-budgetary funds*		Consolidated budget		
	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	per cent budget
8.5. Transfers at the expense of VAT		0,0	9569,9	0,4					
9. Other receipts	0,0	0,0	213,2	0,0			213,2	0,0	0,0
10. Revenue from public enterprises and organisations	0,4	0,0					0,4	0,0	0,0
11. Revenue receipts on the accounts of the tax administrations	0,0	0,0	959,9	0,0			959,9	0,0	0,1
12. Revenue from the state extra-budgetary funds			7894,5	0,3			x	x	x
13. Other revenue of the state extra-budgetary funds					40137,7	1,5	40137,7	1,5	4,3
TOTAL NON-TAX REVENUE	41824,0	1,6	80081,0	3,0	85260,0	3,2	111936,5	4,2	12,0
REVENUE OF THE BUDGETARY FUNDS	38322,0	1,4	5969,9	0,2			44291,9	1,7	4,8
Payments into the targeted budgetary funds (-)	859,6	0,0	113,7	0,0			973,3	0,0	0,1
ÂNĂĂĪ ĂĪŌĪĂĪĂ	322834,2	12,1	414925,8	15,5	289814,5	10,8	932346,0	34,9	100,0
ĐĂÑŌĪĂŪ									
1. State administration	9669,3	0,4	18899,7	0,7			28569,1	1,1	2,4
2. International activities	8177,0	0,3					8177,0	0,3	0,7
3. National defence	79692,1	3,0					79692,1	3,0	6,8
4. Law enforcement and government security	43652,3	1,6	13755,1	0,5			57407,4	2,1	4,9
5. Fundamental research	9548,9	0,4	575,4	0,0	16,8	0,0	10141,1	0,4	0,9
6. State services to national economy, of which:	52342,0	2,0	166177,7	6,2	30270,6	1,1	248790,2	9,3	21,3
6.1. Industry, energy and construction	26563,2	1,0	18709,3	0,7			45272,5	1,7	3,9
6.2. Agriculture and fishing	12134,0	0,5	19219,5	0,7			31353,6	1,2	2,7
6.3. Environment protection and preservation of natural resources, hidrometeorology, cartography and geodesy	2500,2	0,1	1470,0	0,1			3970,2	0,1	0,3
6.4. Transport, roads, communication and informatics	3811,9	0,1	19504,8	0,7			23316,7	0,9	2,0
6.5. Development of market infrastructure	678,1		498,3	0,0			1176,4	0,0	0,1
6.6. Housing sector	0,0		105991,0	4,0			105991,0	4,0	9,1
6.7. Forecast and liquidation of emergency situations and consequences of natural disasters	6654,6	0,2	784,7	0,0			7439,3	0,3	0,6
6.8. At the expense of road funds					30270,6	1,1	30270,6	1,1	2,6
7. Social services	48484,5	1,8	205854,8	7,7	269806,8	10,1	524146,1	19,6	44,8
7.1. Education	14385,4	0,5	94466,6	3,5	396,2	0,0	109248,3	4,1	9,3
7.2. Culture and arts	1186,3	0,0	10934,3	0,4			12120,6	0,5	1,0
7.3. Mass media	1331,2	0,0	1830,2	0,1			3161,5	0,1	0,3
7.4. Health care and physical culture	8831,7	0,3	66251,0	2,5	30879,9	1,2	105962,6	4,0	9,1
7.5. Social policy	22749,8	0,9	32372,7	1,2	238530,8	8,9	293653,2	11,0	25,1
8. State debt service	117800,0	4,4					117800,0	4,4	10,1
of which: GKO, OFZ and KO service	87200,0	3,3							
9. Replenishment of state inventories and reserves	9733,6	0,4					9733,6	0,4	0,8
10. Expenditure of state targeted budgetary funds	29113,4	1,1	5690,8	0,2			34804,2	1,3	3,0
11. Other expenditures	59152,4	2,2	30076,7	1,1	5806,5	0,2	43416,0	1,6	3,7
11.1. Financial assistance to other levels of government	49903,4	1,9	105,0	0,0			đ	đ	
- Donations transferred to the budgets of RF subjects budgets ZATO							đ	đ	
- Donations transferred ZATO	3345,9	0,1					đ	đ	
- Subventions	2400,0	0,1					đ	đ	
- Transfers to even income	23088,2	0,9					đ	đ	
- Transfers at the expense of VAT	9569,9	0,4	105,0	0,0			đ	đ	
- Funds transferred in mutual payments	11499,4	0,4					đ	đ	
11.2. Other expenditures not related to other items	9248,9	0,3	29971,6	1,1			39220,6	1,5	3,4
11.3. Other expenditures of extra-budgetary funds					4195,4	0,2	4195,4	0,2	0,4

	Republican budget		Local budgets		Extra-budgetary funds*		Consolidated budget		
	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	per cent budget
TOTAL EXPENDITURES	467365,4	17,5	441030,2	16,5	305900,6	11,4	1162676,7	43,5	99,4
CREDITS MINUS REPAYMENTS	18255,2	0,7	5885,5	0,2			6721,9	0,3	0,6
1. Budgetary loans	23988,9	0,9	5885,5	0,2			12455,7	0,5	1,1
Loans to budgets	17369,3	0,6	1096,0	0,0			0	0	
Loans repayments by budgets	352,5	0,0	694,1	0,0			0	0	
Offset loans by budgets							0	0	
Budgetary loans granted by ministries, committees, enterprises and organisations	12021,6	0,4	11849,9	0,4			23871,5	0,9	2,0
Repayment of loans by ministries, committees, enterprises and organisations	5049,5	0,2	6366,3	0,2			11415,8	0,4	1,0
2. State credits to CIS	-1884,1	-0,1					-1884,1	-0,1	-0,2
Credits granted	377,3	0,0					377,3	0,0	0,0
Credits repaid	2261,4	0,1					2261,4	0,1	0,2
3. State credits to foreign governments	-4371,2	-0,2					-4371,2	-0,2	-0,4
Credits granted	603,6	0,0					603,6	0,0	0,1
Credits repaid	4974,8	0,2					4974,8	0,2	0,4
4. Foreign credits granted to enterprises and organisations	558,8	0,0					558,8	0,0	0,0
Credits granted	1549,6	0,1					1549,6	0,1	0,1
Credits repaid	990,8	0,0					990,8	0,0	0,1
5. Credits on conversion purposes	-94,1	0,0					-94,1	0,0	0,0
Credits granted	20,6	0,0					20,6	0,0	0,0
Credits repaid	114,6	0,0					114,6	0,0	0,0
6. Credits for investment purposes	138,2	0,0					138,2	0,0	0,0
Credits granted	231,1	0,0					231,1	0,0	0,0
Credits repaid	93,0	0,0					93,0	0,0	0,0
7. The share of CBR earnings not transferred	-81,3	0,0					-81,3	0,0	0,0
TOTAL EXPENDITURES AND LOANS MINUS REPAYMENTS	485620,6	18,2	446915,7	16,7	305900,6	11,4	1169398,6	43,7	100,0
SURPLUS OF REVENUES OVER EXPENDITURES AND LOANS MINUS REPAYMENTS	-162786,4	-6,1	-31989,9	-1,2	-16086,1	-0,6	-237052,6	-8,9	
TOTAL FINANCING									
1. Internal financing									
1.1. CBR credits to finance the budget deficit	-580,9	0,0							
- Credits received									
- Repayment of the major part of debt	580,9	0,0							
1.2. Change in the budget residuals on the rouble accounts of the banks	-9528,8	-0,4	-4620,6	-0,2	19358,7	0,7			
Residuals by the beginning of the period	2306,9	0,1	6454,0	0,2					
Residuals by the end of the period	11835,7	0,4	11074,5	0,4					
1.3. State short-term bills	112699,1	4,2							
1.4. Savings loan	5107,1	0,2							
- Borrowed funds	13107,1	0,5							
- Repayment of the major part of the debt	8000,0	0,3							
1.5. Other state securities	1632,6	0,1	5602,3	0,2					
- Borrowed funds	8555,4	0,3	19974,1	0,7					
- Repayment of the major part of the debt	6922,8	0,3	14371,7	0,5					
1.6. Budgetary loans received from the superior budget	0,0	0,0	17016,8	0,6					
- Loans received		0,0	17369,3	0,6					
- Loans offset		0,0		0,0					

	Republican budget		Local budgets		Extra-budgetary funds*		Consolidated budget		
	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	Rb bn	per cent GDP	per cent budget
- Loans repaid		0,0	352,5	0,0					
1.7. Other domestic loans	-11,8	0,0	14208,6	0,5					
- Borrowed funds	1143,7	0,0	35695,7	1,3					
- Repayment of the major part of the debt	1155,4	0,0	21487,1	0,8					
1.8. Credits and loans to the extra-budgetary funds					-3272,6	-0,1			
- Borrowed funds					95,2	0,0			
- Repayment of credits and loans					2459,8	0,1			
TOTAL INTERNAL FINANCING	109317,3	4,1	32207,2	1,2	16086,1	0,6			
2. Foreign financing									
2.1. Credits of the international financial organisations	24868,1	0,9							
Credits received:	27782,7	1,0							
- tied	4665,8	0,2							
- non-tied	23116,9	0,9							
Rate difference on credits:	30,4	0,0							
Repayment of the major part of debt on credits:	2945,0	0,1							
2.2. Credits granted by foreign governments, foreign commercial banks and firms to the Russian Federation	28601,0	1,1							
- Credits received (used)	35190,3	1,3							
- Repayment of the major part of the debt	6589,4	0,2							
2.3. Change in the residual budgetary funds on the currency accounts in the banks			-217,2	0,0					
Residuals by the beginning of the period			99,9	0,0					
Residuals by the end of the period			317,2	0,0					
TOTAL FOREIGN FINANCING	53469,1	2,0	-217,2	0,0					
OVERALL GENERAL FINANCING	162786,4	6,1	31989,9	1,2	16086,1	0,6			

\* estimate

The reconstruction of the execution of the federal and local budgets and extra-budgetary funds is given in Table 9. In addition to the execution of the federal and local budgets, the Table gives the data on the execution of the extra-budgetary funds. That data was obtained from the reports for the nine months of 1997.

The volume of the secondary federal budget deficit declined compared with 1996 by around 1.1 per cent of GDP. At the same time, the volume of the primary deficit also declined (by 0.3 per cent of GDP) and constituted 2.8 per cent of GDP. On the whole, this decline took place at the expense of a reduction in the volume of debt service. Moreover, expenditure on the international activities was sharply reduced by about 4-fold. Expenditure on all other budget

items somewhat increased--on social policy by 0.4 per cent of GDP, on national defence by 0.2 per cent, on law enforcement activities by 0.3 per cent of GDP.

In 1997, the volume of revenue in the whole public finance system went up compared with 1996 (34.9 per cent of GDP and 34.4 per cent of GDP correspondingly). Tax receipts, at that, despite the fact that tax withdrawals to the federal budget decreased, went down insignificantly (from 29.2 percent of GDP to 29.1 per cent of GDP) owing to a substantial (by one per cent of GDP) growth of tax withdrawals into the local budgets. Increase by 1.7 per cent of GDP of the consolidated budget expenditure (to 43 per cent of GDP) in 1997 resulted in the deficit growth by 1.4 per cent of GDP (to 8.9 per cent of GDP).

Tax receipts of the extra-budgetary funds were considerably cut compared with 1996--from 8.2 per cent of GDP down to 7.6 per cent of GDP. That fall was offset by a growth of non-tax revenues from 2 per cent of GDP up to 3.2 per cent of GDP. However, against the background of an increase in the expenditure side of the extra-budgetary funds, it led to a deficit of 0.6 per cent of GDP. In 1996 a profit was registered in the amount of 0.1 per cent of GDP.

Table 10

### Dynamics of public debt

TYPE OF DEBT	as of 1 January 1994		as of 1 January 1995		as of 1 January 1996		as of 1 January 1997		as of 1 January 1998	
	RB bn	% GDP	Rb bn	% GDP	Rb bn.	% GDP	Rb bn.	% GDP	Rb bn	% GDP
<b>1. Debt on securities, of which:</b>	329,5	0,2	18917,4	3	85196,9	5,1	249034,7	11,04	449230,8	16,79
State loan 1992	15	0,009	22	0,003	53	0,0	55	0,00	105	0,004
State Russian domestic loan 1990	0,35	0,0002								
State domestic loan 1991	80	0,04	80	0,01	80	0,0	79,7	0,00	79,7	0,003
GKO	185	0,1	10594	1,7	66118,7	4,0	203600	9,02	272612	10,19
OFZ					7597	0,5	37300	1,65	163352,4	6,11
Treasury bills			6681,4	1,1	7348,2	0,4	-			
Treasury <i>veksels</i>			1540	0,2			-			
Gold certificates	49,1	0,03			1000	0,1	-			
State savings loan					3000	0,2	8000	0,35	13081,7	0,49
<b>2. Debt to CBR</b>	29156,7	18,0	58752,3	9,30	61026*	3,7	59583,27	2,64	0,0	0,0
<b>3. Debt to commercial banks (under government guarantees)</b>	1899,8	1,2	1700	0,3	5793	0,3	17057,17	0,76	4916,8	0,18
<b>4. Debt of the former USSR on commodity debt, of which:</b>	3204	2	3100	0,5	2500	0,2	5300	0,23	4237	0,16
Targeted loan 1990	2500	1,5	2400	0,4	1850	0,1	2300	0,10	2037	0,08
Targeted deposits, checks on automobiles, debt to agricultural workers	704	0,4	700	0,1	650	0,0	3000	0,13	2200	0,08



TYPE OF DEBT	as of 1 January 1994		as of 1 January 1995		as of 1 January 1996		as of 1 January 1997		as of 1 January 1998	
	RB bn	% GDP	Rb bn	% GDP	Rb bn.	% GDP	Rb bn.	% GDP	Rb bn	% GDP
5. Debt to AIC securitised into treasury bills	0		5441,6	0,9	5040	0,3	4480	0,20	3920	0,15
6. Debt on centralised credits and accumulated interest of AIC organisations which carry out procurements to the Northern territories					25000	1,5	25000	1,11	25000	0,93
7. Debt of AĬĖMĀZ securities into the Ministry of Finance <i>veksels</i>							1745,5	0,08		
8. Debt of textile enterprises of the Ivanovo <i>oblast</i> on interest arrears							560	0,02	560	0,02
9. Debt on financing expenditure in mobilising reserve					1960	0,1	2389,5	0,11	1993,5	0,07
10. Other, of which:	276,6	0,2	153,6	0,02	2028	0,1	398,027	0,02	8233,2	0,31
Debt to Gosstrakh	23,8	0,01					-			
CBR domestic debt assumed from the former USSR	330	0,2	335	0,05	335	0,0	335	0,01	191,4	0,007
Price difference on agricultural resources which require repayment	61	0,04					-			
Deficit of 1991 republican budget	63	0,04	63	0,01	63	0,0	63,027	0,00		
CBR debt on the credit resources of the former Sberbank	128,8	0,08	90,6	0,01			-			
Debt to Pension fund					1630	0,1	-			
Debt on technical credits granted by CBR to CIS									2408	0,09
Debt to FEC enterprises and of other sectors									5000	0,19
Debt on centralised credits and accrued interest by enterprises of AIC of the Cheliabinsk <i>oblast</i>									93,8	0,003
Availed <i>veksels</i> of Agroprombank									540	0,02
<b>Overall state domestic debt</b>	<b>35196,6</b>	<b>21,7</b>	<b>88400</b>	<b>14</b>	<b>188543,6</b>	<b>11,4</b>	<b>365548,2</b>	<b>16,20</b>	<b>500959,1</b>	<b>18,73</b>
for reference: GDP (Rb trln)	162,3		630		1659,2		2256		2675	

The volume of the domestic state debt of the Russian Federation with respect to GDP increased in 1997 compared with 1996 by 16 per cent. Debt growth on securities and specially OFZs (by 4.5 per cent of GDP) and GKO (by 1.1 per cent of GDP) has contributed to that increase. The volume of the state debt practically on all other items declined insignificantly.

In 1997 new types of taxes appeared. Among them are, for instance, debts to FEC enterprises amounting to Rb 5,000 bn old roubles (0.19 per cent of GDP) and debt on technical credits to CIS countries granted by CBR in the amount of Rb 2,408 bn (0.09 per cent of GDP).

### 2.6.2. The draft 1998 budget

While analysing the draft 1998 budget, it is important to bear in mind the history of the budget crisis over 1993-1997 and the reasons which have brought

it about as well as the measures which the government undertook in order to resolve it. Intensification of the budget crisis in 1996 has many reasons, but the main one consists in the fact that the government while cutting the budget deficit during 1993-1995 did not try to start a fundamental tax reform. There were no positive changes in the structure of public expenditure. In reality, the government in the circumstances of revenue shortfalls and insufficient borrowed funds confined itself to a reduction in the volume of public expenditure by way of their sequestration and incomplete indexation in accordance with the current inflation rate.

An illusion about the absence of problems in the public finance sphere was due to the fact that from 1992 till mid-1993 the government was able to maintain a rather high level of tax receipts by improving the taxation technique as well as owing to a rather slow erosion of the taxpayer discipline. However, from 1993 there was an uncontrollable reduction in tax receipts. That is why, further development in the fiscal crisis in 1997 would have been unavoidable without the implementation of the radical tax reforms.

Fiscal crisis which sharply intensified at the turn of 1995-1996 and turned out to be a very complicated phenomena by its consequences. Had it been only the influence of financial stabilisation and political uncertainty resulting from the election campaign, then tax collection should have more or less automatically returned in 1997 to at least the starting point. However, the real situation was rather different. Without constant purposeful efforts of the executive power aimed at collecting taxes, the tendency reflecting the fall of tax receipts continues to unfold.

Submitted to the State Duma on 25 August, the draft 1998 budget was being prepared parting from the more strict procedures of distribution of public funds than it was in previous budgets (Table 11). In particular, ministries have

received the limits for financing and could not haggle with the government over the volumes of financing. The proposed draft budget was based on the main provisions of the draft Tax Code which was approved by then in the first reading. The draft Tax Code envisaged a reduction in the tax burden on the economy with simultaneous increase in tax collection and a reduction in the scale of an illegal tax evasion. The draft budget foresaw a reduction in the primary deficit (without the state debt service) to 0.5 per cent of GDP. Expenditure on the state debt service was envisaged in the amount of 4.38 per cent of GDP. That was based on the forecast of the further decline in the interest rate down to 14 per cent. Priority items of budgeted expenditure became allocations on the implementation of the military reform, social and culture sphere, health care.

In the course of discussions in the State Duma and the work of the Trilateral working Commission on the discussion of main indicators of 1998 federal budget, the parameters of the draft budget have been modified. As aforesaid, calculation of the budget revenues were based not on the forecasts which corresponded to the draft Tax Code but on the packet of tax laws submitted by the government as an alternative to a comprehensive tax reform.

Table 11

**Main indicators of the 1998 federal budget**  
(% of GDP)

	1996 (real execution) GDP - RB 2256 bn	1997 (real execution) GDP - Rb 2675 bn	1998 (draft submitted on 25.08.97) GDP - Rb 2750 bn	1998 adopted in 1 reading 05.12.97 GDP - Rb 2840 bn	1998 adopted in 2 reading on 25.12.97 GDP - Rb 2840 bn	1998 adopted in 3 reading on 05.02.98 GDP - Rb 2840 bn	1998 adopted in 4 reading on 04.03.98 GDP - Rb 2840 bn
<b>TOTAL EXPENDITURE</b>	12,6%	12,07%	12,37%	12,94%		12,94%	12,94%
<i>including:</i>							
<b>I. TAX REVENUES</b>	9,7%	9,10%	10,52%	10,81%		10,81%	10,81%
<i>including:</i>							
1. Corporate income (profit) tax	1,4%	1,24%	1,04%	1,70%		1,70%	1,70%
2. Tax on capital gains	0,00%	0,00%	0,36%	0,00%		0,00%	0,00%
3. VAT	3,7%	4,38%	5,38%	4,97%		4,97%	4,97%
4. Excises	2,0%	1,88%	2,40%	2,77%		2,77%	2,77%

	1996 (real execution GDP - Rb 2256 bn	1997 (real execution) GDP - Rb 2675 bn	1998 (draft submitted on 25.08.97) GDP - Rb 2750 bn	1998 adopted in 1 reading 05.12.97 GDP - Rb 2840 bn	1998 adopted in 2 reading on 25.12.97 GDP - Rb 2840 bn	1998 adopted in 3 reading on 05.02.98 GDP - Rb 2840 bn	1998 adopted in a 4 reading on 04.03.98 GDP - Rb 2840 bn
5. Payments for the use of natural resources	0,2%	0,26%	0,28%	0,30%		0,30%	0,30%
6. Taxes on foreign trade and foreign economic activity	1,0%	1,04%	0,98%	0,95%		0,95%	0,95%
<b>II. NON-TAX REVENUES</b>	<b>1,9%</b>	<b>1,56%</b>	<b>0,94%</b>	<b>1,00%</b>		<b>1,00%</b>	<b>1,00%</b>
<i>including:</i>							
1. Earnings from public property or from public activity	0,2%	0,25%	0,16%	0,19%		0,19%	0,19%
2. Earnings from the sale of public property	0,04%	0,70%	0,22%	0,29%		0,29%	0,29%
3. Revenue from the foreign economic activities	0,7%	0,32%	0,29%	0,24%		0,24%	0,24%
<b>III. REVENUE OF TARGET BUDGETARY FUNDS</b>	<b>1,0%</b>	<b>1,43%</b>	<b>0,90%</b>	<b>1,13%</b>		<b>1,13%</b>	<b>1,13%</b>
<b>TOTAL EXPENDITURE</b>	<b>15,8%</b>	<b>15,30%</b>	<b>17,17%</b>	<b>17,60%</b>	<b>17,60%</b>	<b>17,60%</b>	<b>17,60%</b>
<i>including:</i>							
I. State administration and local self-government	0,2%	0,36%	0,41%		0,39%	0,40%	0,42%
II. International activity	1,2%	0,31%	0,77%		0,51%	0,51%	0,51%
III. National defence	2,8%	2,98%	2,97%		2,88%	2,88%	2,88%
IV. Low enforcement activities	1,3%	1,63%	1,58%		1,47%	1,47%	1,47%
V. Fundamental research	0,3%	0,36%	0,49%		0,50%	0,39%	0,39%
VI. National economy, of which:	1,84%	1,96%	1,58%		1,85%	1,85%	1,85%
- industry, energy and construction	1,16%	0,99%	0,89%		0,97%	0,97%	0,97%
- agriculture	0,38%	0,45%	0,24%		0,42%	0,42%	0,42%
VII. Social services , of which:	1,22%	1,81%	2,43%		2,37%	2,37%	2,37%
- education	0,50%	0,54%	0,59%		0,61%	0,61%	0,61%
- culture and arts	0,04%	0,04%	0,12%		0,13%	0,13%	0,13%
- health care and physical culture	0,19%	0,33%	0,31%		0,33%	0,33%	0,33%
- social security policy	1,2%	0,85%	1,35%		1,24%	1,23%	1,23%
VIII. State debt service	2,0%	1,55%	4,38%		4,37%	4,37%	4,37%
IX. Replenishment of the state inventories and resources	0,4%	0,36%	0,24%		0,24%	0,24%	0,24%
X. Financial assistance to the budgets of other levels	2,1%	1,87%	1,40%		1,84%	1,82%	1,82%
XI. Targeted budgetary funds	0,7%	1,09%	0,90%		1,13%	1,13%	1,13%
<b>DEFICIT</b>	<b>-3,29%</b>	<b>-3,23%</b>	<b>-4,80%</b>	<b>-4,66%</b>	<b>-4,66%</b>	<b>-4,66%</b>	<b>-4,66%</b>

Some changes into the draft budget the government introduced before its second reading on 25 December taking into account the situation on the financial markets formed by the November financial crisis. As a result of GKO yield growth, expenditure on the domestic debt service was increased by Rb 7 bn which, to certain extent, was offset by the expenditure on the foreign debt service--by Rb 3.6 bn, of which on tied foreign credits--by Rb 3.3 bn, and on contributions to the international organisations-- by Rb 0.3 bn.

As table 11 well shows, as a result of all amendments, the draft 1998 budget undertook some transformations. Submitted for review by the State Duma on 25 August 1997, the draft budget foresaw the volume of GDP of Rb 2,750 bn. Compared with the first variant, the draft budget approved in the second reading envisaged the volume of GDP of Rb 2,840 bn. Budget revenues are being planned at the level of 12.94 per cent of GDP which is by 0.6 per cent more than in the first variant. Expenditures were increased by 0.43 per cent which allowed to somewhat reduce the forecast level of the budget deficit. Main changes in the revenue side of the budget are related to a revenue increase from income tax by 0.7 per cent of GDP and somewhat increase in the volume of excises and payments for the use of natural resources as a result of the amendments introduced into the tax legislation. On the other side, the revenue part of the budget was reduced by an amount planned according to the Tax Code of the tax on capital gains (0.36 per cent). Moreover, planned proceeds from VAT were reduced by 0.59 per cent of GDP.

Among major changes in the expenditure part of the draft budget which were adopted during the second reading in the State Duma should be noted an increase of expenditures on the national economy by 0.27 per cent of GDP at the expense of increasing expenditure on agriculture by twofold and financial assistance to the budgets of different levels--by 0.4 per cent of GDP and expenditures on the targeted budgetary funds by 0.23 per cent of GDP. Simultaneously expenditures on the international activities were cut by 0.26 per cent, on the social security policy--by 0.1 per cent of GDP.

After the adoption of the draft budget in the third reading on 5 February 1998, some of its expenditure items were amended. In particular, expenditure on state administration and fundamental research and assistance to scientific and technical progress were reduced by 0.13 per cent of GDP and 0.1 per cent of

GDP correspondingly. On the whole, comparing the draft 1998 budget adopted in the third reading with the execution of 1996 and 1997 budgets, one can note planned growth of budget revenues at the expense of the growth of budget tax revenues (by more than 1.5 per cent of GDP compared with 1997) which is being somewhat levelled by a decline in the non-tax earnings at the expense of a reduction in proceeds from public property by 0.06 per cent of GDP, proceeds from the sale of the public property--by 0.41 per cent of GDP. An increase in budgeted expenditures and deficit are being planned (about 2.3 per cent of GDP and 1.43 per cent of GDP correspondingly compared with 1997). Among the expenditure items, the biggest expenditure growth compared with 1997 is being planned on the international activity--by 0.2 per cent of GDP, science--0.14 per cent of GDP, social services--by 0.56 per cent of GDP mostly at the expense of the growth of allocations on culture (0.13 per cent of GDP compared with 0.04 per cent of GDP in 1997). It is worth noting that according to the budget law enacted by the State Duma in the fourth reading, the government is allowed to cut proportionately the budget expenditures and direct saved funds (not more than Rb 18 bn) to financing the state debt service in case the actual sum allocated for that purpose overshoots the sum fixed in the budget law. An important aspect of the budget law enacted in the fourth reading is the right of the government to carry out proportional sequestration of the expenditure items in case of revenue shortfall each quarter but not more than by 5 per cent of the planned expenditures. It is worth noting that the government proposal to reduce expenditures by Rb 28 bn in some way looked better compared with the right for the expenditure sequestration. The reason is the fact that the recipients of the budget funds will in their majority be guided by the targets of the budget expenditures which can result in a chain growth of non-payments in the economy as a result of overestimated expectations.

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**Fiscal federalism.** While drafting and adopting the 1998 federal budget, steps were taken to reform the distribution of the financial assistance to the budgets of the Federation subjects out of the federal budget by way of transfers from the Fund for the financial assistance to the regions (FFPR). The volume of the FFPR was reduced from 15 per cent in 1996-97 down to 14 per cent of the federal budget tax revenues except customs duties. Attempts directed at the improvement of the system of interbudgetary relations were aimed at providing a more conditioned character (possibility to adjust the amount of transfer in case of a failure to enforce the federal standards while reforming the housing sector), a more targeted one (introduction of a special transfer in the amount of 3 per cent of the federal budget tax revenues accrued to the territorial funds of the Compulsory medical insurance through the territorial Treasury agencies) as well as a reduction in the number of recipient regions (by way of an additional reducing ratio using the rate of allowed overshoot of budgeted expenditure of a subject of the Federation over its revenues to the tune of 10 per cent).

On September 10, 1997, the State Duma enacted the Federal Law No. 126 FZ "On Financial Basis For the Local Self-government in the Russian Federation" which was signed into law by the President on September 25. That law permanently assigns a number of regional and federal taxes for municipalities. Before the adoption of that law there was no single legislative act regulating financial relations between regional and local budgets in the area of sharing the regional and federal tax revenues. For example, the Law "On the basis of the budgetary rights and rights to form and use extra-budgetary funds of legislative and executive branches of power of the republics which comprise the Russian Federation, autonomous *oblast*, autonomous *okrugs*, *krais*, Cities of Moscow and St. Petersburg and Bodies of Local Self-government" provided the payment rates from the income tax and the property tax for enterprises. The

Law "On the financial basis for the local self-government" provided minimum fixed payment rates to the municipal budgets on the following federal and local taxes: profit tax, personal income tax, value added tax on goods and services produced on the territory of the Russian Federation, property tax on enterprises, correspondingly in the amount of 5 per cent, 50 per cent, 10 per cent, and 50 per cent from the share of a subject of the Federation on average for a subject; on excise taxes on liquor, vodka and alcohol beverages--5 per cent and on the remaining goods--10 per cent of the share of a subject of the Federation on average for a subject.

However new rate will not significantly influence the volume of revenues of the local budgets. Our estimates show that a bigger share of the corresponding tax receipts compared with the share provided by law remained in the vast majority of municipalities during 1996-1997.

The adopted law envisages the formation of the Fund for financial assistance to the municipalities on the regional level. The main purpose of the Fund consists in creating possibilities for a more objective sharing of financial assistance from the budgets of the Federation subjects. The disbursement of funds from the Fund can be carried out by using the single for all municipalities of the RF subjects criteria. That way, preconditions are created in order that the non-targeted financial assistance to the local governments is shared between the local budgets on the basis of "transparent" approach and was available for forecasting and supervision of the legislative bodies and the electorate.

### **Forecast of the federal budget revenues**

While drafting the forecast for the 1998 budget revenues, we considered two scenarios for the economic development. According to the first scenario, the real GDP will drop by 1 per cent and the price growth will come to 5 per cent; according to the second



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scenario the growth of GDP next year will amount to 3 per cent, and the price growth will constitute 10 per cent.

Under those circumstances and assuming that the monthly seasonal movement through time of the real GDP remains in 1998 at its 1997 level, we have obtained two GDP volumes which correspond to two scenarios of economic development. One constitutes Rb 2,850 bn on the assumption for the real GDP growth and second constitutes Rb 2,750 bn on the assumption of the real GDP decline in 1998. While forecasting a possible level of tax withdrawals for 1998, we assumed that the 1998 level will remain at its 1997 level which constituted 9.1 per cent of GDP. Under such premises, tax revenues will constitute Rb 259.3 bn (GDP--Rb 2,850 bn) and Rb 252.6 bn (GDP--Rb 2,780 bn). In 1997 the growth of the shortfall constituted 1.23 per cent of GDP. If the growth of the shortfalls of tax receipts remained at its 1996 level, then in these circumstances the tax revenue level would constitute 10.33 per cent. Under such level of tax withdrawals, the taxes in 1998 can constitute the sum of Rb 294.3 bn and Rb 286.8 bn correspondingly under the growth of the real GDP and under its decline by 1 per cent.

One more feasible scenario is linked with the adjustment to assigned in the draft budget level of tax receipts which is due to the fact that the revenues from some of the draft laws have been assigned to the revenue part of the budget have not been signed by the president. Given adjustments can result in the tax receipts cut by Rb 11 bn. Moreover, we took into consideration a possible reduction in the volume of tax receipts due to the government's failure to obtain additionally Rb 5 bn at the expense of so far unsubstantiated measures aimed at the restructuring enterprises' arrears to the budget. At the same time, tax revenues can come up to Rb 293 bn (GDP growth Rb 2,850 bn) and Rb 284 bn (GDP decline).

In both scenarios the volume of collected taxes will be below the budget target (Rb 307 bn). In the first scenario, the shortfall will constitute Rb 14 bn and in the second--Rb 23 bn. Taking into account the fact that the government has the right to

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carry out proportional sequestration to the tune of not more than 5 per cent of the quarter target, the result of the two mentioned scenarios for tax collection can be different. Parting from the precondition that the rest of the budget revenues will be collected in full, in the first scenario (tax revenues equal Rb 293 bn) when the difference from the plan will constitute Rb 14 bn which is less than 5 per cent of the planned target, the government can use its right and carry out proportional sequestration of expenditures. In the second scenario (tax revenues equal Rb 284 bn), the difference will come up to about 8 per cent of the plan which will require government's submission to the Parliament a draft law on implementation of a larger sequestration of expenditures. It is worth noting that the aforementioned cause of events did not take into account seasonal factor in tax collection which can significantly tell on the need to require sequestration of expenditures.

Hence, the situation with the execution of the revenue part of the budget will to a large extent depend on the tightness and consistency of the government policy aimed at the improvement of tax collection.

# Part 3

## Real sector of economy

### 3.1 Main trends of production development

Production of GDP. In 1997, the Russian economy has seen the U-turn from the economic slump to the stabilisation and, even, a certain growth of the gross domestic product; the production growth began in the industry and agriculture; the decline in the transport reduced significantly. These processes were mainly conditioned by the remonetisation of the economy, the stable slowdown of the inflation rates at the stable exchange rate policy, the growth of the domestic production and consumer demand, and the revival of the business activity in the real sector.

With the restoration of the economic growth, the positive changes in the dynamic of the social parameters are seen. The number of the officially registered unemployed reduced from 2.5 to 2.0 million persons. The efficiency of the use of the labour force in production grew; in particular, the incomplete employment reduced. The estimated incomplete employment at large and medium enterprises (due to the shortened labour week and forced vacations at the initiative of the administration) are, in the conventional number reduced to

the full labour time, 1.3 million persons in January to November 1997, and 1.9 million persons in January to November 1996.

As the labour payment and social liability debts are covered, the changes of the structure of the population's expenditures and the growth of the effective demand are seen. This favours the activation of the trade and service suppliers.

*Table 12.*

**Dynamic of the main macro-economic indexes  
(per cent of the relevant period of the preceding year)**

	I quarter of 1997	II quarter of 1997	III quarter of 1997	IV quarter of 1997	1997 in percent of 1996
Gross domestic product	100.3	99.4	101.0	100.8	100.4
Industry:	100.7	100.9	102.9	103.4	101.9
raw materials	103.0	101.6	102.1	103.1	103.0
manufacturing	99.9	100.3	102.6	101.6	101.8
consumer goods	98.4	98.1	106.4	105.4	102.1
Rural economy	94.1	95.7	100.9	98.6	100.1
Investments	91.2	91.7	97.1	101.3	94.5
Cargo turnover of transport entities	98.7	95.0	94.1	96.7	96.4
Commodities turnover	101.0	101.0	100.7	106.6	101.4
Paid services	101.1	102.5	103.7	107.3	103.7
External economic turnover	99.4	94.9	104.1	107.3	102.4
Export	102.4	92.5	97.1	98.0	98.0
Import	95.4	98.1	113.8	122.4	108.6
Balance	125	92.3	72.4	58.8	69.5
Real incomes in money	103.7	105.7	99.0	103.3	103.5
Unemployed, officially registered	99.5	90.4	99.1	81.6	79.4
Prices index:*					
consumer:	105.4	103.0	100.5	101.8	111.0
food	106.0	103.3	98.6	101.1	109.1
non-food	102.4	101.6	101.8	102.2	108.1
paid services to population	108.7	104.6	104.6	103.1	122.5
industrial:					
finished product	104.1	102.1	100.6	100.3	107.4
purchased resources	104.8	101.1	100.6	100.5	106.8
capital construction	101.2	101.2	101.9	100.6	105.0
cargo transport	98.3	102.1	100.1	100.3	100.9
communication services	102.4	100.9	100.4	100.5	104.2
Official exchange rate of US dollar*	103.1	101.0	101.3	101.6	107.6

\* price indexes to the preceding quarter.

This year, the inflation rate reached its minimum of the latest years and has become acceptable for the economy functioning in the economy growth

mode. The dynamic of the prices has been forming under the influence of the strict crediting limitations and the measures improving the efficiency of the governmental control of the prices and tariffs of the natural monopolies. The lower prices growth rates in the production sector from the growth rates of the consumer prices has also helped the visible reduction of the inflation expectations. The trend to the inflation lowering is seen in practically all the sectors or the national economy and is accompanied with a revivification of the economic activity.

As the proportions of the national economy are changing, the structure of production of the gross domestic product shows the trend to a stable growth of the share of services: from 48.3 per cent to 49.4 per cent. The share of production in the structure of the gross domestic product has reduced, during the same period, by 3.0 per cent.

Table 13

**Structure of formation of the gross domestic product  
(per cent of result)**

	1995	1996	1997*
Gross domestic product	100.0	100.0	100.0
incl.:			
Production of goods	43.5	42.8	39.8
of them:			
industry	28.8	25.2	26.8
rural economy	6.4	8.0	4.7
construction	7.6	7.2	6.2
Production of services	44.4	48.3	49.4
of them:			
transport	8.7	10.9	12.3
communications	1.2	1.6	2.0
trade	16.8	21.4	23.6
Net taxes on products and import	12.1	8.9	10.8

\* calculated by authors based on the data of the Goskomstat of Russia.

Source: Goskomstat of Russia.

In 1997, compared with December 1996, the consumer prices grew by 11 per cent (twice less than in 1996) with the producers prices growth by 7.4 per cent. The growth of the prices of the paid services to the population was 22.5

per cent from the beginning of the year; the growth rate was twice higher than for the consumer prices. One of the causes of such ratio of the prices and tariffs in the consumer market was the further reduction of the subsidies on the communal and other services.

The faster growth of the service tariffs compared with the prices of the consumer and capital goods and the structural shifts in the real sector of economy have determined the trends to the change of the GDP formation structure.

*Table 14*

**Dynamic of production by industries, 1997  
(per cent of the same period of the preceding year)**

Industries	1st quarter	1st half-year	January-September	January-October	January-November	January-December
electric energy	94.0	95.2	96.4	96.5	97.3	97.9
fuel	99.4	99.1	99.8	100.0	100.2	100.3
ferrous metallurgy	99.5	99.2	100.7	101.3	101.2	101.2
non-ferrous metallurgy	106	102.3	102.9	103.8	104.6	105.0
chemical and petrochemical	100.1	100.7	101.6	101.9	102.2	102.0
mechanical engineering	101.0	101.9	103.2	103.0	103.1	103.5
forestry, wood, and cellulose-paper	89.0	98.7	101.2	101.0	101.1	101.2
production of construction materials	89.0	92.9	94.5	95.0	95.5	96.0
light	94.0	95.0	95.9	96.5	97.2	96.1
food	92.0	95.1	98.3	98.3	98.5	97.6
microbiological	102.0	101.2	102.2	102.4	104.4	99.2
medical	105.0	108.6	114.1	115.1	115.5	115.1
polygraphy	102.0	102.9	103.7	13.9	105.0	107.1

Source: Goskomstat of Russia

The 1997 GDP was Rb 2,675 trillion in the real expression; it grew by 0.4 per cent in comparison with 1996. Of course, the positive effect on the macro-economic situation came from the production growth at the large and medium size industrial enterprises. The year saw a gradual growth of the industrial production growth rates; it whole, during the year, it was 1.9 per cent. In 1997, for the first time during the last five years, the growth of the value-added in the industry was observed. This has led to the growth of the share value-added of the industry in the GDP formation structure.

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The trend to the stabilisation of the production and restoration of the positive dynamic was observed in practically all the industries, especially in the second half-year. This confirms the principle of dependence of the revival of the business activity and restoration of production on the desinflation and the growth of the economy monetisation level.

In 1997, the production growth in the raw materials industries was 3 per cent. The raw materials export remains one of the main factors of the support of the business activity, though its growth rates reduced for the first time in the latest years. The improvement of the domestic market situation in 1997 had a compensating effect on the raw materials industry positions.

The gradual overcoming of the recession in the manufacturing sector was a structure-forming factor in 1997; beginning from the second quarter of 1997, it has been showing a revival of the economic activity. The in-kind manufacture of the inter-sector and general industrial purpose grew in the non-ferrous metallurgy, chemistry, and mechanical engineering.

In the manufacturing industries, the dynamic and structure of manufacture of the products is completely determined by the level of demand in the domestic market. For the first time from the beginning of the reforms, the last year showed the production growth in the mechanical engineering. After a long-term recession in the automobile industry, in 1997, the production increment made 12.5 per cent at 8.0 per cent for the trucks, 13.5 per cent for the passenger cars, and 21.6 per cent for the buses. This stimulated the growth in the associated industries: the ferrous metallurgy (the manufacture of the rolled steel grew by 8.3 per cent) and the manufacture of the tires (by 11.6 per cent).

By the measure or restructuring and development of the assembly facilities using imported components, in 1997, the production growths were observed in the instrument making (by 5.8 per cent) and in the communications

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facilities manufacture (by 23.2 per cent). The medical and microbiological industries are getting out of the crisis situation.

With the reduction of the inflation rates and the gradual adaptation of the enterprises to the market economy conditions, since the end of the last year, the trend showed itself of the reduction of the gap between the production rates in the consumer goods sector and the dynamics of the capital goods manufacture in the industry in whole. The recession rates in the consumer goods production have been reducing progressively. In this very field, the significant changes of the institutional and production structures take place; the mobilisation of the private, including foreign, investors expands.

The statistical data on the stabilisation and the transition to the industrial production growth in 1997 and on the role of the domestic demand in this are confirmed by the results of the conjuncture polls of the managers of industrial enterprises (see Appendix II).

The structural shifts in the economy take place on the background of the growth of the share in the DGP of the infrastructure: transport; communications; trade; financial, crediting, and insurance services; and operations with the real estate. The dynamics of the transport and communications correspond to the changes of the production rates in the national economy. In 1997, the reduction of the gap between the rates of the cargo turnover and of the GDP was observed. In 1997, the mass of the communications services grew by 8.9 per cent, compared with the preceding year, and came to Rb 51 trillion. The shares of the transport and communications in the GDP structure are constantly growing. This is supported by the redistribution of the investment flows to this sphere of activity; however, the insufficient level of development of the infrastructure hampers the processes of the market transformations in Russia and the Russia's ingression in the system of the world economic relations.



As the economic situation is stabilising, the saturation of the wholesale and consumer markets is steadily improving; the network of the shops, trade areas is expanding; and the trade stocks are stabilising. In 1997, the goods turnover in the retail trade grew by 1.4 per cent, compared with the relevant period of the preceding year.

The growth of the share of services in the GDP is accompanied by changes of the proportions in offering the market and non-market services. The revivification in the paid services market is accompanied by the formation of a perfect competitive environment in this sphere of activities. The mass of the paid services to the population is formed, by 34.1 per cent, by the services offered by the individual private contractors; by 24.6 per cent, by the non-governmental sphere organisations; and by 41.3 per cent, by the governmental sector organisations. Among the services, the sale of the services in the spheres of the paid education, medicine, passenger transport, services of the financial and crediting institutions, and the legal services is growing the most rapidly.

*Table 15.*

**Structure of formation of GDP by incomes (per cent of balance)**

	1995	1996	1997*
Gross domestic product, total	100	100	100
including:			
labour payment of workhands	43.4	45.9	49.0
net taxes on production and import	11.4	12.6	9.5
gross profit, including the net entrepreneurial income	45.2	41.5	41.5

\* calculated by authors based on the data of the Goskomstat of Russia.

Source: Goskomstat of Russia.

**Formation of GDP by incomes.** The difficult financial situations of enterprises, the high level of non-payments in the economy, and the indebtednesses in the wages payment had negatively affected the formation of the incomes in the GDP. From 1996, a significant lag is seen between the indexes determined on the basis of the charges and the estimates of the real money flows in the economy.

The share of the labour payment of the workhands (charged) increased from 45.9 per cent in 1996 to 49.0 per cent in 1997. After the tax on the sum of the labour payment excess over the norm was abolished on 1 January 1997, the growth of the labour payment was observed.

Table 16

### Production profitability by sectors of industry

	Share of unprofitable enterprises, per cent of the total in the industry		Profitability of the sold product, per cent	
	1996	1997	1996	1997*
<b>Industry, total</b>	42.0	47.5	9.1	10.1
incl.:				
electric energy	23.9	28.4	15.9	17.3
fuel	44.8	49.7	11.6	14.5
ferrous metallurgy	30.6	42.5	3.7	3.0
non-ferrous metallurgy	66.1	63.9	13.1	13.3
chemical	39.0	44.4	4.1	4.0
petrochemical				
mechanical engineering	40.2	44.6	11.9	9.7
forestry, wood, and cellulose-paper	61.7	70.4	1.1	-6.9
production of construction materials	46.5	54.4	4.3	-1.7
light	55.6	60.3	-1.1	-2.9
food	34.2	41.3	5.8	7.4
Rural economy			-8.9	-17.4
Transport	59.0	59.4	2.9	8.1
Communications			25.3	25.5
Public utilities			-9.8	-11.9

\* pre-estimates for January-September 1997

Source: Goskomstat of Russia.

With the increase of the business activity, the real mass of the profit of the large and medium size enterprises is growing. In 1997, the total profit for all the sectors of activities stabilised at the 1996 level. However, the number of the unprofitable enterprises continued growing.

The changes of the production structure distribution by sectors bolster the differentiation of the industries by the financial-economic parameters (the profitability in the industry, transport, and communications is growing, while in the rural economy it is reducing).

The production profitability in the high material consumption sectors is the most influenced by the ratio of the dynamic of the finished product prices to the purchase prices of the resources. In the sectors with high labour consumption, the reduction of the profitability level has been toughening under the effect of the labour payment share in the aggregate expenditures.

**Use of gross domestic product.** The main factor influencing the dynamic and structure of the use of the gross domestic product in 1997 was the gradual growth of the effective domestic demand in the consumer market.

Table 17

**Structure of end use of gross domestic product  
(per cent of the balance)**

	1995	1996	1997*
Gross domestic product, total	100.0	100.0	100.0
incl.:			
expenditures on end consumption:	71.1	72.3	73.9
incl. Households	49.2	48.6	49.9
gross accumulation	24.7	23.9	23.0
net export of goods and services	4.2	3.8	3.1

\* calculated by authors based on the data of the Goskomstat of Russia.

Source: Goskomstat of Russia.

In 1997, the real effective incomes of the population grew by 3.5 per cent; the real charged labour payment per worker grew by 4.3 per cent.

The share of the expenditures on the consumption of households grew by 1.3 points. From the second half of the year, the structure of the consumption has been showing a stable growth of the purchases of the non-food goods, while the expenditures on the food have been decreasing. The share of the non-food goods in the total goods turnover, decreased from 52 per cent in the first quarter of 1997 to 49.7 per cent in the third quarter of 1997, began growing in August: in the fourth quarter it amounted to 51.7 per cent. The growth of the share of the expenditures of the population on the purchase of goods and services is connected with the traditional seasonal increase of the demand; for the other hand, it was initiated by the subjective fear of the coming money denomination.

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In 1997, the consumer market stayed stable and was characterised by the high level of saturation in the commodities and provision with the commodity resources.

In 1997, for the first time in the five years, the physical amount of the paid services to the population grew. In the structure of the paid services to the population, the three kind of services dominate; their share exceeds two thirds of all the services consumed by the Russian population. These are the public utilities, passenger transport, and paid health protection.

In 1997, the dynamic of the social parameters was not stable: during the year, the high level of the accumulated labour payment debt of the state and enterprises remained.

The changes in the structure of the expenditures of the population are accompanied by the lowering of the share of the savings in deposits and securities. This shows the reduction of the investment potential of the population. Despite the lowering of the purchase capacity of the US dollar in the Russian market, it remains highly attractive as a mean of saving. The structure of the savings of the population is oriented to the growing purchase of the foreign currency, hence, supporting, in a certain extent, the reduction of the inflation.

With the animation, in 1997, of the economic activity, the reduction of the accumulation of the material circulating assets in the GDP has been observed. As the inflation rates are reducing, the shares of both the material-technical resources stocks and the remainders of the unsold products are reducing, as well. This has a stabilising effect on the economy in whole. In the middle of 1997, a certain exceed of the shipment of the end product in comparison with the production dynamic was observed. From the second quarter-year, the share of the paid for product in the aggregate sale volume was

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steadily increasing. However, after the aggravation of the payment crisis in the fourth quarter of 1997, the stocks of the unsold products grew, as well.

In 1997, the share of investments in the fixed assets was 15.3 per cent of the GDP. The volume of the new investments in the fixed assets reduced by 5.5 per cent compared with 1996 (mainly, in the first half-year). One of the causes of the reduction of the investing activity in the first half of 1997 was the reduction of the financing of the governmental investment expenditures and construction programs due to the lack of the circulating assets.

As for the structure of the gross national accumulation, the share of the net accumulation continued reducing. In this situation, it is especially important to determine the priorities and strategies of the reproduction of the fixed assets, taking into account the current restructuring at all the levels of economy.

### **3.2 Investments in the real sector of economy**

**General characteristic of the investment activities.** The 1997's trends of development of the Russian economy were of a contradictory character. Despite the formation of the objective conditions for the improvement of the investment activities, in particular, the low inflation, and reduction of the income on the governmental securities, the investments continued reducing. This is due to the insufficient encouragement for the investing activities in various groups of the economic agents; the limited availability of the finances; the absence of the efficient mechanisms of transformation of the population's savings into investments; and the remaining high investing risks. The negative effect on the dynamic of the investments also came from the absence of progress in the taxation reform; the low level of the market of the corporate securities; and the reduction of the institutional activities in the capitals market.

In 1997, under the sharpening crisis of the Budget system and the implementation of the strict financial and crediting policy, and despite the expansion of the tax privileges for stimulating the investments in the fixed assets, the recession in the business activity could not be delayed.

Table 18

**Dynamic of investments in fixed assets in 1997  
(compared with the relevant period of the preceding year)**

	1st quarter	2nd quarter	3rd quarter	4th quarter	1997
Investments in fixed assets	91.2	91.7	97.8	101.3	95.0
incl. by projects:					
production purpose	98.1	96.0	102.8	99.8	98.9
non-production purpose	80.3	85.0	89.6	99.5	88.5
Putting into operation dwelling homes	89.6	80.3	110.4	98.1	95.0

Source: Goskomstat of Russia

The share of the investments in the fixed assets in the GDP reduced to 15.3 per cent against the 16.3 per cent in 1996. At the 1997's stabilisation of the economic situation, the remaining recession in the investment sphere means the low perceptivity by the subjects of the financial and real sectors to the changes of the conjunction. However, in the latest time, the polls of the construction entities have shown the trend to their more flexible reaction (see Appendix III).

The investment climate is also negatively affected by the unavailability of a reliable information on the production and financial activities of entities; the obstruction to the participation of the investors in the entities management; and the complicated and contradictory normative and legal base. Unfortunately, the national banking system has turned out unprepared for the accumulation of the assets for the long-term crediting of the real sector.

**Structure of financing of investments.** As of today, the non-governmental sector of the economy consumes over 4/5 of the aggregate investments in the national economy.

Table 19

**Structure of investments in fixed assets by forms of property  
(per cent of the balance)**

	1993	1994	1995	1996	1997
Investments, total	100.0	100.0	100.0	100.0	100.0
incl. by forms of property:					
State	51	32	31	24	21
municipal	12	8	6	5	5
private	12	18	14	19	22
mixed Russian	23	40	46	49	49
mixed with Russian and foreign participation	2	2	3	3	3

Source: Goskomstat of Russia

Table 20

**Investments in fixed assets by sources of financing  
(per cent of the balance)**

	1992	1993	1994	1995	1996	1997
<b>Investments, total</b>	100,0	100,0	100,0	100,0	100,0	100,0
of them financed from:						
<b>budget assets</b>	26,9	34,3	26,0	21,8	20,1	19,2
incl.:						
Federal Budget	16,6	19,2	13,4	10,1	9,9	9,5
budgets of Federation subjects and local budgets	10,3	15,1	10,6	10,3	10,2	9,7
<b>out-budget assets</b>	73,1	65,7	74,0	78,2	79,9	80,8
incl.:						
own assets of organisations and enterprises	69,3	57,4	64,2	62,8	63,3	71,2
individual builders	0,9	2,6	2,3	2,5	3,2	4,2

Source: Goskomstat of Russia

In 1997, a characteristic trend was the change of the structure of the investments in the fixed assets by the sources of financing. The share of the out-budget finance in the structure of investments in the fixed assets reached 80 per cent in 1997 against the 65.7 per cent in 1993. Moreover, the stable increase of the share in the investments structure of the assets of joint ventures and individual builders. The share of the budget assets is reducing; here, the ratio of the Federal Budget to the budgets of the Federation subjects and local budgets is changing towards the growth of the share of the latter. While, in 1992, the aggregate share of the budgets of the Federation subjects and local budgets formed 38 per cent in the total financing of the investments from the consolidated budget, in 1997, this share exceeded 50 per cent.

The own assets of enterprises and organisations form over 70 per cent of the aggregate investments in the fixed assets and form the dominant source of financing. The production restructuring leads to the differentiation of entities by the financing parameters. The real assets of the entities used for investing are going down due to the difficult financial situations of most of them and the growth of the number of the unprofitable entities. The reduction of the production profitability conditions the reduced share of the profit in the investments financing sources. In 1997, the share of the profit in the aggregate investments was 17.9 per cent, while the share of the depreciation was 35.4 per cent.

The outlooks of activation of the investment activity had been associated with the implementation of the new investing policy, which envisioned the right of selection of the depreciation methods, their simplifying, and the depreciation norms combining by the entities themselves. However, despite the real necessity to restore the fixed assets reproduction process, the depreciation allotments are, yet, been used to replenish the own circulating assets and solve the current problems.

In most cases, enterprises do not have the enough available investment assets; moreover, they stay unable to mobilise enough borrowed funds. Though, in 1997, the refinancing rate decreased from 48 per cent (beginning of 1997) to 28 per cent, the credit interest rate increases, still, the average profitability of production; hence, the difficulties in using the borrowed assets.

After the change of the situation in the commodities and capitals markets, the absence of a promising investing strategy has become one of the main factors hindering the processes of the economy growth restoration and the production restructuring. The role of the managers of enterprises is limited, as a rule, to solving the production problems. The control of investments within the



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limits of the stereotyped notions of the plan system has become the factor hindering the processes of the economy restructuring and the capital market formation.

The low investing activity of 1997 was due to the State policy in the capitals market. The budget sphere crisis initiated the reduction of the expenditures on the governmental investments financing. Taking into account the situation of the low inflow of the incomes to the budget system and the necessity of the unconditional fulfilment of the governmental liabilities in ensuring the social guarantees to the population, the sequestering of the Federal Budget affected, first of all, the level of financing of the Federal Investment Program and the governmental investments.

The start-up Federal Investment Program was cut almost two-fold. Its implementation took Rb 14.5 trillion of the governmental investments; of them, the Federal goal-oriented Programs used Rb 6.7 trillion, and Rb 7.8 trillion for the development of certain sectors of industry and economy.

In such situation, the implementation of some socially important Federal Investment Programs had to be suspended. The goal-oriented Programs «Own Home» and the defence industry conversion were limited in financing; the tender-based investment projects were financed on a quite insignificant basis.

In order to ensure the financing of the 1997 Federal Budget expenditures and fulfil the liabilities of the receivers of the assets from the Federal Budget for the accomplished works, the Decree of the RF President of 14 September 1997, # 880, ordered the offsets of the debt of the Federal Budget for the governmental investments before the investors and of the debt of the investors for the liabilities to the Federal Budget. The maximal reduction of the overdue credit indebtedness in the capital construction financed from the Federal Budget and subject to transfer for the next year is the main condition in preparing the

starting conditions for the acceptance and implementation of the 1998 Federal goal-oriented Investment Program.

The principles of the investing policy for 1997 were aimed at invigorating the inflow to the economy of the money of the private investors, first of all, of the large national corporate capital. However, these plans failed. The unstable political situation, the support of the relatively high profitability of the financial operations, and the high risk of the long-term investments in the real sector determine the passive character of the investing activity of the private and joint stock capitals. In this connection, the implementation of the governmental guarantees to the investors seems extremely urgent.

**Structure of investments by spheres of activity.** In 1997, the share of the investments in production continued growing. In 1997, the construction, expansion, reconstruction, and re-equipment of production projects used Rb 263.5 trillion; this is 64.4per cent of the total, against the 61.7per cent in 1996. While the total investments reduced by 5per cent, compared with 1996, the investments in the production construction reduced by 1.1per cent. Moreover, the third quarter of 1997 showed their growth by 2.8per cent, compared with the third quarter of 1996 (see Tables 18 and 21).

*Table 21*

**Structure of investments by production and non-production purpose projects  
(per cent of balance)**

	1992	1993	1994	1995	1996	1997
Investments, total:	100.0	100.0	100.0	100.0	100.0	100.0
incl.:						
production purpose	65.5	60.1	56.0	58.9	61.7	64.4
non-production purpose	34.5	39.9	44.0	41.1	38.3	35.6

Source: Goskomstat of Russia

The growth of the investments in the production activities does not, in any event, mean the indicator of the changed attractiveness of this form of

activities: it is due to the deepening crisis in the social and civil, and, first of all, dwelling, construction

Table 22

**Putting into operation of dwelling homes, by forms of property  
(millions of square meters of aggregate surface)**

	1994	1995	1996	1997
Built, total	39.2	41.0	34.3	32.6
incl. by forms of property:				
governmental	10.0	9.1	5.9	4.6
municipal	4.3	4.0	2.9	2.8
private	11.8	14.8	14.6	15.9
mixed Russian	13.0	13.0	10.8	9.2

Source: Goskomstat of Russia

In 1997, the social sphere used Rb 145.3 trillion; this is by 11.9 per cent less than in 1006. Despite the general stabilisation of the macro-economic processes, the dwelling construction by the State-owned entities came to the crucially low amounts in 1997 (see Table 22).

The crisis in the dwelling homes construction in Russia must not be considered an unexpected event in the Russian economy. The trend to the lowering of the dwelling homes construction in the investments in the social-cultural construction has been observed during the latest five years. The share of the investments in the dwelling construction in the aggregate investments in the non-productive sphere reduced from the 62.2 per cent in 1992 to 53.3 per cent in 1996, and 50 per cent in 1997.

A stable enough trend to the enhancement of the construction of the private dwelling homes by the population remains operative. In 1992, the share of the dwelling homes put into operation and financed by the population was 12 per cent in the whole amount of the dwelling homes put into operation; meanwhile, the respective shares made 29.1 per cent for 1996, and 35.4 per cent for 1997. The share of the governmental property in the whole volume of the

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dwelling homes put into operation was 17 per cent in 1997 against the 70 per cent in 1992.

The low incomes of the main part of the population, the remaining high debt in the labour payment and social transfer liabilities, the low trust of the population in the banking and financial organisations reduce the motivation to the organised form savings. At a high enough inclination of the population to the savings, the population prefers the forms not allowing to use their saved assets for investments.

At the today's incomes and savings of the main part of the population, the main share of the potential consumers is unable to solve the problem of the dwelling conditions improvement. The possibilities of the demand revivification are limited by the unavailability of the well-developed long-term dwelling crediting or mortgage systems. In its turn, the mortgaging system evolution is hampered by the institutional and legal limitations. If they stay effective, the dwelling homes construction will never overcome its crisis.

The limited effective demand reduces the sales volume of the finished dwelling facilities. The financial situations of the construction organisations are worsening because of the growing expenses on the conservation and maintenance of the finished projects.

The continuing crisis of non-payments negatively affects the activity of the construction firms. In 1997, the profit of the construction organisations was Rb 10.6 trillion, or 76.2 per cent of the level of the preceding year. The number of the unprofitable construction organisations is growing. The sum of loss of the construction organisations was Rb 3.9 trillion, which is by 24.6 per cent higher than of the relevant period of the preceding year.

**Structure of investments by sectors and industries.** Of course, the intensification of the investment flows to the infrastructure, in particular,

transport and communications was a positive phenomenon for the Russian economy. During five years, the aggregate share of these sectors in the investment structure practically doubled.

Table 23

**Structure of investments in fixed assets by sectors  
(per cent of balance)**

	1992	1993	1994	1995	1996	1997
Investments in fixed assets, total	100.0	100.0	100.0	100.0	100.0	100.0
incl. by projects:						
Production purposes	65.5	60.1	56.0	58.9	61.7	63.0
incl.:						
industry	40.9	37.0	32.3	34.4	37.0	36.7
rural economy	10.8	7.9	5.0	3.5	3.3	2.5
transport	8.2	10.4	11.9	13.2	13.9	15.5
communications	0.6	0.6	0.9	1.4	1.9	2.5
construction	2.7	2.4	3.3	2.5	2.5	4.0
Non-production purposes	34.5	39.9	44.0	41.1	38.3	37.0
incl.:						
dwelling construction	21.7	23.1	23.7	22.8	20.7	18.5

Table 24

**Structure of investments in fixed assets by industries  
(per cent of balance)**

	1992	1993	1994	1995	1996	1997
Industry, total	100.0	100.0	100.0	100.0	100.0	100.0
incl.:						
electric energy	12.0	13.5	14.6	15.2	17.3	21.1
fuel	41.1	42.2	40.2	41.8	42.6	42.8
ferrous metallurgy	5.6	5.3	5.4	5.9	5.2	4.5
non-ferrous metallurgy	5.6	5.4	6.0	5.5	4.4	5.1
chemistry and petrochemistry	5.6	4.5	4.6	4.7	4.7	4.6
mechanical engineering and metal working	12.0	10.8	11.1	9.0	8.3	7.8
wood, timber, and cellulose-paper	3.9	2.4	3.2	3.6	2.7	2.1
production of construction materials	3.9	2.5	3.4	3.0	2.3	1.9
light	2.4	1.7	1.4	0.9	0.7	0.5
food	6.6	8.1	8.2	8.0	7.6	7.6

Source: Goskomstat of Russia

The material-technical base of the communications saw its further development. In 1997, the number of the main telephones in the common use network grew by 5.1 per cent. In accordance with the «Russian Popular Telephone» Program, 891,000 numbers of the automatic telephone stations were put into operation in January through October. The process of replacement of the obsolete switchboards by the state-of-the-art electronic ones is

accelerating. Due to the intense development of the radio-telephonic communications, the number of the network users grew 1.85-fold, including 1.97-fold for the users of the mobile cellular phones.

Table 25

**Structure of investments by regions of Russia  
(per cent of balance)**

	1992	1993	1994	1995	1996	1997*
Investments, total	100.0	100.0	100.0	100.0	100.0	100.0
of them by regions:						
North	5.5	4.4	4.4	4.5	3.9	3.3
North-West	3.6	3.2	4.0	4.2	4.6	4.0
Central	16.0	18.0	21.1	20.5	20.3	20.6
Volga-Viatka	4.3	4.8	3.6	3.5	3.5	3.3
Central-Chernozem	4.7	3.8	3.2	3.4	3.8	3.1
Volga	11.0	10.6	8.9	9.6	9.3	9.3
North Caucasus	7.1	7.0	6.5	9.3	7.4	6.1
Ural	15.2	13.7	12.4	13.3	14.2	12.3
West Siberia	24.0	21.1	17.7	19.8	21.1	21.2
East Siberia	3.6	5.9	5.6	6.0	6.5	4.8
Far East	7.3	6.9	6.1	5.2	5.1	4.6
Kaliningrad region			0.4	0.4	0.3	

\* 1997: data for January-September

Source: Goskomstat of Russia

In the investments in industry, the fuel-energy complex dominates. For a long enough time, their share in the structure of investments in the fixed assets of the industry has been at the level 40 per cent. The systematic growth of the share of the capital expenditures on reproduction of the fixed assets in the electric energy production is conditioned by the necessity to renew the active part of the fixed assets: their wear has reached 50 per cent.

In 1997, the trend of the recession of the investment activity remained in the mechanical engineering and consumption sectors. At the difficult financial situation, the enterprises made the minimal possible expenditures for the support of the fixed assets and mobilisation of the back-up facilities in production. The facilities utilisation coefficient grew in the enterprises of the metallurgy, chemistry, and mechanical engineering.

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**Regional aspects of investment activity.** The investment activity is quite different by regions. The analysis of the investment activity from the regional viewpoint shows that the Central and West-Siberian regions get, yet, up to 2/5 of the total investments in the fixed assets. However, the structure of the territorial distribution of the investment sees the gradual shift from the regions specialised in resources to the regions with high industrial-agrarian, consumption, intellectual, and informational potentials. The Sverdlovsk, Cheliabinsk, Samara, Saratov, and Primorski regions maintain their high investment attractiveness (see Table 25).

The investment activity in the territorial aspect is highly determined by the regional laws. For example, the Amur, Vladimir, Irkutsk, and Saratov regions, Tatarstan have promulgated the most comprehensive packages of the legislative acts governing the investment activity. They envision the tax privileges and vacations for the investors; the preferential credits; guarantees and protection for investors.

### **3.4 Agrarian-food complex**

In 1997, the main issue in the development of the agrarian-food complex was that, for the first time since 1992, the attempt to continue the agrarian reform was made. This time, at last, the activity was concentrated rather not on the reorganisation of the agricultural entities and land relationships, but on the transformation of the mechanism of the governmental agro-economic policy. Not all the governmental measures in the agrarian-food complex may be considered as unambiguously positive: the 1997 policy was very contradictory; however, its equiponderant is oriented on the reformation, not on the safeguard of the stagnation trend of the preceding four years.

Under the constant reduction of the budget transfers in the rural economy, the main tool of effecting the agrarian-food sector at the federal level is the macro-economic policy: monetary, fiscal, and trading. At the regional level, the agrarian-food control realised by the budget transfers is also somehow reducing; however, the methods of the fiscal and trade regulation are enhancing, but already at the regional levels. In the other words, the emerging positive changes in the agrarian-food sector result, rather, from the adaptation of the economic subjects after the social-economic stress than from a goal-oriented governmental agrarian-food policy.

Among the most crucial transformations, the change of the agrarian-food crediting mechanism should be mentioned, first of all. On the background of the stabilised conditions of exchange for the rural economy, the reduced profitability in the GKO's market resulted in the expansion of the bank crediting in the agrarian sector, strengthening of the market mechanisms. The recoverability of the bank loans began growing. Commercial banks showed a high interest in the agro-industrial complex. While, before, their interest had been conditioned exclusively by the exchange of the budgetary assets, they had been transferring to the rural economy, in 1997, this factor played a supporting role. For the other hand, the volumes of the institutional money were insignificant; for the other hands, already today, many financial structures operate their own assets in the agro-industrial complex. The growth of the GKO's profitability to the end of 1997 somehow changed the situation. Besides, the inadequate governmental policy in the agrarian finances resulted in the further worsening of the problem of debts of the agrarian producers, and, hence, the expansion of the barter operations.

Another positive moment of the past half-year was the attempt of the government to implement the contracts tenders for the governmental supplies of



the rural and food produce. For the moment being, this system is inefficient; however, the change of the governmental approach to the problem is, already, seriously changing the situations in the agrarian and food markets.

The growth of the real incomes of the population during the whole year, and the series of the protectionist measures in the external trade of the agrarian and food produce conditioned the growth of the produce turnover and production.

The emerging stabilisation of the Russian economy also influenced the agrarian-food sector. For the first time since 1991, the rural production did not reduce: it even grew a little (growth by 0.1 per cent against the decrease by 7-8 per cent in the preceding years). Among the important factors of stabilisation are the growth of the real incomes of the population and the favourable weather conditions.

Animal husbandry. In the second half of 1997, the rates of the livestock reduction became lower (see Table 29). The IET<sup>15</sup> conjuncture poll has shown that the share of the economies planning to reduce the livestock, swine, and poultry reduced sharply, compared with the end of 1996: at the end of 1996, 44 per cent of the respondents planned to reduce the livestock while at the end of 1997 this figure made only 43 per cent; the respective figures are 35 per cent and 24 per cent for the swine, and 17 per cent and 8 per cent for the poultry. The share of the economies wanting to increase the stock, in particular, swine, grew from 11 per cent in 1996 to 15 per cent in 1997.

*Table 29*

### **Livestock population in 1997**

	As of 1 January 1998, mn heads	Change in 1997, per cent	Change in 1996, per cent

<sup>15</sup> The polling is made every quarter-year. The panel is 800 rural entities. The return of the questionnaires is 25-30 per cent.

Cattle	31.7	90.4	90
Swine	17.3	90.5	86
Sheep and goats	19.3	84.8	84

Source: Information on social-economic situation in Russia. January-December 1997, p. 33.

*Table 30*

### **Production of main animal husbandry produces in 1997**

	1997, mn. t	1997, per cent of 1996	1996, per cent of 1995
Meat (cattle and poultry for slaughter, live weight)	7.7	90.0	92.0
Milk	34.1	95.1	91.3
Eggs, billion	31.9	99.9	94.3

Source: Information on social-economic situation in Russia. January-December 1997, p. 35.

The production of the milk and meat continued falling. However, positive changes were seen in the agriculture, the sector of the animal breeding the best capable for rapid restoration. For the first time during the latest years, the production of the eggs grew (see Table 30). In certain regions (Sverdlovsk, Omsk, Nizhni Novgorod, etc.) the growth in the production of the broilers was seen. In average, in Russia, a certain decrease of the percent of the murrain, a higher yield of the get, and a growth of the animals' productivity were seen.

It should be noted that the productivity and the gross milking of the dairy cows grow, almost exclusively, in the European part of Russia, while in Siberia and Far East the trend to the reduction stays. With this, the East-Siberian and Far East areas get the main shares of the milk (56per cent and 60per cent, respectively) from the private farms, while in the European Russia this index does not exceed 50per cent (except the 53per cent in the Caucasus). Probably, the low productivity of the animals in the East of Russia is purely statistical: the statistics of the private farms is, as a rule, worse, thus yielding the underestimates. Besides, when considering the livestock productivity statistics, one should take into account that the animal produce is the main source of the cash for the farms: this money does not come to the settlement accounts with cardfiles. The high debts of the rural economy to the budget provoke this

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activity in the whole country. Thus, the real yield of the animal produce is underestimated by the statistics.

*Plants growing.* In 1997, the total land under cultivation in all categories of economies reduced by 4 per cent, compared with 1996. The reduction of the land under crop itself does not reflect the real processes in the agrarian sector. However, taking into account the use of the chemicals in the agrarian sector, the reduction of the land under crop shows the beginning return of the agriculture to the intensive method, though at a small scale, yet.

The instability of the markets and agrarian policy of the State lead to the sharp structural reactions of the producers, in particular, the restructuring of the crops. The inefficiency of the governmental programs of support of the flax and soja growing has resulted in the sharp reduction (by 26 per cent and 20 per cent, respectively) of the land under these crops. The continuing displacement of the domestic sugar by the imported one or manufactured from imported feedstock incited the reduction of the land under the sugar beet (by 12 per cent) accompanied by the reducing yield of this crop.

A positive thing is the transition of certain southern regions of the European Russia from the almost single-crop system focused on the sunflower, a crop with a high export potential, to the wheat. The high efficiency of the grain production in these latest years and a certain decrease of the sunflower profitability show themselves in a certain displacement of the oil plants by the grain crops, especially the wheat. This diversifies the structure of the cultivated lands, thus favouring a higher productivity (for several years, the sunflower has been sown outside the crop rotation, with the reduction of the use of the mineral fertilisers, thus exhausting the land to the limit).

In the structure of the land under cultivation, the shares of the sunflower and fodder cultures reduced; the shares of the grain crops and vegetables increased; the share of the potatoes remained at the same level (see Table 31).

Table 31

### Dynamic and structure of land under crops in 1996-1997

	Land under crop			Structure, per cent of	
	1997 mn. Ha	1996 mn. ha	1997, per cent of 1996	1996	1997
Total land under crop	95.7	99.7	96	100	100
grain (without corn)	53.5	54.0	99	54.2	55.9
wheat	25.7	25.7	100	47.6	48.0
sugar beet	944	1072.7	88	1.1	1.0
soja	389	486.3	80	0.5	0.4
sunflower	3.6	4.0	90	4.0	3.8
flax	113	152.7	74	0.2	0.1
potatoes	3.3	3.4	98	3.4	3.4
vegetables, thous. ha	723	737.8	98	0.7	0.8
fodder crops	32.1	35.1	91.3	33.5	35.3

Source: Current information of Goskomstat of Russia

The main positive result of the last year was the good crop of the grain which made 88.5 million tons (see Table 32). This is almost by a quarter higher than in 1996 and even exceeds a little the level of 1991-1995. The crop of the food wheat was about 25-27 million tons, while the annual need in it is about 17 million tons. During these latest years, when the massive import of the fodder grain stopped, the import needs of Russia focused, mainly, on the food grain. The good crop of the food grain resulted in the marked reduction of the import of both the grain and flour. The 1997 crop of the fodder grain also exceeds the domestic needs. As a result, Russia is increasing the grain export.

Table 32

### Gross yield of main crops in 1997

	1997 mn. t	1997 per cent of	
		1996	1991-1995
Grain (weight after treatment)	88.5	127.6	100.6
Sugar beet	13.8	85.6	63.9
Sunflower	2.8	102.1	91.0
Potatoes	37.0	95.8	100.6
Vegetables	11.1	103.3	108.3

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Source: Development of agro-industrial complex and farms in RF, issue 2, Goskomstat of Russia, 1993, p. 85-88; Information on social-economic situation in Russia. January-December 1997, p. 30.31.

*Structure of agrarian production.* The reduction of the share of the rural farms in the animal produce production continues. The share of the stock on their balance in the whole number of cattle reduced, during the year, by 2.5 percentage points and is now 65 per cent; for the swine and sheep the figure is 3-6 percentage points (down to 58 per cent and 39 per cent, respectively).

The implementation of the Presidential Decree «On Realisation of Constitutional Rights of Citizens on Land» (of 17 May 1996) led to the growth of the average sizes of the private farms. While, during all the years of the agrarian sector reforms, an average farm had 42-43 ha, the last year, it was 48 ha for the whole country. In the Amur region and Tatarstan, the average size grew by 15-21 ha; 8 other regions saw the growth by 8-15 ha. In a significant degree this is due to the registration of the rights on the land plots. In many cases, the private farmers offer more profitable condition of the rent of the plots; hence, the redistribution of the land in their favour (the plots of the retired persons and workers of the rural social sphere).

#### **Financial situations of rural producers**

Of the Rb 16.1 trillion of the 1997 expenditures on the rural economy, Rb 9 trillion, or almost 56 per cent, were expended, as of 1 November 1997. This is one of the highest indexes of execution of the main items of the Federal Budget. In addition to the above sum, in the first half of 1997, the Ministry of finance gave the guarantees to the Agroprombank and Alpha-bank for Rb 2.8 trillion: this money was intended to credit the rural producers. Though late, this money came to the level of the entities. Besides, the rural economy was receiving the budget money from the other expenditure items (e.g., pesticides).

The delay of the Federal credits for the Spring works in the rural economy resulted in that, in the first half of 1997, the share of the territorial budgets in the financing of the agro-food complex reached 67.2 per cent, compared with the 45.5 per cent of the relevant period of 1996. However, to the end of 1997, the share of the regional budgets began reducing: it dropped by 2 percentage points in comparison with the preceding year.

The retail to wholesale, and to purchase animal product prices ratio stayed almost the same as in 1996 (the change stayed within the 5 per cent limit).

The correlation between the dynamics of the prices on the agrarian produce and on the industrial means of production also improved. In January-September 1996, the respective price indexes on the industrial means of production and animal product were 124 per cent and 106.3 per cent, respectively (1 : 1.17 ratio); in January-September 1997, the respective indexes were 107.6 per cent and 101.8 per cent (1 : 1.06).

All these create the potential for the normal functioning of the agro-food complex.

The results of the IET conjuncture poll for the third quarter of 1997 have shown the sufficiently positive shift in the 1997 financial situation of the rural producers, at least, in the main agrarian regions. The evaluations of the changes of the financial situations by the producers conflict with the stereotype of the crisis in the agrarian sector: 17 per cent of the respondent economies noted the improvement of their financial situation compared with the precedent year and 19 per cent think that the situation has remained the same. In 1996, only 16 per cent of the respondents thought that their situation had not worsened. In 1997, this figure made 36 per cent.

The high credit indebtedness remains the main financial problem of the agrarian sector; hence, the impossibility of the normal crediting. As of the

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beginning of November 1997, the aggregate stale indebtedness of the sector, including on credits and loans, reached almost Rb 61 trillion. Of this, the indebtedness to the budget and for the payment to the out-budget funds exceeded Rb 20 trillion. The late charges formed a significant share of the indebtedness to the budget.

The cardfile, the no-acceptance order of writing off the money from the settlement accounts, and the queue of the creditors in whose benefit the money is written off the accounts made it impossible for most entities to get a normal seasonal credit; this also resulted in large-scale barter and «grey» operations, mutual settlements.

In these conditions, the crediting mechanism offered by the Government instead of the commodity credit played a special role.

At the end of 1996, Agroprombank, the main governmental agent in distribution of the centralised credits to the agrarian sector, was sold at tender to the Stolichni Bank of Savings. In 1997, the powerful commercial structure of the SBS reorganised the Agroprombank (APB). The centralised control over the branches network was restored. In 1991, the Agroprombank was transformed in a joint stock company in such a way that the territorial offices received a high independence with their own stockholders, management boards, fiduciary councils, and credit portfolios. The bank had no common treasury or budget. All this led to the worse control over the cash flows, the impossibility to redistribute rapidly the resources between the territories, and the absence of a unique coordinated crediting policy. Moreover, the APB was traditionally dependent upon the governmental bodies, both in the centre and on-site: hence, the lower efficiency of the operations. After having purchased an immense network of branch offices, the SBS totally checked it and restored the centralised management and control.

In such conditions, the network of the branch offices began growing due, seemingly, to the return to the earlier system of the branch offices which had formed independent subsidiaries during the earlier privatisation of the APB. Possibly, new branch offices are being created in the main regions of the agrarian production.

The APB has come to the more commercial conditions of crediting of the rural producers; the approach to the loans return became more demanding.

In addition to the SBS-Agro, another large Russian commercial bank, the Alpha-bank, began working in the Russian rural credits market.

Thus, commercial banks turned to the operations in not just the real sector of economy, but in its least attractive segment, the agro-industrial complex.

For the other hand, the inertia of the governmental policy had its effect even in these conditions. In 1997, the fund for the agro-industrial complex preferential crediting was created. It was supposed that the smaller share would be formed by the direct allocations from the budget and the larger share would be formed by the return of the debts on the 1996 commodity credit (over Rb 9 trillion). The credits from this fund are one-year, at 1/4 of the CB discount rate. The APB and Alpha-bank were designed the agents of the Fund for 1997. Their margin for the operations does not exceed 4per cent.

In summer 1997, following the long-term tradition, the Government, in shortage of the budget assets, loaned from the above banks Rb 2.8 trillion to credit the sewing, under the guarantees of the Ministry of finance. The Ministry for agrarian production distributed these credits by territories (the traditional «limits» of the Soviet times) proportionally to the lands under cultivation. In principle, such limits were mandatory for the agent banks. However, the interference of the State in the relationships between the banks and borrowers was not limited to this: the Ministry for agrarian production and the local



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administrations wanted to control the conditions of the crediting agreements. Of course, this reduced the efficiency of the financial resources distribution, getting back to the practice of the equal distribution of the credits. Only the economic power of the banks participating in the crediting scheme and the lack of the financial support of such expansion conditioned the prevalence of the commercial character of the APB crediting in 1997.

The second part of the Special fund for crediting of the agro-industrial complex was to be replenished by the returns from the commodity credit. In 1996, the territories received the over Rb 12 trillion credit for the supplies of the fuel and lubricants and combined fodder to support the seasonal works. As of the beginning of 1997, the stale debt was Rb 9.6 trillion. In May, in order to accumulate the money in the Special fund for crediting of the agro-industrial complex, the Government made the decision to transform the debts of the territories as of 20 March in the securities (bonds) of these territories, in order to sell them in the securities market. Thus, the Special fund was reduced, de facto, by the value of the discount of the sale of the securities of the territories. The interest on the bonds is 10 per cent annual, they are issued in equal tranches, and are subject to the repayment by equal instalments during three years.

In the half of the cases, the agent banks made the agreements directly with the rural producers. In the other cases, they worked with the intermediaries — purchasers, processors, suppliers of fuel and lubricants, fertilisers, etc. — under the agreements with the producers. For the one hand, this results from the high debt of the rural economy and the cardfile system. For the other hand, when the agent banks began granting the really commercial credits, they faced the problem of the evaluation of the agrarian entities solvency, the criteria of which are lacking.

In addition to the agent banks offering the money from the Special fund, the seasonal credits to the rural producers came from many local commercial banks, especially in the grain-producing regions.

To the end of 1997, the situation in the credit market changed due to the growth of the GKO's yields. The crediting of the real sector became a secondary activity of the banks again. In such conditions, the Government tried the competition determination of the Special fund agent banks. Evidently, in the conditions of the profitability growth in the governmental bonds market, the access to the budget assets resulted in a strong interest of the banks to the tender: 35 banks gave their offers. The 12 banks, including the SBS-Agro and Alpha-bank won it. However, the Sberbank (savings bank) did not win though it has the largest branch office network in the rural territories. For the tender, the competing banks had the three main purposes. First, and most, of all, this was to get an access to the additional money resources in the conditions of the profitability growth in the governmental bonds market. Secondly, and, of course, in addition to the first purpose, SBS-Agro wanted to saturate the obtained immense network of the rural offices with the real crediting work. The third purpose was the one of the banks with the interests in the food production complex (Alpha-bank, Menatep, Incombank, etc.) because the access to the money from the Fund for the agro-industrial complex preferential crediting could give them the cheap assets to credit the purchase of the agricultural feedstock for their firms. The order of crediting from the Fund and the agreements of the Ministry of finance with the winning banks were developed after the tender; their conditions do not let the banks use the money to come to the first purpose. As a result, as of February 1998, only six of the twelve winner banks were engaged in distributing the credits, the ones that have an obvious interest. The most of the credits were granted by the SBS-Agro.

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The conditions of distribution of the credits from the Special fund stay the same; however, the crediting agreements are to be issued by the Ministry for agrarian production.

The tender resulted in the political scandal between the Ministry for agrarian production and the SBS-Agro, the main agent bank. The reason was quite objective. The Government-authorized 4 per cent margins for the servicing of the governmental program of the preferential crediting of the agro-industrial complex cannot be interesting for the commercial banks under the 11 per cent inflation. The only motivation for participating in such program is the access to the budget funds, or, as in the event of the SBS-Agro which had acquired a network of branch offices in the rural territories, the intention to conquer the agrarian credit market. In such circumstances, the forming system of the preferential crediting of the agro-industrial complex will result in an even greater tension between the Ministry for agrarian production and the banks and increase the risks of the wrong use of the money from the Special Fund; meanwhile, the procedures of the credit agreements control by the governmental officials will increase the corruption in this sphere.

On the background of the relatively languid development of the governmental program of the leasing in the rural economy, the largest financial institutions of Russia began engaging in their own leasing operations. Thus, the Incombank founded, in the Northern Caucasus, the AgroIncom subsidiary. One of the main forms of its operation is the creation of the machine and tractor service stations. The SBS-Agro has also declared its agreement with the Rosagrosnab for the leasing operations, which are, in addition, oriented to the Russian mechanical engineering.

Thus, commercial structures are beginning to get involved in the long-term crediting of the rural economy.

To the end of 1997, the problem of the stale debts became the most crucial in the financial situation of the rural economy. Unless the settlement accounts of the rural producers are freed, the normal financing of the sector in the next season will be impossible. The Government has drafted the Presidential Decree on the restructuring of the rural economy debts to the budget. In contrast with the earlier action of 1994, this restructuring means the restructuring of an economy in debt. Unfortunately, the Decree was several months delayed and its implementation will need the development of a series of by-laws, while the need in credits in the main agrarian regions will surge in 1 or 2 months.

### Food industry

In 1997, the three processing sectors showed growths: for two years running, the production of the sugar was increasing; besides, the production of the strong alcoholic drinks grew much (by almost 20 per cent); and a certain growth of the flour production was observed (see Table 33). However, in most sectors, the recession continued. Its rates were lower than in 1996 in the grit and bread production; however, the recession accelerated in the meat and dairy production.

Table 33

### Production of main products of food industry in 1997

	1997, thous. t	1997, per cent of 1996	1996, per cent of 1995
Vegetable oil	687	79.7	109.7
Sugar	3,800	114.3	104.2
Bread	8,900	93.8	87.0
Flour	10,900	101.3	83.0
Grit	888	98.2	67.7
Sausages	1,139	89.8	97.5
Meat*	1,400	76.9	78.6
Unskimmed milk products**	4,800	93.3	94.7
Butter	277	89.3	75.8
Strong alcoholic drinks, million Ddal	86.6	124.2	57.8

\* including category 1 sub-products

\*\* counted in milk

Source: Information on social-economic situation in Russia. January-December 1997, p. 23.

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**Agrarian produce and food markets**

Since the beginning of 1997, one more step to the liberalisation of the agrarian product and food markets was made: the share of the State in the purchases continues reducing, while the market institutions and instruments are becoming the most important. For example, in 1997, the Nizhni Novgorod agro-industrial exchange began the forward tender for the grain of the new crop; the Belgorod region introduced, on 1 August 1997, the grain bills; the Moscow grain exchange began the auctions for purchase of the grain and grain products.

In the middle of 1997, the Federal Food Corporation having served the main agent for the governmental purchase of the agrarian and food produce was liquidated. Instead, the Federal Agency for market regulation was founded. It has almost the same functions; besides, it inherited the many-trillion Roubles debt to the State of its predecessor.

Finally, the decisive step was made to the tender distribution of the contracts on the food supplies to the federal funds. The Governmental Ordinance (March 1997) «On Purchases and Supplies of Agrarian Produce and Feedstock to Cover the Defence and other Consumers of the Federal Food Fund in 1997» introduced the tender contracts instead of the earlier approved governmental customers. The first tender took place at the end of May 1997; to the end of August, 4 tenders took place. With all this, the evolution of the tendering practice is rapid. The first, May, tender for the purchase of 10,000 tons of sugar for the Army stayed quite traditional: the announcements were not widely displayed; and the winners were traditional, as well: half of the amount was to be supplied by the Federal Food Corporation and its Stavropol affiliate. The later tenders were more open: the announcements are published in press, the number of the bidders is growing, and the number of private

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companies among the winners has grown, as well. The tendering practice is beginning to be used in province, as well.

However, the real supplies by the tenders' winners are frequently inadequate. Thus, according to the data of the Ministry of Defence, the Federal Food Corporation having won the largest contract on the sugar supplies to the Army delayed by more than a month the real shipment of the product, by putting forward a series of the requirements (in particular, the payment for the intermediary services) conflicting with the terms and conditions of the contract.

The barter operations remain in the sale of the agrarian product, especially grain. Though the State commodity credit had been abolished, many intermediary structures (purchasers, processors, suppliers of fuel and lubricants, mineral fertilisers, etc.) were receiving the centralised preferential credits to advance the agrarian producers in kind. Practically all of them demand the credit repayment in kind, as well. As a result, the fixed proportions of exchange, e.g., grain against fuel and lubricants, include the average banking interest rates (about 25 per cent). Besides, the private intermediaries commodity credited the agrarian producers at their own expense, as well. As a result, the commodity crediting form and the related natural exchange form remained quite important in the agrarian markets.

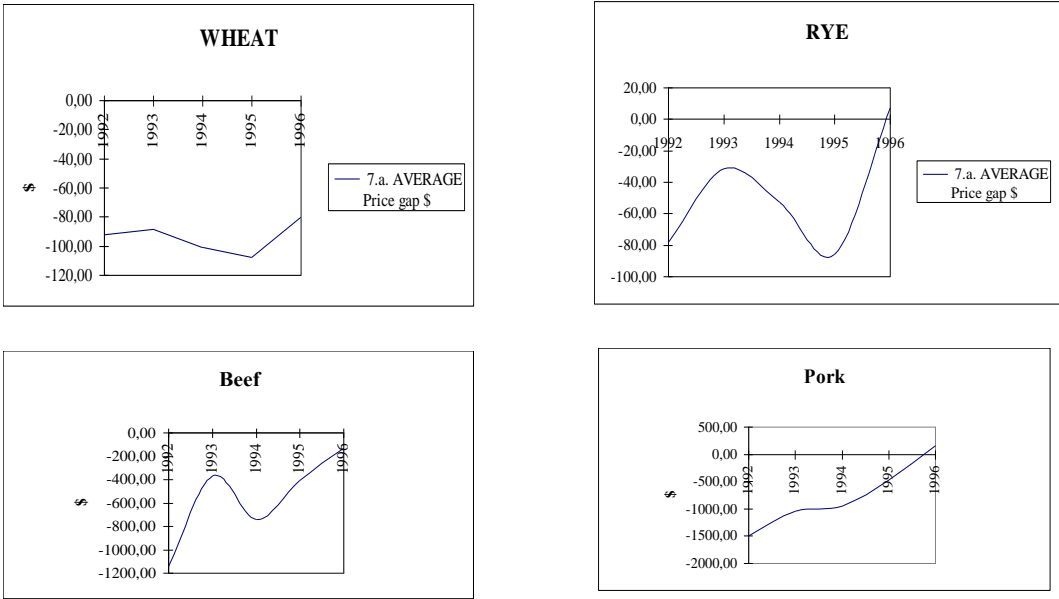
The in-kind payments to the taxation bodies also exist: this is especially characteristic for the grain producing regions. The practice of purchase of the debts of the agrarian entities for the produce supply is expanding.

Thus, the main part of the agrarian produce is sold, first, under the direct contracts, and, second, in the commodities exchange operations. This means the opacity of the market, the absence of the prices levelling mechanism. The official pricing statistics reflects the real agrarian product sale prices inadequately.

In 1997, the activity of the main agrarian regions in the bans for the agrarian products export increased. This practice was, paradoxically, stimulated by the transformation of the commodity credit debt of the Russian Federation subjects in securities. In order to cover the preceding year debts, the regional administrations require the produce supplies and close the borders for the economies that have not repaid such debts. Hence, the economies having the outlooks for a more profitable sale (sometimes, export abroad) have to make supplies to the regional funds at lower prices. For example, in the Rostov region, the free harbour export price of the fodder wheat is US\$ 108 to US\$ 120 per ton, transport included; at the same time, the officially fixed regional price on the similar wheat is US\$ 60 to US\$ 65 per ton. Evidently, the producers loose very much from the export ban and loose the possibility to cover their debts by themselves.

Figure 21

**Domestic to world prices ratio (prices gap)  
on main agrarian produce  
(US\$/ton)**



The domestic prices of the agrarian produce are approaching the world ones. IET has calculated the dynamic of the domestic and world prices using the three regions of Russia (Pskov, Orel, and Rostov); the averaged results are shown in Fig. 33.

Fig 33 shows that, formerly, the domestic prices had been lower than the world ones. Further on, the gap began contracting rapidly. First of all, this was due to the macro-economic stabilisation and the growth of the Rouble exchange rate, leading to the relative rise in price of the domestic product. Secondly, the trend to the sharp fall of the relative prices for the agrarian produce having existed at the beginning of the reforms, (the prices disparity growth) became invalid in 1995. It should be supposed that, as the Rouble stabilises further on, the domestic prices will level with the world ones, thus enhancing the price competition of the import.

The 1997 growth of the real incomes of the population conditioned the growth of the retail food turnover. In the first three quarters of 1997, the dynamic of the growth of the real incomes of the population and the dynamic of the growth of the retail food turnover coincided; however, the reduction of the real incomes of the population in the fourth quarter of 1997 did not induce any reduction of the food trade. Possibly, this is due to the inertia, and the beginning of 1998 may see the drop of the retail food turnover.

The stabilisation of the economic situation led to the growth of the foreign investments in the national food production complex. The specificities of the foreign investments in the national food production complex include the following:

- the direct investments (over 10 per cent of the control block) supposing the right to participate in an entity management are preferred . In the first half of 1997 they amounted to 87 per cent of all the investments in the



food production complex. This is due to that the investors are, as a rule, very large companies (Coca Cola, PepsiCo, Nestle) aspiring for a long-term stay in the Russian market; besides, they are capable for the large investments not repayable in the short term;

- the high geographic concentration of the investments: the main volume (over 60 per cent) goes to the Moscow region;
- from the sectoral viewpoint, the food industry is preferred (mainly, the sectors with the high value-added) and the public catering; the shares of the foreign investments in the other sectors of the food complex is not high (see Table 34).

As for the ready food markets, they see the large-scale processes of concentration of the production and capital, both the national, and the foreign. The specificity of these processes is that they are characteristic for the large industrial, mainly central, cities without any practical demand limits; moreover, they touch, mainly, the sectors having the high value-added. As for the province, the traditional basic production (dairy and meat production) continues facing the limited purchase capacity of the population and continues stagnating.

*Table 34*

#### **Foreign investments in individual sectors of the Russia'**

	1995	1996	1997*	1995	1996	1997*
	US\$ bn.			per cent		
Agro-industrial complex	1,269.08	1,540.1	1,876	100.0	100.0	100.0
agrarian sector	21.2	19	24.7	1.7	1.2	1.3
purchasers	0.28	51.6	0.6	0.0	3.4	0.0
food industry	498.9	975.5	1,340.1	39.3	63.3	71.4
retail sale and public catering	748.7	494	510.6	59.0	32.1	27.2

\* - for the first nine months

Source: Goskomstat of Russia

In 1997, the best dynamism was shown by the markets of the ice cream, beer, dried breakfasts, tea, and confectionery: these have reflected the production concentration (reconstruction of the production facilities), the

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capital concentration (mergers), and the more aggressive competition between the national and foreign companies.

The mergers of the latest 70 years has let the two national giants, the OAO «Confectionery Concern ‘Babayaevskoe’» and «Krasny Oktiabr» control the confectionery market. However, at the same time, foreign investors are active in getting into this market.

Another interesting example is the market of the ice cream. The mass import of the ice cream was replaced by the grown activity of the domestic producers who had been able to update the production.

### **Agrarian policy**

In 1997, the agrarian policy saw great changes. An attempt of transfer to the tender distribution of the budget money for the implementation of the Federal programs in the agro-industrial complex. As noted above, the tenders for the supplies to the federal funds began. The tenders selected the depository banks and the agent banks to transfer the debts of the territories for the 1996 commodity credit. The Ministry for agrarian production formed the commissions to organise the tenders for selection of the suppliers of the machines and equipment and of the insurers for the governmental leasing operations; the suppliers of the seeds in the State funds; the contractors for the supplies of the veterinary medicaments; the suppliers of the equipment for production of the food for children; etc. For the moment being, most of such tenders are quite formal. However, if the tender procedures are improved and become open for the public, a more rational distribution of the agrarian budget money may be expected in the nearest future.

In 1997, the Russian Ministry of finance formed a reliable barrier to the attempts of worsening the conditions of the external trade in the agrarian and food produce. It rejected the two projects: increasing by 5per cent the import

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tariff on the food in order to form the Federal fund for the agro-food complex crediting; and introducing the licensing of the export of the wheat and sunflower seeds. The agrarian market stabilisation measures also include the abolition (June 1997) of the subsidies for the import of the pesticides, the ones that had remained effective for so long.

Despite the low efficiency of the Federal subsidies to the agrarian sector, they were continued in 1997 (with only the changed rates). The State Duma promulgated the laws on the governmental control over the agro-industrial complex and on the food safety of the nation. These laws have brought nothing new in this sphere. The new laws are, rather, the instructions on the possible measures of governmental support of the rural economy and the related sectors than the real legal documents setting forth the limits of the agro-industrial complex regulation by the executive power bodies. It is doubtful that these documents will have any effect on the agrarian policy of the nearest years; hence, the Government itself needs to make the effort to revise the support measures.

The Government has adopted the Federal Program «Sugar» aimed to replace the import to 2005. At the same time, the annual cost of this Program implementation is approximately equal to the cost of the whole annual Russian import of the sugar (white and raw); hence, the doubts in the necessity to implement it. Seemingly, this Program will not be implemented as the dozens of the earlier ones. In particular, at the beginning of 1997, the attempt was made to revive the program of the domestic flax production; this time, the mechanisms of the Russian-Belorus union were used. It does not seem rational to seek co-operation in this very field with Belorus, which is competing Russian in the flax sector and gives great subsidies to its own agrarian producers.

Despite the strengthening political arguments around the Land Code, its approval by the Parliament and rejection by the President have not, yet, effected in any way the situation in the rural sector. The gradual implementation of the Presidential Decree «On Realisation of Constitutional Rights of Citizens on Land» (1996) seems more important, though the contracts between the land users and the land shares owners have been made in less than the half of the cases. However, even this degree of implementation of the Decree led to the positive shifts in the agricultural land use. Another important issue was the development and adoption of the laws on land envisioning the market turnover in certain subjects of the Russian Federation (Saratov region).

### External trade in agrarian produce and food

According to the customs statistics, in the first nine months of 1997, the share of the Russian food import in the aggregate cost of the import was 27.7 per cent, which is a little more than in the preceding year. During the first nine months of 1997, the share of the food export reduced. Hence, the growth of the negative balance of the Russian food trades (see Table 35).

Table 35

### Balance of foreign trade in agrarian produce and food, 1994-1997 (I-III quarters), US\$ million

	1994	1995	1996	1997	per cent of the preceding year		
					1995	1996	1997
Export of agrarian produce and food	938	891	1,097	881	95.0	123.1	80.31
Share of the export of agrarian produce and food in the aggregate export, per cent	2.1	1.6	1.9	1.6	-	-	-
Import of agrarian produce and food	7,773	9,009	8,789	9,062	115.9	97.6	103.11
Share of the import of agrarian produce and food in the aggregate import, per cent	28.4	27.3	27.0	27.7	-	-	-
Balance for the agrarian produce and food	-6,835	-8,118	-7,692	-8,181	-	-	-

Source: Customs statistics of RF foreign trade

The commodity structure of the agrarian produce and food export saw certain changes: the export of the grain grew and the export of the vegetable oil reduced. The export of the wheat and meslin grew almost 3-fold and reached 386,700 t in 1997. The export of the rye exceeded the relevant index of 1996 and reached 21,400 t (see Table 36). About 30 per cent of the wheat were exported to Israel, and 40 per cent were exported to Uzbekistan also was the main importer of the Russian rye (94 per cent).

In 1997, no serious changes in the commodity structure of the Russian import of the agrarian produce and food were observed (see Table 37).

*Table 36*

**Dynamic of export of main foods, 1994-1997  
(I-III quarters), thousand tons**

	1994	1995	1996	1997
Wheat and meslin	242,1	135,9	130,1	386,7
Rye	63,6	338,8	4,5	21,4
Vegetable oil	72,6	94,5	23,3	18,4
Sunflower	632,9	463,4	1,779,0	N/A

Source: Customs statistics of RF foreign trade

In such conditions, the low elasticity of the offer in the domestic meat market resulted in the significant augmentation of the meat import: almost 40 per cent in January-May 1997; to the third quarter-year, this dynamic reduced somehow (22 per cent). On this background, the authorisation by the Ministry for agrarian production (which must protect the interests of the domestic agrarian producers and pretends to be such protector) to import the reserves of the beef from the EC seems more than strange.

As in the preceding years, the main suppliers of the meat were the USA, France, Germany, and Ukraine. The beef came mainly from Ireland, Germany, and Ukraine (13 per cent, 18 per cent, and 26 per cent of the total beef import); the three fourth of the poultry meat came from the USA. The increase of the

poultry meat import tariffs at the beginning of 1997 reduced significantly its import; however, further on it began growing again.

In 1996, the reduction of the milk, butter, and sunflower oil was observed; however, in 1997, the growth was seen (by 97 per cent, 71 per cent, and 37 per cent, respectively) (see Table 37).

In 1997, the stable trend to the growth of the import of the flour was replaced by the reduction. In the first nine month of 1997, Russia imported 269,100 tons of the flour, which is by 57 per cent less than in the relevant period of 1996. Besides, the import of the grain reduced by 53 per cent, which is due to the growth of its domestic production. The main shares of the wheat and barley imports came from Kazakhstan

*Table 37*

**Dynamic of import of main foods, 1994-1997  
(I-III quarters), thousand tons**

	1994	1995	1996	1997	per cent of preceding year		
					1995	1996	1997
Meat	452.2	518.1	562.0	684.6	114.6	108.5	121.8
Poultry	334.0	551.6	688.7	793.1	165.1	124.9	115.2
Milk and cream	59.1	62.3	34.1	67.0	105.4	54.7	196.5
Butter	128.6	192.0	74.8	127.8	149.3	39.0	170.9
Wheat and meslin; barley; corn	3,047.1	1,431.4	3,232.5	1,532.3	46.6	225.8	47.4
Flour	45.5	105.0	624.9	269.1	230.8	595.1	43.1
Sunflower oil	47.1	177.7	155.1	212.5	377.3	87.3	137.0
Raw sugar, incl. cane	921.4	953.9	1,534.6	2,170.9	103.5	160.9	141.5
beat	20.7	34.7	16.7	8.7	167.6	48.1	52.1
White sugar	654.2	1,204.2	1,269.0	832.4	184.1	105.4	65.6
Citruses	405.0	328.5	135.4	356.6	81.1	41.2	263.4
Coffee	20.7	18.9	20.5	20.1	91.3	108.5	98.0

Source: Customs statistics of RF foreign trade

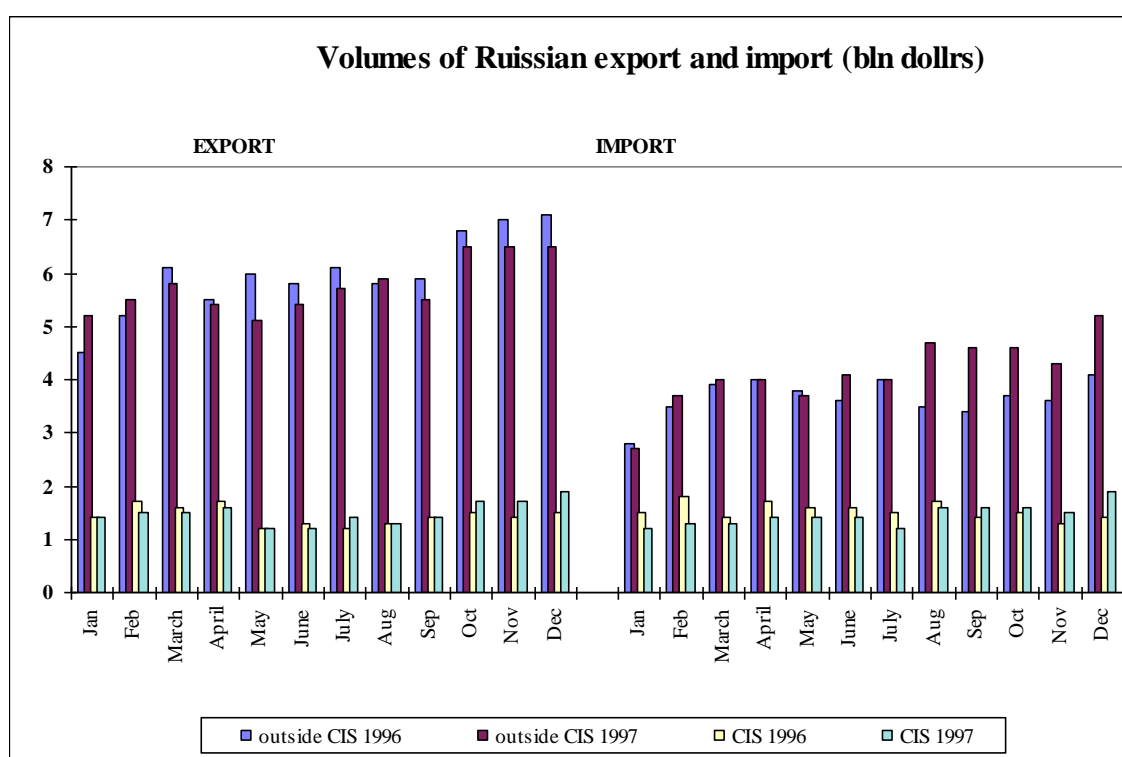
### 3.5 External trade

In 1997, the Russian foreign trade was developing in the close correlation with the main macro-economic trends (renewal of the investment growth,

growth of the domestic purchase demand, remonetisation of the economy, etc.). This was seen, in particular, in the dynamic of the external trade turnover, the trade balance.

The Russia's external trade turnover has been growing since 1993. The maximal growths of the both export and import were observed in 1995. Further on, the rates began slowing down. In 1997, the Russia's external trade turnover increased by 2.4 per cent, compared with 1995, to US\$ 155 billion. For the first time in the four years, the growth of the external trade turnover was conditioned by the growth of the import: it amounted to US\$ 67.6 billion, which is by 8.6 per cent, more than in 1996. Meanwhile, the export reduced by 2 per cent, to US\$ 84.4 billion.

Figure 22

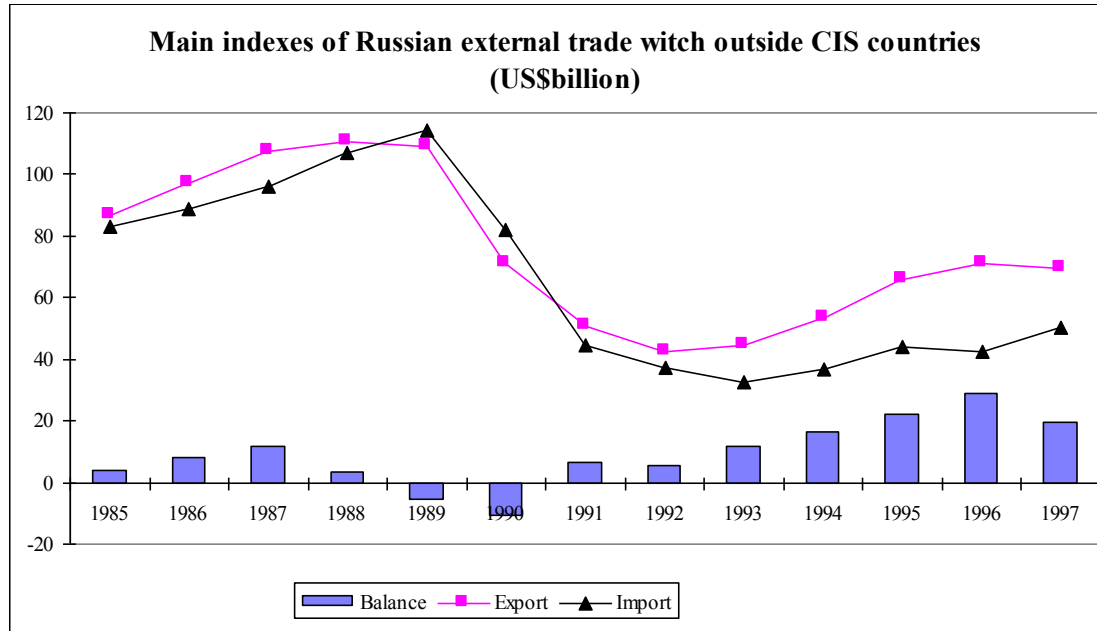


Source: Goskomstat of Russia

The share of the outside FSU countries in the Russian external trade turnover grew from 76.6 per cent in 1996 to 77.2 per cent in 1997. The trade turnover with these countries, including the unorganised trade was

US\$ 119.6 billion having grown by 3.2 per cent, including the growth of the import by 13.8 per cent (US\$ 50.1 billion). Meanwhile, the export reduced, for the first time in five years, by 3.3 per cent (US\$ 69.5 billion).

*Figure 23*



The growth of the import at the reduction of the export led, for the first time in the latest years, to the reduction of the positive trade balance. In 1997, the balance was US\$ 19.4 billion, which is by 30.5 per cent lower than in 1996.

The dynamic growth of the export (exceeding the growth rates of the import) in 1993-1996 was, in a large extent, due to the liberalisation of the external trade in that period. To 1997, no reserves for a further liberalisation remained. At the same time, the growth of the import was motivated, for the one hand, by the growth of the real incomes of the population, a great share of which was directed to the purchase of the imported goods and services; and, for the other hand, the stop, in the middle of 1997, of the investment recession in the Russian economy at the revivification of the business activity led to a certain growth of the investment production demand for the imported products.



The rapid growth of the Russian export in 1993-1996 was also favoured by the fortunate situation of the world feedstock markets, on which the Russian export is highly dependent, because the specific share of the fuel and energy goods in it is 46.9 per cent. In 1997, the situation in the world market was unfavourable for Russia. The financial crisis in the countries of the SouthEastern Asia, the main consumers of the non-ferrous metals, led to the drop of the world prices on these metals. The decision of the OPEC to increase by 10per cent the oil production quotas and the information on the soon-to-be increase of the Iraq export quota under the «Oil against Food» UN Program led to the reduction of the world oil and petroleum products prices.

Table 38

**Prices of main commodities at international exchanges  
(US\$/unit of measure)**

	Unit of measure	December 1996	December 1997
Aluminium	t	1,498.1	1,532.4
Copper	t	2,291.1	1,768.7
Lead	t	685.9	524.1
Nickel	t	6,649.9	5,957.4
Tin	t	5,896.4	5,541.7
Gold	troy ounce	369.6	287.4
Oil (brand-mix)	t	170.0	127.4
Oil (west-Texan)	t	185.0	133.2
Gasoline	t	180.7	147.9
Boiler fuel	t	191.8	138.4
Natural gas	thousand m <sup>3</sup>	138.5	87.0

Source: calculated by authors based on the data of Commercant-Daily

Besides, to 1997, the main goods of the Russian export reached the limit export quotas in most of the feedstock sectors (see Table 39).

The improvement of the Russian export structure, its shift from the feedstock base are hindered not only by the low competitiveness of the Russian products, but also by the use, by certain countries, of the non-tariff limitations on the goods from Russia. AS of today, Russia has fixed 55 cases of such limitations. According to the estimates of the Ministry for foreign economic relations, the direct annual loss from such measures exceeds US\$ 500 million.

According to this, our country is the most discriminated in the world after China.

Partially, this is explained by that Russia is not, yet, a full member of the World Trade Organisation.

*Table 39*

**Share of export in production volume (per cent)**

	1994	1995	1996	1997
Oil	37.4	39.1	40.9	42.5
Gasoline	6.9	8	19.6	19.2
Diesel fuel	29.1	38.6	45.1	47.2
Fuel oil	18.5	23.3	22.0	44.4
Rolled ferrous metals	49	54	61	-
Aluminium	80.5	80.5	88	85.9
Copper	62.9	64.9	56.6	51.2
Nickel	78.3	79.9	79	84.7
Mineral fertilisers	65.2	72.5	74	74.4
Timber wood	16.3	20	19	24.4
Sawn timber	19.8	21.4	24.2	-
Commercial cellulose	74.6	74.6	80	83.0
Paper and cardboard	44.1	47	49	36.9

Source: Goskomstat of Russia

The three groups of the commodities are discriminated, mainly: the metal products, the chemical fertilisers, and the textile goods. The EC employs 17 limitations measures, the USA employ 8 ones. Among the other countries, the most frequent limitations on the Russian goods come from Mexico, Brazil, Turkey, India, Republic Korea, and Poland.

Up to today, Russia is considered a country with the non-market economy; hence, in the anti-dumping proceedings, stricter legal and procedural norms are applied to it than to other countries.

However, in certain cases, the anti-dumping measures are validated. Due to the peculiarities of the pricing, shortcomings of the Russian laws, discrepancies between the Russian and world systems of accountancy, use of the barter and surrogate money at settlements in the domestic market for certain

group of the goods, a dumping margin forms sometimes, i.e., the export prices become lower than the domestic ones.

The incomes on export had formed one of the main sources of the financial inflows of Russian enterprises. However, since not long ago, the export became unprofitable for them. Thus, due to the growth of the prices and tariffs on the services of the natural monopolies, the transport and energy component in the metallurgy structure exceeded 50 per cent, while the profitability dropped from 40 per cent to 4 per cent. Hence, certain enterprises have to export their products at the prices lower than the production cost, while the expenditures are charged on the domestic consumers using the barter and mutual settlement mechanism. Thus, the domestic prices are artificially overestimated against the export ones; hence, the prosecution against the dumping.

In 1997, the Russian export stayed, mainly, the feedstock one. As before, the fuel and energy resources (45.1 per cent), and ferrous and non-ferrous metals (19.6 per cent) formed the main shares of it. The share of the machines and equipment remained low (8.1 per cent). However, in 1997, it grew by 0.3 percentage points.

*Table 40*

**Russian mechanical engineering export (US\$ million)**

	1994	1995	1996	1997 (estimate)
General mechanical engineering	2,003	2,253	2,189	2,040
Electrical equipment and radio-electronic equipment	1,017	1,171	1,167	1,120
Rail transport vehicles	175	231	248	190
Automobiles	1,608	1,664	1,500	1,350
Aerospace products	343	1,648	1,203	1,240
Vessels	252	409	1,170	1,000
Instruments	176	219	255	290
Total	5,574	7,625	7,732	7,230

Source: State committee for customs

In 1997, only the instrument-making export grew. At the same time, for the export of the largest export items — products of the heavy and general mechanical engineering, electrical engineering, radio-electronics, automobiles — the growth is either insignificant or does not exist, at all. The dynamic of the aerospace export is unstable.

The commodity structure of the foreign import has not changed: as before, the mechanical engineering products prevail (38.5 per cent).

The second half of 1997 showed a significant growth of the import from the countries outside the CIS. Compared with August 1996, in 1997, the import grew by 25.1 per cent in August, by 26.0 per cent in September, by 42.2 per cent in October, by 43 per cent in November, and by 27 per cent in December. The main share of the import growth was due to the machinery and equipment: this confirms the revivification of the investing activity in Russia.

All these were stimulated by the VAT-release (except for the excise tax) for the commodities intended to be included in the fixed assets imported by the foreign investor as the share in the fixed assets of the enterprises with foreign investments were released from the customs duties. The same was true for the equipment imported under the credits granted by the foreign States or international financial organisations in accordance with the international treaties of the Russian Federation were released from the customs duties.

The machinery and equipment are leading in the Russian import: 37.2 per cent. The import of the machinery is based (48 per cent) on the products of the heavy and general mechanical engineering; the electrical engineering and the radio-electronic products cover about 23 per cent; the automobiles and instruments cover 10 per cent to 14 per cent each.

*Table 41*

**Russian mechanical engineering export (US\$ million)**

	1994	1995	1996	1997 (estimate)

General mechanical engineering	6,450	7,155	6,351	5,840
Electrical equipment and radio-electronic equipment	3,074	3,504	3,142	2,950
Rail transport vehicles	266	524	457	260
Automobiles	1,938	1,395	1,383	1,950
Aerospace products	119	190	166	290
Vessels	212	187	360	740
Instruments	1,565	2,034	1,632	1,060
Total	13,624	14,989	13,491	13,090

Source: State committee for customs

The greatest import growth was seen for the transport vehicles: over US\$ 0.5 billion for the automobiles and about the same sum for the vessels. On the contrary, the import of the machine tools, equipment, and mechanical units decreased.

The non-competitiveness of the domestic home equipment led to the its full replacement by the imported one. In this connection, the Government fell back on the protective measures. Thus, from 1 January 1998, the import of the colour TV sets will be licensed, because, in 1993 to 1996, their manufacture in Russia decreased 20-fold. At the same time, in 1996, the illegal import of the colour TV sets was 2,500,000. The licensing procedure will let the State Committee for customs and the State Taxation Inspection records all the importers of the video equipment: this will favour the taxation and reception of the duties. The «washing-out» of the cheapest models usually supplied to the market by the «grey» importers will result in the higher retail prices. As a result, the importers will, probably increase the import to Russia of the components for the TV sets for their assembly by the domestic entities.

At the same time, it should not be forgotten that, s for many kinds of the mechanical engineering product, especially of the investing demand, the import is necessary for Russia and is economically efficient, because it is, practically, the only source of attraction of the high-tech equipment and certain transport vehicles to the Russian market. Hence, the excessive protectionism would have only harmed.

### External trade with CIS countries

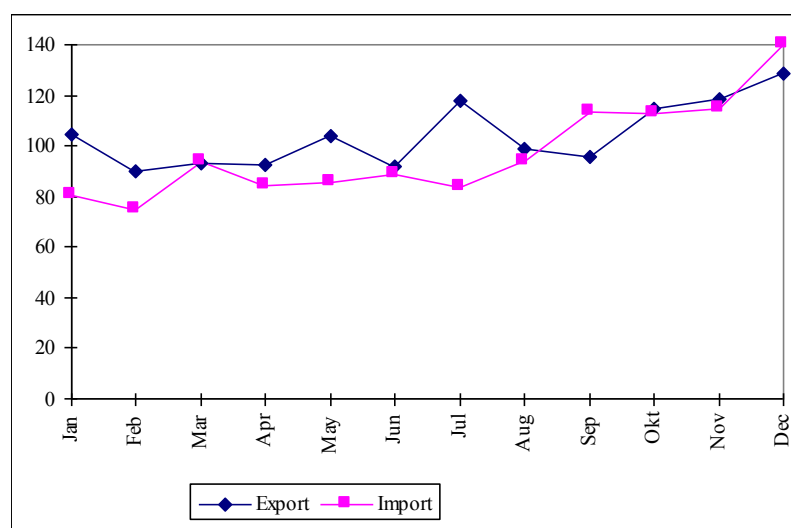
In 1997, the external trade turnover between Russia and the CIS countries was US\$ 35.4 billion, which is lower by 0.2 per cent than in 1996. For the whole year, the trade balance with the CIS countries was positive (US\$ 0.4 billion).

The trend to the rapprochement of the external trade volumes was first seen in the second half of 1996; in 1997, it continued. However, in the third quarter of 1997, the rates lowered. Thus, if compared with 1996, the fourth quarter of 1997 already showed the significant enough growth of the export supplies (by 21 per cent). In the aggregate trade turnover of Russia, the specific share of the CIS countries dropped to 22.8 per cent (compared with the 23.4 per cent of 1996).

During 1997, the volumes of the mutual trade inside the CIS continued reducing, as well: the reduction was by 10 per cent to 12 per cent. At the same time, the trade of these countries with the countries outside the FSU increased by 2 per cent to 3 per cent.

Figure 24

#### Dynamic of export-import supplies of Russia and CIS (per cent of the relevant period of the preceding year)



Source: Goskomstat of Russia

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The export-import structure of the mutual trade between Russia and the CIS countries remains the same: the export consists, mainly, of the energy carriers, while the import consists, as before, of the food.

In 1997, the Russian export to the CIS countries grew by 3.8 per cent compared with 1996 and made US\$ 17.9 billion. Due to the continuing crisis and reduction of the effective demand in these countries, the physical volumes of the export reduced in 1997: by 16.9 per cent of the oil; by 37.7 per cent of the coal; by 33 per cent of the ferrous metals; and by 15.7 per cent of the round timber. The export of the gas increased by 13.5 per cent due to the partial arrangement of the payment-settlement relations relative to the already made supplies.

The supplies of the machinery and equipment also grew by 11.6 per cent in 1997 compared with 1996; this is due to the reorientation to the export to the neighbouring countries resulting from the non-competitiveness in the other markets. As a result of the grown volume of the mechanical engineering products to the CIS countries, the share of these products in the general structure of the Russian export grew from 9.4 per cent in 1996 to 10 per cent in 1997.

The insignificant growth, in certain months, of the value of the Russian export of the energy media to the CIS countries was due to the growth of the exported goods prices. Thus, the export prices of the crude oil, petroleum products, coal, and natural gas grew 1.2- to 1.4-fold. At the same time, the physical volumes for certain positions grew, as well. For example, in 1997, the export of the petroleum products grew by 11.5 per cent compared with 1996, due, in particular to the profitability (especially for Belarus) of the re-export to outside the FSU.

As for the results of 1997, the value of the import of the goods to Russia from the CIS reduced by 4.0 per cent having made US\$ 17.5 billion. In the total volume of the import to Russia, the CIS countries' share was 25.9 per cent. The main reasons of the import volume reduction are the relative saturation of the domestic market with the consumer goods and the strengthening of the tariff and non-tariff import control whose main aim is to protect the domestic producers and manufacturers. In 1997, the import reduced: of the ferrous metals, by 37.1 per cent; of the coal, by 24.1 per cent; the most significant reduction was observed for the refined sugar (by 47.7 per cent) and the butter (by 24.1 per cent). In whole, the share of the food in the whole import from the CIS countries reduced from the 26 per cent of 1996 to the 23 per cent of 1997.

This, it was the import of the goods the requirements in which had been covered by the supplies from the neighbour states that reduced in the first turn. For example, the import from the CIS covered the needs in the imported sugar by 92.3 per cent in 1996 and by only 66.7 per cent in 1997; for the ferrous metals the relevant figures are 77.5 per cent and 69.4 per cent.

*Table 42*

**External trade of Russia the with countries of the CIS in 1997**

	Turnover, (US\$ bn)	Export, (US\$ bn)	Import, (US\$ bn)	Share of the country in the turnover with Russia (per cent)
CIS total	21,333	11,546	9,787	100
Azerbaijan	312.7	152.1	160.6	1.5
Armenia	89.8	47.7	42.1	0.4
Belorus	6,201.7	3,204.5	2,997.2	29.0
Georgia	194.0	89.3	104.7	0.9
Kazakhstan	3,715.5	1,716.3	1,992.2	17.4
Kirghizia	223.7	114.9	108.8	1.0
Moldavia	848.5	256.3	592.2	4.0
Turkmenia	289.5	155.6	133.9	1.4
Tajikistan	122.2	60.5	62.1	0.6
Ukraine	7,980.8	5,069.4	2,911.4	37.4
Uzbekistan	1,361.0	678.9	682.1	6.4

As Table 42 shows, Ukraine remains the largest trade partner of Russia.



However, in 1997, the volumes of the trade with Ukraine decreased by 28 per cent compared with 1996. First of all, the reduction of the trade with Ukraine was influenced by the limitation on the sugar supplies: on 15 May 1997, the 25 per cent custom duties were introduced for the sugar imported from Ukraine, just as for the outside CIS countries. The 1997 reduction of the trade with Ukraine was influenced by the changes in the tax laws. In 1996, Ukraine unilaterally released its exporters from the VAT. Russia, in its turn, began levying the VAT from all the imported goods, in order to protect its producers. In 1997, the two countries managed to settle somehow this problem: the Decree of the RF President abolished, from 1 February 1998, the VAT on the imported Ukrainian goods after the abolishment of this tax by the Ukrainian side. According to experts, the abolition of the VAT will allow to increase the volumes of the Ukrainian export to Russia by about 25 per cent. However, the mutual abolition of the VAT did not change the principles of the VAT levying in the both countries. Russia does not release from the VAT its export to the CIS countries, including Ukraine. Ukraine adopted the zero VAT on its export to Russia: hence, the goods became cheaper than their Russian analogues.

Thus, the problems of the VAT in the mutual supplies between Russia and the CIS countries require the immediate settlement; this is confirmed by the active position of the Russian exporters requesting the equal conditions of the export to the FSU and outside the FSU. One of the possible ways to solve this problem is to introduce the temporary import duties for certain Ukrainian goods, in particular, tobacco, sugar, etc.

However, the certain success in the negotiations between Russia and Ukraine as for the abolition of the VAT on import had become the basis for the negotiations on and signing of, at the end of last February, the large-scale

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10-year program of economic co-operation. The implementation of this Program will let expand the mutual exchange between the two countries by about 2.5-fold during these ten years.

To the end of the period under analysis, the slow-down of the recession of the mutual trade between Russia and the CIS countries was observed. This was, in a high extent, conditioned by the growth of the mutual commodity turnover with the member-states of the Custom Union of the CIS (especially due to the faster growth of the import from these three countries to Russia). In January to November 1997, the Russian import from the member-states of the Custom Union of the CIS grew by 19per cent compared with 1996, and amounted to US\$ 6 billion; its share in the aggregate Russian import from the CIS was 54per cent (37per cent in 1996).

At the beginning of 1997, the member-states of the Custom Union (Russia, Belarus, Kazakhstan, and Kirghizia) managed to co-ordinate almost the whole volume of the possible customs tariffs; however, further on, the implementation by each of these states of its own customs policy led back to the 1995-1996 level of co-ordination of the custom duties. Besides, despite the efforts of the Custom Union, Kazakhstan and Kirghizia introduced the VAT on the imported goods from 1 January 1997.

Among the member-states of the Custom Union of the CIS Belarus remains the largest partner: in 1997, the import from Belarus grew by 55 per cent and the share of Belarus in the aggregate commodity turnover between Russia and the CIS grew to 29per cent. However, this growth of the commodity turnover between Russia and Belarus cannot be estimated being only positive. Thus, the evolution of the Custom Union made these countries face new problems. Russia may be forced to renew the levying of the custom duties on the goods exported via Belarus because it does not transfer the payments due to

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Russia. As of the beginning of October 1997, the debt of Belarus in the customs payments reached US\$ 47 million, or 45 per cent of the aggregate sums due to Russia under the terms and conditions of the Custom Union.

Another heavy problem in the relations with Belarus is practically uncontrollable re-export of the Russian oil to the West. Thus, during the first nine months of 1997, Belarus exported 250,000 tons of oil to Poland only. Meanwhile, the annual Belarus production of the oil is 1,000,000 tons which does not cover its interior needs; hence, the supplies abroad came from the re-export. This worsens the situation for the Russian exporters of the energy media.

The commodity turnover was also affected by the unpredictability of the Belarus actions in the relations with the other countries. For the one hand, in 1997, Belarus equalised its import duties with the Russian ones and introduced the VAT on the Ukrainian import. For the other hand, without informing Russia, it signed with Ukraine the bilateral trade agreement destroying any limitations of the mutual trade between these countries, and, hence, favouring the flow of the Ukrainian goods to the Russian market by-passing the custom barriers.

The above allows for the conclusion that the real level of the import supplies reduced much less than the custom statistics say. This was the reason for the limitation by Russia of the import of the alcohol coming from Belarus; for this, in January 1997, the special excise marks were introduced. Possibly, this led to the reduction by 13.4 per cent, in 1997 compared with 1996, of the import of the alcoholic drinks from the CIS countries.

On the basis of the brief analysis of the trends of the trade with the CIS countries, the positive trade balance of Russia can be forecast for the short-term

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future period. The dynamic of the external trade with the outside the FSU countries confirms this.

### **3.6 Situation in research and development**

In 1997, the main trends in the development of the science remained practically the same as in 1996.

*Firstly*, the outflow of the scientific staff continued: compared with 1996, the number of the researchers reduced by 6.8 per cent and the reduction of the number of the employed in the research and development had approximately similar rates in all the sectors of the science: governmental, entrepreneurial, and higher school. As a result, as of today, Russia has only a little more than 450,000 researchers, which is less than the half of the number of the Russian scientists that had existed at the moment of the USSR disintegration.

Moreover, for the first time in the several latest years, the number of the Doctors of sciences began (the reduction was 0.3 per cent in the first half of 1997); the rates of reduction of the number of the Masters of sciences augmented somehow (their number reduced by 3.3 per cent). At the same time, the rates of reduction of the number of the Masters of sciences were lesser than the average rates of reduction of the number of scientists in the science in whole; hence, the share of the superior qualification personnel in the aggregate number of employed continued growing: in 1995, it had been 22.4 per cent; in 1996, it had been 23.2 per cent; and in the first half of 1997, it was already 24.2 per cent.

Those who continue working in the scientific sphere often do not do this full time. The 1997 polls have shown that every second scientific worker earns overtime, which is much more frequent than in the other sectors of economy where only every seventh person has additional employment. Hence, only with

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26.6 per cent of the scientists the additional employment corresponds to the profile of the main employment<sup>16</sup>.

*Secondly*, the structural crisis continued: the number of the scientific-technical organisations reduced only by 5.3 per cent. If compared with the swift reduction of the number of the scientific personnel, this means that the changes are taking place within the framework of the former institutional structures. In whole, compared with the 1991 level, the number of the personnel reduced 2-fold; meanwhile, during the same period, the number of the scientific-technical organisations reduced only by 14.5 per cent, and the interior expenditures on research and development reduced by 64.8 per cent in the constant 1989 prices. What is more important, is that almost three fourths of the scientific-technical organisations stay governmental entities, i.e., exist, in a great extent, at the cost of the Federal Budget<sup>17</sup>. However, the superior qualification specialists prefer working in the governmental sphere despite that the scientific-technical organisations of the private and mixed forms of property have appeared: as of today, the governmental entities concentrate 95.5 per cent of the Doctors and 90.6 per cent of the Masters of sciences.

*Thirdly*, in 1997, on the background of the aggravated structural crisis, the financial conditions remained unfavourable. The problem of the *governmental financing of the science* remained crucial. In 1997, the Federal Budget expenditures on science from the item «Fundamental research and support of scientific and technical progress» made 0.4 per cent of GDP<sup>18</sup> against

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<sup>16</sup> Express-information of CISN «Monitoring of reformation of the Russian science», 2 December 1997.

<sup>17</sup> In average, in 1997, the share of the Budget in the structure of financing of the governmental scientific-technical organizations was about 50per cent.

<sup>18</sup> Data for the first 11 months of 1997 «Economy and Policy of Russia. The White Book». Moscow, IET, 1988, p. 45.

the planned 0.56 per cent of GDP<sup>19</sup>. However, this is a step forward compared with 1995-1996 when the relevant expenditures remained at the level 0.29 per cent of GDP. This seems even better, because in April 1997, the Budget was sequestered, and the expenditures from the item «Fundamental research and support of scientific and technical progress» were reduced, in average, by 37.5 per cent<sup>20</sup>. The different directions of the budget financing suffered differently: for example, the budget of the Russian Foundation for Fundamental Research (RFFR), one of the most efficient structures in the science field, was cut by almost 50 per cent. This confirms the domination of the former, «Soviet», priorities and approaches to the finance distribution when the basic financing of the scientific organisations was considered the main (and, in the Soviet times, the only) priority. At the same time, for example, in the USA, 90 per cent of the financing come from the contests<sup>21</sup>. In Russia, in 1997, the share of the budget finance distributed by contests was 6.75 per cent<sup>22</sup>.

According to the Law of 3 September 1996, «On Science and Governmental Scientific and Technical Policy» the financing of the science was to form 4 per cent of the expenditure side of the Budget. However, the actual expenditures of the latest years were the following: 3.7 per cent in 1993; 2.83 per cent in 1994; 3.25 per cent in 1995; 2.3 per cent in 1996; and 2.8 per cent (initial plan) and 2.58 per cent after sequester (plan) in 1997. No significant changes are foreseen for 1998: it is planned to allocate to the civil science 2.65 per cent of the expenditure side of the Budget. However, the reality may turn

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<sup>19</sup> See «Russian Economy in 1996. Trends and Outlooks» Issue 16. Moscow, IET, 1997, p. 131.

<sup>20</sup> Calculated on the basis of the data on the Budget: Rossiyskaya Gazeta, 9 August 1997, p. 10.

<sup>21</sup> The Economist, Nov.8, 1997.

<sup>22</sup> Itogi, 6 May 1997, p. 51.

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out quite worse: as of the beginning of 1998<sup>23</sup>, one percent of the supposed sum of the expenditures on science was withdrawn and directed to the implementation of the defence reform.

On such background, the foreign programs and foundations continued remaining an important source of support of the national science. According to the expert estimates, the annual volume of financing of the Russian science via different foreign channels is US\$ 150 to US\$ 200 million. In the scientific-technical organisations well adapted to the today's economic conditions, the foreign sources amount, in average, to 20 per cent to 50 per cent of the institutions' budgets.

The main trends observed in 1997 in the fields of the foreign grant financing consist in the reinforcement of the selectivity, integrity, and application orientation of the support.

*Firstly*, the goal-oriented programs not connected with the direct support of the research itself, but directed to the development of the scientific infrastructure: telecommunication projects, programs of support of magazines and libraries, competitions for development of new manuals.

*Secondly*, in financing of the scientific research itself, the selective support of both the specific scientific directions and the certain categories of the employed in the sphere of science intensified. Among the science directions, the humanitarian sciences received support from various sources, just as before: the environmental sciences («Open Society» Institute, IRECS, ASPRIAL, Fullbright Program); the socially oriented studies (Moscow Scientific Foundation, Ford Foundation, McArthurs Foundation); and the application-oriented research in the natural and technical sciences (INCO-COPERNICUS, CRDF). The foreign financing became more directed: the emphasis shifted to

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<sup>23</sup> Poisk, # 7, 7-13 February 1998, p. 2.

the younger<sup>24</sup> researchers (CRDF, INTAS), professors of higher schools, post-graduates, students (International Soros Program of education in exact sciences - ISSEP), and to the science schools («Open Society» Institute).

*Thirdly*, as a result of the greater financial participation of the Russian side, the transition began to the more equal co-operation within the framework of the implementation of the joint research projects. The joint RFFR-INTAS, RGNF-INTAS competitions whose budget equals ECU 9.9 million, the contribution of the both parties included, were declared; the implementation of the RFFR-German Scientific Research Society program, where every party pays the expenditures in its territory, began. Some of the already existing programs began developing on the financial new basis: using the regional money (ISSEP<sup>25</sup>, Program of the regional INTERNET centres of the «Open Society» Institute).

*Fourthly*, the shift to the support of the applied research and encouragement of the innovative activity continued, mainly relative to the projects whose implementation had already been supported by the Western sources (CRDF, ISC). Thus, in July 1997, within the framework of the ISC the «Partnership» Program began; within its framework, the first 12 contracts (for the aggregate sum about US\$ 2 million) were made with the US and West-

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<sup>24</sup> The younger researchers were in the focus of the attention of certain local national initiatives, as well. Thus, in 1997, on the basis of the Institute of Catalysis under Siberian Division of the Russian Academy of Sciences the K.I. Zamarayev International philanthropy scientific foundation was created; it declared the program of the fellowships for 1998. The International Center-Foundation for promising researches founded in 1995 in Nizhni Novgorod also continued functioning; there, the younger researchers, post-graduate students, and students were to take part in implementing projects.

<sup>25</sup> In 1997, the RF Government allotted US\$ 10.5 million for the shared participation in the ISSEP Program. The additional financing of the Program from the local budgets was agreed by 40 Federation subjects.



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European companies. These contracts continued the projects financed before by the ISC<sup>26</sup>.

*Fifthly*, the plans of implementation of the structural programs of the science support, e.g., support of the science in the universities, are at the stage of the dynamic discussions. The problem of *joining the science and education* is really important; it has been called one of the priorities at the governmental level. During the period after the USSR disintegration, the share of the higher education institutions sector of the science in the aggregate financing reduced from about 20 per cent to about 5 per cent<sup>27</sup>. As the expenditures on the science are decreasing and the material basis of the higher education institutions science is constantly worsening, they are concentrating more and more the education of the higher school personnel: in 1991, the higher school covered 60 per cent to 70 per cent of the admission to and graduation from the post-graduate and doctorate courses, and as of today, this figure has already exceeded 80 per cent<sup>28</sup>. Hence, the polarisation between the scientific research and the education of the scientific personnel is becoming more and more pronounced.

The traditional large-scale program approach was selected as the tool, which could aid the process of integration of the science and education. In 1997, the implementation of the governmental Program «Universities of Russia — Fundamental Research» began. The main purpose of the Program is

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<sup>26</sup> It may be said that the national foundations develop a similar strategy. In 1997, the first joint competition was declared by the RFFR and the Foundation for support of development of smaller entities in the science and technology sphere. In accordance with its conditions, the fundamental research will be performed for the issues that interest the smaller enterprises. Hence, the competition will be sponsored by the firms having proposed the topics of the research.

<sup>27</sup> Data of CISN, according to the materials of the International workshop «Statistical studies for scientific and technical policy in the countries with the economy in transition», October 1997.

<sup>28</sup> Express-information of CISN «Monitoring of the reformation of the Russian science», 11 December 1997.

to support the fundamental research and the basis for them in the higher education institutions, and to attract the younger researchers to the universities. Besides, the Presidential Program «State Support of Integration of the Higher Education and Fundamental Science for 1997-2000» («Integration») continued developing. However, due to the insufficient financing (the support was granted for only three subdirections of the five directions, and the contest for 1998 for two more subdirections) and certain limitations (only the organisation of the academic sector are considered fundamental science) it has not, yet, shown any tangible results. Thus, in 1997, the direction «Expedition and field research with participation of students, post-graduate students, and professors of the higher education institutions» received Rb 10 billion: the sum is comparable with the one the Moscow University expends on these purposes annually. According to Mr. A. Tikhonov, Vice-Chairperson of the «Integration» Program, such result «is not an achievement — it shows our misery»<sup>29</sup>.

In addition to the certain improvement of the attention to the higher education institutions science, several more sectors where, in 1997, the activity of the governmental structures responsible for the development and implementation of the scientific and technical policy in Russia, may be marked. These are: the support of the science in the regions; solving the problems of the «science-towns»; the re-attestation of the State Scientific Centres (SSC); the stimulation of the innovative activity; and, last, but not least, the development of and discussion on, in the second half of 1997, the Conception of the reformation of the Russian science for the period 1997-2000.

It should be noted, at once, that no one of the implemented measures was fundamental indeed. In whole, despite the replacement of the administration in the RF Ministry of science and technologies, one of the main offices in the

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<sup>29</sup> Poisk, # 23, 31 May - 6 June 1997, p. 4.

science and technology sphere, and announcement of the course of reforms, the implemented policy seemed, rather the successful «evolutionary»<sup>30</sup> development. From the moment of adoption, in the summer 1997, of the Doctrine of development of science, no significant changes in the sphere of science have taken place. Thus, the RF President's Message «On the Budget Policy in 1997» focused the attention on the necessity to introduce the amortisation privileges and on the importance of creation of the economic conditions to improve the technologies of the defence and double purpose. Unfortunately, no serious progress in implementation of these two directions was seen: the available indirect motivations are inefficient, and the developments in the civil and military spheres are isolated; hence, the notion «double-purpose technologies» itself relates, rather, to the scientific literature than to the practice.

In 1997, various governmental instances proclaimed the importance of the *support of the science in regions* more than once and for various occasions. The fact that the Council of Federation Committee for science, culture, education, public health, and environment proposed to envision the goal-oriented financing of the regional science by a separate line in the Federal Budget confirms the acknowledgement of this task as a priority one.

The actual news in this field is the beginning of the regional contests in the RFFR (Kamchatka and Baikal problems), the declaration, for 1998, of the

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<sup>30</sup> The former administration was developing the «soft» variant of the reform, called «evolutionary». During the first years of the transformations it had its advantages (the environment was too «revolutionary» in relation to the sphere of science). However, in 1997 as well, Mr. V. Fortov, RF Minister of science and technologies declared that «The reformation of the science will be evolutionary» (Rossiyskaya Gazeta, # 199, 14 October 1997).

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regional contest in the RGNF, and several more special regional contests in the RFFR.

The regions themselves are, yet, passive in supporting the science: in average, the local budgets expend on the science 0.06 per cent-0.07 per cent of the money, while no significant changes can be expected without the initiative of the regions.

Among the «regional» problems is the issue of the so-called «*science towns*». On 7 November 1997, the RF President signed the Decree # 1171 «On the Measures of Development of the Science-Towns as Towns of Science and High Technologies». It is supposed that, in several years, the «science towns» will become self-financing; the role of the local budgets in this process will remain very important. However, the transition mechanism stays, yet, underdeveloped. As of today, the indirect load on the local budgets is high enough: the scientific organisations in the «science towns» do not pay the land and property taxes; the re-training and unemployment allowances are also borne by the local budgets. As a result, for example, in the Moscow region, which concentrates 30 per cent of the regional budget is consumed by the «science towns», though they concentrate only 15 per cent of the regional population<sup>31</sup>.

The year 1997 was also the year of the re-attesting of the *Governmental Scientific Centres* (GNC); most of them have had this status for more than three years. At the beginning of 1997, the analysis of the 61 centres available for the moment was completed. Notwithstanding the fact that the estimation results assumed efficient only 10 per cent to 15 per cent of the centres, the positive decisions were made for all the Centres. Actually, 54 organisations conserved their statuses. The seven Academy institutes were rayed off the GNC RAN list: in accordance with the RAN Presidium, they had not approved for re-approval.

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The motivation is that the RAN is a unique organisation; hence, it does not seem logical to give the GNC status to one entity and refuse it to another ones.

Not long ago, the Government decided to «freeze» the number of the GNCs at the level 61.; after the 7 «academical» Institutes had left, the new «vacancies» surged; three more «academical» Institutes had received their «turn» and three more «academical» Institutes had stay waiting. Hence, the GNC situation may be called «conserved»: this means the situation similar to the earlier initiatives: the number of the tenderers had become stable and the competition had turned out a formality.

However, it should be noted that a certain reformation of the GNCs is planned. As the centres quite differ by their structures and activities, the differentiated approach is supposed to be used. Some of the GNCs will become private, other ones are planned to be included in the financial-industrial groups, and the third ones will become the federal centres of science and high technologies. The latter will be formed on the basis of the best NTOs, including the GNCs. According to the projects of the Ministry for science, they will be created not instead of, but in addition to the GNCs. It is not, yet, clear what will be the difference from the GNCs.

The development of the *innovation activity and innovation potential* also saw a high attention at the governmental level. In 1997, the innovation activity continued reducing. According to the data for the first half of 1997, only 52 per cent of the enterprises had any innovations during the last eighteen months. Only 16 per cent of the enterprises manufactured new products<sup>32</sup>. In 1997, of the money directed from the Budget for the investments, less than 3 per cent were used for the innovations. The Government plans to increase it to 5per cent in

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<sup>31</sup> Poisk, # 44, 25-31 October 1997, p. 5.

<sup>32</sup> Data of the poll by the Russian Economic Barometer.

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1998. However, no privileged innovation environment exists, and the planned growth of the innovation activity is not well based.

The attempts to motivate the innovation activity in Russia are fragmentary and not well co-ordinated. For the moment being, the most efficient are such organisational and economical mechanisms as the foundations acting on the basis of the returnable financing. These are the Foundation for support of the small enterprises in the science and technology sphere, the Russian Foundation for the technology development, and the St-Petersburg regional Foundation for the science and technology development. In the Foundation for support of the small enterprises in the science and technology sphere, the return of the money is about 70 per cent, which is very good. Unfortunately, the sizes of such foundations are not large.

When evaluating the situation formed in the scientific and technical complex of Russia, the Government came to the conclusion on the necessity of a well-balanced reform in this sphere. The Governmental Ordinance # 1142-r of 15 August 1997 created the Governmental Commission for the reformation of the scientific sphere; the form of this Commission is very close to that of the Commission for the scientific and technical policy. The organisational and technical support of the new Commission was charged to the Ministry of finance.

The reformation began from the creation of the Conception and its large-scale discussion in the scientific community of Russia. At the same time, the attesting and accreditation of the Russian NTOs began. The processes of the «inventory» were quite spontaneous and badly co-ordinated. However, the certain terms of the accreditation had been planned: its completion had been planned for 1 October 1997. The planned events had not been co-ordinated with

the general program of reformation. Further on, the attesting and accreditation became important elements of the reform.

The Governmental Ordinance # 1291 of 11 October 1997 «On the Governmental Accreditation of the Scientific Organisations» and the Regulations on the governmental accreditation of the scientific organisations fixed the criteria of relating organisations to scientific ones and the mechanism of the accreditation. The Ministry for science was charged with it; to 11 November 1997, the methodology of the attestation and accreditation was developed. Hence, the mechanism of the attestation was proposed after its actual beginning.

The attestation had been supposed as a method for the selection of the best entities for the governmental support. The expert examinations with the participation of the Ministry for science had shown that the Government was able to give a paid for support to only 40 per cent of the researchers. This meant that only about 10 per cent of the Russian scientists were able to get such support.

The Russian Academy of Science (RAN) was the first to complete the attesting of its institutes. As the attesting process had began before the «instructions», it was «inside-based» and revealed clearly all the problems accompanying all the reformation processes of the latest years<sup>33</sup>.

According to the initial claims of the representatives of the RAS Presidium, the number of the scientific organisations had to be reduced practically 2-fold, with the by 15 per cent reduction of the number of the scientists; this had been supposed to enlarge many

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<sup>33</sup> E.g., in 1997, the Ministry for science initiated the inventory of the NTOs in order to reveal and eliminate the 9nstitutions having lost outlooks. The «STO Certificate» was developed to be filled in by every organization. As a result, no «inefficient structures» were revealed, and all the checked entities tried to validate, in any way, the necessity of their existence and the importance of the research.

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available institutions and lead to their restructuring. However, the events went on following the traditional scenario. The attestation criteria had been fixed inside the every of the six (formed under the RAS Presidium) commissions for the sciences. A methodology of evaluation based on a certain set of criteria had been developed. There could not have been any innovation: all the more or less formal criteria had been existing for a long time. The problem is not that the scientists cannot evaluate: they just do not want to do it, because any objective analysis will affect the interests of the science management elite. Hence, it is quite obvious that the reform in the Russian Academy of Sciences came to either the simple renaming of the institutions or their amalgamation without any serious changes in the researches or in the number of employed. Moreover, in certain events, the number of the legal entities even grown: e.g., two institutions were amalgamated into one; the both institutions conserved their legal statuses; and the newly founded institution received the status of a legal entity<sup>34</sup>. As a result, the list of the Academy institutions submitted, at the end of 1997, for accreditation to the Ministry for science included 98 per cent of the today's scientific organisations. Moreover, the expediency of the 10 per cent reduction of the scientific personnel stays under discussion up to today, though it is obvious that without such reduction the salary of the scientist cannot be increased. Such results show that the ongoing attempts of reformation continue facing the older decision-making system and cannot overcome it.

The concept touches not only the issue of the NTOs restructuring, though this issue is the best worked out and has even become a practical one. The other problems and issues, e.g., the contractual system of hire and works, change of the structure of the finance inflows from the State budget, mobilisation of the new financing sources, development of the tax privileges in the science stay, yet, declarative. Many of the announced «principles» go from one Conception to another. For example, the new Conception declares the necessity of the governmental support of the fundamental research, safeguarding and development of the

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<sup>34</sup> Poisk, # 8, 14-20 February 1998, p. 1.



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scientific schools, motivating the innovation activity, integrating the science and education, supporting the intellectual property rights. All these had been fixed by the Conception of development of the science developed and approved by the Government in 1992 and in the Doctrine of the development of the Russian science approved in 1996. The problem is that these really urgent directions of the reformation do not, yet, have any mechanism for implementation. Besides, the new Conception does not show either the main purposes of the reform or the supposed model of the science development. Meanwhile, the supposed model of the Russian science development will determine its structure, mechanisms of financing and the economic motivation.

The Message of the RF President «On the Budget Policy in 1997» had a good reason to criticise the Government for not having been able to fix the threshold limits of the main social indexes relative to the science on whose bases the required financing volumes are to be determined. The same repeated in 1997. It does not seem that the adoption of the Conception of the science reformation by the Meeting of the Government on 8 January 1998 will change the situation in the foreseeable future, because no obvious and stage-wise plan of its *practical* implementation has been developed, yet. Hence, the year 1998 began, again from the already traditional discussion on the necessity to pay the 1997 debts: this is a characteristic index of the «financial crisis of the beginning of the year».

# Part 4

## Social sphere

### 4.1 Living standard

Macroeconomic stabilisation and the fact that the inflation had been brought under control have exerted main influence over the population's income in 1997 and most importantly they have influenced the growth of the real income of the population and have reduced income differentiation. Average per capita income of the population in 1997 amounted to Rb 920 thousand per month, increment in the real disposable money income constituted 3.5 per cent. Specially favourable movement through time of the real disposable money income was registered in the second quarter of 1997 when the increment compared with the corresponding period of 1996 amounted to 6 per cent. They were mainly linked with the intensive implementation of measures aimed at paying arrears to the population accrued by the budgets of all levels of government.

In the circumstances of general favourable dynamics of money income, their interregional differentiation has increased. According to the data obtained for the first three quarters of 1997, the real income went up only in 36 regions

of Russia, in several regions the growth rates were significantly higher than all average (in Moscow--126.5 per cent, in the Orenburg *oblast*--123 per cent, in the Samara *oblast*--119 per cent, when the national average for the same period amounted to 102.8 per cent). Average per capita income in Moscow were 5-7-fold of the corresponding indicators in the Central region. The Tyumen *oblast* outpaced the rest of the *oblasts* of the Western Siberia region by 3-5-fold with respect to this indicator. Hence, renewed in 1997, the growth of the real money income has led to an improvement in the living standard of about 30-35 per cent of the Russia's population.

In a number of regions, there was a decline in the average per capita income compared with an all-Russia average level. This is confirmed by the data of a survey "Monitoring of income and standard of living of the population" carried out by the All-Russia Centre for Living Standards Studies under the Ministry of Labour of Russia (Table 43).

Table 43

**Distribution of Federation subjects across the correlation between the money income of a Federation subject and money income in Russia as a whole\***

Gap	III quarter 1996	III quarter 1997
to 75 per cent	50	53
75-100 per cent	16	11
100-125 per cent	7	8
above 125 per cent	7	7

\*Chechnia and autonomous *okrugs* which form part of *krai* and *oblast* were not included in the number of Federation subjects

Source: Monitoring "Income and standard of living of the population", III quarter 1997. Ì., All-Russia Centre for Living Standards Studies, 1997

In 1997 the trend toward the growth of the share of labour remuneration in the overall volume of people's income remained unchanged. Compared with 1996 the share of social transfers went up by 0.6 percentage points. The share of proceeds from the sale of the public property, entrepreneurship activities and other earnings declined by 1.6 per cent (Table 45).

Table 44

**Dynamics of regional differences in money income**

	Per capita money income (monthly, thousand Rb.)				Correlation between money income and the subsistence minimum (per cent)			For reference Distribution	
	1994	1995	1996	9 month	1995	1996	9 month 1997	populn umber	Social fund money income
Russian Federation	206,3	515,4	764,2	888,1	195	207	214	100,0	100,0
Northern region	236,4	600,3	798,1	897,9	197	172	187	4,0	4,2
North-Western region	196,4	553,2	782,3	829,6	224	212	199	5,5	5,2
Central region	316,7	791,2	1131,8	1421,2	370	305	359	20,3	32,8
Volga-Viatskii region	143,8	346,7	474,2	546,3	187	153	158	5,7	3,6
Central Black Soil region	135,2	345,6	509,6	577,0	204	188	189	5,4	3,6
Volga region	146,3	365,3	520,5	619,0	205	165	184	11,6	8,3
North Caucasus region	129,9	310,4	453,9	522,2	163	146	164	11,5	6,9
Urals region	162,8	402,2	582,9	706,0	168	153	193	14,0	11,4
Western Siberia region	228,2	593,6	847,6	1011,9	248	211	221	10,3	12,0
Eastern Siberia region	205,5	521,9	740,7	815,6	197	167	173	6,2	5,9
Far East region	281,7	638,5	927,5	975,4	173	153	186	4,9	5,7
Kaliningrad <i>oblast</i>	167,7	378,8	502,1	588,8	213	145	168	0,6	0,4

Table 45

**Structure of money income (per cent)**

Year	1992	1993	1994	1995	1996	1997
Total money income	100	100	100	100	100	100
Labour remuneration	69,9	60,5	46,6	40,7	41,9	42,9
Social transfers	14,0	15,1	15,4	12,4	14,2	14,8
Proceeds from property, entrepreneurship activity, etc.	16,1	24,4	38,0	46,9	43,9	42,3

In the whole of Russia, the average wage was above the average per capita income and only in Moscow it was below and amounted to only 37 per cent of the average per capita income level.

Average monthly wage in 1997 constituted Rb 965 thousand. In the first half of 1997 the real wage grew slower than the average real per capita income and in the second half-year the situation changed for reverse. That was owing to an economic revival and increase in employment. Wage growth in 1997 was

uneven: it was declining in January, February and August and significantly increased in March and June<sup>35</sup>.

Table 46

### Wage changes by sector

	Ratio of the average wage of the 10 per cent highest paid to the 10 per cent lowest paid wage-earners, times		
	April 1995	May 1996	June 1997
Industry	20,6	20,9	21,4
of which:			
electric energy	9,6	8,6	8,9
fuel	15,2	15,1	15,6
metallurgical	11,6	10,5	10,8
chemical and petrochemical	12,4	10,9	11,3
machine building and metal workings	16,3	15,8	16,1
timber, wood processing and pulp and paper	18,0	16,8	17,2
construction materials	11,5	12,7	12,9
light	15,8	14,8	14,8
food	16,3	14,0	14,4
Agriculture	23,8	21,0	20,1
Construction	24,7	25,1	25,8
Transport	13,3	12,1	12,5
Communication	14,2	15,2	15,6
Trade and public catering	17,8	16,8	17,4
Material and technical supply, marketing	14,9	15,1	15,5
Housing sector, household services	14,7	13,9	14,3
Health care, physical culture and social security	13,5	13,0	13,7
Education	13,0	14,6	15,1
Culture and arts	16,2	17,2	17,8
Science and scientific services	16,8	15,5	15,6
Banking activities	20,3	26,3	27,9

In 1997 the wage differentiation by sector remained as it was before: wages in gas industry were 4-fold of its all Russia level, in oil production--3-fold, in electric energy production, oil refining, coal mining, non-ferrous metallurgy--2-fold. Wage growth rates in electric energy production and fuel industries in 1997 compared with 1996 were somewhat above the average all-Russia level. Table 46 shows the data on wage differentiation by sector.

<sup>35</sup> It is interesting that a reduction in wages coincides with the slowing down of economic reforms, softening of the stabilisation policy, and the growth, on the contrary, is linked with the activation of reform process, strengthening of the stabilisation policy.

Ten per cent of the highest paid received more than 33 per cent of the overall sum allocated for wage payments, 10 per cent of the lowest paid received 1.4 per cent of that sum. The largest differentiation in labour remuneration was registered in the banking sphere (27.9). It is explained not only by the highest wage of the 10 per cent highest paid but by the relatively low wage of the 10 per cent of the lowest paid.

During the first three quarters of 1997, by more than 20 per cent grew the overall volume of wage arrears which amounted by the end of September to Rb 55.3 trillion or about 90 per cent of the monthly calculated wage fund. At the end of 1997, as a result of government's measures and first of all of its reformist wing, a significant reduction in the budgetary wage arrears took place.

The absolute amount of the average calculated pension during 1997 remained unchanged and constituted for the year Rb 328 thousand. As a result, the real size of calculated pensions were slowly falling with the rate equal to the inflation rate. As a result, the situation of pensioners during the period under consideration would have worsened considerably (the average calculated pension during the year amounted to one third of the average wage, correlation between the average pension and the subsistence minimum of a pensioner fell from 155 per cent in January down to 107 per cent in June 1997 and to 109 per cent in the third quarter of 1997), had it not been a simultaneous payment of pensions arrears. The real size of the calculated pension in June 1997 approximately corresponded to its average 1993 level. At the same time, due to the liquidation of pension arrears, in mid-1997 the real situation of pensioners have improved. Moreover, preconditions were set up in order to regular payment of pensions in the future.

Distribution of the population of the Russian Federation by average per capita income in January-September 1997 is given in Table 47. Distribution of

the overall volume of money income of the population among separate income-groups is shown in Table 48.

Table 47

**Distribution of the population in 1997 by average per capita monthly income, thousand roubles (per cent to result)**

Total population	100
Income up to 400,0	19,7
400,1-600	19,7
600,1-800	16,4
800,1-1000	12,2
1000,1-1200	8,8
1200,1-1600	10,6
1600,1-2000,0	5,5
above 2000,0	7,1

According to the All-Russia Centre for Living Standard Studies survey, the most significant change in the movement through time of the decile coefficient of income differentiation took place in the Far East economic region where it declined from 20 to 16.4 times. The lowest value of this coefficient was remaining in the Central Black Soil region (6.4), the highest--in the Central region (23.3 against 12.8 in 1995). In Moscow decile coefficient during the year declined from 19.7 down to 15.9, in St. Petersburg--increased from 6.6 up to 9.3.

Table 48

**Distribution of the overall money income of the population in 1994 -1997 (per cent)**

	1997	1996	1995	1994
Money income	100	100	100	100
including by 20 per cent population groups:				
first (lowest income)	6,2	6,5	5,5	5,3
second	10,6	10,9	10,2	10,2
third	15,1	15,5	15,0	15,2
fourth	21,4	22,4	22,4	23,0
fifth	46,7	44,7	46,9	46,3
Gini coefficient	0,375	0,375	0,381	0,409
Ratio of income of the wealthiest to the poorest 10 per cent	13,2	13,0	13,5	15,1

Source: RF Goskomstat.

Value of the subsistence minimum (calculated on the methodology of the Ministry of Labour) amounted to Rb 411,000 per person in 1997. The poverty

level continued to fall, the share of those whose income was below the subsistence minimum declined. Average money income of the 21.2 per cent of the population in January-September 1997 were below the subsistence minimum (during the same period in 1996 that group included 22.4 per cent of the population).

Figure 25

### Income distribution by their components (Lorenz curves)

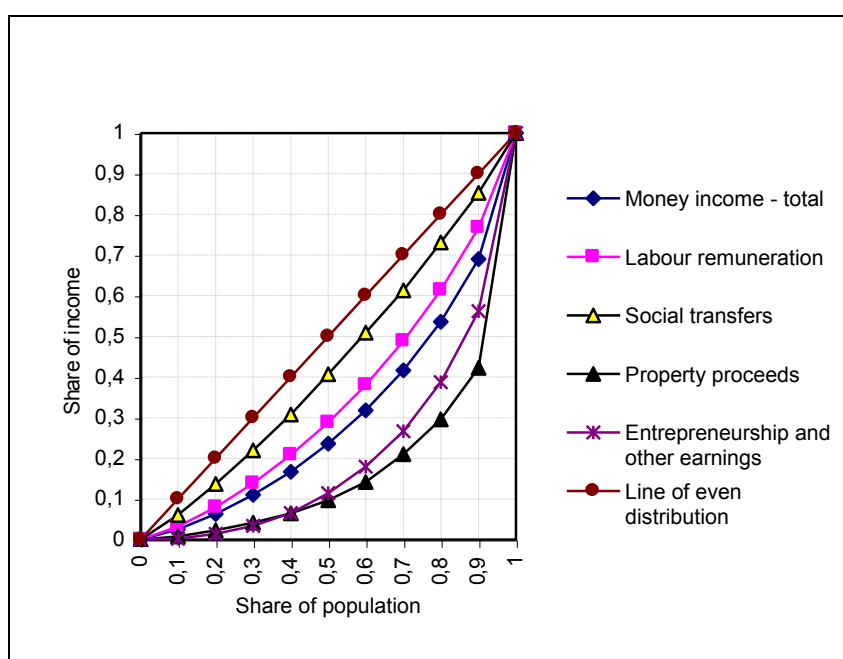


Table 49

### Dynamics of the number of people whose money income is below the subsistence minimum

	mn people	in per cent to the number of people	For reference ratio of average money income to subsistence minimum, in per cent
<b>1996</b>	32,5	22,0	207
<b>1997 (monthly average)</b>	30,7	20,8	223,7
January	31,9	21,6	211
February	31,5	21,4	205
March	31,3	21,2	210
April	30,4	20,6	225
May	32,5	22,0	208
June	28,9	19,6	227



	mn people	in per cent to the number of people	For reference ratio of average money income to subsistence minimum, in per cent
July	29,8	20,2	218
August	31,0	21,0	218
September	31,6	21,4	220
October	30,8	20,9	232,7
November	37,0	21,7	223,4
December	27,5	18,6	288,8

Accordingly, ratio between the average money income and the subsistence minimum constituted 2.16, significantly surpassing its last year level.

In the third quarter of 1997, a sharp increase in the size of the subsistence minimum was registered in those Russia's *oblasts* which till lately were maintaining the artificially low prices on foodstuffs which comprise the basis of the basket of the subsistence minimum. In Ulianovsk and Orlov *oblasts* the increment in the size of the subsistence minimum surpassed 25 per cent during the year. Twenty-twenty five per cent increment was registered in Tula, Kaluga, Ivonovo, Yaroslavl and Kursk *oblasts*. In Russia as a whole, the size of the subsistence minimum increased by 11 per cent during that period.

**Money spending.** In the first half of 1997, there was a gradual decline in the share of people's spending on purchases of goods and services with respect to the overall volume of people's income. At the same time, monthly values of this indicator in the first half of 1997 were by 2.2 per cent lower than their volume during the corresponding periods of 1996. Later, owing to a relative reduction in the real income in the third quarter of 1997, the share of the consumer spending went up sharply (up to 78.8 per cent in September), as a result of which in the third quarter it turned out to be higher than in the same period of 1996 and according to the year's results coincided with its 1996 level (Table 50).

There were further changes in the structure of people's savings. We refer both to the savings in individual deposits and securities and in "unorganised" type of savings--purchases of currency and increment in cash money on hand).

Table 50

**Share of population's spending on goods and services in population's income in 1996-1997**

	1996	1997
Year as a whole	68,8	68,9
January	78,3	72,9
February	69,4	68,3
March	69,1	68,5
I quarter	72,1	69,9
April	67,9	65,4
May	71,9	69,4
June	66,3	63,7
II quarter	68,6	66,1
First half-year	70,3	67,9
July	69,0	66,1
August	69,7	72,2
September	73,0	78,8
III quarter	70,6	72,1
October	68,2	71,9
November	68,3	74,7
December	50,1	64,2

In January-September 1997, there was a fast decline in the CBR refinancing rate (from 41 per cent down to 21 per cent), simultaneously bank individual deposits rates were falling. During the financial crisis the refinancing rate was raised up to 28 per cent. Some increase in the bank individual deposits rate was registered only in November-December, which resulted in an increase in the savings norm by the end of the year. Hence, the rule was confirmed that people's savings clearly and quickly react to the bank interest rate. As Table 51 shows, during the first nine months of the year, the share of the savings increment in the form of individual deposits and securities turned out to be less than the previous years and hardly surpassed 9 per cent. The volume of bank individual deposits in August-September was shrinking in line with a decrease in the refinancing and deposit rates.

There were structural changes in the given expenditure item: if in 1996 increment on bank individual deposits constituted 80 per cent of the overall savings increment in the form of individual deposits and securities, then in 1997--only 50 per cent. About 83 per cent of the new individual deposits were registered with Sberbank. The share of individual deposits in Sberbank remained stable (76 per cent). Despite the fact that the deposit rates in commercial bank were remaining by the end of the first half-year a little bit above the Sberbank rates, dramatic reduction in those rates after a fall of the CBR refinancing rate has led to an outflow of capital from the commercial bank while there was a certain increase in the volume of individual deposits with Sberbank. The volume of individual deposits with commercial bank by 1 October 1997 remained at its first quarter-end level.

Stable low inflation rates together with a sharp fall in the bank individual deposits yields preconditioned a fast growth of the residual cash on hand in the second quarter. It became most noticeable in June 1997. If in the first quarter of 1997 the share of increment of cash on hand constituted 0.3 per cent of the overall volume of the money income of the population, then in the second quarter, it has reached 5.8 per cent and in the third quarter it again shrank to 0.7 per cent, in the fourth quarter the volume of cash on hand contracted insignificantly.

*Table 51*

**Structure of households' savings in 1993 - 1997 (in per cent)**

	1993	1994	1995	1996	1997
Overall savings, per cent to result	100	100	100	100	100
Increment of savings on individual deposits and securities	26,7	22,7	21,9	17,8	9,0
Unorganised savings,	73,3	77,3	78,1	82,2	91,0
including:					
purchase of currency	33,9	61,6	62,7	76,7	84,4
increment of cash on hand	39,4	15,7	15,4	5,5	6,6

The share of capital stock directed to the purchases of hard currency remained at its 1996 level (for the whole year--21.6 per cent of the overall money income). In the third quarter, with certain level of stagnation in money income, the share of income directed to the purchases of hard currency reached 22 per cent (July), in August-September it declined to 17 per cent. The growth of the purchasing power of the population was accompanied by a reduction in the share of all types of savings, in the fourth quarter this indicator grew to 22.6 per cent.

Retail turnover in 1997 grew by 1.4 per cent in comparable prices compared with its 1996 level. The growth of the share of food products in the overall volume of commodity turnover continued since 1993. In January-September 1997, that indicator constituted 49.4 per cent. Somewhat increased the share of turnover of goods, mixed and food markets in the total volume of commodity turnover: from 28 per cent in 1995 up to 29 per cent in 1997. The markets provide at present about three fourth of the total volume of cloths and linen, about 70 per cent of footwear, over one third of the amount of eggs, vegetables and fruit and about 30 per cent of meet. In the structure of goods turnover in the markets the share of the soled food products is growing (from 22 per cent in 1996 up to 25 per cent in 1997).

In 1997, the growth of people's spending on services were outpacing the growth rates of commodity turnover which, to a considerable extent, was explained by a fast growth of tariffs on services compared with the consumer price index (for January-September, consumer price index constituted 109.5 per cent and tariffs on services increased by 19 per cent). The share of paid services in consumer spending of the population in January-September as a whole went up to 24 per cent against 22 per cent in the same period of 1996. For the first nine months of 1997, tariffs on the communal services, passenger transport and

recreational services increased by 40-50 per cent. The share of the communal sector in the overall volume of the rendered services surpassed 20 per cent (in 1993 it constituted 10 per cent).

During the whole of 1997, the dynamics of income and living standard were determined by the following factors:

- growth of the real income;
- decline in the level of income differentiation, first of all, in the group of the "upper" 20 per cent of the population which testified about a real formation of the middle class in Russia;
- noticeable growth of goods turnover, considerable share of current expenses and dramatic decline in interest to the organised savings as well as to purchases of hard currency as a result of a reduction in the bank interest rates.

## **4.2 Social and cultural sphere**

During 1997 evolution of health care, education and culture continued to be characterised by all negative aspect which existed in 1996. First of all, it refers to the budget arrears on wages and development of strike movement.

The situation in the social and cultural spheres continued to worsen. However, at last, it became a subject for a constructive dialogue in the government. Supporters of the liberal economic reforms who joined the government at the beginning of 1997 have indicated as one of major tasks of the economic policy the solution of the budgetary crisis and liquidation of the gap between the governments obligations which were reflected in budgeted expenditures and its real revenues. One of the first steps of the reformed government became an attempt directed at drafting a project of a large-scale reform programmes in the social sphere. Their essence consisted in reviewing and rationalising financial support for public guarantees in the social sphere,

reduce the "social burden" on the public finance by shifting it to the regional and local budgets as well as onto the population. Carry out organisational and economic and structural transformations in order to secure an efficient performance of the social and cultural sectors in market economy.

### **Budget financing**

While approving 1997 federal budget, again, as in 1996, the intention to increase the share of expenditures on health care, education, culture and mass media was declared (Table 52). Up to December 1997, these indicators were below the target. However, the last month of the year received 20 per cent of the annual allocations in the sectors of the social and cultural sphere. By year-end results, expenditure on health care and education turned out to coincide with the budget targets approved by the State Duma. Culture, as before, turned out to be less important in the budgetary process. Nevertheless, in 1997 as a whole compared with 1996, the federal budget expenditures on all sectors of the social and cultural sphere increased in comparable terms: on health care--by 75 per cent, on education--by 8 per cent, on culture, arts and mass media--by 7 per cent.

*Table 52*

#### **Share of expenditure on sectors of social and cultural sphere in the Federal budget expenditures (in per cent)**

	Execution in 1995	Law for 1996	Execution in 1996	Law for 1997	Execution in 1997
Sectors of social and cultural sphere	5,4	6,5	4,9	7,4	6,3
of which:					
health care	1,3	1,7	1,2	2,2	2,2
education	3,1	3,6	3,2	3,5	3,5
culture and mass media	1,0	1,2	0,5	1,7	0,6

Source: RF Goskomstat

Expenditure growth in these sectors was registered in the budgets of the Federation subjects. However, the ratio of expenditure on the sectors of the

social and cultural sphere from the Federal budget and from the budgets of Federation subjects have changed insignificantly in favour of the Federal budget (Table 53). Allocations from the consolidated budget on health care grew over the year in comparable terms by 14 per cent, on education--by 10 per cent, on culture, arts and mass media--by 12 per cent (Table 54). At the same time, relative level of wages in those sectors fell (Table 56).

Table 53

**Ratio of Federal budget expenditure to budgets of Federation subjects on sectors of the social and cultural sphere (in per cent)**

	1992	1993	1994	1995	1996	1997
Federal budget	27	17	18	14	12	13
Budgets of Federation subjects	73	83	82	86	88	87

Source: RF Goskomstat

Budget arrears on wages to the social and culture sphere were increasing in the first half of 1997 by 8-10 per cent monthly, then in April they were reduced by 9.5 per cent. However, they again started to grow in May and June reaching by the beginning of July its March level.

Table 54

**Public expenditure on sectors of the social and cultural sphere (in comparable terms)**

	1991	1992	1993	1994	1995	1996	1997
Health care	100	80	108	98	72	71	79
of which:							
state budget	100	80	91	81	59	57	65
mandatory individual social security contributions	-	-	17	17	13	14	14
Education*	100	79	79	76	56	58	64
Culture, arts, and mass media*	100	91	81	87	63	54	60

\* - state budgeted expenditures.

Source: calculated on RF Goskomstat data using GDP index-deflators.

Table 55

**Public expenditure on the sectors of the social and cultural sphere (in per cent of GDP)**

	1991	1992	1993	1994	1995	1996	1997
Health care	2,9	2,5	3,7	3,9	2,9	3,1	3,4
of which:							

state budget	2,9	2,5	3,1	3,2	2,4	2,5	2,8
mandatory individual social security contributions	-	-	0,6	0,7	0,5	0,6	0,6
Education*	3,6	3,6	4,1	4,5	3,4	3,7	4,1
Culture, arts and mass media*	0,5	0,6	0,6	0,8	0,6	0,5	0,6

\*- state budgeted expenditure

Source: calculated on RF Goskomstat data.

Table 56

### Average wage in sectors of the social and cultural sphere (in per cent)

	1985	1990	1991	1992	1993	1994	1995	1996	1997
Industry as a whole	100	100	100	100	100	100	100	100	100
Health care	70	68	76	65	76	78	69	74	67
Education	77	68	71	62	68	73	62	67	62
Culture	69	63	67	54	62	63	57	62	59

Source: RF Goskomstat

Further energetic attempts of the government aimed at normalisation of the situation with paying wages in the budget sphere have resulted in significant changes in the trend which showed movement through time of the arrears in the social and cultural sphere. However, by the beginning of November 73 per cent of the overall budget arrears were accumulated in the sectors of the social and cultural sphere (Table 57). Throughout the autumn of 1997, the government took attempts aimed at liquidating wage arrears in the budgetary sector trying to honour promises made by the President of the Russian Federation about the repayment of arrears by 1 January 1998. Scheme dealing with the arrears repayment was adopted. It indicated that the payments from the Federal budget would not surpass the amount of funds disbursed by the budgetary organisations of the Federation subjects, i.e. arrears will be repaid in the ratio 50:50.

From July to November 1997, in addition to two Federation subjects which did not have wage arrears in the budgetary sphere (cities of Moscow and of St. Petersburg), two more Yamalo-Nenets autonomous *okrug* and Jewish autonomous *oblast* joined them. The rest of the Federation subjects continued with wage arrears, at that three quarters of the Federation subjects accrued arrears surpassing two months wages and over ten of them--arrears surpassing four months wages. Nearly half of the arrears volume pertained by the end of



November to eleven Federation subjects (including Irkutsk, Krasnoirsk, Kemerovo, Sverdlovsk *oblasts*, republics of Sakha, Tatarstan, Altai *krai*). These subjects of the Federation not only reduced the arrears volume but increased them by Rb 700 bn compared with July. At the same time, during the last month of 1998, the government managed to reduce budget arrears on wages by 61.6 per cent.

Table 57

### Budgetary wage arrears in 1997 Rb bn

	as of 27.01.	as of 24.02.	as of 24.03.	as of 28.04.	as of 02.06.	as of 01.07.	as of 01.08.	as of 01.09.	as of 01.10.	as of 01.11.	as of 01.12.	as of 01.01.98
Total	9482	10334	11305	10761	11017	11354	10940	10186	10198	9609	9300	4990
<i>of which:</i>												
social sphere	7532	8293	8956	8245	8521	8926	8532	7789	7865	7195	6820	2618
<i>of which:</i>												
education	4571	4948	5306	4917	5129	5437	5024	4303	4310	4088	3974	1382
health care	2115	2334	2540	2239	2230	2304	2343	2375	2419	2073	1842	574
culture and arts	473	524	568	533	565	568	565	528	541	472	443	132

Source: RF Goskomstat

Table 58

### Strikes in sectors of the social sphere in 1997 (aggregate from the start of the year)

	January	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Number of organisations on strike :												
<i>education</i>	5503	10143	12583	13531	13803	13803	13803	13805	14768	15172	15605	16092
<i>health care</i>	184	198	600	631	645	653	680	683	684	686	703	732
Number of workforce on strike (thousands of persons):												
<i>education</i>	161	293,5	419,2	456,6	468,6	469,0	469,0	469,0	489,2	501,5	513,3	532,0
<i>health care</i>	18,7	21,9	75,9	79,9	83,7	87,9	92,7	93,0	93,3	93,4	93,5	95,1

Source: RF Goskomstat

During the passed year, there was a wide practise of spending budgetary funds allocated by the federal authorities on repaying the wage arrears in the social and cultural sphere on other purposes. This practise became specially widespread in the autumn during preparation for the heating season when the regional administrations were facing a choice: to direct allocated funds to the

housing sector or to leave the people without heating but to repay wage arrears in the budgetary sphere. Thus, the adopted government's scheme did not help to solve the arrears problem in a number of regions who were unable to repay wage arrears in the budgetary sphere.

### **The strike movement**

In 1997, there were significant changes in the structure of the strike movement: for the first time, the sphere of education became the centre for the strikes. The vast majority of strikes took place in that sphere. If last year, the number of strikers in industry outnumbered the number of striking teachers, this year there were less strikers in industry than the number of strikers in the educational sector. In November 1997, about 92 per cent of total number of strikes fell on the educational sector. In some regions (Kemerovo, Chita, Kirov *oblasts*, Primorski, Krasnoyarski *krai*) strikes in the educational sphere were chronic.

Because major demands of the strikers were mainly economic, it is possible to assume that in case of duly payments of the wage arrears in the budgetary sphere and, in particular, education, the strike movement will weaken the next year.

### **The start of a new stage in the heal care reform**

Main aspect in the transformation process in health care in previous years was introduction of the medical insurance system. The reform began in 1991 and reached its culmination in the first half of 1994 and then was practically halted. Introduction of a compulsory medical insurance system turned out to be inconsistent and fragmentary and was replaced by the attempts at a counterreform which consisted in the return to a state system of health care and which were taken during 1995-1996 by the sectoral health care administrations in the centre and in regions.

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In spring 1997 the reformist wing in the government launched a new stage in the health care reform. In November the government approved "Concept for the development of health care and medical science" according to which main tasks of the reform are the following.

The key economic problem of health care system is an imbalance between the state funding of the health care system and the guarantees of the free medical care granted to people. During 1992-1997, funding of the health care system at the expense of the budget and insurance contributions declined by 21 per cent in real terms. However, state guarantees enshrined in the legislation have not been revised. At the same time, the guarantees proper are formulated in the Constitution and other normative acts in a very general terms and are not represented in volume and finance equivalent.

The government did not dare to revise the guarantees concerning free medical care. Even in the circumstances of the financial stabilisation and signs for a near economic revival, introduction of amendments into the Constitution seem very problematic. Even government's request to revise the constitutional guarantees will be used by the opposition to aggravate political outlook.

Nevertheless, state guarantees will be specified. Each year the "Federal programme of state guarantees on ensuring free medical care for the citizens of the Russian Federation" must be approved. The programme determines the list of medical services rendered free, their volumes and the federal per head costs. An integral part of that programme becomes a basic programme for compulsory medical insurance which determines the conditions and the volumes of medical services rendered at the expense of the compulsory medical insurance funds. On the basis of the federal programme, regional programmes of state guarantees on ensuring free medical care to the citizens must be approved.

The government's idea is designed to stimulate structural changes in the health care system resulting in the cut of general requirements of the sector in public funding. In the draft of the federal programme for 1998, the rates of the medical services have been calculated taking into account structural changes in favour of an out-patient aid. Correspondingly, financial rates are aimed at a new more efficient structure of medical care. At the same time, the total sum needed to cover the federal programme constitutes 104 per cent in comparable terms of the real volume of health care funding in 1997 out of the budgets of the RF subjects and at the expense of the contributions made by the employers to the Compulsory medical insurance fund.

There are two serious dangers in the government's chosen course. First, required structural changes can take place very slowly. And if the structure of assistance changes little, then the funds calculated by the programme will not be enough to finance medical organisations. Second, there is a real possibility that there will not be a balanced budget during the near one or two years and that the planned targets will not be met again. As a result, in mid-term perspective there will be an imbalance between state guarantees and their financial support.

However, in case the government pursues a stringent course aimed at specifications of state guarantees (annually approve a detailed programmes of state guarantees and strive to make it realistic), then the acuteness of the imbalance problem can be solved as the country comes out of the economic crisis. Nevertheless, in future the government will not manage without a revision of the state guarantees in the health care system. However, in a more favourable economic situation when there will be a stable growth of population's incomes, it will be easier to solve this problem.

In the government's concept, medical insurance is being looked at as the main mechanism for funding health care. Major task for the near future consists

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in the overcoming of fragmentary introduction of the Compulsory medical insurance (CMI) system and removal of dual authority in funding the medical services which is envisaged by the Compulsory medical insurance system. For the solution of this problem, it is planned to introduce a new regime for paying contributions into CMI for the non-working people. They should be carried out in proportion from the federal budget and the Federation subjects' budgets. Thus there will appear economic incentive for the executive authorities of the Federation subjects in funding CMI system from the regional budgets in total volume.

The proportion in which transfers from the Federal fund correlate with the payments into the regional funds out of the Federation subjects' budgets should be calculated by applying a single method. The amount of a transfer to each region will depend on the costs of the implementation of the federal CMI programme on the territory of a given region and on the level of its social and economic development which determines the volume of collected contributions into CMI of working population and revenues of regional budgets. Volume of transfers should be determined while approving the federal budget.

The draft Federal 1998 budget envisaged allocation of Rb 8 bn for targeted transfers to the Federation subjects destined for CMI programme. The ratio of the transfers from the Federal CMI fund to the payments from the regional budgets will constitute on average 1 : 2.25. However, the State Duma has not approved allocation of such targeted transfers.

Government's concept preserve orientation to the competitive CMI model which envisages creation competitiveness between insurance companies and medical organisations. Indispensable conditions for the introduction of a competitive CMI model consist in the removal of duplication of insurance companies by the insurance medical organisations and branches of CMI funds.

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The latter should be allowed to do that only in the regions with a low population density which objectively hampers activity of the insurance companies.

While assisting in the creation of legal conditions for the development of competition among the insurance companies, it is obvious that at present in those regions where the insurance companies operate within the CMI system, one can observe a division on the sphere of influence than the competition. By the estimates of the Federal CMI fund, out of 500 insurance companies operating in the CMI system not more than 150 operate actively and the rest are passive intermediaries between CMI funds and medical institutions.

As a result, administration of the Federal CMI fund and a number of regional health care authorities propose to select the "efficiently operating" insurance companies by way of state accreditation. It may result that only "selected" insurance companies will remain in the CMI system with whom the health care authorities and/or CMI funds have created friendly relations. It is worth noting that such approach has been already tested in Moscow. In December 1996, accreditation of insurance companies operating within the CMI system was carried out. Out of 25 insurance companies only 9 remained.

Negative results of such course are obvious. Removal of insurance companies from the CMI system may lead to its transformation into a quasi-state bureaucratic system for the financing of medical services. Non-market selection of insurance companies will result in strengthening clan structures which satisfy their interests to the detriment of the public interests. The insurance companies operating in the CMI system should fulfil a number of requirements set by the state. However, these requirements should be fixed in the legislation as a clear criteria for obtaining licenses needed for the operation in the CMI system and conditions for revoking those licenses.

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On the Federal level the following policy seems to be feasible. Where there are elements of competition between the entities of CMI or it is possible to create them, it is worthwhile to promote competition there. However, one should not attempt at all costs to introduce competitive model of relations in CMI. On those territories where insurance companies do not operate, it is unnecessary to artificially introduce them there. However, we should not go back by initiating or stimulating exclusion of insurance companies from the regional CMI systems or purposefully cutting their number. The role of the insurance companies should consist in strengthening the economic approach to rendering medical services and promote that activity. Such policy will minimise the negative risks and with time, on the basis of comparative analysis of CMI and insurance companies efficiency in different regions, will provide a chance to introduce amendments in the CMI model.

Among feasible ways of transformations, the concept names a creation of a single system of compulsory medical and social insurance. Such consolidation can really interest a united funds of medical and social insurance and insurance companies to reduce the number of sick people among those insured as well as in the rational disbursement of funds directed to the prevention of diseases, treatment and rehabilitation period. There can appear possibilities to redistribute the funds in favour of a more important and efficient form of prevention of diseases types of medical services at the expense of a reduction of low-efficient funding of the present system of social insurance (financing of sanatoria and health resort services and medical treatment by the enterprises). At the end of last year, the Nizhny Novgorod *oblast* proposed to the government to carry out in 1998 an experiment on its territory in 1998 designed to consolidate the funds for social insurance and compulsory medical insurance.

In Russia about 15 per cent of all out-patient facilities and 6 per cent of hospitals belong to various ministries and committees and are funded from the budget. "Departmental" medicine disposes of about 6 per cent of the total number of hospital beds and 10 per cent of the total number of medical staff. About 15 per cent of public medical funds are allocated on financing the "departmental" medicine.

In order to eliminate duplication of medical facilities in the public sector and guarantee the principles of social equality and rational allocation of public financial and material resources, it is necessary to gradually integrate "departmental" medical facilities into the territorial health care systems. Facilities belonging to the "departmental" medicine should gradually be transferred to the Federation subjects' ownership and into the municipal ownership. Their funding should be carried out via the CMI system or out of the Federation subjects' budgets.

### **Reform in education**

In 1997 attempts aimed at drafting directions in the reform of the sphere of education increased. With this purpose, special governmental commission has been set up whose aim was to prepare a draft for a new stage in reforming the system of education. In autumn 1997, the RF governmental commission approved "Concept for the organisational and economic reform of education". The most important task of the reform in this sphere are the following.

Financial constraints for the development of education in contemporary Russian society determine the need for a clear definition of the public obligations in offering free education: structure, quality standards, volume of educational services, minimum level of their budget financing. Everything which is above those obligations can be fulfilled in case the Federation subjects dispose of additional funds, or cover at the expense of the extra-budgetary



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financial resources: orders of enterprises, fees paid by the students. At the same time, it is necessary to implement for efficient market mechanisms of public financing educational organisations by way of “money follow after the students”.

Precisely this idea has been enshrined in the mentioned concept. Transformation of the organisational and economic mechanism in the system of education should follow the following directions:

- replacement of the per item financing of educational establishments with per head financing, directly transmitting the funds to the educational establishments; formation of a regulated market of educational services on the basis of per head budget funding of the establishments which render such services irrespective of their form of ownership;

- widening the types of education together with the introduction of the national system of educational standards and tests in order to ensure uniformity of requirements to the quality of rendered services and education received;

- creation of conditions for the efficient management of the transferred property to the educational establishments and for the efficient disposal of the obtained income as a significant additional source of funding the educational activity;

- ensuring targeted support of the students which will allow to eliminate the present system of distribution of scholarships.

Among the proposals discussed by the mentioned Commission the following directions have been studied:

- creation of a regulated market of the educational services on the basis of per head budget funding of the educational establishments which render such services despite the forms of ownership;

- introduction of measures aimed at changing the structure of rendered educational services, trying to move it closer to the solvent demand with the minimum losses for the accumulated potential in the sphere of education;
- further development of different types of education;
- creation and implementation of the national system of educational standards and tests in order to secure single requirements to the quality of rendered services and education received;
- granting to the public and municipal educational institutions rights of legal entity, elimination of discrimination of non-public educational institutions in the sphere of budget funding and taxation;
- stimulating the growth of solvent demand of the population on educational services (targeted social educational loan, tax privileges).

The government have also discussed a wider concept for the education reform. However, there were no decision by the end of the year.

# Part 5

## Russian Privatisation: Results and Outlooks

### Results of 1997 privatisation

The massive «put-away» of the packages of the shares of stock having remained in the State property (Table 59) has not and could not have yielded any incomes to the Budget. In 1995-1997, this source yielded relatively small sums. In addition to the other reasons (redistribution of property, political events), the failure to fulfil the 1995-1997 Budget tasks has conditioned the surge of the quasi-privatisation instruments, such as the mortgage auctions, the compensations of the debts to the budget and other Budget-supported regions, etc<sup>36</sup>.

- The use of the various non-standard methods initiated, as well, by the largest banks, is connected with numerous factors:

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<sup>36</sup> For more detail see IET (1997): «Russian Economy in the First Half of 1997». Trends and outlooks» Moscow: IET; Radygin A. (1997 г.): «Corporate Governance Through the Banks: The Experience of Russia.» OECD AGP, 11th Plenary Session, Rome, 18-19 September 1997, Room Doc. DAFF/PRIV/AGP/11/1.

- the actual «collapse» of the «monetary» privatisation of the 1995-1996 (due, first of all, to the absence of the demand for most of the products under sale);
- the corresponding interests of the Government (replenishing the inflow part of the Budget by any methods) and of certain banks (gaining control over certain industrial and production corporations at minimal costs);
- the large debts of entities to the Budget and to each other; and
- the beginning of the new «war for property» between the largest Russian financial and industrial groups.

In a certain sense, this situation has also influenced the rapid (if compared with the former practice) passage by all the instances of the new draft law on privatisation. The Government, focusing its attention on the incomes from the «individual projects» (whose conditions are fixed by the executive power), did not want to confront again the Duma on the general limits of the privatisation process. The formal interdiction of the privatisation of the land plots of enterprises (or, rather, the reference to other federal acts) has not, either, become another stumbling block: this process can go on under the relevant Decrees of the RF President.

Officially, the new Law «On Privatisation of the State Property and on Bases of Privatisation of the Municipal Property of the RF» took force and effect on 2 August 1997. Among the main novelties, the following may be mentioned:

- the accent (already in the title) not on the enterprises, but on the property (property shares of the State)<sup>37</sup>;

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<sup>37</sup> It is also supposed that the unitary enterprises will be transformed into joint stock companies with the 100 per cent share of the State. Thus, the State will get an additional

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- the privatisation stops being the mandatory annual «planned event» of the Government and will go on in accordance with the forecast and the program annually approved by the Duma;
  - the privatisation program envisions the list of the objects to be privatised in the current year (this depends on the current conjuncture) and the list of the strategic objects whose privatisation is prohibited (these may be privatised only in accordance with the Federal Law);
  - the set of the privatisation methods was extended (by legalising the already existing sale of the derivative securities);
  - the privileges for the employees of an entity are possible (5 per cent to 10 per cent rebate from the sale price of the shares of stock); however, these may be abolished or become more flexible;
  - the cost of the «property complexes» is determined in aggregate, on the basis of the statutory capital, balance evaluation, and market price;
  - the commercial tenders with the investment conditions were introduced, while the investment tenders were abolished (if a bargain envisions the investment conditions, the right of property are transferred to the winner upon completion of the relevant obligations); and
  - the «leasing» notion has been restored; however, at the «market cost».

Certain observers connect (yet, without basis) the notion «**individual project**» with the beginning of the third — after the «voucher» and «money» — stages of the privatisation. Though this term had not been legalised by the new Law on privatisation, the interest of the Government in the «individual projects» was fixed by the Ordinance No. 363 of 1 April 1997 «On the Order of

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possibility to sell certain property. This possibility has hypothetical at the right of the «full economic management» of a unitary enterprise.

## Implementation of the Individual Projects of the Federal Property Privatisation»

(as amended by the Ordinance of the RF Government No. 564 of 12 May 1997).

Table 59

**Certain general data on the number of the joint stock companies and the blocks of the shares remaining in the State property**

	As of 1 January 1997	As of 1 January 1998
(1) Entities of all the forms of property and economy (data of the United State Register of the RF), including the entities stated by parag. (2) and (3)	2,425,000	2,711,000
(1.1.) incl. joint stock companies and partnerships	1,125,000	1,471,000
(2) Government-owned entities (according to the data of the RF Ministry for property)	89,000	88,264*
(2.1.) incl. the Federal ownership entities and institutions	30,500	29,666
(2.1.1) defence	893	N/A
(2.1.2) fuel and energy complex	1257	N/A
(3) Privatised (fully or partially) entities, incl.	124,000	127,000
<b>(3.1.) Total number of the registered joint stock companies</b>	<b>30,000</b>	<b>31,000</b>
(3.2.) Total number of the registered joint stock companies where 100 per cent of the shares are in the private ownership.	12,500	15,000**
Information: Blocks of shares, shares in joint stock companies, partnerships, and other entities of the mixed form of property fixed for the federal property.	6,490	4,866
(3.3.) Blocks of shares fixed for the federal property***	2,900****	4,235*****
up to 25 per cent	558****	1,400
from 25 per cent to 50 per cent	1,037****	2,004
over 50 per cent	286****	831
(3.4.) «Golden share» in federal property	1,300	631
(3.5.) Other block of shares (0.5 per cent and more) remaining in the property funds for various reasons.	11,500	11,000

\* Data of the RF Ministry for the State property on all the enterprises with independent balances (including all the kinds of property: federal, republican, regional, and municipal). According to the Goskomstat of the RF, the aggregate number of the governmental entities and institutions (except municipal) with the statuses of legal entities reduced from 202,000 in January 1997 to 131,000 in January 1998.

\*\* Pre-estimate on the basis of the plans of sale of the 2,500 «residual» blocks of shares for 1997. Taking into account the fact that many packages had stayed unsold, the actual figures may differ from those given in the Table.

\*\*\* These data cannot be accurate because of the (1) constant changes of the packages' statuses and their numbers and (2) absence of the accurate accountancy in the Ministry for the State property. According to the Decree of the RF President No. 478 of 11 May 1995, the federal property covers only the blocks of shares of the joint stock companies having the strategic importance for the national defence. Initially, this list had been formed by the 2,700 joint stock companies manufacturing the products (goods, services) of the strategic importance for the national defence. (Ordinance by the RF Government No. 949 of 17 September 1995). Further on, in 1996-1997, this list was constantly expanding.

\*\*\*\* Only the blocks of shares without the right of the pre-term sale.

\*\*\*\*\* Including the 700 entities of the fuel and energy complex, 1,300 transport entities, and 370 entities of the military industry complex.

Source: RF Ministry for the State property, on the basis of the 1996 and 1997 results, respectively; Goskomstat of the RF; and estimates by the author.

According to this document, the «individual projects of the federal property privatisation» is the set of the measures aimed at privatising the federal property of a special importance for the nation, region, or industry and envisioning the pre-sale preparation of this property under the surveillance of an independent financial consultant. The main goals of the implementation of an individual project are to ensure the maximal inflows in the Federal Budget; mobilise the investments; and improve the efficiency of the use of the privatised property. While the first aim is quite adequate to the current situation, the second and third ones are, rather, of the propagandist character.

Table 60

### Main indexes of the privatisation in Russia, 1992-1997

By increment from 1 January 1992	to 1 January 1993	to 1 January 1994	to 1 July 1994*	to 1 January 1995	to 1 January 1996	to 1 January 1997	to 1 January 1998
1. State-owned entities with independent balances (units)	204,998	156,635	138,619	126,846	90,778	89,018	88,264
2. Claims submitted (units)	102,330	125,492	137,501	143,968	147,795	149,008	155,660
3. Claims refused (units)	5,390	9,985	11,488	12,317	13,295	13,642	15,607
4. Claims under implementation (units)	46,628	24,992	19,308	17,491	13,214	12,327	10,305
5. Claims implemented (units)	46,815	88,577	103,796	112,625	118,797	123,744	126,825
6. Sale price of property (billion roubles, old prices)	57	752	1,107	1,867	2,510	3,230	5,723
7. Cost of property under implemented claims (billion roubles, old prices)	193	653	958	1,092	1,618	2,205	2,875
8. Governmental entities reformed into joint stock companies whose shares had been issued for sale (units)	2,376	14,073	20,298	24,048	27,040	29,882	30,900
9. Entities rented	22,216	20,886	20,606	16,826	14,663	14,115	11,885
incl.: leasing with purchase	13,868	14,978	15,658	12,806	12,198	11,844	10,413

\* Official date of the completion of the voucher privatisation.

\*\* paras. 6 and 7: without accounting for the largest and «non-standard» bargains with the blocks of shares.

Source: database of the RF Ministry for State property

In whole, the tendency to the reduction of the privatisation rates (by the number of the entities) characteristic for 1994-1996 remained actual (see Table 60). According to the RF Ministry for State property, in 1997, about 3,000 entities became private (6,000 in 1995 and 5,000 in 1996). As a result, as

of 1 January 1998, the sector of the privatised enterprises included about 127,000 entities (124,000 ones as of the beginning of 1997).

The Law «On the Federal Budget for 1997» had fixed the inflows to the income side of the Federal Budget at Rb. 6.5 trillion, including the Rb. 4.1 trillion from the sale of the governmental property and Rb. 2.3 trillion from the dividends on the shares and the rental payments. Taking into account the numerous privileges for the dividends and the rental payments for certain largest companies (Gazprom, LUKoil, EES of Russia, etc.) and certain Ministries (Ministry for railroads, Ministry of defence industry), the latter figure was, certainly, unrealistic.

Table 61

## Incomes of the Federal Budget from privatisation, 1995-1997.

Incomes (without denomination)	Actual income, 1995	Actual income, 1996**	Actual income, 1997***
1. Incomes from sale of State property, Rb. million	1,105*	1,081	-
1.1. Shares of joint stock companies	-	1,076	15,646
1.2. Entities not being joint stock companies	-	5	26
2. Dividends on shares, Rb. billion	92.8	-	407
3. Rent of governmental property, Rb. billion	116.7	3	305
4. Shares submitted as collaterals, Rb. billion	3,573.7	-	-
5. Recovery of the debts to the budget of the joint stock companies whose shares were submitted as collaterals and sold at the investment tender, Rb. billion	1,543.5	-	-
6. Shares of stock of the LUKoil oil company, Rb. billion	887.6	-	-
7. Sale of debtors entities	-	39	168
8. Sale of real estate	-	24	67
9. Sale of land	-	33	46
10. Other	-	352	542
Total, Rlb. Billion	7,319.4	1,532	18,654

\* In accordance with the corrected planned income of the Federal Budget for 1995 (Law of 27 December 1995), the incomes from the sale of the property were to amount to Rb. 4,785.4 billion at the aggregate planned income amounting to Rb. 4,991.8 billion. Formally, this budget task was fulfilled (and overfulfilled) due to the collaterals auctions whose aggregate share (lines 4 and 5 of the Table) made 70.8 per cent of the budget income from the privatisation.

\*\* At the budget task Rb. 12.3 trillion for 1996.

\*\*\* The actual data and the sum of the incomes from the rent and the sum of the dividends received are for 1997; the other items of the incomes are for January to November 1997.

Source: data of the Russian Goskomstat, RF Ministry for State property; and RFFN.



However, taking into account the results of 1997, the aggregate budget task of privatisation **has been overfilled almost 3-fold**, due to the several large-scale bargains. Thus, to the end of 1997, the aggregate income from the privatisation was Rb. 23.7 trillion, of which almost Rb. 18.654 trillion came to the Federal Budget (at the planned Rb. 6.525 trillion including the Rb. 4.179 trillion from the sale). As supposed, the other sources (except the large-scale projects) did not yield a sensible income: in 1997, the rent of the federal property yielded Rb. 305 billion (against the Rb. 1,939 trillion planned); the dividends on the governmental shares made Rb. 407 billion (against the Rb. 270 billion planed).

Thus, from the viewpoint of the formal budget criteria (i.e., fulfilling the budget task without, at least, the schemes of the collateral auctions type) the 1997 was the first year of success of the «money privatisation» (see Table 61).

However, it should be noted that not all the bargains planed for 1997 were implemented. Thus, no one of the bargains planned for the last quarter of 1997 took place (except the VNK auction. As we see it, for the moment being, there is no real progress in supporting the real transparency at preparing and implementing the bargains connected with the sale of the largest and most attractive corporations.

If we deal with the 1995-1997 transformation of the privatisation policy directly relative to the privatisation sphere, the following may be said:

- a) as a rule, the essentially «spontaneous» process of the «residual privatisation» (blocks of shares of the «common» entities remaining after the implementation of the «mass model»);
- b) the domination of the Budget-supported organisations aided by the privatisation decisions;

- c) the use of the privatisation (quasi-privatisation) instruments when mobilising the political allies among the regional elites and largest financial groupments;
- d) the visible «regionalisation» of the privatisation process, including for the political purposes; and
- e) the well related to the above peculiarities process of consolidation and further re-distribution of the property between the largest financial alliances and the natural monopolies.

### **Largest privatisation bargains**

**The largest privatisation bargain of 1997** was the sale of the blocking parcel of shares (25 per cent plus one share) of the Sviazinvest financial and investment holding at the auction of 25 July 1997. The holding was founded in August 1995; 51 per cent of its shares are fixed for the federal property, and 49 per cent are intended for sale (25 per cent for both the Russian and foreign investors and 24 per cent for only the Russian ones). The auction was organised by the MFK bank (a group of the UNEXIMbank). The formal winner was MUSTCOM Ltd. from Cyprus (among its founders is a group of the UNEXIMbank) having offered US\$ 1.875 billion.

It should be noted that the gained sum does not very much differ from the one offered in November 1995 by the Italian holding STET (US\$ 1.44 billion). However, already after the failure of the initial bargain, the holding received the control blocks of shares of the AO «Rostelecom», AO «Central Telegraph», and some other. In whole, to summer 1997, the capitalisation of the Russian securities market increased<sup>38</sup>. Obviously, the real price could hardly have been

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<sup>38</sup> According to AO «Sviazinvest», in summer 1997, the aggregate market capitalisation of the 88 companies of the holding was US\$ 15 billion. The aggregate market capitalisation of the 23 companies of the holding having been listed by the Russian trade system was

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received; however, the losses of the State from the current underestimate of the holding could have been compensated by selling the blocking package of shares to a really strategic, not a financial, investor. Further on, when selling the 24 per cent of the shares to the portfolio investors, the real price could have served the basis.

With all this, no one of the largest telecommunication companies of the world (or their consortium) took part in the auction. However, after the sale of the blocking package the Government has no other mean (except the full privatisation of the holding) to attract a strategic investor. Certain observers also note the grown danger of the disintegration of the holding: in the new situation, the regional companies will have to look for the strategic investors by themselves.

The **bargains completing the series of the collaterals auctions** also were a noticeable event though they did not give any significant money to the budget. Of course, practically all the collateral holders were interested in receiving such packages in property and minimise the financial expenditures.

The widest spread variant was the quasi-open sale of the collaterals blocks of shares and their purchase for property using the affiliated persons. This variant had already been used for the packages of the YUKOS oil company (the 45 per cent initially sold and the 33.3 per cent sold after the «disintegration»; qualified control by the Menatep bank); Sidanco (51 per cent; control by the UNEXIMbank); Sibneft (51 per cent; formally the Oil Financial Company); Surgutneftegaz (40.12 per cent; actual self-purchase by the issuer); LUKoil (5 per cent; actual self-purchase by the issuer); and RAO «Norilsk Nickel (38 per cent; under control of the UNEXIMbank).

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US\$ 11 billion. During 1995-1997, the capitalisation of «Sviazinvest» grew by 118 per cent; according to forecasts, it may grow 2-fold.

The scandals associated with most of these bargains are well known. Seemingly, the least conflicts resulted from the sale of the collaterals packages of shares of Surgutneftegaz and LUKoil: these were the trivial self-redemptions of the shares by the issuers with the mediation of the companies managing their pension funds.

At these bargains (just as at some other ones) in addition to the other methods, such method of the competitors harrow was actively used at the requirement to transmit to the issuer whose shares are purchased its own securities or the shares of another company. Thus, at the purchase of the 34 per cent of the shares of Sidanco at the investment tender, the RFFR put forth, among the other conditions, the transfer to Sidanco of the 13 per cent of the shares of Chernogorneft. Evidently, these 13 per cent were already possessed by the UNEXIMbank while the competitors did not have such package. This method was also used by the Alpha-bank when purchasing the shares of the Tyumen Oil Company. The investment conditions of the tender on the sale of 5 per cent of the shares of LUKoil included the condition to transfer to it 15 per cent of the shares of the Nizhnevolzhskneft company. A similar condition existed at the purchase of the block of shares of Surgutneftegaz oil company: the winner was to transfer to it 5 per cent of the shares of OAO Surgutneftegaz.

The Decree of the RF President No. 505 of 19 May 1997 «On the Sale of the Earlier Fixed for the Federal Property Shares of Certain Joint Stock Companies of the Russian Fuel and Energy Complex» (and the relevant Ordinance of the Russian Government No. 616 of 21 May 1997) began the new stage of the confrontation between the largest financial groupments around the **oil companies**.

According to these documents, the blocks of shares of 6 oil companies: Vostsibneftegaz (38 per cent), Eastern Oil Company (VNK) (51 per cent),

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Suberia-Ural oil and gas chemistry company Sibur (36.28 per cent), Tyumen oil company (TNK) (48.68 per cent), Komi TEK (21.7 per cent), and NORSI-OIL (45.45 per cent) have been rayed off the prohibition lists and are subject to sale at the specialised money auctions. Though these specialised auctions are intended for the small private investors (analogues of the voucher ones), the main potential tenderers will be, of course, the competing Russian banks (financial groupments). For the four companies (VNK, Sibur, TNK, and NORSI-OIL) the investment tenders are envisioned as prerequisites for the investment tenders.

Accordingly, the first conflict touched the TNK. Thus, AO Nizhnevartovskneftegaz, its main subsidiary, has claimed against the winner of the investment tender, the New Holding company (40 per cent) which is the group of Alpha-bank. Seemingly, the specialised money auction for the sale of the 48.68 per cent shares of the TNK will take place in 1998.

The government had the greatest hopes (from the viewpoint of the additional income) on the incomes from the bargains with the VNK blocks of shares. The Menatep bank became the absolute winner of this tender (45 per cent of the shares); for this it used a credit from the French Credit Lyonnais (under the collateral of the YUKOS oil supplies). The commercial tender with the investment conditions on the sale of the 34 per cent of the shares of the VNK did not take place because Incombank had refused to take part in it. Among the possible reasons of the refusal, the lack of the required money under the financial crisis of November-December 1997 is supposed.

The earlier supposed sale of 0.96 per cent of the LUKoil shares (auction) and of 19.68 per cent of the Slavneft shares (commercial tender with investment conditions) did not take place in 1997. While the shares of LUKoil are obviously intended for the portfolio investors (hence, the critical importance of

the more favourable market situation), the Slavneft may become a possible tenderer for the block of its own shares (hence, the necessity to mobilise the resources).

The Decree of the RF President of 4 November 1997 was an important innovation: it abolished the 15 per cent quota of the non-residents participation in the statutory capital of the oil companies. The obvious purpose of the Ministry for State property when supporting the Decree was to create a much larger income basis. However, under the crisis of the Russian financial market, the investment of the new money of the non-resident portfolio investors in the Russian corporate securities stays under question for an indefinite period. However, the abolishment of the quota (for the companies the decision on the sale of whose shares is taken after the Decree) has become a signal for the formation of the large alliances for the further struggle for Rosneft in spring 1998.

This struggle is the struggle between the interests of the groups of UNEXIMbank, Menatep bank, Incombank, LUKoil, Gazprom, groupment Sibneft-Logovaz-United Bank, foreign partners, and the administration of the Rosneft itself. In November 1997, the two powerful tandems formed: Gazprom with Royal Dutch Shell (at a possible alliance with LUKoil) and UNEXIMbank with British Petroleum.

It is known that for the UNEXIMbank and Sidanco oil company the control over Rosneft is of a principle importance due to the long argument with the Rosneft itself for its Purneftegaz subsidiary. According to estimates, a certain resistance to the «emergency» privatisation comes from the today's management (at least, a part of it) of the Rosneft. If we take into account, first, the earlier support of the Rosneft management in the struggle for Purneftegaz against UNEXIMbank by certain top persons of the Government and, secondly,

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the degree of the confrontation between the groups UNEXIMbank and Sibneft-Logovaz-United Bank (which has become a political factor, as well), the probability is high that, in future, the Gazprom (formally politically neutral) wins.

In whole, if we do not take into account the pungent budgetary crisis and the actual causes of such situation, there are many important factors in favour of postponing certain bargains:

- the unfavourable situation in the securities market and the outflow of, at least, the portfolio investors<sup>39</sup>;
- the political reasons connected with the conflicts between the largest financial groupments;
- the inefficiency of the simultaneous sales of the large blocks of shares of several companies; and
- the necessity of the elementary technical preparation of the large bargains before the necessity to fill the budget by any methods arises.

### **Some outlooks for 1998**

According to the draft Law «On the Federal Budget of 1998», the inflow of the money from the privatisation to the income side of the Federal Budget are Rb. 8 billion (in the new prices). According to the pre-estimates, the Ministry for State property intends to overfulfil this at least 2.5-fold, first of all, from the large once-at-a-time sales. At a really transparent and rational scheme of organisation of such bargains, the Budget incomes may be much higher. In particular, the list of the shares offered for 1998, includes the unsold in 1997

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<sup>39</sup> However, the beginning of the placement of the Templeton foundation shares at the end of November 1997 shows if not the opposite trend, but, at least, a certain position of the global foundations due to the drop of the quotation prices of the shares in the Russian market.

blocks of shares of Rosneft and other companies; and the second intended for sale package of the Sviazinvest holding (25 per cent plus 1 share). The shares of certain unitary enterprises (which may, then, be transformed into joint stock companies) may also be sold in 1998. In whole, according to the Ministry for State property, in 1998, about 2,500 block of shares must be sold in 1998.

What are the **main factors** determining the situation of the privatisation sales and property redistribution processes in whole in 1998?

**First**, much will depend on the general situation of the financial markets and the situation of the corporate segment of the Russian securities market.

**Second**, the principle factor which will influence the 1998 Budget incomes from the large bargains is connected with the continuing consolidation of the assets of the main financial groupments and with the property redistribution processes in whole. These processes are catalysed by both the coming 2000 Presidential elections and the longer-term financial and economic interests of the competing groupments.

Within the framework of the property re-distribution and consolidation, several processes can be seen.

(1) The liquidation of the certain Governmental holdings created during the period of the unformed property structure immediately after the privatisation and the simultaneous surge of the new Government-controlled large corporation of the holding type.

It is known that, to 1996, Russia had over 90 officially founded holdings with the Governmental participation. A typical example is the foundation, in 1995, of the OAO «Russian metallurgy». The statutory capital of this holding was formed by the 105 blocks of shares of 9 Russian metallurgical companies and some other property. According to the estimates, the real purpose of creation of the holding was to conserve the blocks of shares to prevent them



from being purchased by the «alien» shareholders. However, the not long ago liquidation of this holding (Decree of the RF President of 24 November 1997) is another example of the inefficient strategy of privatisation (the attempt to sell 40 per cent of the shares of the holding) under the conditions of the already relatively formed structure of the property (control) in most of the metallurgy enterprises. Obviously, the blocks of shares of certain such companies will be joined to the large enough blocks already accumulated by certain Russian banks (financial groups). Another example of a liquidated holding is the AO «Rosugol» which had been a substitute of the Ministry for coal industry.

Another trend is also seen, mainly in the telecommunications, «high-tech» and/or military industry complex. The examples include the creation and reinforcement of the Sviazinvest holding in 1995-1997 (it had multiple purposes: to conserve the control and obtain the budget incomes by the privatisation. The 38 per cent of the shares of the forming companies were transferred); the decision on creation of the Russian electronics holding (July 1997. The 10 per cent of the shares of the companies to be founded will be transferred, the remaining will stay in the Governmental property). Already in February 1998, the State Duma discussed the issue of creation of the Russian automobile instruments making corporation (holder of the control or blocking packages of shares of 10-12 enterprises of the relevant profile).

(2) The processes of consolidation of the blocks of shares of the real sector entities and financial institutes are continuing. These are within the framework of the financial groups (the holdings officially registered financial-industrial groups), controlled by the largest banks, or within the framework of the multi-level groupments formed around the largest raw materials producing companies and natural monopolies.

To the beginning of 1998, 72 financial-industrial groups were officially registered in the State Register (about 1,500 enterprises and about 100 crediting and financial institutions). Indeed, as of today, Russia has about 150 unions of the economic entities (industrial holdings) which, though are not officially financial-industrial groups, may pretend for such nomination from the formal point of view.

Among the main directions in which the assets consolidation process goes, the following should be noted:

- transactions in the secondary market of securities;
- transformation of the debts into the shared property participation;
- purchase of the assets of the entities liquidated in the bankruptcy;
- cross-ownership of the shares;
- control by the crediting policy and accountancy;
- participation in the standard bargains during the «residual» privatisation;
- use of the quasi-privatisation tool (collateral auctions, etc.); and
- access to the control over the Governmental blocks of shares (trusts, Governmental holdings, etc.).

(3) The process of uniting of the already relatively formed large financial groupments has begun. The main incentives for such uniting include the objective needs in the long-term strategic alliances, the world trend to uniting the assets, the heightening competition between the main national groups, the inability of the power bodies to form the really «equal» and «stable» rules, and the protection of the specific financial interests.

A well-known example is the signing of the memorandum of intentions to form the YUKSI oil company (YUKOS and Eastern oil company from the ROSPROM-YUKOS-Menatep group and the East Siberian oil and gas company

from the Sibneft-Logovaz-United Bank group). Though the intentions of the new company (as of today, seemingly, only of the alliance of the former companies) to take part in the privatisation of Rosneft, Onaco, and Slavneft have been declared, the purposes of the creation of the oil giant are, evidently, of the long-term character. In the longer-term, according to the estimates, a more powerful alliance of the financial-industrial groupments of Menatep, SBS-Agro, Most, and Logovaz-United bank is possible. In February, the information came that RAO «Gazprom» intends to purchase a share of participation in the Incombank capital and on the possible negotiations between LUKoil and UNEXIMbank for the strategic partnership.

However, the importance of even the declared and supported by the President alliances should not be overestimated. With the political uncertainty and before the coming Presidential elections the situation can change quickly and the new financial-political alliances can strike the imagination of even the most versed politologists.

In such situation, the Presidential elections and consolidation of the assets, the struggle for Rosneft in spring of 1998 (or later) is, of course, of a derivative character. However, ideology of «transparency» of the privatisation bargains declared by the Ministry for State property in 1998 can, obviously, become a fiction already at the stage of the preparation of this very bargain.

The «open» tender for the right to make the agreement on determination of the initial sale price of the Rosneft shares<sup>40</sup> is, of course, important, as an insurance for the Governmental officers, but it does not have much sense as a

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<sup>40</sup> The tender has been declared for both the Russian and foreign investors. On 28 February the winner must be declared and on 2 March the agreement must be signed with it. On 14 March the determination of the initial price of the shares must be completed. It is formally supposed that the winner shall not take part in the privatisation tender itself; however, in practice, this can be overcome quite easily.

guarantee of the «transparency» in the conditions of the coming elections and redistribution of the assets.

It is known that the plan of the Rosneft privatisation was changed more than once in 1997: the variants supposed to distribute 5 per cent-7 per cent of the shares among the administration and employees; to offer 50 per cent-65 per cent of the shares to the special money auction; and to sell the remaining at a commercial tender with investment conditions in one package. The «once-at-a-time» (75 per cent plus one share proposed by the Ministry of finance), the «two-step» (tender for the 50 per cent plus one share and the auction), the «three-step» (two auctions for 25 per cent-35 per cent of the shares plus the tender) schemes were also proposed. Another important point was the problem of access of the non-residents (in practice, it can be easily overcome).

Obviously, the discussion on the scheme went in the two directions:

- ensuring the maximal income to the budget. The problem is that both the «strategic» and «portfolio» approaches have their advantages and drawbacks. Thus, the multi-stage scheme of sale can enlarge the circle of the initial participants and, thus, enhance the competition and increase the initial income; however, at the low transparency, this allows to harrow the competitors and decrease the price at the following stages (however, at the efficient organisation, the increase of the competition is possible up to the completion of all the bargains). The initial sale of the simple control package of shares allows to enlarge the circle of the initial participants but can «eliminate» all the other bidders at the following stages due to the established control. The once-at-a-time sale of a package ensuring the qualified majority allows for the high transparency of the bargain and attract a large strategic investor; however, the competition (due to the limited number of bidders) and the

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possible income decrease, and the remaining shares can stay unsold, taking into account the instability of the Russian and world financial markets.

- lobbying such scheme of the sale that lets one of the competing groups be a priori outside the competition. In this case the problem is that, first, the Government will hardly allow the repetition of the scandals of the summer 1997 and, second, the different lobbying groups mutually neutralise the efforts of each other. A paradoxical result may come from a certain trade-off version not directly reflecting the interests of any group.

To the beginning of 1998, the Ministry for State property accepted the following scheme: 50 per cent plus one share are offered for the tender with the investment conditions; 46 per cent are offered for the auctions; and the remaining shares are offered to the administration and employees. However, the further protests of certain potential participants may make the Government agree with the scheme «75 per cent plus one share» with the participation of the non-residents. Possibly, in the today's situation, this may be a reasonable decision and the bargain price can be «transparently» enough fixed during the direct negotiations with the bidders. At least, the obligations of the «evaluator» of the company (which must be determined in March) include, according to the conditions of the tender, determining the prices for the both packages: 50 per cent plus one share and 75 per cent plus one share.

**Third**, an important problem is the approval of the Law «On Approval of the Governmental Program of Privatisation of the State Property in the RF» (within the ten days following the approval of the Budget for 1998). First of all, it is interesting to pay attention to the **shifts in priorities** compared with the earlier programs.

Thus, such formulas as «mobilisation of investments», «restructuring of enterprises»<sup>41</sup>, «creation of the mechanisms of support of the socially unprotected layers of the population» «ensuring the inflows in the Federal Budget», «creating the conditions for the development of the real estate market», «supporting of the small-scale enterprise» have become habitual and traditionally pass from one program to another.

Such program innovations as «conserving the governmental control over certain strategic productions ensuring the national safety of the State» and «optimisation of the budget expenditures on the management of the governmental property» are quite reasonable.

The other innovations of the 1998 program cannot help alerting (of course, if these are not just sheets of paper) or, at least, lead to bewilderment: these are «ensuring the optimal ration of the domestic to foreign investments», «protectionism toward the domestic producers». Such priorities as the «production, social, and economic rehabilitation of the territories connected with the mining, processing, and transport of the non-renewable natural resources», the «creation of the conditions for the security of the competitive position of Russia with certain products in the world market» also seem interesting (within the framework of the specific investment program).

Though, in many aspects, the problem of drafting the lists of the enterprises is, rather, of the «legal formality» character, without this document any bargain may be acknowledged null and void<sup>42</sup>. Such document must include

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<sup>41</sup> A certain shift in this direction (i.e., expending the privatisation incomes on the restructuring and investments) may take place due to the possible presence in the Law on the 1998 Budget of the article, according to which the relevant incomes must be used for the expenditure items «Industry, energy, and construction».

<sup>42</sup> According to para. 2, Article 4 of the Law «On the Privatisation of the State Property and on the Bases of the Privatisation of the Municipal Property in the RF», the privatisation program shall include the following: the forecast of privatisation of the State property in the relevant

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the forecast list of the unitary governmental enterprises subject to be transformed into joint stock companies; the forecast list of the joint stock companies whose shares are supposed to be sold; the supposed forms and terms of their privatisation; the supposed limitations at their privatisation; the packages of the shares subject to sale; and the forecast prices of such packages. At the same time, if a strategic enterprise (legally defined as such) is not included in such «forecast list», its shares must not be sold.

The 1995-1997 practice of making such lists of the enterprises has shown that a fierce struggle occurs around the candidate enterprises. The Government, ministries, regions, administrations of the enterprises, potential purchasers, their competitors, etc. take part in it. The experience of discussions on such privatisation programs in the State Duma is also well known. Hence, it is easy to understand how long may be the drafting of such lists with all the consequences for the privatisation sales of 1998.

### **State as shareholder: innovations of 1996-1997**

The participation of the State in the management of the new joint stock companies and control over their activity form a separate problem whose solution is at the initial stage. The yet remaining influence of the governmental structures on the corporate relations in the joint stock companies in the transition period is, in most cases, a forced measure. First of all, this is the policy of conserving by the Government of the control or just large packages of

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industries; the forecast changes in the payment balance due to the privatisation; the forecast growth of the domestic and foreign investments; the requirements to the privatisation programs of the RF subjects; the order of selection of the privatisation methods and of making the privatisation decisions; the conditions for fixing the shares of the joint stock companies in the governmental and municipal property; the order of making the decisions on the use of the «golden share»; the order of evaluation of the cost of the property under privatisation; the order of giving privileges to the employees of the unitary enterprises to be transformed into

shares and the «golden shares» (see Table 59). However, only the amounts are large, while no influence of the Government based on any integral concept of control is observed.

In 1993-1996, the widest spread method of «management» by the Government was the so-called **institute of governmental representatives**. In 1996, the boards of directors of the joint stock companies with the governmental participation included about 2,000 governmental officials of different ranks. Of them 92 per cent were the employees of various ministries and offices and 8 per cent were the governmental representatives nominated by the RF President, RF Government, RF State Committee for property, RFFP, and other functional bodies.

Such representation is only formal. The 1993-1996 experience of control over the federal blocks of shares obviously shows that a governmental official is unable to control efficiently the packages of shares in 5 or 10 joint stock companies in different regions and, often, of different industries. This is due to not only the technical and time complications but also the absence of the required skill (knowledge of the specific enterprise) and of the legal material incentives. The two most typical examples of the governmental representatives' behaviour in the joint stock companies may be given:

(1) «indifferent behaviour»: the governmental representative in a joint stock company just shows no interest in the management of the company despite the large block of shares and significant debts of the company. Such position just gives full freedom to the management of the company;

(2) «interested behaviour»: (a) conscious disregard of the debts of the company to the State during the activity of the governmental representative and

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joint stock companies; and the order and norms of distribution of the money received from the privatisation.



the further reception of a better paid office in such company; and (b) voting by the governmental block of shares in the name of the government at a general meeting of shareholders for the secondary issue at which the share of the State reduces. In such case, as a rule, the government does not use its priority right of a shareholder to purchase the newly issued shares. According to estimates, the erosion of the governmental packages of shares had led to the hundreds billions of roubles losses for the State.

The packages of shares that have remained in the property funds and have not been sold for these or that reasons may become objects of trade (for sale, «good» voting between the local power (fund for property), management, and other interested structures). However, in the typical cases, the fund itself or the governmental representative in a company have no positions relative to the management of a specific enterprise.

According to the estimates of the Federal Commission of the Central Bank, the most important pretensions to the activities of the joint stock companies whose shares are in the governmental property consist in the following:

- the absence of the sufficient information on the activities of such companies for both the common shareholders and the governmental management bodies;
- the undue maintenance of the register of shareholders;
- the transfer of the assets from the parent company to the subsidiaries; and
- the attempts to diffuse the assets<sup>43</sup>.

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<sup>43</sup> All-Russian Conference «On the Situation and Outlooks of Development of Joint Stock Companies in the Russian Federation». Moscow, 10 February 1998; Vasiliev, 1998.

In April 1996, the closed meeting of the RF Government and RF Central Bank on the issues of support of the efficient management of the strategically important enterprises, including the natural monopolies, took place. At the level of the joint declaration (taking into account the recommendations of the IMF) the following approximate scheme was developed:

- the official representative of the State at an enterprise shall be the representative of the Government not connected with such enterprise by the labour relations and having all the rights to manage the federal control block of shares; and
- the representative of the Government shall renew the board of directors by introducing into it the «professional experts» striving for the «priority of the State interests» and support of the «profitability, capital investments, and payment of dividends».

The practical steps in implementing this decision are interesting. Thus, in accordance with the Decree of the RF President No. 656 of 16 April 1996 «On the Measures for Stabilisation of the Economic Situation and Development of Reforms in the Agro-Industrial Complex», the powers of the RF State Committee for property in controlling the block of shares were transferred to the relevant industrial offices without any specific decisions on the control of these blocks of shares. For the defence complex, a Federal Commission was created (Decree of the RF President No. 541 of 13 April 1996 «On the Measures of Support of the Governmental Control over the Privatisation of the Defence Complex Enterprises»). The Commission has drawn only the list of the 480 defence enterprises not subject to privatisation (Ordinance of the RF Government No. 802 of 12 July 1996 «On the List of the Enterprises and Organisations of the Defence Complex whose Privatisation Is Not Allowed»).

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As for the **specific fragments** of the governmental policy in this field, the following should be mentioned<sup>44</sup>:

- certain «strategically» important cases (e.g., the trust agreement on the 34 per cent of the governmental shares of Gazprom in 1997);
- transfer of block of shares to certain regions to cover the debts of the Federal Budget in 1996;
- «reinforcing» an enterprise (holding) with the State participation by investing in its statutory capital the governmental blocks of shares of other enterprises (coal companies, etc.);
- restructuring («securitisation») of the debts to the Budget;
- transfer of the governmental shares to the control of legal entities (the series of the special Decrees of the RF President No. 1403 of 17 November 1992, No. 1702 of 30 December 1992, and No. 1334 of 5 November 1992 on transfer of the federal blocks of shares in the oil, coal, and electric energy industries under the control of then State-owned enterprises Rosneft, Rosugol, and RAO EES Russia);
- transfer of blocks of shares in trust to the controlling (central) companies of the financial-industrial groups or holding companies (FIG «Ruskhim», RAO «Biopreparat», etc.);
- personal nominations in the boards of directors by the Ordinances of the RF Government or decision of the RF President (RAO «Gazprom», RAO «Norilsk Nickel»); and

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<sup>44</sup> The Decree of the RF President No. 986 of 7 October 1995 «On the Order of Making Decisions on the Control over and Disposal of the Shares in the Federal Property» has fixed that the transfer of the shares to the control of the legal entities and natural persons, for collateral, or other their loading, transfer of them to the statutory capitals of organisations are possible only on the basis of the Decrees of the RF President.

- fixing the order of voting by the governmental block of shares at the meetings of shareholders (in the oil companies: under the Ordinance of the Government; in the RAO EES Russia and AO «Rosgazifikatsiya: at the decision of the board of the governmental representatives).

As a result, today, **there is no integral policy for the control over the State-owned blocks of shares**. The possible measures of action had envisioned the re-attesting of the governmental representatives, revealing the companies where they had voted for the erosion of the governmental blocks of shares. As of today, the two variants of the control over the governmental blocks of shares can serve alternatives to the institute of the governmental representatives which has shown its unsoundness.

**First**, this is the representation of the interests of the State in companies under agreements (for the natural persons this means the **institute of trustees** in the affairs of the State).

The Ordinance of the RF Government No. 625 of 21 May 1996 «On the Support of the Representation of the Interests of the State in the Management Bodies of the Joint Stock Companies (Economic Partnerships) a Part of the Shares (Investments) of Which if Fixed for the Federal Property» fixed the example agreement for the representation of the interests of the State, the order of legalisation and registration of such agreement. The RFFP was instructed to act on the basis of the proposed order.

This order (agreement) was to be approved already in 1994 in accordance with the Decree of the RF President «On Certain Measures for Support of the Governmental Control over the Economy», No. 1200 of 10 June 1994. In particular, the Decree envisioned: (1) the framework requirements to the contract between the Government (Federal body) and the manager of the company; (2) the framework requirements to the representatives of the

governmental interests in the company. These representatives were divided into the two categories: (1) the governmental officials (to be nominated at the decisions of the RF President, RF Government, Federal bodies, or RFFP); and (2) the other citizens of the RF (under the agreement on representation of the governmental interests in a company with the RF State Committee for property, Russian Fund for Federal Property, or their territorial bodies).

The two-year delay of this extremely important document (without it, the Decree itself was practically useless) is due to the traditional struggle between the RF State Committee for property and the industrial offices and regional administrators. However, even the above Ordinance regulates only the last category («the other citizens of the RF»). It is important that the selection of the governmental representatives is charged on the industrial offices. No similar mechanism of the activity of the governmental officials exists, yet. For the moment being, the agreements on the representation of the State interests with legal entities are not regulated.

Moreover, though the basic documents to implement the institute of trustees have been promulgated, this mechanism remains inoperative due to the absence of the relevant decisions on the labour payment for the relevant activity.

The separate Ordinance of the RF Government No. 777 of 1 July 1996 «On the Nomination of the Representatives of the Russian Federation for the Control over the Blocks of Shares Fixed for the Federal Property of the Joint Stock Companies of the Fuel and Energy Complex» gives the regulation of this issue to the fuel and energy complex. Such representatives must be officials of the RF Ministry for fuel and energy; they must vote at the general meetings of shareholders in accordance with the directives of the Ministry. In particular, such representatives have been nominated to the RAO EES Russia, LUKoil,

Rosugol, etc. The companies whose shares have been transferred for collateral at the collateral auctions are not in the list.

The above documents give a clear understanding of the reinforcement of the role of the industrial offices relative to the control of the State-owned blocks of shares and of the gradual expelling of the State Committee for property from this sphere. If the problems with the incomes from the privatisation are also taken into account, the purpose itself of this office becomes doubtful.

Another variant of improving the efficiency of the control over the State-owned blocks of shares is the transfer of the shares for **trust** (by a legal entity).

Certain possibilities for this were given by the Decree of the RF President No. 1660 of 9 December 1996 «On the Transfer for Trust of the Shares Fixed for the Federal Property of the Joint Stock Companies Created during Privatisation». This Decree fixes the general conditions of transfer of the blocks of shares to trust: by the results of the tender for the right to make the agreement on the trust control over the blocks of shares. The trustee (In contrast with the collateral scheme) is not entitled to dispose of the shares transferred to it, and the agreement fixes the limitations for the actions of the trustee relative to the most important issues of the activities of the company.

The priority objects were the 5 companies of the coal industry (including at the requirement of the IMF). For this reason, the more detailed Ordinance of the RF Government No. 1485 of 11 December 1996 «On the Tenders for the Right to Make Trust Agreements on the Control over the Shares Fixed for the Federal Property of the Joint Stock Companies of the Coal Industry» formally relates only to the coal industry. However, these rules may be extended to other industries, as well.

However, it is impossible to count on the soon mass use of the new norms. According to many experts, the regulations on the tenders have many

drawbacks that form an important obstacle for their use. Neither does this document deal with the key practical problem: the real transparency and the criteria of determination of the winner. The second negative moment is the real guarantees of protection of the interests of the enterprises and State from such control (despite the requirements of securing the liabilities of the winner by its own property). The particular sources of remuneration for the trustee have not been fixed, either.

Certain amendments to this document were made only in spring 1997 (the Ordinance of the RF Government No. 517 of 30 April 1997 «On the Amendments to the Ordinance of the RF Government of 11 December 1996, No. 1485»). In particular, the Ministry for fuel and energy is instructed to act as the founder of the trust control and make with the winners the agreements on the control over the shares in the federal property. Certain amendments were also made to the rules of the tenders.

However, this is a positive step forward. The more the State refuses the direct intervention in the economic processes, the more actively it forms the conditions, rules, and institutional structures supporting the independent economy, the more chances it will have to establish the «controlled» economy.

- A certain influence on the formation of the definite list of the enterprises intended for the privatisation sale may come from the supposed classification of the blocks of shares fixed for the federal property. The plans of the Ministry for the State property for 1998 include the delimitation of the five types of enterprises:
- the regional and national natural monopolies where the governmental block of shares is controlled by the board of the

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governmental representatives (the RF Ministry for the State property believes the latter structure quite efficient)<sup>45</sup>;

- the companies dominating in a specific market, and, hence, subject to restructuring in order to form the competitive environment (fixing the control block of shares or introducing the «golden share»);
- the companies whose blocks of shares may be transferred to holdings or other unions of enterprises (with conservation of the «golden share» in these companies);
- the companies whose shares may be transferred for the control to the RF subjects; and
- all the other companies whose shares may be sold or put on tenders for the trust (All-Russian Conference «On the Situation and Outlooks of Development of Joint Stock Companies in the Russian Federation». Moscow, 10 February 1998).

Obviously, just as in the case with the formation of the list of the enterprises for the privatisation program, the decisive reasoning for the formation of the final list will be the lobbying power of the enterprise in the power structures (whether this deals with the future of the company itself or with the consolidations of the blocks of shares of other enterprises).

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<sup>45</sup> The traditionally significant is the situation with the forthcoming elections of the board of directors of RAO «Gazprom» by the meeting of shareholders in June 1998. According to the available data, there are the two opposite approaches to the quota of the board of the governmental representatives: either 3 representatives of the Ministry among the 11 members of the board of directors (in accordance with the proposal of the Ministry for State property based on the right to «realise the authority for the control over the shares»), or 5 representatives, 2-3 outside investors and 3-4 representative of the RAO in the board of directors (at the proposal of the Ministry for fuel and energy, from the 40 per cent of the State-owned shares). See «The Russian Telegraph», 12 February 1998.



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