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Section 1. Macroeconomics

1.1. Russian Economy at end-1998 and the Prospects of the Economic Policy

The financial crisis sharply aggravated in summer of 1998 was caused by a number of fundamental factors determining the weakness of the Russian economy. The key factors among them were budgetary problems reflecting the inability of the Russian authorities to adjust public expenditure to state revenues in 1992 through 1998, what resulted in a large budgetary deficit and a fast growth of the public debt. Deteriorating balance of payments resulting from growing expenditure of the government and private borrowers for servicing external debts and unfavorable terms of Russian foreign trade became an important factor. Problems related to the vulnerability of the Russian banking system also played a major role in the development of the financial crisis. Obviously, the emerging world financial crisis and a number of wrong economic decisions in 1997 through 1998 became an important factor, which determined the terms and the pattern of crisis manifestations.

As it was noted in the previous IET survey¹, the August 1998 events set a course for Russia's economy in 1999. Declining confidence of both foreign and domestic investors in Russian official policy boded a loss of most sources the government could rely on to finance its budget deficit and a continuing flight of capital from the country.

In 1998 GDP declined by 4.9 per cent as compared with 1997, while the industrial output fell by 5.2 per cent. In 1998 inflation was at 84.4 per cent. By end-1998 the official dollar exchange rate

¹ Russian Economy in 1998. Trends and Perspectives (Issue 20), IET, Moscow.

increased from 5.96 Rub/\$ to 20.62 Rub/\$. On the whole, gold and forex CBR reserves diminished by about \$ 5.5 billion (from \$ 17.784 to 12.223 million, i.e. by 31.3 per cent) over 1998.

Tax revenues of the enlarged government declined from 32.6 per cent of GDP in 1997 to 31.3 per cent of GDP in 1998. Total revenues made, respectively, 36.4 per cent and 34.8 per cent of GDP. However, due to the fact that the government refused to service and repay a larger part of the domestic debt and decreasing noninterest expenditure, the expenditure of the federal budget diminished by 5 percentage points. The budgetary deficit declined from 6.7 per cent of GDP to 3.3 per cent of GDP.

The Ruble devaluation and the public domestic debt freeze aggravated the problems Russian banks had experienced for a long time due to systemic flaws intrinsic for the Russian banking system and related to the state protectionism, bad management, high forex risks assumed by the banking system, etc. In August through September a payment crisis spread all over the banking system. It hampered interenterprise payments, while tax payments were being delayed in problem banks. The interbank credit market all but ceased to exist. People started to withdraw their deposits from banks.

Over the second half of 1998 the Central Bank revoked licenses of 77 banks, among them Inkombank (the largest Russian private bank), Promstroibank RF, Mosbiznesbank, and a number of others included in the top hundred of Russian banks due to the amount of their capital.

The payment crisis was overcome in a few months; however the confidence in the banking system could not be restored even by the beginning of 2000. In particular, from July till October of 1998 the nominal amount of household deposits in commercial banks decreased by 18.6 per cent (from Rub. 167.2 billion to Rub. 136.1 billion). If computed in constant prices, the amount of deposits fell

by almost 46 per cent. Until end-December of 1998 the nominal amount of deposits grew at slightly above 3.6 per cent. Thus, on the whole household deposits decreased by 15.6 per cent (in nominal terms) and by 52.4 per cent (in real terms) over the period from July till December of 1998. At the same time, the share of deposits in Sberbank in the total amount of household deposits increased from 76.7 per cent to 83.5 per cent.

The financial crisis resulted in sharply deteriorating living standards. Real incomes decreased by 18 per cent over 1998. Average wages and salaries dropped by 40 per cent and average pensions fell by over 40 per cent as compared with December of 1997. Income differentiation grew and Gini coefficient increased from 0.370 to 0.379. The share of the poor in the population topped 38 per cent that intensifying social tensions reflected, in particular, in a growing number of strikes. However, by end-1998 the government could pay a part of wage and social benefit arrears, what somewhat improved the social situation in the country.

The procommunist government under Yevgeni Primakov, brought to power in September 1998, stirred expectations of momentous change in the country's macroeconomic policy. An inflationary scenario of impending events could be grasped from leading cabinet figures' public appearances, calling for greater government interference in the economy, compensation for the losses inflicted on the public by the crisis in autumn 1998, and government support for the banking system. The government looked poised for an open confrontation with international financial institutions and foreign investors. Its statements of intent to ease the tax burden, step up government support for Russian manufacturers, enter into custom-tailored agreements with major corporate taxpayers on their tax arrears to the budget, allow massive set-offs between businesses and revenue authorities, waive, in fact, its right to initiate bankruptcy

proceedings against tax dodgers, revoke the previous government's decision to charge VAT on different principles, and many more sweeteners, were signals of a relaxed tax policy and bound to cut deep into budget revenues.

At the same time, the choice between the inflation and stabilization (anti-inflation) scenarios of overcoming the crisis was not predetermined by the development of the political and social situation in Russia in 1998. In fact, the government had to make a political decision on what social strata and groups would have to pay the biggest price for one or another course of economic policy.

The populist course pursued by the authorities after the August crisis resulted in a serious slackening of the monetary policy. While immediately after the crisis the money supply grew at the background of falling inflation rates and were not accompanied by a noticeable drop of exchange rate, by end-year inflation and Ruble depreciation rates started to accelerate.

By our estimates in case the measures announced by the Primakov government in September through December of 1998² would cause the money supply to grow by 55 to 170 per cent in 1999 thus making inflation rates to increase by 65 per cent within the framework of an optimistic scenario, or by up to 250 per cent in case a pessimistic outlook would come true. By end-1999 the GDP monetization level was down at about 11 to 13 per cent (as compared with 13.8 per cent in December of 1998), while the Ruble exchange

² The basic scenario was based on the following key assumptions: in 1999 GDP will fall by 2 per cent; tax revenues of the RF federal government will be below 8.5 per cent of GDP; the RF external debt servicing will be about 5 per cent of GDP; the real Ruble exchange rate will not change; the money multiplier will be at the level of end-December of 1998, i.e. at 2.15 to 2.2. Besides, we allowed for a possibility that extra money will be issued for subsidizing regions and for a transfer to the RF Pension Fund. See: Russian Economy in 1998. Trends and Perspectives (Issue 20), IET, Moscow.

rate dropped to 80 Rub/\$. In fact, in such a situation the non-interest expenditure of the RF government would not exceed 9 per cent of GDP (as compared with 13.9 per cent of GDP in a relatively prosperous pre-crisis year (1997).

The government's 1999 budget bill submitted to the State Duma on December 11, 1998 and passed within record time was signed into law by the President on February 22, 1999. The budget underpinnings were rather vulnerable – the Budget Law was based on tax revenues amounting to 10 per cent of GDP, inflation of 30 per cent, and foreign loans contributing 5 per cent of GDP. Which meant that, given the looming threat of declining tax revenues, the nominal budget figures could only be met by whipping up inflation.

Off the stump, however, the Primakov government was more cautious than it wanted to look. Despite arm-twisting from the Communists, it succeeded in having a tough 1999 budget pushed through the legislature and implemented, for all its restraint in monetary policy. Its practical policy was a blend of procommunist rhetoric and “pragmatic liberalism.”

We can now recognize the following principal factors that kept events from following the inflationary scenario, despite the government's clear intentions to the contrary. First, the media had a key role in this by providing space and air for an open wide-ranging discussion of what the government's measures could lead to and, in this way, deflating somewhat the parliamentarians' populist electioneering zeal. Second, the alignment of forces among the different interest groups changed, as the banking and energy moguls, better known as “oligarchs” here, saw their omnipotence severely undercut, while import-substituting producers had their power boosted. Regional business, above all that with links to the real sector and regional markets, was mauled by the crisis noticeably less than its

counterparts with connections to country-scale financial-industrial groups³.

As a result, the events took a course much different from those we had described, and the 1999 performance results proved more pleasant than expected. This was due to the following causes:

First, both the Government and the Central Bank stopped sending signals in 1999 of any easing in their tax policy anytime soon and instead persevered in their efforts to improve tax collection. Combined with greater returns on capital invested in the real sector and a rising percentage of cash payments (of which more will follow), this tactic nudged the actual tax revenue to 11 per cent of GDP. The twosome also succeeded in marshaling a larger share of taxes into the federal budget. In the absence of major indexation of federal budget spending items, the GDP overall share of budgetary expenditure slipped to 14.5 per cent in 1998 from 18.4 per cent in 1997 and the budget deficit edged to 3.3 per cent of GDP (down from 3.9 per cent of GDP in 1997).

Second, the Central Bank's monetary policy was prudently restrained through 1999. The financial policy it maintained in November and December and its intervention on the currency market

³ In the situation characterized by the political and economic weakness of the federal authorities (the permanent conflict between the legislature and the executive at the federal level, which intensified at the pre-election time; the extremely limited financial resources the Center disposed of) the political influence of regional authorities increased. The crisis of 1998, the expectations of a financial paralysis, massive merchandize shortages, and a full economic collapse stimulated autonomization processes and the struggle to concentrate the available resources within regions. This process developed along several lines: a classical method of hampering merchandize and financial flows out of regions; the support of local businesses via regulating the system of prices and tariffs; the control over property via bankruptcy and sanation mechanisms; and, finally, the transfer of some public property in the hands of regional authorities via agreements between the government and regional administrations.

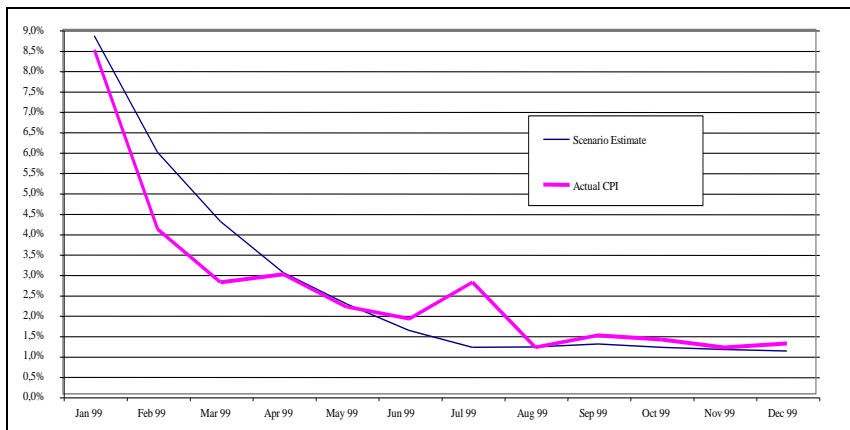
were rewarded with inflation rates slowing down and the ruble exchange rate stabilizing early next year. The growth in tax revenue and abandonment of a large-scale rehabilitation of the banking system allowed it to reduce monetary financing despite a substantial fall in loans from international financial organizations to \$1.2 billion in 1999, from \$4.5 billion the Central Bank had reckoned on. As a result, the annual inflation rate only moderately overshot the budget 30 per cent target to less than 37 per cent.

Third, beginning in the autumn of 1998, the Russian economy was showing hopeful signs of recovery – following the ruble devaluation that reduced the ruble exchange rate to the 1994 level and a more benign situation on international commodity markets, a rebound was registered in export-oriented and import-substituting industries. Rather than falling as feared, GDP showed a healthy growth of 3 per cent.

Basing on the model used in the previous annual survey we have re-evaluated the macroeconomic forecast for 1999 by replacing scenario values of a number of parameters with values close to actual ones: tax revenues of the federal government are at 11 per cent of GDP; issue of money (growth of narrow money) is below Rub. 100 billion; GDP growth is at 2 per cent; the money multiplier increases up to 2.3 by end-1999.

The estimated and actual consumer price index dynamics in 1999 are shown in Figure 1. It is obvious that the model allows for result quite close to actual facts. Thus, annual inflation is at 38.3 per cent (in fact it was at 36.7 per cent); GDP monetization level is at 15.27 per cent (the estimate was 14.71 per cent); the Ruble exchange rate was Rub. 27.17 per \$ at end-year (as compared to 27 Rub./\$); real non-interest expenditure is at 9.6 per cent (in fact it was at 11.6 per cent of GDP).

FIG.1



The successive governments of Primakov, Stepashin and Putin certainly deserve a big credit for their efforts through 1999 to bring the country's budget into balance. For the first time in a decade, the budget showed a profit and was implemented in full. This achievement was equal in significance to the market equilibrium attained under the Gaidar cabinet (through price liberalization) and development of a creditable monetary policy under Chubais. Finally, the principal elements of macroeconomic stability – a tough monetary policy and a balanced budget – were put in place. This macroeconomic success of the left cabinet was, more than anything else, behind the rapid stabilization of basic physical parameters and improvement in the health of the economy's real sector. The main causes and factors responsible for this development of the situation are examined in more detail below.

1.2. Balance of Payments, Monetary Policy and Real Ruble Exchange Rate

The period between price liberalization and right up to the August 1998 crisis was actually highlighted by the growing strength of the ruble, in real terms. Overall, the real exchange rate of the rubles rose 19.65-fold between January 1, 1992 and August 17, 1998 (see Figure 2).

Foreign trade liberalization and the opening up of the Russian economy to the world, which helped meet the demand of the consumer market within months of the start of market reforms and allowed Russian exporters to increase their presence on the world market, contributed to a convergence of domestic and world prices for identical goods. The growing exchange rate of the ruble in 1992 to 1997 and the population's rising purchasing power stimulated an influx of consumer imports superior to their domestically produced substitutes. But then, the growth in dollar-denominated production costs reduced the profit-making potential of Russian exports. Many Russian manufacturers found themselves completely unprepared to face growing competition in conditions when the benefits of low prices or low costs ceased to play the key role they did previously.

In August and September 1998, the Russian economy was thrown into a shock by a fourfold devaluation of the ruble. Elsewhere, a currency crisis of this magnitude is commonly followed by a relatively fast rise in the real exchange rate of the national currency owing to a growing surplus in the balance of trade.⁴ Throughout 1999, the real exchange rate of the ruble in Russia was only about half what it was over the first six months of 1998.

⁴ See, for example, Eichengreen, B., A. Rose, and C. Wyplosz (1995), "Exchange Market Mayhem. The Antecedents and Aftermath of Speculative Attacks," *Economic Policy*, October 1995, pp. 249-312.

File 18.p65

This real exchange rate dynamics is largely explained by the fact that the Central Bank was lending direct to the Russian Ministry of Finance so it could service and repay the government's foreign debts and purchase hard cash on the currency market, keeping up a downward pressure on the nominal ruble exchange rate through the year, even at the price of rising inflation.

Russia's Balance of Payments in 1999

A close look at Russia's balance of payments shows that its key figures changed drastically in 1999 from what they had remained for years. Despite the fact that the changes were engineered by factors that had previously been a major influence on them. Even though, for example, the balance of payment on capital account stayed stubbornly in the red the balance of payment on current account held just as steadily in the black, over \$5 billion nearly at all times through the first to third quarters of 1999, while in the fourth quarter of 1998 the balance on payments on current account shot beyond \$6 billion, an all-time record for as long as Russia has kept a balance of payments (see Figure 4). This situation was brought about by a buoyant trade balance that was showing a surplus of \$6.5 billion to \$9 billion every quarter. Moreover, the trade balance surplus grew at the expense of falling imports, because Russian exports regained their 1998 average of \$18 billion in the third quarter of 1999 only.

It must be admitted that exports forged ahead in the fourth quarter of 1998 because, in the first place, of their higher efficiency following the ruble devaluation that continued to pull up the trade balance surplus (as imports fell off) by inertia well into the first quarter of 1999. The second quarter of 1999 saw a recovery of the real ruble exchange rate, rebounding in larger imports. Although exports continued to grow, tagged along by rising world oil prices,

this factor accounted, in our view, for the trade balance surplus receding in the second quarter. Beginning in the third quarter, the trade balance was, as previously, swayed by the behavior of world prices for oil and nonferrous metals. The Figure 3 clearly shows that a strong growth in world oil prices gave a boost to the trade balance surplus in the third quarter of 1999.

The favorable current account was used to chop the deficit in the capital and financial account. The balance in this account was driven deep into the red, beginning in the fourth quarter of 1998. Against the background of the contracting surpluses in the direct and portfolio investment accounts, there was an increase in Russian overseas accounts (growth in outstanding debt, balances in the residents' overseas current accounts and deposits, and swelling overdue export receipts from abroad). Foreign liabilities in Russia eased insignificantly in the fourth quarter of 1998 through the third quarter of 1999, chiefly because of the accrued debt being paid off in the absence of new loans. In the situation, the loan balance could only be maintained in surplus by the public sector piling up its outstanding debt. In January through September 1999, for example, general government paid off \$6 billion in government debt on schedule, and another \$5.9 billion became outstanding or was deferred in the same period, and, combined with \$1.9 billion in foreign loans drawn, pushed the general government's balance of the above operations into the black.⁵

⁵ General government operations here include those of the Bank of Russia (involving \$454 million to repay the IMF loan in the third quarter) and those of local government, whose balance of loans received, repaid, past-due or deferred between January and September stood at \$43 million.

A close examination of the analytical cross-section of Russia's balance of payment shows that the overall balance of payments surplus was rising along with the surplus of the current account balance (that is, the surplus less the reserve assets and government sector operations to contract new loans). In late 1998 and the first six months of 1999, the total balance of payments deficit was financed by dipping into the reserve assets, building up outstanding debts, and deferring payments in the public sector. The current account surplus rising in the third quarter of 1999 and the loan tranche received from the IMF allowed the Government to chip its outstanding debt and rebuild some of its depleted reserve assets.

These balance of payments characteristics are evidence of a high demand for foreign exchange by the Finance Ministry which accounted for the high nominal exchange rate of the ruble despite an abrupt surge in the trade balance surplus.

Within the context of Russia's balance of payments analysis, attention should be focussed on capital export from Russia, one of the problems widely canvassed by economists and even more so by political figures. At the same time, it shall be noted that an analysis of the capital export problems includes not only capital outflows officially registered in the balance of payments, but also illegally exported capitals. It is impossible to evaluate the latter, although there are some methods permitting to estimate the scale of capital flight.

Official capital exports are made up of sums channeled into direct and portfolio overseas investments, capital transfers, financial and commercial credits by businesses in the non-state sector, and hard currency cash taken out of the country. The balance of payments records currency earnings that have not been credited to domestic accounts and unpaid import loans. It is wrong to regard these monies as illegal exports, since no one knows how much of

them will return as outstanding debt repayment. In 1998, Russian residents paid around \$16 billion (at a monthly rate of \$1.3 billion) through these channels, with approximately \$11 billion (at a rate of \$1.2 billion per month) in the first three quarters of 1999. The monthly average of registered capital exports in the first nine months of 1999, therefore, was slightly lower than the year before, probably because of declining imports, more than anything else.

An indirect indicator characterizing the scale of illegal capital flight from the country may be the amount reflected in the BOP “net errors and omissions” entry. In particular, it is noted in the works of the Bureau of Economic Analysis⁶ that its stable negative value may be seen as an evidence of permanently existing capital export not registered in other entries of the balance of payments.

Indeed, the stable negative value of the entry “net errors and omissions” may reflect the fact that while aggregating information from different sources either the data on merchandise exports did not correspond to the amounts of receipts, or the amount of import advance payments exceeded the value of actually imported goods. However, on the other hand, this discrepancy may be explained not only by permanent illegal capital flight, but by other factors, among them, for instance, imperfect statistics, incomplete accounting of export and import operations of non-organized trade, flaws of customs statistics, unaccounted for import of cash foreign currency, etc.

⁶ See, for instance: *Informatsionno-analiticheskiy byulleten'* (Information and Analytical Bulletin) “O statistike vneshnei torgovli i otsenke tendentsiy v dinamike platezhnogo balansa Rossiyskoi Federatsii (On Foreign Trade Statistics and Evaluation of Trends in the Dynamics of Russian Federation Balance of Payments),” No. 5, Byuro ekonomicheskogo analiza (Bureau of Economic Analysis), April of 1998.

As per calculations of the Ministry of Finance Economic Expert Group taking into account net errors and omissions, the capital outflow out of corporate and banking sectors made \$ 25 billion in 1998 (\$ 2 billion a month), while over first nine months of 1999 it made \$ 17.3 billion (\$ 1.9 billion a month)⁷.

As per RF Central Bank estimates, the foreign currency control measures undertaken in 1999 resulted in illegal capital flight declining from \$ 18 – 20 billion a year (6 per cent of the foreign trade turnover) in 1996 through 1998 to \$ 13 – 14 billion (4 per cent of the foreign trade turnover) in 1999⁸. However, due to the Ruble depreciation the capital flight burden on the economy not lightened, but became even more heavy as the share of capital exports in GDP increased from 4 per cent in 1996 through 1997 to 7 per cent in 1999⁹.

⁷ See: Ye. T. Gurvich, O. V. Dynnikova “Prognoz makroekonomicheskikh pokazateley i problema obsluzhivaniya vneshnego dolga (The Forecasting of Macroeconomic Indicators and the Problem of Servicing the Foreign Debt),” a report at the second annual conference of the Bureau of Economic Analysis “*Ekonomicheskiiy krisis v Rossii i puti ego preodoleniya (The Economic Crisis in Russia and the Ways to Overcome It)*.”

⁸ See: V. V. Geraschenko “O predvaritel’nykh intogakh raboty Banka Rossii za 1999 god i osnovnykh zadachakh na 2000 god (Bank of Russia: Preliminary Results of Work in 1999 and Key Targets for Year 2000).” A report at the meeting of managers of chief departments (national banks) of the Bank of Russia taken place on January 19, 2000; Andrei Belousov, Aleksandr Ivanter, Nikita Kirichenko “*Ekonomicheskaya ekspansia: kak ne proyest’ udachu (Economic Expansion: How not to Waste Good Luck)*” // *Ekspert*, December 20, 1999.

⁹ According to other estimates, the Central Bank data on the scale of illegal capital exports seem to be understated. Thus, according to M. M. Zadornov, the former RF Finance Minister (see: *Rossiyskaya Gazeta*, March 9, 2000), the measures CBR and the government undertook in autumn of 1999 helped to prevent capital flight for a short time. In the second quarter of 1999 forex outflows amounted to only \$ 1 billion a month. In case administrative measures could maintain this situation, the country would loose only \$ 12 billion in 1999. How-

As concerns capital flight from Russia forecasts for 2000, it shall be noted that the variation of estimates is even wider than that in 1998 through 1999. Thus, according to evaluations by the Institute of International Finance (Washington, DC) the illegal capital flight will make about \$ 20 billion in 2000¹⁰. On the other hand, although experts of the Russian -- European Center of Economic Reforms think that the scale of illegal capital outflow shall increase as the volume of exports grow, the CBR measures in the field of forex constrains shall help to check the growth of capital flight: the illegal capital drain may make about \$ 14 billion¹¹.

Monetary and Exchange Rate Policy

In 1999, the Russian Central Bank adhered to a sufficiently tough monetary policy against the background of the nominal ruble exchange rate dynamics described above. Despite major ruble interventions in the currency market, the Central Bank held up the growth in money aggregates by keeping the growth in net domestic assets to low rates. Otherwise (given the expansionist monetary policy) it would have hardly been possible to expect the real exchange rate of the ruble to remain relatively stable – with inflation rising with expanding domestic lending, the ruble would probably be falling faster, by nominal measure, than prices could possibly rise just to keep the balance. Alongside the ruble devaluation, therefore, the Central Bank's monetary policy became the second most important factor in the scenario for the Russian economy in 1999.

ever, yet in the third quarter of 1999 the picture began to change as \$ 8 billion were illegally exported. So, over the last year Russia lost from \$ 18 billion to \$ 20 billion, i.e. about the same amount as in previous years.

¹⁰ See: «Capital Flows to Emerging Market Economies,” a report of the Institute of International Finance, 24/01/2000 (www.iif.com).

¹¹ See: P. Westin interview to IA “Finmarket” on January 28, 2000 (www.finmarket.ru).

The growth rates of the consumer price index were falling over the period as a whole (see Figure 5). On balance, the consumer price index rose by 36.7 per cent in 1999, or at a monthly average of 2.64 per cent. The food price index rose by 35.9 per cent, non-food goods by 39.2 per cent, and services by 34.0 per cent.

The following factors are to be reckoned with in an analysis of the exchange rate policy pursued by the Russian Government and Central Bank in 1999.

First, the spurt of consumer prices in the autumn of 1998 and the inflation surge that followed in its wake in late 1998 and early 1999 focused the nation's attention on the Government's anti-inflationary measures again. The low ruble devaluation rate on the currency market was, under the circumstances, a necessary yet insufficient condition to keep inflation under control.

Second, imminent repayment of large sums of external public debt in 1999 and 2000 required the Central Bank to maintain its gold and hard currency reserves at an adequate level.

Third, the absence of attractive ruble-denominated instruments on Russian financial markets, on one hand, pushed up commercial banks' demand for hard currency. On the other hand, the existing constraints on the banks' investment in hard currency (such as rising provisions for obligatory reserves for hard currency deposits and caps on commercial banks' open hard currency positions) resulted in large ruble-denominated sums piling up in commercial banks' correspondence accounts with the Central Bank.

Fourth, a long string of political events witnessed in 1999 spurred currency market players into stepping up their speculative efforts. Under two cabinets and with the Duma elections in late 1999, the currency market was highlighted by inordinately volatile quotations against the background of swelling trading volumes.

Figure 6 helps identify several periods of varying money demand dynamics: restrained anti-inflationary policy in January to March; monetary expansion in April to June; restrictive monetary policy in July to November; and rising monetary base growth rates in December 1999 and January 2000.

According to Figure 7, approximately the same periods may be recognized from the perspective of exchange rate dynamics: year beginning to mid-March; mid-March to early August; and mid-August to the end of 1999.

Year Beginning to Mid-March 1999. Inflation could be slowed in the first quarter of 1999 largely thanks to the Government and Central Bank's sufficiently tough monetary policy in late 1998 to early 1999. Some fluctuations notwithstanding, the monetary base held practically stable through the first three months of 1999 (registering a tiny blip of 0.24 per cent only). In January, inflation stood at 8.5 per cent (i.e. 166 per cent over the year), in February it dropped to 4.1 per cent (or 62 per cent as recalculated in annual terms), and in March it fell again, to 2.8 per cent (at an annualized rate of 39 per cent).

A moderate growth in inflation in late 1998 (see Figure 4) sent up demand for dollars by the public and currency market players. The relatively large amounts of hard currency the Russian Ministry of Finance required to service the foreign debt in late 1998 and early 1999 hiked up the dollar exchange rate against the ruble already in November and December 1998.¹² Early in 1999, the Central Bank succeeded in achieving relative stability on the currency market. In January 1999, the official exchange rate of the dollar rose against the ruble from 20.62 to 22.60 (see Figure 7). This was equivalent to a 9.60 per cent growth. The Central Bank cooled the

¹² In the fourth quarter of 1998 as a whole, Russia spent nearly \$3 billion to repay its foreign debt.

participants' speculative mood by massive dollar interventions. Its gold and foreign exchange reserves diminished by almost \$602 million in January 1999 (4.93 per cent), by another \$184 million in February (1.58 per cent), and a further \$672 million in March (5.88 per cent). In the absence of any sizable foreign debt repayment,¹³ this rapid dwindling of the Central Bank's gold and foreign exchange reserves through heavy market interventions allowed it to rein in the official exchange rate of the dollar against the ruble at 23 rubles through the first three months of 1999.

In the first three months of 1999, the Central Bank's gold and foreign exchange reserves were slashed by about \$1.5 billion, or 12.3 per cent. The emerging trend stirred up concern among investors over the consistency of the monetary authorities' exchange rate policy and Russia's ability to pay off its foreign debts. The plummeting confidence in the Government, the Ministry of Finance and the Central Bank led to a currency market squeeze on the ruble. As a result, the ruble exchange rate leapt several times in February through April and expectations about inflation racing up soon again persisted despite the monetary authorities' continuing tough monetary policy.

An analysis of the situation dominating the currency market over the period reviewed shows that the beginning of 1999 was marked by a succession of devaluations in countries rated as developing markets.¹⁴ Since recently, the trends on emerging markets

¹³ At the end of the first period (March 25 and 31, 1999) DM297 million (around \$170 million) was paid on Deutschmark-denominated Eurobonds.

¹⁴ In particular, a successive wave of financial crisis swept Brazil in mid-January 1999, bringing devaluation of the real in its wake. The creep of the crisis to other Latin American countries spawned what appeared to be a new legal tender initiative. The Central Bank of Argentina proposed the US dollar for the country's national currency. A monetary union with the US could certainly undercut the power of Argentina's Government and Central Bank to control the situation in its

had had a perceptible effect on the Russian financial markets. The wave of suspicion for weak currencies that rolled across the world in early 1999 was, therefore, a factor that jacked up risks of investment in ruble assets.

Second Half of March to Early August 1999. After a spell of relative lull in January and February 1999, with its typically low dollar gains, the official dollar exchange rate and CELT quotations picked up again in March. Domestic debt repayment resumed by the Ministry of Finance (in particular, the repayment of “new” GKO tranche No. 21132 and the coupon of OFZ-PD No. 27004) can be singled out as the principal market factor. In the situation that had emerged by late March, the ruble-denominated funds raised by the investors put a considerable pressure on the ruble exchange rate. The Central Bank’s deeply dented reserves and the prospect of Rub. 1.5 billion being paid on internal currency bonds in May buoyed up the market players’ speculative mood.

In March 1999, the official dollar exchange rate rose from Rub/\$ 22.84 to Rub/\$ 24.18 (see Figure 7), or by 5.87 per cent that being equal to 98.21 per cent in annualized terms. Beginning on March 25, the Central Bank intensified its market presence. Its massive interventions stemmed the growth of the official exchange rate and stabilized the market for a time. In the opening days of April, however, speculative demand sent the ruble falling again, with the official dollar exchange rate going up by 4 per cent between April 1 and 8 (from Rub/\$ 24.16 to Rub/\$ 25.12). This turnaround forced the Central Bank to waive, beginning on April 7, 1999, the right previously enjoyed by authorized banks to purchase dollars on their own behalf and for their own account to pay hard

economy. For all the fickleness of the Argentine financial system, however, this proposal looked like a perfectly viable alternative.

currency withdrawals by private individuals from their accounts and deposits with these banks.

The Central Bank's move, combined with Russia's public admission of being unable to pay the \$1.5 billion on internal foreign currency bonds¹⁵ in mid-May 1999 turned around the moods on the currency market. Some of Russia's largest companies dumping their dollar holdings as a result helped reverse the official dollar exchange rate and CELT dollar quotations in the second half of April.

A certain role in stabilizing the market was played by the rate of obligatory sale of exports receipts within seven days having been raised from 50 per cent to 75 per cent. In late March, the President signed an enabling decree. For all the concern about the growing flight of capital out of Russia, increased hard currency supply on the market allowed the Central Bank to build up its reserves and improve its capacity to smooth out ruble exchange rate fluctuations.

Talks continued in April 1999 over an IMF loan and restructuring of Russia's foreign debts. Toward the end of the month, the parties had basically harmonized their positions on the IMF giving Russia about \$4.5 billion to be drawn down over two years. As the

¹⁵ In late April, the differences between the Russian Finance Ministry and several investors over domestic debt novation resurfaced at a meeting in London between the first Deputy Finance Minister, Kasyanov, and members of the London Club. In fact, the Russian Deputy Minister stated in London that Russia would not be able to repay the \$1.5 billion on internal foreign currency bonds in mid-May in full. On one hand, this admission improved the Central Bank's chances of keeping in hand ruble exchange rate fluctuations on the open market. On the other hand, though, the Russian Government's unilateral move on its foreign debts dealt a further blow to Russia's reputation on international financial markets. On April 20, the Standard & Poor agency took the rating of Russian internal foreign currency bonds down to the CC level and confirmed Russia's rating on hard currency liabilities at the SD level and that of Russian eurobonds at the CCC- level.

principal condition for releasing the loan, the IMF directors required the Russian Government's budget to show an initial surplus of 2 per cent of GDP, a start to be made on realistic reforms in taxation, banking, bankruptcy regulations, and so on.

In formal terms, the official dollar exchange rate rose by 0.21 per cent in April 1999 (at an annualized rate of 2.51 per cent). Actually, however, the dollar jumped almost 4 per cent in the first week of April. After this sharp rise in the official dollar exchange rate, the Central Bank launched an intervention that brought down the dollar by the end of the month. After such a sharp increase in the official rate CBR had to intervene and succeeded in bringing the rate down by end-month. This seesaw of the dollar exchange rate shooting up within days, only to be shot down after a longer period of Central Bank intervention to where it had been previously, became a typical behavioral pattern of the Russian currency market in 1999 (see Figure 7).

In April through June 1999, consumer prices slowed down to a leisurely pace, 1.9 per cent in early June. An important factor contributing to price stabilization was the downscaling of inflationary expectations of businesses for a variety of reasons. First, the absence of large-scale lending by the Central Bank to finance the federal budget deficit. Second, a significant recovery on Russian financial markets and consequent rising demand for cash to be fed into transactions. Third, the Central Bank's success in repelling the attack attempted on the ruble in April 1999: stabilization, and even some strengthening, of the ruble against the dollar is, in the Russian context, read by businesses as an important sign of the monetary authorities' tough policy. Fourth, the gathering process of import substitution in the population's consumer basket (the growth in the ruble-denominated value of imports following the ruble devaluation

was a key force driving the prices rapidly up in September 1998 through January 1999).

In a drive to build up its gold and foreign exchange reserves, including those purposed for crediting the RF Finance Ministry to enable it to service the foreign debt, the Central Bank switched, early in April 1999, to a policy of money supply expansion, with the monetary base growing at a faster pace than it registered in the first quarter of 1999. Also at that time, the Federal State Duma passed an amendment to the 1999 Budget Law, raising the ceiling of the gold and foreign exchange reserves the Central Bank could use to repay the government's foreign debt over the year from \$2.1 billion to \$4.5 billion.

While analyzing this trend, two different aspects determining the developments in 1999 shall be noted. First, the accumulation of gold and foreign exchange reserves by the RF Central Bank was linked to a considerable surplus of the balance of trade providing a constant flow of foreign exchange in the country. Second, the prospects of Russia getting the next tranche of stabilization credit from the IMF remained uncertain. Therefore, the accumulation of gold and forex reserves was aimed at creating a foreign currency stock for servicing the foreign debt. Meanwhile, the monetary base was expanding without pulling along net domestic assets too strongly, drawing instead on the growing net international reserves. The Central Bank getting no loans from international organizations in this period, the growth in its gold and foreign exchange reserves was equivalent to that in net international reserves. In April the money supply grew by 9.03 per cent, in May it increased by 7.53 per cent, and in June – by 7.04 per cent.

In April and May 1999, the monetary base was growing faster than it was in the first quarter of the year (see Figure 6). In April the money supply increased by 8.45 per cent, over the first three weeks

of May by another 5.43 per cent. Overall, the monetary base had grown by about 14.2 per cent from the start of the year, which means that the real monetary base had contracted by 6.3 per cent. The Central Bank's liabilities were growing in April and May chiefly because of the hard currency purchases it was making to replenish its gold and foreign exchange reserves (see Figure 6) and to pay off the federal external debts.

In May 1999, political factors reigned supreme on the currency market. Resignation of the Primakov government and voting in the State Duma to impeach the President on May 12 destabilized the currency market for a few days. The failure of the impeachment attempt on May 15 and the rapid endorsement of S. Stepashin as prime minister by the State Duma on May 19 added up to lower the risk level and improved the market situation somewhat. The situation on the currency market stabilized and the official dollar rate reached 24.44 Rub/\$ before the month was out.

The currency market remained relatively calm through June 1999. Its composure gave the Central Bank an opportunity to introduce, beginning on June 29, 1999, a single trading session for US dollars to be exchanged for Russian rubles.¹⁶ In this connection it shall be noted that in spite of a relatively stable situation existing on the currency market at end-June and increasing gold and forex reserves of the Central Bank the introduction of a single trading session increased the possibility of Ruble exchange rate to be attacked.

¹⁶ This decision was brought into effect by the Central Bank's Regulation No. 17-P, of June 16, 1999, simultaneously with the repeal of the Central Bank's Regulation No. 57-P, of September 28, 1998, on special trading sessions.

The monetary aggregate M_2 had grown by 26.6 per cent in the six months of 1999 and cash in hand (M_0) had increased by 15.2 per cent. In the absence of developed financial markets, the changes in money supply structure (the share of cash in hand having fallen to 38.1 per cent from 44.1 per cent in October 1998 and the monetary multiplier¹⁷ having edged up from c 2.0 to 2.2-2.3) were expected to be evidence of improved liquidity in the non-financial sector of the economy. However, the share of claims against non-financial sector businesses in the total domestic lending (aggregate of all claims by the banking system against the economy) went down from 40.31 per cent to 32.52 per cent in the period between August 1998 and June 1999, while that of claims against the enlarged government rose from 58.89 per cent to 66.34 per cent. Russian commercial banks had not, therefore, modified their attitude to the real sector despite a visible growth in industrial output and rising profitability of manufacturing enterprises. Loans were as rigidly rationed as before, and in the absence of financial markets, lending to government at all levels remained a single most important area of business for commercial banks.

A useful illustration is provided by the ratio of the two monetary multipliers computed from two different bases: the ratio of M_2 to the narrow monetary base and the ratio of M_2 to the broad monetary bases (or reserve money, see Figure 8). Whereas these two indicators had identical dynamics before the August 1998 crisis, they started, beginning in January 1999, to move in different directions – while the narrow monetary base was now growing, the broad monetary base multiplier continued to slump. This difference can be explained, in the first place, by a wider gap between the narrow and broad monetary bases, that is, the sum of idle reserves (balances in correspondent accounts with the Central Bank) and funds deposited

¹⁷ The ratio of M_2 to the narrow monetary base.

by commercial banks (for example, deposits, see Fig. 11) with the Central Bank. An analysis of the broad monetary base dynamics shows, therefore, that money is locked up within the banking system, where it poses a threat against the national currency exchange rate at the slightest blip of uncertainty or risks, reluctant to flow into the real sector of the economy.

In the first half-year of 1999, the money aggregates were trailing inflation in growth rates. As a result, the real money supply (aggregate M₂) in early July 1999 was 28 per cent to 29 per cent below the pre-crisis level registered in July 1998 (see Figure 10).

On June 10, 1999, the Central Bank reduced the refinancing rate, for the first time in a year (see Figure 9), by 5 percentage points to 55 per cent per annum. In a situation when the number of the government ruble-denominated bond market participants was limited (see Appendix 2), this change in the refinancing rate was a symbolic gesture.

The money the Central Bank continued to issue through the second quarter of 1999 speeded up price growth rates. Because of the time lag of six to nine months (shorter in the absence of financial markets) between a rise in money supply and the time prices start to go up, the impact of this policy was not felt until mid-summer 1999.

In July 1999, the weekly consumer price index growth rates picked up noticeably, bringing inflation up to 2.8 per cent for the month. Considerable variations in the relative growth rates of prices for different groups of goods may be named among supplementary factors impacting the inflationary processes. In the period 1992 to 1998, prices for consumer services were leading those for food and nonfood products, mostly below the CPI growth rates. In the first seven months of 1999, however, the food product price index rose 30.0 per cent, nonfoods registered a 26.1 per cent growth, and the

services tracked behind at 23.1 per cent only. To make matters worse, gasoline prices were hiked up sharply in late June and early July.¹⁸ Changes in the tax system were a further contributing factor: a sales tax, effective from July 1, 1999, was introduced in some regions of the Russian Federation and the list of goods eligible for reduced VAT was slimmed down severely.

The narrow monetary base continued to rise through July 1999, posting an increase of almost 3 per cent in the first two weeks of the month (Rub. 7.8 billion). The actual money issue scale proved even more significant, since the Central Bank sterilized the money supply growth by expanding its deposit and open market operations. In the third week of July 1999, however, the Central Bank adopted a tougher monetary policy than it had followed in the preceding three or four months. The money supply growth slowed down to a monthly rate of 1 per cent or less through the rest of the year.

Although it was dangerous to attempt to ensure foreign debt repayment via new money issues, the government was able to control the situation because its declining social expenditures (this expenditure was sharply devaluated by the government of Ye. Primakov and Yu. Maslyukov, in detail see below) were combined with existing low social expectations. These circumstances enabled the pursuit of a cautious and responsible macroeconomic policy.

It shall be stressed that the transition from one stage of the monetary policy to another in 1999 was not related to the changes

¹⁸ Specifically, according to Goskomstat figures, prices for different gasoline grades grew between 7 per cent and 11 per cent in June. In July 1999, they rose by another 15.2 per cent. The prices for motor fuel were raised in the wake of oil prices growing on the world markets combined with coordinated moves by Russian market participants. Moreover, producer prices in April through June were outstripping consumer prices, at an average 3.5 per cent to 3.6 per cent a month, escalating inflation on the consumer market in months ahead.

of cabinets. Moreover, the frequently changing Prime Ministers were a clear illustration of the continuity of the economic course pursued by representatives of major groups of the political elite and in this sense was a factor strengthening the political stability.

The currency market remained calm in July 1999. The official dollar exchange rate was almost flat through the month as it declined from Rub/\$ 24.22 to Rub/\$ 24.19 (see Figure 7). No substantial growth of demand for dollars was registered in July. Toward the end of the month, however, the market players were exhibiting faint signs of speculative activity. In all probability, they were encouraged by the Central Bank's rapidly dwindling gold and foreign exchange reserves (in July, the gold and foreign exchange reserves were reduced by \$231 million, or by 1.9 per cent in July, and in August they shed another \$690 million, or 5.8 per cent).

Mid-August to Late 1999. Exactly a year after the crisis in August 1998, the currency market was again reverberating with political events. The population's demand for cash dollars rose sharply within days of Stupishin's resignation as prime minister. Yet, the hard currency purchasing and selling rates went up only insignificantly at exchange offices. The US dollar, for example, gained a paltry one or two rubles.

The Central Bank's vigorous interventions quelled the rising speculative wave of demand for dollar and calmed the currency market. On August 9, 1999, the today dollar exchange rate at the single trading session (STS) at CELT rose by 3 per cent over its August 6 showing (up to Rub/\$ 25.29). It then started sliding back gradually, to reach 24.75 rubles at the end of the month. The Central Bank's interventions on August 9 to 15 dented its gold and foreign exchange reserves by 2.65 per cent, from \$11.7 billion to \$11.4 billion.

In September 1999, the dollar reached a new peak at the CELT single session, registering 25.89 rubles on September 3 for trades executed tomorrow. The official exchange rate reached Rub/\$ 25.89. Again, the dollar was slowly retreating for the rest of the month (see Figure 7), both yielding to the pressure of the Central Bank's currency interventions and under the effect of the Government's decision to feed the nonresidents' funds into the MICEX settlement system.¹⁹ The official dollar exchange rate advanced 1.33 per cent for the whole of September.

In October 1999, the ruble lost some more ground to the dollar, slightly faster than the month before. The official dollar exchange rate moved up 4.03 per cent (60.6 per cent per annum). The deadline for large sums to be repaid on foreign debts at the end of 1999, the IMF's postponement of another tranche and lack of progress at the talks with the London Club of creditors for a restructuring of the debts of the former USSR forced the Central Bank to review its open market position. The Central Bank reverted to its policy of building up its gold and foreign exchange reserves. In the first half of the month, it managed to add \$0.8 billion to its reserves. A faster growth of the monetary base in October (3.9 per cent for the narrow monetary base) could largely be attributed to ruble interventions on the currency market. In turn, increasing money issue led to faster inflationary processes and resumed wobbling of the ruble against the dollar.

¹⁹ The Central Bank's decision of September 16, 1999 applied to nonresidents who kept their funds in C accounts with Russian commercial banks. Under that decision, all ruble-denominated monies in these accounts, which their owners received as a result of GKO-Minfin bond novation or from the sale of bonds issued as a result of restructuring on the secondary market were to be transferred into the MICEX settlement system. Since commercial banks relied on respective liabilities to finance their own active operations, the decision caused demand for liquid assets to rise within the banking system.

In August 1999, the consumer price index ended up at 1.2 per cent. Seasonal factors typical of this month were chiefly behind the slowdown in the consumer price creep. They continued well into September, holding inflation to 1.5 per cent. In October 1999, the consumer price index eased to 1.4 per cent. The relatively low inflation persisting in this period could be put, above all, to slackening money issue by the Central Bank in the summer months and early autumn 1999. To forestall an inflationary fallout of expanding money supply, the Federal Government approved, on October 12, 1999 regulations to control money issue and registration of Central Bank bonds. This financial instrument was to give the Central Bank added powers to control the money supply, specifically, by sterilization of ruble interventions on the currency market. The auctions held as late as December 14 only to place the new instruments were aborted due to lack of demand at prices acceptable for the issuer.

The money aggregate dynamics in November was, therefore, typical for several months of 1999: rapid acceleration at the start of a month and gradual slowdown in the following two or three weeks, a pattern that allowed the Central Bank to combine its policy of building up gold and foreign exchange reserves and restraint of money supply growth. In November and December 1999, consumer prices held steady at a monthly growth rate of 1.2 per cent to 1.3 per cent.

In November 1999, the currency market was spared sharp exchange rate fluctuations. The dollar advanced by 1.26 per cent during the month at the official exchange rate. And yet, devaluatory moods among currency market players edged up a little. Even when the Export-Import Bank of Japan agreed in late November to give \$375 million in loan to Russia, some concern over foreign debt repayment persisted: in late November and December, Russia was to pay about \$352 million on eurobonds, \$800 million to repay the

IMF loan, and a further \$170 million to the Paris Club. It was very probable that the Central Bank would soften its exchange rate policy and the dollar shoot up in early 2000 as a result.

In December 1999, days before Russia's foreign debt came due and new foreign loans were nowhere in sight, the Central Bank stepped up its ruble interventions on the currency market in an attempt to rebuild its gold and foreign exchange reserves. Over the month, its gold and foreign exchange reserves rose by \$1.2 billion (or by about 10 per cent) to \$12.7 billion, a record since November 1998. The scale of ruble interventions is reflected in the monetary base having grown from Rub. 272.0 to Rub. 307.5 billion, or by 13.05 per cent. As an obvious result of this policy, balances in commercial banks' accounts with the Central Bank rose sharply and the ruble exchange rate jumped in the opening days of 2000. In the period from December 27, 1999 to January 10, 2000, the Central Bank's gold and foreign exchange reserves decreased by \$400 million. They rebounded, however, from January 10, 2000 (reaching \$12.8 billion by January 21, 2000). For all that, though, a combination of measures undertaken by the Central Bank (such as resumption of deposit operations and operations in the secondary GKO-OFZ bond market) it could sterilize the monetary base growth. On January 24, 2000, the narrow monetary base fell to Rub. 302 billion (or Rub. 7.2 billion less than it was on January 10).

In December, the increased supply of foreign exchange by exporters selling their foreign exchange holdings to pay taxes kept the ruble stable against the background of the Central Bank's ruble interventions. In December, the official exchange of the dollar went up by 2.20 per cent (or 29.77 per cent on the annualized basis). The situation was different in January, however. Actually, in its drive to save its reserves during the first two weeks of January only, the Central Bank allowed by ruble to decline by 5.7 per cent. In this

way, the Central Bank's gold and foreign currency reserves diminished by \$400 million between December 27, 1999 and January 10, 2000 (see Figure 6). Beginning on January 10, 2000, however, the Central Bank's gold and foreign exchange reserves started rebuilding again (to \$12.8 billion by January 21, 2000). Meanwhile, the official dollar exchange rate climbed by 5.74 per cent (95.39 per cent per annum).

January of 2000 saw the CPI growth rates to accelerate. The consumer price index grew by 2.3 per cent (31.4 per cent per annum) over the first month of 2000. Monetary factors combined with number of seasonal and institutional factors, which determined the inflationary expectations of economic agents, were responsible for growing rates of consumer prices. First, the news of an immediate increase in tariffs on services provided by natural monopolies started to appear more frequently. In particular, the top officers of the Transport Ministry, RAO ES Rossii, and OAO Svyazinvest announced that it would be necessary to urgently increase prices of their products. The Federal Energy Commission announced natural gas supply tariffs to be increased by 5 per cent for households and by 15 per cent for industrial enterprises since November 1 of 1999. According to the Russian experience in 1992 through 1995 a price hike in these industries is reflected in inflation rates with a short lag usually below one to two months. Second, the effect of seasonal factors (contract and retail prices are usually adjusted by the beginning of the new calendar year) was much stronger due to the fact that in 1999 prices of some consumer goods, public services, and regulated tariffs grew at a considerably slower rate than the general consumer price index that to some extent being due to political reasons (the elections to the State Duma and of some heads of the Federation subjects). It seems that in year 2000 this gap will become somewhat narrower.

On January 24 of 2000 the Central Bank reduced its discount rate for the second time over the last half-year: from 55 to 45 per cent per annum (see Figure 9). Last time the CBR rate was so low in the first half-year of 1998. This measure is not unexpected, since the current inflation rate and interest rates on the inter-bank credit market are below 15 to 20 per cent per annum. The reduction of the discount rate will also facilitate lower rates of longer GKO/OFZ tranches, since limits on the maximum yield of government bonds (double CBR discount rate) remain in force²⁰.

The narrow monetary base grew by 48.3 per cent for the whole of 1999 (from Rub. 207.3 to Rub. 307.5 billion), and the broad monetary base swelled by 66.8 per cent, from Rub. 263.7 to Rub. 439.7 billion. The share of cash declined from 71.2 per cent to 60.6 per cent over 1999, while the share of the mandatory reserve fund of crediting organizations (MRF) increased from 7.4 per cent to 9.3 per cent (in June of 1998 it made 16.5 per cent), the share of balances of corresponding accounts increased from 10.7 per cent to 15.8 per cent (in July of 1998 it was 6.5 per cent), the share of deposits and other liabilities rose from 10.7 to 14.3 per cent (in July of 1998 it made 10.5 per cent). In 1999, the monetary base registered a real growth of 8.5 per cent (for the aggregate in its narrow sense) and 22.0 per cent for the aggregate defined broadly.

Other monetary aggregates grew more slowly in 1999. In particular, the money supply M_1 gained 53.7 per cent (or 12.4 per cent in real terms), the monetary supply M_2 expanded by 57.2 per cent (or 15.0 per cent in real terms), and the broad money rose by 56.7 per cent (or by 14.6 per cent in real terms). Given a drop of the real money supply in January 1999, demand for money (in the aggregate M_2) was set to advance by 25.8 per cent for the year. With the GDP deflator lagging behind the consumer price index, the GDP moneti-

²⁰ Yields to maturity of GKO and OFZ due in 2000 are over 30 to 40 per cent per annum.

zation was, by preliminary estimates, to reach 14.6 per cent in 1999, a record for the period since price liberalization.

The Finance Ministry's high demand for foreign exchange versus the Central Bank's restrictive monetary policy translated into an insignificant growth in the real exchange on the ruble in 1999. The consequences of this real exchange rate policy for the Russian economy were varied, particularly when the short- and long-term effects of devaluation are separated. An analysis of theoretical constructions measuring the impact of the real exchange rate of the national currency on economic growth, as applied to the development pattern of the Russian economy in September 1998 to December 1999, yields a number of beneficial and adverse effects of devaluation and restraints preventing long-term advantages to be gained from the devalued ruble.

1.3. Trends in the Real Sector of the Economy: Revival in Export-Generating and Import-Substituting Industries

1.3.1. Production Revival: Export-Oriented Industries and Import-Substitution.

Rapid growth of manufacturing was a distinctive feature of the Russian economy in 1999. The gross industrial output in 1999 advanced at 8.1 per cent, the highest growth rate in ten years. In 1999, industrial output was 2.5 per cent higher than in the memorable year 1997, when recovery was achieved for the first time since the onset of reforms, and the industrial growth index reached 102.0 per cent. GDP increased by 3.2 per cent on 1998. Not even these high growth rates in 1999 could offset the consequences of economic slump triggered by the crisis on the world and domestic financial markets between October 1997 and August 1998.

TABLE 1

Key Macroeconomic Indicators Dynamics
(% of the previous year figures)

	1992	1993	1994	1995	1996	1997	1998	1999
GDP	85,5	91,3	87,3	95,9	95,1	100,8	95,4	103,2
Industries	82,0	86,0	79,0	97,0	96,0	101,9	94,8	108,1
Extracting	89,0	90,0	90,0	99,0	98,0	103,0	96,5	
Processing	81,0	85,0	76,0	96,0	95,0	101,8	92,8	
Consumer goods	85,0	89,0	74,0	87,9	93,4	102,1	93,6	
Agriculture	91,0	96,0	88,8	92,0	93,0	100,1	87,7	102,4
Investment in fixed assets	60,0	88,0	76,0	90,0	82,0	94,5	93,3	101,0
Freight turnover	86,0	88,0	86,0	99,0	95,4	96,6	96,5	105,2
Communication services							119,9	133,1
Retail trade turnover	97,0	102,0	100,1	93,0	96,0	101,4	96,7	92,3
Paid services to households	82,0	70,0	62,0	82,0	94,0	103,7	99,5	102,4
Foreign trade turnover	-	90,6	100,3	122,3	108,2	102,9	82,3	
Exports	-	87,9	106,9	118,8	113,9	97,7	84,1	
Imports	-	77,2	90,8	128,2	99,4	107,0	80,2	
Real disposable money incomes	53,0	116,0	112,0	84,0	100,0	106,3	81,9	84,9
Real wages and salaries							86,6	76,8
Unemployment (registered)	-	164,6	202,5	145,2	124,9	88,9	82,1	85,1
Price indices:								
Consumer	2608,6	939,9	315,1	231,3	121,8	111,0	184,4	136,5
Foodstuffs	2626,2	904,9	314,1	223,4	117,7	109,1	196,6	134,0
Non-foods	2673,4	741,8	269,0	216,3	117,8	108,1	199,5	139,2
Paid services to households	2220,5	2411,2	622,4	332,3	148,4	122,5	118,3	134,0
Industrial								
Finished products:	3380,0	1000,0	330,0	275,0	125,6	107,4	123,2	167,3
Purchased resources	-	-	305,0	314,4	124,3	106,8		
Capital construction	1610,0	1160,0	530,0	270,0	137,3	105,0	112,1	146,0
Freight carriage	2050,0	1850,0	760,0	300,0	122,1	100,9	116,7	118,2
Communication services	-	-	-	-	144,7	104,2	106,2	122,8
Agriculture	940,0	810,0	300,0	330,0	140,0	108,0	166,4	191,4

Source: Russian Statistical Agency

Comparison between key socioeconomic figures for the last two years shows that Russia's economy is yet to make to the pre-crisis level. In 1999, real GDP was 98.1 per cent of the 1997 level.

It follows from an analysis of structural shifts in the real sector that, between 1992 and 1998, the slump in the service-providing industries was more moderate than the recession in manufacturing. Actually, this was a factor restraining the trend toward lower GDP growth rates. In 1997, too, the uptrend dynamics of GDP propelled by the rising output in both economic sectors was dominated by the services growing at a faster pace than the manufacturing output. The situation turned around in 1999: structural shifts occurred in GDP as manufacturing growth rates outraced the smoother growth curve in the services.

An analysis of output proportions in the various economic sectors is to allow for the specifics of price formation and dynamics in individual industries and sectors of the economy. While producer prices for manufactures rose through 1999 by 67.3 per cent from year beginning and those for farming produce posted an increase of 91.4 per cent, in the services sector, charges paid for consumer services climbed by 34.0 per cent, freightage fees advanced 18.2 per cent and communications charges rose by 22.8 per cent. Changes in the price structure had an effect on GDP generation proportions. A comparison between GDP generation in current and comparable prices allows the extent of changes in proportions in different economic sectors to be assessed and the real contribution of each industry to be estimated. The manufacturing infrastructure industries intensified their favorable impact on the growth dynamics of GDP generated in 1999. Given a restrained tariff policy, the growth of value added in transport and communications was due to both the larger scale and wider range of services provided.

TABLE 2

GDP Structure as Broken Down by Industries (% of the total)

	1998	1999	1998	1999
	Current prices		Comparable prices*	
GDP, including:	100,0	100,0	100,0	100,0
Commodities, including:	42,2	45,7	42,2	43,3
Industry	29,0	32,9	29,0	30,4
Construction	7,1	5,5	7,1	6,1
Agriculture	5,3	6,7	5,3	5,8
Services	57,8	54,3	57,8	56,7
<u>Market services</u> , including::	42,4	42,6	42,4	43,0
Transportation	9,1	7,2	9,1	9,5
Communications	1,9	1,8	1,9	2,3
Trade (wholesale, retail, foreign)	19,1	23,1	19,1	19,4
<u>Non-market services</u>	15,4	11,7	15,4	13,7

Source: Rosstatagentstvo

* Calculated by authors as per preliminary data of the RF Economy Ministry

A comparative analysis of dynamics in different industries shows that manufacturing responded the fastest to changes in the domestic market situation after the August 1998 crisis. Positive monthly dynamics in manufacturing was registered beginning in the third quarter of 1998, with a slowdown in the uptrend in the second quarter of 1999 being adequately explained by the influence of seasonal factors. Almost all manufacturing complexes registered growth in 1999.

Growth dynamics in individual sectors were affected by a set of specific factors and conditions. Real ruble devaluation, however, was certainly the most important influence. The beneficial effects of devaluation are widely known. They are, above all, growth in

import-substituting output in the real sector of the economy and a higher earning capacity in export-oriented industries.²¹

Favorable changes on the world market for fuel and primary resources was, alongside the devaluation, a factor boosting growth rates in export-oriented industries of the mining sector. Recovery of the manufacturing dynamics could be traced to growth in demand for domestically produced manufactures on the internal market and to intensified import-substitution processes.

It must be noted that actually all economic growth forecasts made in autumn 1998 underestimated the Russian economy's capacity to respond to devaluation by vigorously stepping up output. It appeared more probable to expect the niches previously filled by imports to stand empty. What actually happened was that a large percentage of imports were adequately replaced with their Russian-made equivalents. This situation was achieved owing to both changes in the domestic consumption structure (a shift toward less expensive, and at times lower quality, goods after more expensive consumer goods had been put out of reach of the general public following a deep plunge in real incomes) and the pent-up potential of

²¹ Below we proceed to examine the effect of manufacturers' improved financial position on the declining proportion of non-monetary settlements in the real sector, reduced arrears among businesses, and improved tax collections to the budget. Besides, devaluation of the national currency and attending growth of domestic prices cut into the real wealth of businesses denominated in the national currency. In these conditions, current consumption contracts and savings grow, providing the economy with additional funds to step up investment, and labor supply expands. These are the factors facilitating production expansion and accelerating economic growth. In the Russian economy, however, the banking crisis and high inflation rates devalued a considerable proportion of the population's savings and sharply undercut confidence in the banking system, a poor climate for investment resource accumulation. Besides, a large proportion of the Russian public makes savings in foreign exchange, so the actual effect of wealth cannot be estimated with a sufficient degree of accuracy.

domestic industries. Whatever the standards of their technologies and labor quality, the Russian manufacturing industries proved remarkably capable of turning out a wide range of products, demand for which used to be previously met almost entirely by imports.

Along with the falling real exchange rate of the ruble, production growth in the manufacturing sector was stimulated by government measures imposed to restrict import of competing goods (steel pipes, for example) and by greater government support for certain industries, as, for example, by placing more orders with defense industry enterprises. Accordingly, predominantly the industries oriented toward the domestic market demonstrated fastest rates of growth.

TABLE 3

Growth Rates of Industrial Performance Indices

	Jan 97 – Jan 2000	Aug 98 – Jan 2000
Total industry	16,60 %	23,57 %
Fuel and energy complex	2,56 %	4,68 %
Electric power industry	3,98 %	5,08 %
Oil extracting industry	2,41 %	2,53 %
Oil processing industry	-0,61 %	5,19 %
Natural gas industry	-0,94 %	-2,68 %
Coal industry	5,49 %	14,22 %
Ferrous metallurgy	19,46 %	36,42 %
Non-ferrous metallurgy	18,12 %	12,20 %
Machine building	21,22 %	46,79 %
Chemical and petrochemical industry	28,61 %	37,74 %
Wood, wood-processing, and pulp-and-paper industry	50,44 %	36,95 %
Constructing material industry	7,58 %	11,24 %
Food industry	22,05 %	23,48 %
Light industry	36,14 %	83,74 %

* Source: RF Government's Center for Economic Trend Analysis (seasonally adjusted values)

Output grew in the light and food industries in 1999, first time since the start of reforms. As businesses improved their financial standing to be able to make investment, demand for capital goods and, accordingly, output growth rates rose in the second half of 1999. Rising output of high-quality goods raised the share of added value industries in the structure of generated GDP from 29.0 per cent in 1998 to 32.9 per cent in 1999.

Industrial growth urged a higher demand for infrastructure services – commercial freight turnover rose by 5.2 per cent on 1998 and communications services went up by 33.1 per cent.

Communications and information technologies remain a leading and dynamically growing industry of the national economy. Communications services accounted for 1.8 per cent of GDP in 1999, up by 1.2 percentage points over the past eight years. Communications have been showing recovery since 1996.

Commercial freight turnover in all modes of transport operations rose 5.2 per cent from 1998, with railroads (carrying over a third of total freight) posting an 18.1 per cent growth. Growing freight carriage rates have been stimulated by both rising demand for domestically produced goods on the internal market and steadily climbing exports, both in volume and share of the total freight.

Shrinking effective consumer demand negatively affected the dynamics of wholesale trade amounts. Over 1999 the amount of sales of wholesale trade enterprises made 97.1 per cent of the previous year levels. Two thirds of the wholesale market turnover were formed at the expense of sales carried out by industrial enterprises and organizations. An intensive growth of sales on the part of industrial enterprises was observed since the fourth quarter of 1998. The persisting dominance of industrial enterprises on the market of products for industrial and technological purposes was a factor facilitating the increasing merchandize turnover of industrial enter-

prises by 5.8 per cent as compared with 1998 figures. Intensively growing sales of industrial enterprises compensated for the recession in business activity of wholesale trade organizations and the turnover of the wholesale market increase by 2.6 per cent as compared with 1998.

The retail turnover had a negative impact on the dynamics of market services in trade in 1999. The downtrend in retailing began in early 1998, being fueled by gradually falling personal incomes. The retail turnover shrank by 10.8 per cent from the year before. The growth in the retail gross income under the effect of value factors, however, acted to increase its GDP share.²²

A factor to be reckoned with in analyzing retail trade dynamics is that the period 1998-1999 was accentuated by a downtrend in the share of imports in the structure of commercial inventories. While in the first and second quarters of 1998 domestically manufactured goods accounted for 52 per cent of retail inventories, their share had risen to 71 per cent by the fourth quarter at the expense of imports that had fallen proportionally. This trend continued into 1999, the preliminary estimates of the Russian Ministry of Economy putting the shares of imports and domestically produced goods in the retail turnover structure at 27 per cent and 73 per cent, respectively. The gloomy predictions of a possible crisis on the consumer market made on the heels of the August 1998 crisis proved utterly wrong. The growing output of domestically produced consumer goods was a factor for stability in the consumer sector.

²² An analysis of changes in the GDP share of trade should take account of specific methods used to compute this indicator, in particular, estimates of the foreign trade gross income at basic prices. As the level and structure of domestic prices changed with ruble devaluation, foreign trade became a more lucrative operation, with the GDP share of trade having risen by 4.0 percentage points from 1998.

Another specific of 1999 was that manufacturing infrastructure services were growing at a higher rate than services provided to the public. Continued reduction in the scale of non-market services paid from the government budget and off-budget funds was a trend that had a significant effect on the situation on the public services market. The GDP share of these services dropped by 3.7 percentage points as compared with 1998.

The growth in output raised demand for labor, easing somewhat the squeeze on the labor market. Beginning in February, employment was steadily growing and the total jobless figures, including people registered with the employment service, showed a strong trend to fall. Employment started to rise for the first time in many years of reform. The total unemployment decreased by 1.3 million in absolute figures over the year, and the number of people on official jobless lists of the employment service fell by 0.6 million. The ratio of the jobless registered with the employment service to one advertised vacancy dropped from 6.5 in November 1998 to 2.4 in the same month of 1999. As a result, the total unemployment was back to its pre-crisis figures, helping to gradually ease social tensions, particularly at the regional level. Despite these favorable changes on the labor market, the situation remains unstable, as is evidenced by persisting stagnant unemployment, widespread involuntary part-time employment and related overstaffing.

1.3.2. Profitability of Production and Changes in the GDP Structure According to Incomes

Ruble devaluation has significantly improved the earning capacity of exporting manufacturers. The growing output in import-substituting industries has improved earnings and profit margins. Over 1999, the economy made an aggregate profit of Rub. 279.9 billion, a threefold improvement on previous year (or nearly two-

fold in real terms). The share of loss-making industrial enterprises fell by 10.0 percentage points as compared with 1998 figures. Profitability for all industries showed an improvement of 7.2 percentage points on 1998, reaching 15.3 per cent. Financial performance actually improved in all manufacturing industry groups. The GDP share of gross economic profit and production and import taxes rose as well.

TABLE 4

**GDP Formation Structure as Broken Down by Revenue Source
(% of the total)**

	1995	1996	1997	1998	1999*
Total GDP including:	100,0	100,0	100,0	100,0	100,0
Wages and salaries (including concealed) of employees	45,2	49,6	49,3	49,3	40,2
Net taxes on production and imports	11,9	13,5	14,2	14,8	15,7
Gross economic profit and gross mixed incomes	42,9	36,9	36,5	35,9	44,1

Source: Russian Statistical Agency, calculations basing on Rosstatagentstvo and Ministry of Economy data

The beneficial combination of devaluation and rising prices on the world market for fuel and primary commodities gave a healthy boost to profit margins in export-oriented extractive industries and primary processing enterprises. Also headed in the same direction on the domestic market was a trend for prices of intermediate products staying ahead of price dynamics in capital and consumer goods. The share of extractive and primary processing industries in the total industrial profits expanded by almost 30.0 percentage points.

Assuming the share of foreign exchange costs of Russian exporting manufacturers to be in the range of 10 per cent to 20 per cent of the total production costs,²³ the falling exchange rate of the

²³ Estimates of the expert group of the Russian Finance Ministry.

ruble translates into profit a significant proportion of receipts resulting from a higher ruble-denominated value of products sold for foreign currency. This effect stimulates investment of company assets, broadens opportunities for borrowings from banks at higher interest rates, and helps increase budget tax revenues at all levels.

Government regulation of prices and tariffs for the output of natural monopolies was a further factor to stimulate industrial growth. Gas prices maintained stable from late 1996 to October 1999 were responsible for low-keyed dynamics of prices in power engineering –electric power sold to industrial consumers registered a price rise of 20.7 per cent for all of 1999. Wholesale prices for natural gas were raised by 15 per cent on November 1, 1999.

Restrained prices for the output of natural monopolies produced significant disproportions between their prices and tariffs in consumers' favor. At mid-point of the first half-year, price dynamics revealed new trends toward a considerable slowdown in prices for consumer goods and capital goods and higher growth rates of prices for intermediates.

Manufacturing industries reeling under the tough constraints of domestic effective demand reverted to a restrained pricing policy in the second quarter of 1999. In our estimates, about 80 per cent of profit growth in industries producing capital and consumer goods is contributed by pricing policies and the remaining 20 per cent by material input reductions.

Inflation at 67.3 per cent was much higher in manufacturing as a whole in 1999 than on the consumer market. Prices were rising at high rates under the pull of demand for domestically produced goods, higher efficiency of exports, lower competition from significantly curtailed imports, growth of world prices for oil and petroleum products and several other Russian exports, and rising costs of imported primary materials.

Improvements in the financial standing of manufacturing enterprises and their growing profits were made possible also by positive shifts in production and technologies – cost reductions, adoption of resource-saving technologies, restructuring, and manufacture of competitive products. In the nine months of 1999, manufacturing costs fell by 13.7 per cent from the same period of the preceding year. Profit margins, however, rose to 27.1 per cent, up from 9.7 per cent for the nine months of 1998. The fuel industry posted the greatest cost reduction (24.8 per cent) of all manufacturing industries.

Costs fell in all categories of assets, except primary materials. Fuel and power costs were forced down by the government's policy of holding up prices for the output of natural monopolies. Depreciation charges dropped as well because producers and offices failed to revalue their fixed assets as at January 1, 1999.

1.3.3. Investments in the Real Sector of the Economy²⁴

The dynamics of investment in fixed assets showed an uptrend in 1999, for the first time in the past eight years. The slump in investment was slowing down over the first half of 1999, and July marked a bottoming out and a rise in fixed capital investment. Over the whole of 1999, organizations and enterprises under all forms of ownership invested Rub. 598.7 billion in fixed assets, or 1 per cent more than the year before. Production in investment industries posted growth in 1999 for the first time during reform years.

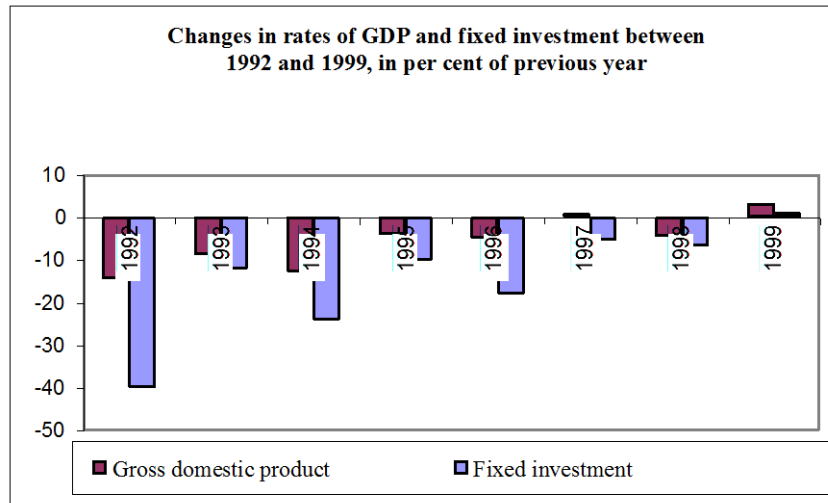
Investment in housing construction and utilities accounted for about a third of the total investment made in social and civilian projects. After a five-year lull, investment in housing construction started to grow again in 1999, with more ready housing commis-

²⁴ Changes in the GDP utilization structure are analyzed in Annex 3.

sioned. In 1999, enterprises and organizations under all forms of ownership built 32.0 million square meters of housing, or 4.3 per cent more than in the preceding year. More housing was built in 1999 in 63 out of the 89 Federation members than in 1998. Business activity in housing construction kept up to finish previous startups and to expand building operations.

To assess the effect of this process on the general conditions in the economy, we need to put its specific aspects in retrospect. An unprecedented curtailment of investment is a striking specific of Russian reforms. In 1999, investment in fixed capital was a lowly 26.3 per cent of the level of outlays in the pre-reform year 1991. The investment slump in the period 1992 to 1999, however, was structural in nature, exposed to the combined effect of such factors as shifts in the sectoral, technological and reproductive forces in the national economy.

FIG. 11



Sectoral Structure of Investment in Fixed Capital. Changes in the GDP structure were attended by a reshuffle of fixed capital investment flows from manufacturing into the services sector. In 1999, investment in the services accounted for 52.40 per cent of the total investment made in the national economy, against 43.0 per cent immediately before the start of reforms. The channeling of investment flows into the services went along with an increase in the share of infrastructure industries. Between 1997 and 1999, transport, communications and trade claimed, on average, a fifth of the total investment in fixed capital, almost doubling from the 12 per cent average for the period 1992-1996.

The dynamic growth of communications and information technologies was maintained by heavy investing. Whereas investment in communications was made at under 1 per cent of the total for the national economy in 1994, it reached 3.5 per cent in 1999. Expanding investment activity in the industry and growing demand for communications services tend to trigger economic recovery. Notably, the investment policy in the industry aims to solve long-term problems. Typical for 1999 was a trend toward expanding the market and structure of communications services provision and, at the same time, restraining the tariffs charged for communications services. The communications companies could, as a result, retain or expand their presence on the communications services market and build up potential for future growth.

With a change in the institutional structure of the economy and reduced government presence on the capital market, the share of investment in agriculture declined from 10.8 per cent in 1992 to 2.5 per cent - 3.0 per cent in the period 1996-1999. Between 1994 and 1998, investment in manufacturing averaged approximately a third of total investment in fixed capital.

As the slump in industrial production abated, the decline in investment slowed down as well. This process was acutely differentiated according to periods and industries. In 1997, for example, a revision of tax privileges caused a considerable slowdown in the foldup of investment in industrial construction. For a 5.0 per cent reduction in investment in fixed capital in the economy in general, investment in industrial construction stood at 99.0 per cent of the preceding year's level. This trend did not survive, however, in 1998 when a crisis exploded in the financial sector of the economy, and investment activity ebbed sharply again. A change in the economic climate in 1999 brought about an 8.8 per cent growth in investment in industrial fixed capital as compared with the preceding year.

A notable development of the past two years have been significant changes in the investment structure of industrial complexes. The situation in 1999 was radically different from the period between 1992 to 1997, when the share of investment in the fuel and energy complex was steadily rising and that of the investment complex was falling correspondingly. According to tentative figures of the Russian Ministry of Economy, investment in engineering rose by 36.9 per cent on 1998, against a 2.2 per cent fall in investment in the fuel industry and 21.4 per cent in the power industry.

A vigorous growth of investment in the consumer complex was another characteristic development of the two years, 1998 and 1999. The food industry, which in 1997 accounted for 8.2 per cent of the total investment in industrial fixed capital, saw its share rise to 15.2 per cent in 1999. The expanding investments in the fixed capital of the food and medical industries, 35.7 per cent and 94.8 per cent, respectively, echo the policy of substituting consumer imports with domestically produced goods.

The structural change in investment from industry to industry reflects the Russian business community's response to shifts on the

domestic market and growing demand for domestically produced manufactures. Despite a sturdy growth, the current investments are too little to sustain a steady economic growth trend.

Structure of Financial Investment Sources. Corporate funds are the principal sources enterprises and organizations can rely on to finance investment in fixed assets. In 1999, the share of own funds in the fixed assets of enterprises stood at the preceding year's level of 53.4 per cent. The percentage of own funds differs significantly with industries and sectors of the economy. In the power industry, own funds account for around 90 per cent of the investments, in the gas industry they amount to 82 per cent, in the oil industry 74 per cent, and in pipeline operations 55 per cent.

Given the high risks involved, the lending and banking sector shows virtually no interest toward investment projects in the real sector of the economy. Lending institutions give clear preference to short-term operations, their share of long-term loans standing at under 6.0 per cent.

The share of bank loans and foreign direct investments in the structure of sources drawn upon to finance investment in fixed capital in 1999 registered an uptick under the impact of favorable changes in general economic conditions.

Foreign direct investments went up by 26.7 per cent in 1999 against the 1998 level to \$ 4.3 billion. Actual investments were made, however, as a result of the talks held for several years already and launch of the projects discussed at the talks. The heaviest flow of direct investments went into the fuel industry (oil above all) and the food industry for readily explainable reasons: fuel is the most efficient industry in strategic terms, while food has a short payback period.

The talks with international financial organizations that went on through the year showed that, in an atmosphere of no confidence

in the Russian authorities, repayment of outstanding loans could be deferred and new loans granted only as a political expediency. Domestic political uncertainty in the run-up to parliamentary and presidential elections and growing tensions with developed countries (first over Kosovo, and lately over Chechnya) had a discouraging effect on foreign creditors' position on cooperation prospects with Russia in 1999.

The restrained budgetary policy reinforced the trend toward further cuts in the share of budgetary funds among the sources available to finance investment in fixed capital, at the same time the share of the Federation subjects' budgets increased at the expense of the federal budget. The federal budget targeted Rub. 6.7 billion for the financing of governmental investment that being by 15 per cent below the level of the preceding year. A characteristic feature of 1999 was an increasing financing of budgetary expenditure for investment. According to the Finance Ministry estimates Rub. 6 billion were invested over the year that being at 90.2 per cent of the year's target. As a result, the share of budgetary funds in fixed capital investments shrank to 1.5 per cent of GDP in 1999.

The share of private investments in the total funds invested in fixed capital of businesses under various forms of ownership was at about same level as in the preceding year (25.9 per cent), although a trend toward its stable growth was registered in 1995 through 1998.

Since the bulk of private investments is made by private home builders, it could be expected that reductions in personal incomes and savings would reduce investment capacities and the number of prospective investors. However, even in this difficult situation the priority of investment in housing construction persisted.

TABLE 5

Investment in Fixed Assets as Broken Down by Financing Source, (prices of respective years)

	1997	1998	1999 January - September
Investment in fixed assets	100,0	100,0	100,0
Including:			
1. Internal and borrowed funds		80,2	83,3
Including:			
- <i>Internal funds of enterprises</i>	60,8	53,6	53,5
Including: accumulation fund	13,2	13,3	14,2
- <i>borrowed funds</i>	18,5	25,2	28,9
Including:			
Commercial banks' loans			5,7
- Funds borrowed from other sources			5,5
Extrabudgetary funds			9,5
- other			8,2
2. Consolidated budget funds	20,7	19,2	17,6
Including: federal budget funds	10,2	6,6	4,8

Source: Russian Statistical Agency

Public confidence in savings institutions, wrecked by the financial crisis, is rebuilding only too slowly. With the share of cash in hand, rather than in bank accounts, remaining high and in the absence of a mechanism to transform it into investment, the national economy is suffering heavy losses through underutilization of the population's accumulated investment potential.

Investments packaged according to forms of ownership had a specific property that came to the surface in 1999. The change in the domestic market situation following ruble devaluation spurred

foreign capital into activity. The share of investment flowing from enterprises partly or fully owned by foreign capital increased by 4.5 percentage points and made 10.7 per cent of the total investment in fixed assets in 1999.

TABLE 6

**Investment in Fixed Assets as Broken Down by Ownership Form
(in prices of respective years)**

	1997	1998	1999
Investment in fixed assets	100,0	100,0	100,0
Including ownership forms:			
State	24,5	22,3	21,3
Private	22,7	25,7	25,9
Mixed domestic ownership	43,0	40,6	37,3
Foreign	1,2	2,2	3,2
Mixed domestic and foreign ownership	3,1	4,0	7,5

Source: Rosstatagentstvo

1.3.4. Financial Standing of Enterprises: Reduction in Non-Payments and Non-Monetary Settlements

More money available to enterprises, reduced arrears, and declining numbers of deals settled in ways other than money payment was perhaps the second most important positive effect of ruble devaluation in August 1998, after the start of economic recovery²⁵. Swelling circulating assets in the real sector of the economy and money used in all links of the producer-consumer chain stirred up demand for industrial output at every stage of production and, therefore, led to a rise in aggregate demand in the economy as a whole.

²⁵ For an analysis of the effect of the real Ruble exchange rate and internal price structure on payment arrears see Annex 5.

This process was obviously initiated by exporting enterprises, which were deriving larger profits, and import-substituting product manufacturers, which improved their financial standing on a rising wave of domestic demand for their output. Another circumstance, that came to play a prominent role later on, improved tax collection augmented budget revenues and gave the government more money to spend to meet its liabilities to the full extent required under the 1999 Budget Law. As our research²⁶ demonstrates, businesses' arrears in payments to the budget having stopped growing was a major factor contributing to a reduction in arrears on the scale of the economy.

Beginning in late 1998, the deflated scale of debts receivable and payable enterprises owed to one another was steadily declining²⁷ (see Figure 12). All through 1999, therefore, the absolute amount of nominal arrears was rising at a rate below that of inflation. To judge about the dynamics of arrears, however, it is useful to examine series reflecting deflated increments in outstanding receivables and payables or debt increments as percentages of the industrial output for a respective period. As shown in Figure 13, the deflated default increments were going down during the entire period under review as well, at times acquiring negative values. Similar dynamics is displayed by the default increment ratio to the industrial output volume.

²⁶ See: "Ekonomika perekhodnogo perioda" (A Transition Economy), IET, 1998, pp. 1005 – 1033.

²⁷ This indicator permits to compare the amount of arrears at different points in time from the standpoint of debt burden on payers or the amount of creditors' assets; however, it does not permit to evaluate the relative scales of arrears increases over different periods, since it depends on the amount of accumulated inflation.

Arrears and non-monetary settlements were falling as real cash balances were rising. This connection is quite natural one and is confirmed by our calculations²⁸. On one hand, expanding real money supply is equivalent to growing liquidity, which facilitates settlements. On the other hand, more frequent monetary settlements raise demand for real cash balances and, accordingly, cause the real money supply to swell. Moreover, arrears are influenced directly by enterprises' real cash balances, rather than the total volume of the real money supply. Figure 14 shows that the real cash balances in the ruble-denominated accounts of enterprises increased by nearly 50 per cent in the period between November 1998 and December 1999. Meanwhile, the real money supply (aggregate M₂) did not grow by more than 15 per cent or 20 per cent in the same period (see Figure 14). Besides, the near absence of income-yielding instruments in the post-crisis period caused (in combination with low inflation) a drop in the alternative value of money saving, depressing incentives to pile up arrears.

Rising effective demand and decreasing scale of barter in settlements between enterprises is borne out by surveys conducted monthly by the Institute of the Economy in Transition (IET) among enterprises²⁹. Figure 15 shows the dynamics of balanced responses regarding changes in production volume, changes in effective demand and demand for output paid for with goods (barter demand), rather than money, and real tax revenues of the consolidated budget in 1998-1999.³⁰

²⁸ See: "Ekonomika perekhodnogo perioda" (A Transition Economy), IET, 1998, pp. 1005–1033.

²⁹ See monthly IET surveys "Ekonomiko-politicheskaya situatsiya v Rossii" (Economic and Political Situation of Russia).

³⁰ The balance of actual changes in production volume is the share of excess of enterprises that have increased their production volume over enterprises, the production volume of which has decreased from the preceding month in the total number of enterprises (according to survey returns).

Beginning in February 1999, the balance of responses regarding changes in production volume became positive, and so did, from March 1999 on, the balance of responses as regards changes in effective demand. Survey returns also show that barter demand was falling in the same period (balance of responses turned negative beginning in April 1999).

1.4. The Budget

Budget Revenues. Recovery in production described above improved the financial standing of enterprises, reduced tax arrears and, as a result, set off a growth in tax revenues, producing a surplus over the revenue figures provided for in the 1999 Budget Law and ensuring its use almost entirely in monetary form (according to the Ministry of Taxes and Duties, less than 5 per cent of federal budget revenues in 1999 was drawn in by target financing).

This favorable federal budget situation was largely achieved by redistributing tax revenues from regional budgets to the federal budget. Beginning on April 1, 1999, members of the Russian Federation could transfer 15 per cent of the value added tax revenues collected in their respective territories, instead of 25 per cent as previously³¹. Also from that date, the portion of income tax collected at a rate of 3 per cent has been transferred to the federal budget, and the federal and regional profit tax rates have been reduced from 13 per cent to 11 per cent and from 22 per cent to 19 per cent, respectively³². The balance of revenues received from principal federal taxes swayed against the regional budgets – the proportions of VAT and income tax revenues transferred to regional budgets con-

³¹ See: Article 20 of RF law “On Federal Budget for 1999.”

³² See: Paragraph 2, Article 2 of RF law No. 62-FZ of March 31, 1999, “On Amendments to Russian Federation law ‘On Profit Tax on Enterprises and Organizations’.”

tracted, the profit tax distribution remaining unchanged, provided the tax is collected at a maximum regional rate.

The consolidated budget tax revenues in 1999 amounted to 22.2 per cent of GDP, or 1.9 per cent more than their GDP share in 1998 and at the 1997 level. The total revenues of the federal and regional budgets in 1999 claimed 26.6 per cent of GDP, or 2.1 per cent more than their GDP share in 1998 and at the 1997 level. The federal budget revenues in 1999, however, rose by 2.3 per cent of GDP over the 1998 revenues and 1.1 per cent of GDP in 1997. In the end, the share of the federal budget revenues in the consolidated budget revenues rose from 47.0 per cent in 1997 and 46.1 per cent in 1998 to 51.2 per cent in 1999.

A major positive effect on the fulfillment of current tax liabilities to the budget by taxpayers was produced by an almost complete abandonment of set-offs at the federal level, a practice that was outlawed by the recently enacted general part of the Tax Code, which requires taxes to be paid in cash only, and a certain reduction in the scale of set-offs at the regional and local levels.

Figure 17 shows monthly dynamics of tax revenues, dynamics of arrears and assessment of tax liabilities (amount of tax revenues and growth in arrears per month³³) in the consolidated budget. It

³³ Tax liabilities over a current period are equal to tax revenues over this period resulting from tax liabilities of a preceding period, i.e. the timely paid taxes plus the increase in tax arrears accumulated over this current period: $HO^{(t)} = HHT_t^{(t)} + \Delta Hed_t^{(t)}$ (upper indices of variables represent the period, in which liabilities originated, the lower indices show the period, in which the taxes were paid, or tax liability arrears changed). Tax revenues of a current month received at the expense of tax liabilities arising in this current month are equal to the difference between the total receipts in the current month and tax revenues received at the expense of liabilities of preceding months:

follows, therefore, that monthly tax revenues and tax liabilities in both the federal and consolidated budgets tended to grow through the whole of 1999 despite seasonal fluctuations (down at year beginning and up in April when the deadline for past year settlements arrives) (the drop in tax revenues in September was largely caused by diminishing tax revenues from foreign trade, see Figure 16).

The change in the dynamics of macroeconomic parameters led to a sufficiently significant shift in the structure of tax revenue flowing into the consolidated budget (see Table 7). Despite the profit tax rate having been lowered from 35 per cent to 30 per cent, the share of this tax rose significantly, from 14.7 per cent of the budget revenues in 1998 to 22 per cent in 1999. One percentage point was shaved off the income tax share, and the share of excises lost 2.7 percentage points. But then, VAT revenues moved 0.5 percentage point up, and 1.8 percentage points was added to foreign trade tax.

In 1999, manufacturing industries in general paid slightly more taxes than they did in 1998 (approximately by 1 percentage point of GDP). The highest growth was posted by the fuel industry (0.6 percentage point of GDP more than in 1998). In the nonferrous and

$H\Pi_t^{(t)} = H\Pi_t - \sum_{\tau < t} H\Pi_t^{(\tau)}$. Payments of outstanding taxes in the current pe-

riod decrease the arrears: $H\Pi_t^{(\tau)} = -\Delta H e \partial_t^{(\tau)}$, ($\tau < t$) In fact, the receipts statistics include fines and penalties paid alongside with taxes; however these payments are excluded from this calculation. Taking into account the fact that the full increase of arrears in the current month equals to the sum of the increase in tax arrears originating in this current month and the change (decrease) in arrears occurring due to payment of tax liabilities originating in preceding months, the formula is:

$$H O^{(t)} = H\Pi_t - \sum_{\tau < t} H\Pi_t^{(\tau)} + \Delta H e \partial_t^{(t)} = H\Pi_t + \sum_{\tau < t} \Delta H e \partial_t^{(\tau)} + \Delta H e \partial_t^{(t)} = H\Pi_t + \Delta H e \partial_t$$

food industries, tax revenues grew by 0.4 percentage point of GDP and 0.2 percentage point of GDP, respectively, in 1999. At the other extreme, tax revenues from power industry enterprises went down a little (0.3 percentage point of GDP). In some other industries, such as communications, construction and finance, tax revenues declined, reducing their combined GDP share by about 2 percentage points.

The growth in tax arrears slowed down a little in 1999 (see Figure 17).

Accrued arrears showed an absolute decrease in February, March and October 1999. In real terms, arrears to the federal budget dropped by 9.2 per cent, and by 18.1 per cent in the consolidated budget.³⁴

	1996	1997	1998	1999
Real arrears to the federal budget (per cent of the preceding year figures)	193%	132%	86%	91%
Real arrears to the consolidated budget (per cent of the preceding year figures)	182%	136%	79%	82%

As percentages of GDP for the respective period, arrears to the federal budget in 1999 grew by a factor of 2.3 more slowly than they did in 1998 and those due to the consolidated budget rose at a rate that was lower by a factor of 4.1; the arrears had a similar growth pattern in real terms.

	1996	1997	1998	1999
Growth of arrears to the federal budget (per cent of GDP)	1,1 %	1,3 %	2,1 %	0,9 %
Growth of arrears to the consolidated budget (per cent of GDP)	3,0 %	2,4 %	2,9 %	0,7 %

³⁴ As also in the case of arrears, this indicator reflects the real extent of encumbrance of enterprises with debts to the budget.

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Improved tax collection is, to an extent, to be attributed to a stronger financial position of enterprises and a larger share of money-based settlements. It must be admitted, however, that the absence of an unmistakably downward trend in the real growth in arrears that could have been taken for a sign of a consistently tougher government line toward tax dodgers or of a measure of independence of the arrears dynamics from macroeconomic parameters can be explained by tax collectors applying discreet approaches, in particular, such instruments as individual tax arrangements with major taxpayers.

Tax revenues were 28.2 per cent above plan in 1999. More specifically, profit tax receipts were 126.6 per cent higher than planned, VAT was 54.6 per cent higher, and payments for the use of natural resources were 10.6 per cent higher. Income tax collection was 20.6 per cent short of the requirement under the 1999 Budget Law, excises were 6.8 per cent short, and international business taxes 5 per cent short (see Table 10).

TABLE 10

	Budget balance in 1999 (per cent of GDP)	Budget balance in 1998 (per cent of GDP)	Law on budget for 1999		Budget balance in 1999 (% of the law)
			% of targeted GDP	% of actual GDP	
REVENUES					
Profit tax	1,8 %	1,3 %	0,9 %	0,8 %	226,6 %
Personal income tax	0,4 %	0,0 %	0,6 %	0,6 %	79,4 %
VAT	4,9 %	3,9 %	3,6 %	3,2 %	154,6 %
Excises on excisable goods and selected mineral raw materials produced in RF territory	1,8 %	2,0 %	2,2 %	1,9 %	93,2 %
Fees for use of natural resources	0,2 %	0,1 %	0,2 %	0,2 %	110,6 %
Taxes on foreign trade and foreign economic operations	1,9 %	1,4 %	2,3 %	2,0 %	95,0 %
Other taxes, fees and duties	0,2 %	0,2 %	0,2 %	0,1 %	150,1 %
TOTAL TAXES AND PAYMENTS	11,4 %	8,8 %	10,0 %	8,9 %	128,2 %
NONTAX REVENUES					
Revenue from government property	0,2 %	0,2 %	0,2 %	0,2 %	85,6 %

	Budget balance in 1999 (per cent of GDP)	Budget balance in 1998 (per cent of GDP)	Law on budget for 1999		Budget balance in 1999 (% of the law)
			% of targeted GDP	% of actual GDP	
or activity					
Revenue from foreign economic operations	0,8 %	0,6 %	0,6 %	0,5 %	149,0 %
Other non-tax revenues	1,4 %	1,7 %	0,0 %	0,0 %	3612,9 %
TOTAL NON-TAX REVENUES	2,4 %	2,5 %	0,8 %	0,7 %	323,2 %
RECEIPTS FROM GOVERNMENT EXTRABUDGETARY FUNDS	1,1 %	0,9 %	1,0 %	0,9 %	123,9 %
TOTAL REVENUES	13,1 %	11,3 %	11,8 %	10,5 %	124,3 %
EXPENDITURE					
1. Government administration	0,3 %	0,4 %	0,3 %	0,3 %	107,9 %
2. National defense	2,6 %	2,1 %	2,3 %	2,1 %	123,9 %
3. International activities	1,3 %	0,3 %	0,9 %	0,8 %	158,7 %
4. Law enforcement, security, and justice	1,3 %	1,3 %	1,4 %	1,2 %	107,6 %
5. Basic research and promotion of scientific and technological progress	0,2 %	0,2 %	0,3 %	0,3 %	96,2 %
6. Government services to the national economy, of which:	0,8 %	0,9 %	0,9 %	0,8 %	106,2 %
6.1. Industry, power engineering and construction	0,4 %	0,4 %	0,4 %	0,3 %	116,0 %
6.2. Agriculture and fisheries	0,2 %	0,1 %	0,2 %	0,2 %	97,7 %
6.3. Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	0,1 %	0,1 %	0,1 %	0,1 %	99,7 %
6.4. Transportation, road maintenance, communications and information technology	0,0 %	0,0 %	0,0 %	0,0 %	104,4 %
6.5. Preventing and/or eliminating the effects of emergencies and natural disasters	0,2 %	0,2 %	0,2 %	0,2 %	100,4 %
7. Social services	1,9 %	2,1 %	2,0 %	1,7 %	108,9 %
7.1. Education	0,5 %	0,5 %	0,5 %	0,5 %	100,4 %
7.2. Culture and arts	0,1 %	0,0 %	0,1 %	0,1 %	93,9 %
7.3. Mass media	0,0 %	0,0 %	0,1 %	0,0 %	95,9 %
7.4. Health and physical fitness	0,2 %	0,2 %	0,3 %	0,2 %	99,0 %
7.5. Social policy	1,1 %	1,4 %	1,0 %	0,9 %	117,3 %
8. Expenditure by target budgetary funds	1,3 %	0,9 %	1,1 %	1,0 %	136,9 %

	Budget balance in 1999 (per cent of GDP)	Budget balance in 1998 (per cent of GDP)	Law on budget for 1999		Budget balance in 1999 (% of the law)
			% of targeted GDP	% of actual GDP	
9. Government debt service	3,6 %	4,0 %	4,2 %	3,7 %	97,4 %
Domestic debt			1,7 %	1,5 %	
External debt			2,5 %	2,2 %	
10. Financial aid to other levels of government	1,3 %	1,6 %	1,1 %	1,0 %	131,5 %
11. Other expenditure	1,6 %	2,4 %	-0,1 %	-0,1 %	-1672,0 %
TOTAL EXPENDITURE	15,0 %	14,5 %	14,4 %	12,8 %	117,8 %
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-1,2 %	-3,2 %	-2,5 %	-2,3 %	52,2 %

The federal budget revenues totaled Rub. 611.7 billion, or 13.6 per cent of GDP, a rise of 2.3 percentage points over 1998. In terms of tax collection, the preceding year's performance was surpassed by an even higher figure, 2.6 percentage points. Growth was achieved chiefly by improved VAT collections (1 percentage point up). It was less notable in profit tax and foreign trade tax (0.5 percentage point each). Enactment of income tax transfers to the federal budget raised the federal budget revenues by 0.4 per cent of GDP. Excises alone dropped by 0.2 percentage point.

Budget Expenditure. Nominal federal budget expenditure overshot the appropriation levels approved by the law by 17.8 per cent, to Rub. 664.7 billion (or 14.8 per cent of GDP). The budget deficit went down to Rub. 52.9 billion (or to 1.2 per cent of GDP from 2.5 per cent of GDP under the Budget Law). Noninterest budget expenses reached Rub. 514.6 billion, or 11.4 per cent of GDP. Federal budget spending was 1 percentage point lower than it was in 1997, and 0.3 percentage point above the 1998 figure. Non-interest expenditure was reduced by 2.9 percentage points from 1997, rising 0.8 percentage point above the 1998 level. In particu-

lar, defense spending rose by 0.5 percentage point, and spending on social programs went down by 0.2 percentage point.

The expenditure figure stipulated in the 1999 Budget Law was exceeded by 17.8 per cent. Other spending items that exceeded the appropriation levels included international business (58.7 per cent), financial aid to regional and local authorities (31.5 per cent) and defense spending (23.9 per cent). Spending on social programs was 8.9 per cent beyond the limit set in the Budget Law, the largest excess being posted in the Social Policy item (17.7 per cent). Government services to the economy were 6.2 per cent above the appropriation limit, with manufacturing accounting for 16.0 per cent. Government debt servicing received 2.5 per cent less than budgeted.

The Russian budget may be said to be conspicuously desocialized for lack of regular indexation in the period when inflationary processes accelerated sharply after the crisis in August 1998.

The execution of Russia's consolidated budget revealed somewhat different trends. Major reductions were made in the expenditure, now to be borne by regional budgets. Spending under the consolidated budget ran to 27.8 per cent of GDP, or 0.4 percentage point below the 1998 figure and 2.7 less than in 1997. Noninterest spending rose insignificantly over 1998 (by 0.1 percentage point of GDP), falling by 4.4 percentage points of GDP from the 1997 figure, and expenditure under social programs shrank by 0.8 percentage point of GDP from 1998 and by 1.7 percentage points of GDP from the 1997 level.

A scrutiny of the budget figures at constant prices produces a similar picture. Consolidated budget revenues at comparable prices rose by 17 per cent on 1998 (including tax collection growth of 21 per cent) and dropped by 34 per cent from 1997 (of which tax revenue declined by 25 per cent). Real spending under the consolidated

budget fell by 31 per cent from 1997 (with noninterest expenditure decreasing by 37 per cent), and rose by 13 per cent on 1998 (of which noninterest expenditure climbed 13 per cent).

The problem of debts payable under budgets at all levels lost some of its sharp edge last year owing to plan targets being generally attained with a wide margin. Considering, however, that accrued payables for the preceding years added up to an impressive amount (according to Finance Ministry statistics for January 1, 1999,³⁵ obtained on the results of inventory of federal budget debts payable, they amounted to Rub. 92.6 billion, and those due under the budgets of Federation members for 1998 alone ran up to Rub. 85.7 billion), it is still early to speak of their full repayment.

Deficit and Government Debt. The 1999 budget deficit came out at 1.2 per cent of GDP, significantly smaller than in either 1998 or 1997 (3.2 per cent of GDP and 6 per cent of GDP, respectively). The budget deficit was brought down by rising budget revenues and large cuts in the budget interest spending in 1999 (3.6 per cent of GDP, down from 4 per cent of GDP in 1998 and from 4.5 per cent of GDP in 1997).

TABLE 11

Financing Federal Budget Deficit in 1999 (per cent of GDP).

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
I. Domestic financing	-5.7 %	-2.3 %	-1.1 %	-0.9 %	-0.7 %	-1.1 %	-1.0 %	-0.6 %	-0.3 %	-0.1 %	-0.5 %	0.1 %
1.1. Change in bank account balances of budget funds, in rubles	-5.5 %	-2.2 %	-1.8 %	-1.9 %	-1.4 %	-2.0 %	-1.8 %	-1.1 %	-0.8 %	-1.1 %	-1.2 %	-1.1 %
Balances at the beginning of periods	2.7 %	1.4 %	1.2 %	0.8 %	0.6 %	0.5 %	0.4 %	0.3 %	0.3 %	0.3 %	0.2 %	0.3 %
Balances at end-periods	8.2 %	3.5 %	2.9 %	2.7 %	2.1 %	2.5 %	2.2 %	1.4 %	1.1 %	1.3 %	1.4 %	1.4 %
1.2. Short-term government debt	-0.1 %	-0.1 %	-0.7 %	-0.8 %	-0.6 %	-0.8 %	-0.7 %	-0.6 %	-0.5 %	-0.4 %	-0.4 %	-0.3 %
- Borrowings	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %	0.0 %
- Repayment of principals	0.1 %	0.1 %	0.7 %	0.8 %	0.6 %	0.8 %	0.7 %	0.6 %	0.5 %	0.4 %	0.4 %	0.3 %
1.3. Non-marketable gov-	0.0 %	0.0 %	0.0 %	0.5 %	0.4 %	0.8 %	0.5 %	0.4 %	0.3 %	0.2 %	0.1 %	0.0 %

³⁵ Government Directive No. 600 of June 17, 1998 on approval of the Program of Public Spending Reductions.

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
ernment bonds												
- Borrowings	0,0 %	0,0 %	0,0 %	0,5 %	0,4 %	0,8 %	0,7 %	0,6 %	0,5 %	0,4 %	0,4 %	0,3 %
- Repayment of principals	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,1 %	0,2 %	0,2 %	0,2 %	0,3 %	0,3 %
1.4. Federal fixed rate bonds	0,0 %	0,0 %	0,9 %	1,0 %	0,8 %	0,9 %	0,6 %	0,3 %	0,5 %	1,1 %	1,2 %	1,2 %
- Borrowings	0,0 %	0,0 %	0,9 %	1,0 %	0,8 %	1,1 %	1,9 %	1,9 %	2,0 %	2,4 %	2,3 %	4,8 %
- Repayment of principals						0,2 %	1,3 %	1,6 %	1,4 %	1,2 %	1,1 %	3,6 %
1.5. Government savings bonds	0,0 %	0,0 %	-0,1 %	-0,3 %	-0,3 %	-0,3 %	-0,2 %	-0,2 %	-0,2 %	-0,2 %	-0,2 %	-0,2 %
- Borrowings	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,1 %	0,1 %	0,1 %	0,1 %	0,1 %	0,1 %
- Repayment of principals	0,0 %	0,0 %	0,1 %	0,3 %	0,3 %	0,3 %	0,3 %	0,2 %	0,3 %	0,3 %	0,3 %	0,3 %
1.6. Other domestic borrowing	-0,1 %	-0,1 %	0,6 %	0,5 %	0,5 %	0,3 %	0,6 %	0,5 %	0,3 %	0,3 %	0,0 %	0,5 %
- Borrowings	-0,1 %	-0,1 %	0,6 %	0,6 %	0,5 %	0,4 %	0,6 %	0,5 %	0,3 %	0,4 %	0,2 %	0,7 %
- Repayment of principals	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,1 %	0,2 %	0,3 %
2. External financing	5,6 %	3,6 %	3,6 %	3,3 %	3,5 %	3,5 %	3,1 %	2,5 %	1,9 %	1,3 %	1,1 %	1,1 %
2.1. Loans from international financial institutions	-3,4 %	-2,4 %	-2,1 %	-2,4 %	-2,3 %	-1,9 %	-1,3 %	-1,2 %	-1,2 %	-1,3 %	-1,4 %	-1,2 %
Loans received:	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,9 %	0,9 %	0,8 %	0,7 %	0,7 %	0,7 %
- tied	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %	0,2 %
- untied	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,7 %	0,7 %	0,6 %	0,5 %	0,5 %	0,5 %
Repayment of principals:	3,6 %	2,7 %	2,3 %	2,6 %	2,5 %	2,1 %	2,2 %	2,2 %	2,0 %	2,1 %	2,0 %	1,9 %
2.2. Foreign government loans to RF	0,2 %	-0,3 %	-0,1 %	-0,1 %	-0,3 %	-0,4 %	-0,3 %	-0,3 %	-0,2 %	-0,2 %	0,0 %	0,1 %
Borrowed (used)	1,3 %	0,9 %	1,0 %	1,0 %	0,9 %	0,7 %	0,7 %	0,7 %	0,7 %	0,7 %	0,9 %	0,9 %
Principals repaid	1,1 %	1,2 %	1,0 %	1,1 %	1,2 %	1,2 %	1,1 %	1,0 %	0,9 %	0,9 %	0,9 %	0,8 %
2.3. Loans from foreign commercail banks and companies to RF	8,8 %	6,3 %	5,7 %	5,8 %	6,1 %	5,9 %	4,7 %	4,0 %	3,3 %	2,9 %	2,5 %	2,2 %
Borrowed (used)	8,8 %	6,3 %	5,7 %	5,8 %	6,1 %	6,2 %	5,2 %	4,4 %	3,8 %	3,3 %	2,9 %	2,6 %
Principals repaid	0,0 %	0,0 %	0,0 %	0,0 %	0,0 %	0,3 %	0,5 %	0,4 %	0,5 %	0,4 %	0,4 %	0,4 %
TOTAL FINANCING	-0,1 %	1,3 %	2,5 %	2,4 %	2,9 %	2,5 %	2,1 %	1,8 %	1,5 %	1,2 %	0,7 %	1,2 %

In 1999, the net annual budget deficit financing took up 1.2 per cent of GDP,³⁶ of which foreign financing accounted for 1.1 per cent of GDP, the remaining 0.1 per cent of GDP falling on domestic financing. Compared with 1998, total net financing came to 3.2 per cent of GDP (with 3.4 per cent of GDP for foreign financing and -0.2 per cent for domestic financing), while in 1997 it was 6

³⁶ According to data of the Economic Expert Group of the Federal Finance Ministry, the 1999 federal budget deficit was equal to 1.7 per cent of GDP, of which foreign financing claimed 0.2 per cent of GDP and domestic financing, 1.5 per cent of GDP. This discrepancy with the figures given in the table is attributable to a different classification of financing sources. In particular, the EEG report placed IMF loans among domestic financing sources, and includes proceeds from privatization projects, and so on.

per cent of GDP (2 per cent of GDP and 4 per cent of GDP, respectively).

TABLE 12

Government Domestic Debt in 1993 through 1999

	As on January 1, 1994		As on January 1, 1995		As on January 1, 1996		As on January 1, 1997	
	Rub. trillion	% of GDP	Rub. trillion	% of GDP	Rub. trillion	% of GDP	Rub. trillion	% of GDP
Government domestic debt, including:	35,2	21,7	88,4	14,5	188	11,5	365,5	16,2
Bond liabilities	0,3	0,2	18,9	3,1	85,2	5,2	249	11
Debt to the Central Bank	29,2	18	58,8	9,6	61	3,7	59,6	2,6
Domestic debt servicing	0,99	0,6	16,1	2,6	38,2	2,3	105,7	4,7
	As on January 1, 1998		As on January 1, 1999		As on January 1, 2000			
	Rub. billion	% of GDP	Rub. billion	% of GDP	Rub. billion	% of GDP		
Government domestic debt, including:	501	18,7	751	28	584	13		
Bond liabilities	449	16,8	480	17,9	530	11,8		
Debt to the Central Bank	0	0	0	0	0	0		
Domestic debt servicing	96,3	3,6	106,6	4	51,6	1,2		

In all, the funds attracted in 1999 claimed 4.3 per cent of GDP, including 4.2 per cent of GDP from foreign financing sources. The Russian Ministry of Finance included loans from the Federal Central Bank used to pay off foreign debt (around \$4.5 billion, or 2.6 per cent of GDP) among foreign financing sources. This amount is shown as loans from foreign commercial banks in the budget.

The government's domestic debt in 1999 was reduced by Rub. 170 billion (at comparable prices, by 70 per cent, or by 15 percentage points of GDP), while, conversely, bond liabilities were up to Rub. 70 billion (in terms of GDP share, bond liabilities decreased by 6 percentage points of GDP, or by 55 per cent at comparable

prices). Domestic government debts servicing required 1.2 per cent of GDP in 1999.

TABLE 13

	USSR debt (\$ billion)	RF debt (\$ billion)	Servicing (% of GDP)
1992	104,9	2,8	0,7
1993	103,7	9,0	0,3
1994	108,6	11,3	0,5
1995	103,0	17,4	0,9
1996	100,8	24,2	0,9
1997	97,8	33,0	0,7
1998	95,0	55,0	1,2
1999	103,0	54,5	2,4
2000*	68,0	85,0	2,9
2000**	25,0	115,0	2,9

* After restructuring the debt to London Club.

** In case the debt to Paris Club is restructured on terms similar to the arrangements with London Club.

Enlarged Government Budget. The revenues of the enlarged government budget in 1999 ran at 36.2 per cent of GDP, or approximately as much as in 1997 and 1.4 percentage points more than in 1998. There were more taxes collected in 1999 than in each of the preceding two years, or 33.4 per cent of GDP, up from 31.3 per cent of GDP in 1998 and 32.6 per cent of GDP in 1997.

The growth in budget revenues is, to a large extent, due to increased receipts flowing into the federal budget in 1999, at 13.7 per cent of GDP (up from 11.3 per cent of GDP in 1998 and 12.4 per cent of GDP in 1997), or 38 per cent of the total receipts in the budget system (as compared with 34 per cent in 1997 and 32 per cent in 1998). The budget revenues of the Federation members in 1999 were, however, the smallest for three years – 14.5 per cent of GDP (down from 14.9 per cent of GDP in 1998 and 15.9 per cent in 1997), as also were off-budget fund revenues, at 10.1 per cent of

GDP (a fall from 10.9 per cent in 1997 and 11.1 per cent of GDP in 1998).

TABLE 14

Tax Revenue Structure as Broken Down by Tax Base and Per Cent of GDP in 1997 through 1999³⁷.

	Per cent of tax revenues			Per cent of GDP		
	1997	1998	1999	1997	1998	1999
Personal incomes	9,5 %	9,1 %	8,3 %	3,1 %	2,8 %	2,8 %
Revenues of enterprises	12,0 %	11,6 %	15,2 %	3,9 %	3,6 %	5,1 %
Labor cost	24,7 %	24,1 %	20,4 %	8,1 %	7,5 %	6,8 %
Merchandise cost	32,2 %	31,8 %	33,8 %	10,5 %	10,0 %	11,3 %
Other production costs	21,6 %	23,3 %	22,3 %	7,0 %	7,3 %	7,5 %

The year 1999 saw an increase in the share of taxes based on corporate incomes (3.6 percentage points up from 1998 and 3.2 percentage points on 1997), while the share of personal income tax dropped (by 0.8 percentage points from 1998 and 1.2 percentage points from 1997) and payroll taxes (by 3.7 percentage points from 1998 and 4.3 percentage points from 1997).

The expenditure of the enlarged government budget in 1999 fell to a level equivalent to 36.5 per cent of GDP (down from 1998 when the expenditure reached 38.1 per cent of GDP and from 1997, with spending at 43.1 per cent of GDP). Accordingly, noninterest expenditure was 32.9 per cent of GDP in 1999, 34.1 per cent of GDP in 1998, and 43.1 per cent of GDP in 1997.

³⁷ The taxable base included personal incomes for income tax assessment and 1 per cent of earnings withheld into the Pension Fund; corporate incomes for assessment of profit tax, and aggregate income tax; payroll for transfers into social off-budget funds; inventory value for VAT assessment, excises, customs levies and duties; other production costs for other corporate taxes.

TABLE 15

**Tax Revenues Structure of Enlarged Government Budget in
1997 through 1999.**

	1997	1998	1999
1. Profit (income), capital gain taxes	21,0 %	20,0 %	22,5 %
1.1. Profit tax	12,0 %	11,5 %	14,7 %
1.2. Personal income tax	8,9 %	8,5 %	7,8 %
2. Taxes on goods and services. License and registration fees	28,9 %	27,5 %	28,0 %
2.1. VAT	20,1 %	18,6 %	19,2 %
2.2. Excises on excisable goods and selected mineral raw materials produced on RF territory	7,4 %	8,1 %	7,2 %
2.3. Sales tax	0,0 %	0,1 %	1,3 %
2.4. Other taxes on goods and services	1,3 %	0,7 %	7,5 %
4. Property taxes	5,6 %	5,6 %	3,5 %
5. Fees for use of natural resources	4,2 %	2,7 %	3,0 %
6. Taxes on foreign trade and foreign economic operations	3,3 %	4,4 %	5,8 %
7. Other taxes, fees and duties	3,4 %	4,6 %	3,8 %
8. Extrabudgetary fund receipts	27,4 %	30,2 %	26,5 %
8.1. Extrabudgetary social insurance fund receipts	24,2 %	24,7 %	20,9 %
9. Revenue of target budgetary funds	5,2 %	4,9 %	6,5 %
TOTAL TAXES AND PAYMENTS	100,0 %	100,0 %	100,0 %

As in previous years, the bulk of the expenditure under the enlarged government budget fell on social programs, which accounted for 41.2 per cent of the total spending (15.4 per cent of GDP, against 17.9 per cent of GDP in 1997, and 17.3 per cent of GDP in 1998). Government services to the economy claimed 19.3 per cent of the total expenditure in 1999 (down from 20.7 per cent in 1998 and 22.4 per cent in 1997), or an equivalent of 7.2 per cent of GDP (a decrease from 8.0 per cent of GDP in 1998 and from 9.6 per cent of GDP in 1997). Defense spending in 1999 was 6.9 per cent of total expenditure (up from 5.4 per cent in 1998 and from 7.1 per cent

in 1997), or an equivalent of 2.6 per cent of GDP (up from 2.1 per cent of GDP in 1998 and from 3.1 per cent of GDP in 1997).

According to the above table data, the structure of tax revenues flowing into the enlarged government budget has not changed much in the past three years. A point to be made, however, is that the share of deductions into off-budget funds, particularly social off-budget funds, fell (from 24.2 per cent in 1997 and 24.7 per cent in 1998 to 20.9 per cent in 1999), along with that of property taxes assessed to Federation members' budgets (from 5.6 per cent in 1998 and 1997 down to 3.5 per cent in 1999). Simultaneously, growth was registered in the share of foreign trade tax (from 3.3 per cent in 1997 and 4.4 per cent in 1998 up to 5.8 per cent in 1999), and in the share of profit tax (from 12 per cent in 1997 and 11.5 per cent in 1998 up to 14.7 per cent in 1999).

1.5. Social Effects of the Stabilization Policy

According to Goskomstat estimates, the crisis in autumn 1998 was followed by a plunge in living standards of all segments of the population, including 20 per cent of the richest. Statistics from January 1999 shows that 38.2 per cent of the population were thrown below the poverty line. By February 1999, real average monthly pensions had been halved from the pre-crisis period and the real wages per employee have been reduced by more than 42 per cent. In early 1999, the ratio of average money incomes per capita to the subsistence minimum had dropped to less than 1.5. In August 1999, real personal incomes barely touched 80 per cent of those in August 1998.

Comparisons between the official and subjective subsistence levels produce a paradoxical result, or so it appears at first glance. Beginning in November 1998, the subjective subsistence level began to climb down, and between January and July 1999, the objec-

tive subsistence minimum, or the income that respondents in polls conducted by the Public Opinion Research Institute (PORI) were ready to recognize as the least required, proved slightly lower than the official subsistence minimum arrived at by Goskomstat.

The following factors may offer an explanation for this apparent paradox:

First, the economic collapse prophesied by many economists and politicians (paralysis of the financial system, hyperinflation, a throwback to the times of general shortages, and rationing cards) has not arrived. Figure 19 shows, with reference to PORI figures, that after the peak in early autumn 1998 (that is, hot on the heels of the crisis) the share of respondents describing the economic situation in their area and in Russia as bad and very bad tends generally to decline.

Second, the dollars that people keep as the overwhelming part of their savings have added on “weight” at the expense of the ruble, despite the trend, already recognizable early in 1998, for saving modes to diversify, and acquired a greater subjective value in the eyes of their owners.

Third, production started recovery and barter declined in importance (with growth in economy monetization), as one of the many aftereffects of devaluation of the national currency in the second half of 1998, compensating, in turn, for some of the plunge in the real personal incomes, with wages paid mostly on time and in cash and wage arrears tapering off.³⁸

After peaking in autumn 1998, and as wage arrears have progressively been reduced, and real earnings have gone up together with output, the number of striking employees and work time losses have been waning.

³⁸ There is a close link between falling real wage arrears and industrial output growth – the correlation coefficient is negative and equal to 0.98. The correlation coefficient between the industrial production intensity index and the size of subjective average income per capita is positive, reaching 0.73.

The above-described mechanism to compensate for falling personal incomes by paying an increasing portion of wages in cash explains, among other factors, the phenomenon of growing public confidence in the government head against the background of worsening official figures for standards of living.

Figure 19 illustrates the dynamics of confidence in the prime minister and that of real wage arrears. Except for the deep fall set off by the retirement of Prime Minister Stupashin and appointment of the previously unknown Putin in his place, confidence in the prime minister has been growing as wage arrears have been moving down.

The income “compensation effect” has enabled the government, despite a reduction in its social liabilities in real terms, to raise public confidence in the government to a high level.

1.6. Financial Policy in 2000

Monetary Policy. On October 14, 1999, the Government discussed “The Basic Guidelines of the Single Government Monetary Policy for Year 2000” prepared by the Central Bank. According to this document, the major goal of the monetary policy for 2000 was to decrease inflation rates, while maintaining and even accelerating GDP growth rates. CBR confirmed its intention to continue to pursue the policy of floating Ruble exchange rate. However, no Ruble devaluation rates or the exchange rate values at the end of the year were targeted. As it was noted, the Ruble dynamics would depend on a number of factors, the most important among them being changes in the balance of payments and the problem of the settlement of the external debt. According to CBR estimates, the conflicting influence of these factors might rather result in a decline in the real Ruble exchange rate.

Among key goals of the exchange rate policy CBR set for year 2000 are the flattening of considerable fluctuations of the Ruble ex-

change rate and the maintenance of gold and forex reserves at a level ensuring the confidence in Russia's monetary policy and the stability of its financial system. The necessity to improve the existing mechanism of mandatory reserving and its normative basis, to expand CBR operations on the open market and the deposit operations with commercial banks was especially stressed. The Central Bank would indirectly pursue its interest policy via controlling money issue and operations on the open market in 2000. At the same time, it is necessary to note that due to a slow development of the internal market of government bonds the interest policy and CBR operations on the open market viewed as monetary regulation measures will have only a limited effect in 2000.

"The Basic Guidelines" set two basic economic development scenarios for 2000. The "moderate" scenario envisages the money supply growth at 20 to 28 per cent, inflation rates at 18 to 22 per cent, the real GDP growth at 1 to 2 per cent. The second (optimistic) scenario assumes much higher indicators of the real GDP growth at 6 to 10 per cent as compared with the first scenario, while money supply M2 is assumed to grow slightly faster (at 32 to 38 per cent over the year) and inflation being at 25 to 28 per cent.

Budgetary Policy in 2000. The Finance Ministry had started to prepare the draft of the 2000 Federal Budget Law the government submitted to the State Duma at end-August yet under the Primakov government. The draft based on a rather cautious macroeconomic concept presupposing a tough budget and a restrained monetary policy. It was planned that the budgetary deficit would be at 1.13 per cent of GDP (revenues at 14.6 per cent of GDP, expenditure at 15.75 per cent of GDP), while the primary budgetary surplus should be at 3.18 per cent of GDP and the public debt servicing – at 4.32 per cent of GDP. Inflation was estimated to be at 18 per cent in 2000, nominal GDP – at Rub. 5100 billion, while the real GDP should grow by 1.5 per cent.

The State Duma approved the bill in a rather short time, and it was signed by the President on December 31, 1999. For major budgetary parameters see Table 16.

TABLE 16

Major Indicators of the 2000 Federal Budget Law (% of GDP)

	Draft	Law
Revenues	14,6	14,9
Non-interest expenditure	11,4	11,9
Primary surplus	3,2	3,0
Debt servicing	4,3	4,1
Total expenditure	15,7	16,0
Deficit	1,1	1,1
Financing	1,1	1,1

TABLE 17

Expenditure Structure of the 2000 Federal Budget Bill

	Budget Law for 2000			1998	1999
	Rub. mil.	% of GDP	% of total expenditure	% of GDP	% of GDP
Government	25892	0,48	3,0	0,36	0,33
Justice	8123	0,15	0,9	0,12	0,11
International activities	56119	1,05	6,6	0,32	1,29
National defense	140852	2,63	16,5	2,11	2,58
Law enforcement and security	79802	1,49	9,3	1,14	1,23
Science	15927	0,30	1,9	0,19	0,25
Industry	20071	0,38	2,3	0,42	0,38
Agriculture	11505	0,22	1,3	0,12	0,20
Transportation and communications	1639	0,03	0,2	0,04	0,06
Education	32099	0,60	3,8	0,48	0,47
Culture and arts	4679	0,09	0,5	0,04	0,06
Mass media	5725	0,11	0,7	0,04	0,04
Public health	15993	0,30	1,9	0,21	0,23
Social policy	62997	1,18	7,4	1,36	1,09
Public debt servicing	220069	4,11	25,7	3,97	3,61
Other expenditure	153581	2,87	18,0	3,56	2,70
Total expenditure	855073	15,98	100,0	14,49	14,77

So, the revenues envisaged by the 2000 Federal Budget Law were somewhat less as compared with the draft figures (by 0.8 per

cent of GDP). At the same time, taking into account the fact that the law stipulates a larger GDP amount (Rub. 5350 billion), the nominal revenues are increased by 3 per cent. The level of non-interest expenditure envisaged by the law is over the draft figure by 0.5 percentage points.

Table 17 shows the expenditure structure of the 2000 federal budget bill.

While analyzing the structure of non-interest expenditure of the budget law, some increase in expenditure for government as compared with the actual financing in 1998 and in 1999 (by 0.12 percentage points and 0.15 percentage points respectively) shall be noted. It is proposed to considerably increase the expenditure for the national defense as compared with 1998 and 1999 (by 0.5 percentage points and by 0.05 percentage points accordingly).

In accordance with the Budget Law the structure of expenditure for the national economy will slightly change as compared with actual budget expenditure in 1998 through 1999. Thus, the expenditure for industry will remain at the same level as the actual expenditure for the same purposes in 1999; however it will decline as compared with 1998 figures by 0.04 percentage points; the spending for agriculture will be by 0.02 percentage points more than in 1999 (by 0.10 percentage points more than in 1998). The spending purposed for law enforcement will increase considerably (by 0.26 percentage points and by almost 0.35 percentage points as compared with 1999 and 1998 figures respectively) that to some extent being explained by the inclusion of expenditure for customs (0.13 per cent of GDP) in this budgetary item. All spending under social programs increase considerably as compared with actual budgetary expenditure for these programs in 1999: education (from 0.47 per cent of GDP in 1999 to 0.60 per cent of GDP); culture (from 0.04 per cent of GDP to 0.09 per cent of GDP); mass media (from 0.04

per cent of GDP to 0.11 per cent of GDP); public health (from 0.23 per cent of GDP to 0.30 per cent of GDP). The expenditure under social programs increase (from 1.09 per cent of GDP to 1.18 per cent of GDP). Similarly, the financial aid to the Russian Federation subjects shall grow (from 1.27 per cent of GDP to 1.30 per cent of GDP). The financial aid to regions grows by 0.2 percentage points as compared with the 1999 budget bill.

The law on the 2000 federal budget and other normative acts linked to this document envisage some change in proportions according to which federal tax revenues are shared between the federal and regional budgets. The law “On Personal Income Tax” as amended in November of 1999 alongside with some changes in tax rates and scale stipulates that the 3 per cent share of tax revenue previously received by the federal budget shall be abolished; however, the law on the 2000 federal budget provides that 16 per cent of the tax revenues collected in the territories of the RF subjects are due to the federal budget³⁹. The proportions of VAT and profit tax sharing remain the same. On the whole, the revenue sharing arrangements concerning three federal taxes, which determine the amount of tax revenues of the consolidated budget of Russia, slightly shifted in favor of regional budgets as compared with the previous year.

It shall be noted that law “On the Federal Budget for 2000” vests the responsibility to distribute tax revenues between the federal and regional budgets in agencies of the Federal Treasury⁴⁰. Basing on this stipulation of the law the Finance Ministry issued a regulation on the way the Federal Treasury agencies shall distribute

³⁹ See: Article 10 of RF law No. 227-FZ of 31.12.1999 “On Federal Budget for 2000.”

⁴⁰ See: Article 10 of RF law No. 227-FZ of 31.12.1999 “On Federal Budget for 2000.”

tax revenues⁴¹. It shall be remembered that previously tax agencies and taxpayers had themselves shared tax payments between the levels of the budgetary system, what permitted to circumvent the legislation on the interbudgetary distribution of federal tax receipts, in particular, via non-money off-sets.

According to the 2000 budget law the federal budgetary deficit is planned at Rub. 57.2 billion (1.8 per cent of GDP). The deficit financing shall be carried out at the expense of both internal and foreign borrowing, and CBR credits. Net internal financing is targeted at Rub. 38.0 billion (0.71 per cent), including borrowings at Rub. 63.0 billion, from which Rub. 25.0 billion shall be repaid to cover the liabilities.

The RF government plans to repay Rub. 15.4 billion worth of GKO/OFZ, Rub. 4.8 billion of OGSZ, and Rub. 1.8 billion of government debt liabilities. Besides, Rub. 3 billion shall be earmarked for the repayment of a preliminary compensation to Sberbank depositors. The major deficit financing source is the marketing of government bonds (about Rub. 45.0 billion, including Rub. 35.0 billion of government non-market bonds). Another deficit financing source (Rub. 18.0 billion) is the revenues arising from sales of the state property (including stocks in LUKoil, Rosneft, Slavneft, Svyazinvest, ONAKO, etc.).

Net foreign financing of the federal budget deficit is planned at Rub. 18.7 billion (0.35 per cent of GDP, or about \$ 585 million). The amount of borrowings from foreign sources shall be \$ 5.885 billion, it includes: untied credits from international financial organizations at \$ 3.735 billion (IMF - \$ 2.6 billion); investment credits of interna-

⁴¹ See: Finance Ministry Directive No. 91 of December 14, 1999 "On the Approval of the Instruction on the Accounting of Federal Budget Revenues and the Regulation of Inter-Budgetary Revenue Sharing in the Russian Federation."

tional financial organizations at \$ 550 million; bilateral untied credits at \$ 500 million; tied foreign credits at \$ 1.1 billion.

The expenditure earmarked for the repayment of the RF foreign debt is at \$ 5.3 billion (including \$ 3.35 billion to repay the principal debt to IMF, IBRD, and EBRD).

It is remarkable that the funds targeted for the financing of the federal budget deficit fall short of the full amount by only less than Rub. 1.1 billion (0.02 per cent of GDP). However, the 2000 budget law allows the RF government to borrow within \$ 1 billion (Rub. 32 billion at the calculated average annual exchange rate, or 0.6 per cent of GDP) from CBR. In this way the law provides for a probability that Russia would not receive the planned amount of foreign financing. In case Russia faces difficulties while attracting foreign loans, there will be a choice between financing the budgetary deficit at the expense of extra money issue, a cut in non-interest budgetary expenditure, or a default on the new Russian debt. For instance, if real budgetary revenues are at about 13.5 per cent of GDP (an optimistic estimate), and foreign debt liabilities are repaid in the amount stipulated by the budget, without foreign borrowing non-interest expenditure shall decline to about 11.6 per cent of GDP.

1.7. A Macroeconomic Scenario for Year 2000

In order to verify the feasibility of the figures targeted by the 2000 federal budget law and the stipulations of “The Basic Guidelines of the Single Government Monetary Policy for Year 2000” we reviewed several scenarios of macroeconomic development in 2000.

The first scenario is based on the prerequisites set by two aforementioned documents:

GDP will grow by at 2 per cent in 2000;

Federal government revenues will be at 14.9 per cent of GDP;

Budgetary expenditure and foreign debt repayments will reach the amounts earmarked by the 2000 budget law. Non-interest expenditure will be at Rub. 735.0 billion, internal debt servicing - at Rub. 63.3 billion, foreign debt servicing – at \$ 4.9 billion. A successful negotiations with London and Paris Clubs shall permit to limit the repayment of the external debt to \$ 5.3 billion in 2000;

Russia will receive \$ 5.885 billion foreign financing earmarked by the 2000 budget law to be borrowed from IMF, World Bank, and foreign governments;

The remaining federal budget deficit will be covered by primary budget surplus and direct borrowing from CBR;

GDP deflator will somewhat lag behind the consumer price index;

Money multiplier (calculated on the narrow money base) will be increasing over the whole year and reach 2.5 by end-year;

The real ruble exchange rate will remain constant;

Narrow money will increase by less than 30 per cent.

The results of the scenario forecast were received basing on the same model, which had been used for the 1999 prognosis⁴² (see Table 18). For the inflation dynamics in 2000 see Figure 31. As these figures demonstrate, our estimates only slightly differ from the official figures in the budget and monetary program for 2000.

TABLE 18

	1999	Official estimates	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Inflation (%)	36,7%	18%	17,9%	24,4%	26,3%	34,7%
GDP (Rub. billion)	4476	5350	5246	5370	5588	5821
M ₂ growth rate (%)	57,2%	20–38%	26,9%	36,0%	37,5%	46,1%
Ruble exchange rate at end-year (Rub./\$)	27,0	36,0–38,0	32,9	32,8	35,3	39,4
Monetization (% of GDP)	14,63%	18,5–19,5%	16,39%	16,65%	15,62%	14,86%

⁴² Russian Economy in 1998. Trends and Perspectives (Issue 20), IET, Moscow.

However, we do not think that the first scenario and official estimates of the economic development are close to reality. First of all, we doubt the federal budget revenues as set by the 2000 budget law (14.9 per cent). In 1999 the federal budget revenues were below 13.7 per cent of GDP.

Basing on these assumptions, the **second scenario** proceeds from the federal budget revenues at 13.5 per cent of GDP. Other basic figures are similar to those used in the first scenario. Besides, we assumed that:

the amount of money issue in 2000 will be a difference between current revenues of the federal budget and its total expenditure, including the repayment of the RF foreign debt and foreign financing. Therefore we assume that CBR will issue money covering the whole amount of foreign exchange it purchase for the Finance Ministry (about \$ 4 billion);

Money multiplier will be at 2.35 to 2.45 in 2000;

Oil prices will be at the level of end-1999 over 2000, i.e. within \$ 25 – 28 per barrel. It will permit to maintain the balance of trade surplus at \$ 30 to 35 billion;

The balance of trade surplus and foreign credits will ensure the inflow of foreign exchange in the country that forcing the real ruble exchange rate up even in spite of CBR forex purchases aimed at the repayment of the RF foreign debt. We assume CBR to pursue the policy of accumulating its gold and foreign exchange reserves to keep the real ruble exchange rate below 5 per cent over the year;

In order to sterilize ruble interventions on the forex market CBR will continue to attract deposits from commercial banks, issue CBR bonds and expand operations on the secondary market of government bonds. It will permit to limit the growth of narrow money to 30 – 35 per cent over the year.

The results we obtained (see Table 18) demonstrate that under this scenario the price growth will be at about 24.5 per cent; GDP – at Rub. 5370 billion; and the ruble exchange rate will be at 32.8 Rub. per dollar at end-year. Low inflation rates will facilitate growing demand for real cash balances. Owing to this, the real money supply will increase by 13.8 per cent and reach 16.65 per cent of GDP over the year.

Even in spite of the fact that our calculations show a higher inflation as compared with the budgetary targets, a decrease in real non-interest expenditure will be below 0.1 per cent of GDP (from 11.9 per cent to 11.8 per cent), i.e. it will diminish by mere 0.6 per cent. Therefore, the real growth of non-interest expenditure may be about 0.7 percentage points over 1999 (an increase from 10.5 per cent of GDP in 1998 to 11.2 per cent of GDP).

The scenario under review may seem to be too optimistic: the current negotiations with the International Monetary Fund make to doubt that Russia will receive the foreign financing in amount targeted for year 2000 (\$ 6 billion). Therefore, the **third scenario** assumes that there will be no foreign credits, while the RF government will continue to repay its foreign debt in full (up to \$ 10.2 billion). In this case, the shortage of foreign exchange shall be covered by CBR forced to buy extra forex amounts. An increasing CBR demand will permit to compensate for the pressure on the real ruble exchange rate at the supply end and it will be constant over the whole year. The money multiplier will be at the level of end-1999 reaching 2.35.

Our calculations (see Table 18) show that in this case the price hike may reach 26.3 per cent, ruble exchange rate will be 35.3 ruble per dollar at end-year, and GDP – at Rub. 5588 billion. Notwithstanding CBR operations aimed at the sterilization of ruble interventions the inflationary effect of additional money issue (as com-

pared with the second scenario) on the economy (about Rub. 130 billion) can not be completely neutralized. The GDP deflator will increase at a faster rate equal to the rate of inflation, and the real money supply will increase by less than 6.8 per cent (up to 15.6 per cent of GDP) over the year. Non-interest federal budgetary expenditure will make 11.36 per cent of GDP that being below target figures by 0.51 per cent of GDP (by 0.15 percentage points below the level of 1999).

Nevertheless we do not think this scenario is dangerous for the Russian economy. The acceleration of inflation due to the absence of foreign debt refinancing in 2000 will be below 2 percentage points (26.3 per cent as compared with 24.4 per cent). At the same time, the pressure driving the real ruble exchange rate upward will ease, while incentives for restrictive monetary and budgetary policy will persist. Therefore, lessening foreign debt shall have a favorable effect on the Russian economy in the medium and long-term perspective, while short-term costs shall be relatively low⁴³.

All previous scenarios assumed that prices of oil and other Russian staples (natural gas, ferrous and non-ferrous metals) will remain at the relatively high current levels. This assumption permitted to expect forex inflows in the country and a high profitability of exporting enterprises, which provided for a major part of tax and non-tax federal budgetary revenues. The **fourth scenario** is based on the assumption that prices of Russian exports will fall by 30 per cent by end-year.

Preliminary estimates show that this development may bring the federal budgetary revenues down by about 1 per cent of GDP, i.e. to 12.5 per cent of GDP that resulting in a deterioration of the

⁴³ It shall be remembered that a persisting low, although floating, real ruble exchange rate will be the optimal CBR policy ensuring Russia to set off on the path toward sustainable economic growth (see below for details).

trade balance and lower forex supply forcing CBR to further devalue ruble in order to purchase the required amount of foreign exchange. Our calculations reveal that under the fourth scenario (without foreign borrowings as similar with the third scenario) the real ruble exchange rate downfall may reach 8 per cent.

As Table 18 and Figure 31 demonstrate, in this situation inflation may reach 35 per cent over year 2000, while by end-year it may accelerate up to 3 to 3.5 per cent a month (40 to 50 per cent in annualized terms). The nominal M_2 annual growth will be over 46 per cent; however in real terms the growth will make about 1.6 per cent (from 14.63 to 14.86 per cent of GDP).

The fourth scenario may result in a deep decline in real non-interest expenditure to 10.9 per cent of GDP (by 8 per cent as compared with figures targeted in the 2000 budget law and by 0.3 percentage points as compared with 1999). In December of 2000 the real incomes of those employed at enterprises and organizations financed from the budget will decline by over 13 per cent as compared with the levels registered in December of 1999.

The scenarios of macroeconomic development in 2000 demonstrate that inflation will be at 17 to 35 per cent. A key factor determining the government and CBR potential to restrain inflation is the price dynamics of Russian export staples. Calculations show that export price index declining by 1 percentage point results in inflation growing by 1/3 percentage point.

Another major factor (credits of international financial organizations) plays a less important role. Even in case of no foreign financing in 2000 the inflation will be below 26.3 per cent that being lower than 1999 rates.

1.8. Medium-Term Limitations of Economic Policy

As we discussed factors behind an improvement in Russia's economic situation in 1999 above, we examined in considerable detail the consequence of the ruble devaluation in August 1998 and the causes of the continuing low exchange rate of the ruble. The principal conclusion that follows from our analysis is that devaluation has given Russia a few short-term advantages, such as, chiefly, the onset of recovery in its export-oriented and import-substituting industries. Accordingly, our starting point in the preceding scenarios was that the monetary authorities would continue their policy of preventing a rapid growth of the real ruble exchange rate.

Along with some important boons of national currency devaluation, the country's economy has found itself face to face with a set of undeniably negative aftereffects. Ignoring these could, in a varying degree, threaten the country's economic growth. These aftereffects include (1) warning signals of "low economic growth level"; (2) a more expensive foreign debt; (3) probability of overprotection for domestic manufacturers; (4) decline in the real worth of national companies; (5) profit redistribution and possible unfavorable shifts in the economy; and (6) more expensive foreign equipment and technologies required for making investments. Let us take a closer look at these factors.

Warning signals of "low economic growth level". This effect is more a psychological, symbolic fallout of devaluation than a reflection of real changes in the economy. Today, the ratio of the nominal exchange rate of the ruble to the dollar, related to the purchasing power parity of the two currencies, stands approximately at 2.5. Although no formal economic model exists to show the extent

of damage caused to the national economy by this high ratio,⁴⁴ worldwide economic record suggests, however, that this situation is only characteristic of countries at a very low development level. As the national economy ascends to a higher development level, the ratio of exchange rate to purchasing power parity of a currency lowers to a level where deviation from unity does not exceed 10 per cent to 15 per cent for economically developed countries.

A More Expensive Foreign Debt. A more expensive foreign debt owed by Russian businesses (including the country's government) and growing costs of servicing the debt portion denominated in foreign currency is one of the most serious effects of ruble devaluation.

Russia has already come to grips with this problem – its foreign debt has risen from 30 per cent-35 per cent to 70 per cent-80 per cent of GDP as a result of the August 1998 devaluation. It will have to spend between 4 per cent and 10 per cent of GDP every year to service its debts and repay the principal in 2000 to 2005. This is obviously a very heavy burden on its economy (federal budget revenues worked out at 13.3 per cent of GDP in 1999).

As well as weighing down the federal Government, a more expensive foreign debts also came down on some regional administration (as in Nizhny Novgorod and Moscow), giant Russian companies (Moscenergo, Tyumen Oil Company, and Tatneft oil company) and commercial banks (Alfa Bank, Russian Credit, and ONEXIM Bank). The total share of foreign debt in the private sector of the

⁴⁴ The existing models of Balass-Samuelson and Bhagvati-Cravis-Lipsi explain the causes of differences in price levels between countries, but they offer no answer to the question about an economically justified level of the ratio. The problem of finding an equilibrium real exchange rate of a national currency in a transition economy is discussed, for example, in Halpern, L., and C. Wyplosz, "Equilibrium Exchange Rates in Transition Economies", *IMF Working Paper*, WP/96/125.

Russian economy is sufficiently low, and the situation in this area is markedly better in Russia than in a number of developing countries (such as the Republic of Korea, Thailand, and Mexico)

It must be said, though, that the Russian banking system had, by August 1998, been encumbered with enormous contracts to deliver money in foreign exchange (up to \$78 billion at the current exchange rate). But all was not as bad as it looked. First, these liabilities were outweighed with a margin by the counterclaims it had on money deliveries in foreign exchange (nearly \$79 billion at the current exchange rate); second, many fixed term contracts had been made between Russian banks themselves; and, third, no direct foreign exchange deliveries were to be made under most contracts, for they were overwhelmingly futures and options contracts. There is no reason, in our view, to complain, therefore, that the Russian banking system has been crippled by, more than anything else, external liabilities having gone up in value because of ruble devaluation, rather than poor management and massive runs on the banks.

Probability of Overprotection for Domestic Producers. As we said above, ruble devaluation stimulated industrial growth in the economy by offering domestically produced goods important price advantages over imports. We are to distinguish, however, between the substitution effects engendered by demand switching from imports to domestically manufactured substitutes within identical price groups and price barriers thrown up to inhibit entry to the domestic market for foreign-produced goods. Extensive devaluation makes the differences in prices between imports and domestic goods prohibitively large for imports. Competition weakens as a result, the quality of domestic goods remains unchanged, and eventually the living standards of consumers decline and domestic manufacturers are deprived of incentives to make their products competitive.

Decline in the Real Worth of National Companies. The next in turn adverse effect of devaluation is decline in the real worth of national companies. Falling real worth makes companies more attractive for foreign investors who are given a chance to acquire real assets at low prices. Inflow of foreign capital to the stockmarket is the more probable the deeper the stocks had plunged under the pressure of factors unrelated to revaluation of future earnings in foreign exchange in the period preceding devaluation (for example, in consequence of country risk fluctuations). In point of fact, a fall in the stockmarket index (including one denominated in US dollars) before devaluation may be related to a revaluation of future company profits: since a large number of national corporations operate on the domestic market (indeed, the growth in the output of import substitutes targets specifically domestic demand) their foreign exchange-denominated value falls, depreciating the present worth of future earnings (denominated in the national currency) of companies.

The fall of stock prices and capitalization (in foreign exchange terms) of a corporation reduces its chances of attracting external loans. This handicap appears to be sufficiently important for the Russian economy, because modernizing operations and purchasing modern technologies and machinery requiring heavy investment are, for domestic companies, critical factors for transition to a sustainable long-term industrial growth. In a situation where borrowing opportunities on the domestic market are limited, fewer chances of contracting loans on foreign markets may become a strong constraining factor for commencement of economic growth.

Profit Redistribution and Possible Unfavorable Shifts in the Economy. The ruble devaluation and growing profitability in the export industries we have spoken about lay the groundwork for ma-

major structural shifts in the economy, their impact being far from always desirable.

Rising profitability in the export-generating sector causes the profit derived in the economy to be redistributed in favor of export industries, even if output is growing in the import-substituting sector. Besides, exporting enterprises derive their profits in foreign exchange, their worth remains high on the stockmarket, and they have extra chances to borrow on external loan markets (domestic loans, too, are within easy reach for them because of their high profit margins).

All financial resources are, therefore, flowing profusely into a limited number of industries. Commonly, these are capital-intensive industries that drain the economy of labor factor compensation funds in labor-intensive sectors (above all, in the service industries) and encourage labor outflow from these sectors. Moreover, “excessive” devaluation leaves the bulk of industries outside the financial flows. A result of these processes is an economy with an accentuated focus on primary material production, that is dangerously exposed to fluctuations of world prices and has a small share of services, as is typical of countries at a low level of economic development.

The problem should not, of course, be overdramatized in Russia’s case. The danger of this kind of change in the economic structure would be great in the absence of a large and diversified manufacturing sector. The results of the economy’s performance in 1999 show, however, that devaluation has stimulated growth both in primary industries and in manufacturing, such as engineering and the food industry (see Table 3).

More Expensive Foreign Equipment and Technologies. Modernization of domestic industries is an important condition for transforming the recovery of import-substituting industries in the

wake of devaluation into a sustainable economic growth.⁴⁵ Industrial modernization is ultimately aimed at giving Russian goods a sharper competitive edge on the domestic and world markets. The quality of many domestically produced goods launched on the wave of the import-substitution drive is obviously still very poor. They sell mostly because of their relatively low prices next to imports, and their producers can only survive in the present-day greenhouse condition shielding them from competition. Apart from putting on a heavier debt burden on the economy, devaluation of the national currency reduces opportunities for enterprises to purchase imported machinery and technologies to replace and modernize their manufacturing equipment. In today's condition, this limitation appears to be a very serious one.

Problem of Choice of Real Ruble Exchange Rate Policy in the Short Term. The growth sparked off by the devaluation can be sustained, therefore, if it is fueled by investment. To speed up modernization and replace machinery and technologies, the surplus profits companies are deriving in the period immediately following devaluation must be channeled into long-term investment projects instead of current consumption. As we already said, Russia today regrettably has only very limited possibilities for accumulating savings. Besides, industrial managers are mostly preoccupied with expanding domestic demand and meeting it using whatever manufacturing equipment they have. This is yet another argument for the need to improve the investment climate in Russia.

It is still an open question as to which exchange rate policy is to be pursued in the short and medium terms. An analysis of possible variants of a real ruble exchange policy in the short term (up to two years) shows that a rapid revaluation of the ruble today would be

⁴⁵ For more detail, see E. Gaidar, "Anomaly of Economic Growth," Eurasia, Moscow, 1997.

undesirable, and hard to implement in practical terms. Despite the negative effects of the low exchange rate of the national currency we spoke about above, maintaining the existing balance between domestic and world prices is beneficial to Russian manufacturers, the Central Bank and the Government of the Russian Federation.

At a time when exporting enterprises are contributing a fifth of the country's tax revenues (see Table 9), their falling profits would cut into the budget revenues and, in turn, complicate yet more seriously the foreign debt servicing problem for Russia. Consideration is, however, to be given to a certain degree of externality of Russian exports. Indeed, Russian exports are structured in a way that prices for most categories of commodities (such as oil, gas and metals) are set on world commodity markets and are binding on all trading partners.

The experience of antidumping lawsuits against Russian metal producers in the EU and the United States shows that Russia cannot make full use of its relative competitive advantages by selling its commodities below world prices. This means that world prices actually determine the profit margins of Russian exporting enterprises that have little control over their own efforts to cut production costs. The financial "cushion" formed at current prices is sufficiently large to discourage production cost reductions (as in primary industries). If, and when, prices of Russian principal commodity exports fall, profit margins may again be reduced to zero in manufacturing, most likely to be responded to by the Government with another devaluation of the ruble.

As we look at the short-term growth prospects for the Russian economy, we have to emphasize that the need to raise foreign exchange funds to repay the country's foreign debt restricts the Central Bank's potential to pursue a monetary and currency policy capable of strengthening the ruble. Demand for foreign exchange by

the Central Bank and the Ministry of Finance heightens expectations of a continued downfall of the nominal exchange rate of the ruble, and measures that can possibly be taken to sterilize ruble interventions on the currency market would contribute to a further slowdown of the inflationary processes and to a reduction in the real exchange rate of the ruble. Attempts to increase foreign exchange supply (such as the requirement for exporting enterprises to sell 100 per cent of their foreign exchange proceeds, or higher taxes levied on them, along with other foreign trade related payments) in the absence of more efficient currency controls would only force more capital to flee the country, and their net effect on the foreign exchange supply on the domestic market is unpredictable.

On the other hand, because of the inflow of foreign capital started in late winter of 2000 and its possible intensification in summer and autumn of 2000 the Government and CBR may face a dilemma: to allow a fast (as the experience of Latin American countries⁴⁶ and the developments in Russia in summer of 1995 demonstrate) revaluation of Ruble, or undertake protective measures aimed at restraining capital inflows, mainly short term portfolio investments. These measures may include⁴⁷:

⁴⁶ Edwards, S. (1998) 'Capital inflows into Latin America: A stop-go story?', NBER Working paper, 6441; Edwards, S. (1998) 'Capital flows, real exchange rates, and capital controls: Some Latin American experiences', NBER Working paper, 6800.

⁴⁷ Basing on the experiences of a number of countries (Chili, Columbia, Malaysia, Brazil, Czech Republic): Edwards, S. (1998) 'Capital flows, real exchange rates, and capital controls: Some Latin American experiences', NBER Working paper, 6800; Edwards, S. (1999) 'On crisis prevention: Lessons from Mexico and East Asia', NBER Working paper, 7233; Johnston, R. B., N. Tamirisa (1998) 'Why do countries use capital controls?', IMF Working paper, 98/181; World Economic Outlook and International Capital Markets. Interim Assessment, December 1998. Washington, D.C.: IMF.

Restrictions on amounts (or growth rates) of foreign liabilities of commercial banks;

Bar on purchases of Ruble denominated corporate (and bank) bonds by non-residents⁴⁸;

Introduction of mandatory reservation system for certain foreign liabilities (they shall include bank credits and portfolio investment used for investing in Ruble assets (shares, government bonds). Trade credits and direct foreign investment shall be exempted from the mandatory reservation⁴⁹). Mandatory reservation rates shall be set in inverse proportion to investment terms;

Issuance of foreign exchange denominated CBR bonds⁵⁰ and deposit certificates;

Ruble interventions on the foreign exchange market aimed at the repurchase of surplus foreign exchange supply and a broader set of monetary policy measures aimed at their sterilization (CBR bonds, higher mandatory reservation rates, sales of government securities);

Suspension of government foreign borrowings (in the form of Eurobonds);

Taxation of repatriated profits (at 25 to 30 per cent).

These measures shall be aimed at sustaining a low real exchange rate of the ruble for the next year or two. In the medium term (up to five years away), it will probably be desirable to work for a gradual rise in the real ruble exchange rate. There will be several factors to suggest this. First, the peak period of foreign debt repayment will have passed by the year 2005 and the need to raise

⁴⁸ Non-residents will purchase Eurobonds.

⁴⁹ An option: only direct foreign investment for over 12 to 18 months shall be exempted from mandatory reservation (mandatory reservation rate at 20 per cent).

⁵⁰ Similar to *Tesobonds* in Mexico.

foreign exchange for government needs will have declined. A lower demand for foreign exchange at a favorable trade balance will lift restrictions on a stronger ruble. Second, the anticipated economic growth will make Russia more attractive for investors and push both the current account, and capital account balance into the black sooner. Third, as industrial production goes up, it will be vitally important to gradually lift barriers to penetration to the Russian market, in this way stimulating replacement of machinery and technologies and sharpening the competitive edge of Russian industries.

As to the prospects of a long-term growth of the Russian economy driven by import substitution efforts, it is necessary to note yet another aspect related to the ratio of income elasticities in exports and imports. As P. Krugman⁵¹ showed, a sustainable long term growth of a national economy is possible only under conditions of regular devaluation of the national currency at the ratio between them similar to that currently observed in Russia (low elasticity of exports and high elasticity of imports). Raw material exports are constrained by relatively low price elasticity of the demand for fuels and limited possibilities to influence on world oil and natural gas prices. At the same time, as living standards improve the demand for imported goods of a better quality than domestically made substitutes grows. Therefore, the trade balance deteriorates. In case this process coincides with deteriorating terms of trade and intensifying capital flight caused by the mounting country-specific risks, it may result in an economic crisis, like that observed in 1998. In this situation the government has to regularly devalue the national currency in order to maintain domestic economic growth rates and a favorable trade balance.

⁵¹ Krugman, P. 'Differences in Income Elasticities and Trends in Real Exchange Rates', *European Economic Review*, 33, 1989, pp. 1031–1054.

All said above permits to draw a conclusion that at present a floating exchange rate coupled with a slow real ruble revaluation is the most feasible regime. In this situation CBR and government measures aimed at stronger control over capital flows permitting not only check fast capital outflow from the country, but, even more importantly, to limit foreign capital inflow to the domestic market in this way preventing a sharp increase in the real ruble exchange rate are of the key importance.

1.8.1. The Economic and Political Situation at the Time of the Elections

A new political context: forming a consensus. Two interrelated factors are especially important while evaluating the new state the Russian society found itself in 1999, and which will affect the development of the economic and political situation in the country over the foreseeable future. This society has just completed the tasks of post-communist transformation *per se* and its leading political forces have initiated the process bridging the gap between them. These circumstances are an evidence of a close completion of the radical, revolutionary transformation of the society, which is characterized by an irreconcilable political struggle resulting in a weak state authority.

Russia became a country with a market economy and a democratic Constitution. Its further development, its successes and difficulties, breakthroughs and crises will be determined by this fact.

Certainly, it is possible that Russia will encounter moments of hesitation and reversals. The democratic system has not deeply rooted in the country yet. There is no guarantee that Russia will avoid populist experiments resulting in dire consequences for financial and merchandize markets. However all these and other probable crises will rather be linked to the current political struggle

and the search for answers helping to face new challenges of the economic and political life than be direct consequences of the communist legacy.

The conclusion that the communist legacy has been overcome is confirmed by the experience of coping with the financial (in fact, both financial and political crisis of 1998). Even while an utter collapse, the return to merchandize shortages and a political dictatorship seemed to be imminent, the country could overcome the crisis in the framework of existing and usual for modern market economies system of measures, first of all those belonging to monetary and budgetary policies.

In late 1999 and early 2000 these factors and other circumstances resulted in a unique political situation from the standpoint of further economic reforms.

The elections to the State Duma of December 19, 1999 and V. Putin's victory in the first tour of the presidential elections demonstrated that the influence of leftist parties was not growing any more, it even somewhat declined. For the first time since 1993 the number of votes given for political associations, which might be seen as pro-governmental or non-Communist showed a trend to growth. The Duma's composition, if not guaranteeing the approval of all bills favored by the government in any case permits to block practically all unwanted law drafts.

The election of administrative heads in a number of the RF subjects taking place at the same time as the Duma elections also resulted in a defeat of procommunist governor nominees (for instance, in the Tver, Novosibirsk, and Moscow Regions).

However, alongside with a relative weakening of the left and nationalist forces there were other factors helping to strengthen the position of the government and V. Putin personally. It is much more important that 1999 demonstrated a clear trend of political

elites to consolidate, to mend the split between them by means other than a complete elimination of political rivals. Some developments in the economic and political life occurring over the last year may be an evidence of the consolidation of elites: first, the practical activities of the Primakov's neo-communist cabinet; second, an analysis of parties' election programs; third, the political maneuvers of the new Duma in 2000.

For the first time the elites' consolidation process became apparent under Ye. Primakov, when a left cabinet had to agree to implement socially toughest budgetary and monetary measures. In fact, the results of major institutional reforms (first of all privatization) were confirmed at the same time. It became clear that the opportunity window for changes in economic course was not so large as it seemed at that time.

The election campaign of 1999 was even more interesting. In spite of a bitter struggle among political parties their programs showed an apparent trend toward being closer to each other, at least as compared with 1995 and 1996. Certainly, differences (some of them rather considerable) remain. However, the vast majority of programs is within the market paradigm and does not remind of a discussion between the blind and the deaf (more precisely, between a healthy individual and a blind, deaf, and dumb person). Now these disputes are rather like the heated debate between British Laborists and Conservatives in late 1940s and early 1950s.

Indeed, everybody has recognized the importance of private ownership and nobody seriously state the necessity of large-scale nationalization. The privatization results revision is discussed only in the context of court procedures and on the basis of inconsistencies with initial conditions of privatization. Certainly, this is an important problem rising a lot of questions (for instance, the question of court impartiality under the "dictatorship of the proletariat," or

under an authoritarian regional leader); however this way of posing the problem is quite different from usual chanting about “robbery via privatization.”

Everybody recognizes the importance of macroeconomic stability, non-inflationary monetary policy, balanced budget. Even disputes about the currency control regimes, notwithstanding such exotic suggestions as the prohibition of ruble convertibility, are not untypical of Western democracies in the middle of the 20th century.

Finally, a union between communists and pro-Putin forces formed on January 17, 2000, the literally first working day of the new Duma was an important sign. The political forces declaring quite different ideological priorities and planning quite different legislation programs could easily reach an agreement on the leadership of the new Duma. Although it may be expected that these forces will intensively (even somewhat demonstratively) fight each other, the radical character of this split shall not be overestimated.

B. Yeltsin’s resignation was an important factor behind the formation of the new consensus. It became clear that the irreconcilable strife between the left opposition and the government resulted rather from the personality of the first President and the deep mutual hostility existing between him and the communists than from ideological differences. The fact that the left majority easily approved two Prime Ministers, who distanced themselves from any ideology, in May and August of 1999 permitted to draw a conclusion that differences between the government and the opposition were not antagonistic in nature. It seems that after B. Yeltsin’s resignation there are no more obstacles hindering the consolidation of elites.

As it has always happened at the last stage of a revolution, a factor, which should consolidate the society and the elite, was a military success. The grave developments in the course of the Che-

chen conflict over autumn of 1999 played an important role in forming a social consensus. However, this factor could sustain the unity only in case the war would be short and seen as a success.

These developments directly affected the standpoint of the regional authorities. While yet in mid-1999 the governors were split and oriented toward different political forces (“Otechestvo (Fatherland),” “Vsya Rossiya (All-Russia),” “Golos Rossii (Voice of Russia),” and CPRF), by early 2000 the vast majority of governors swore allegiance to V. Putin and supported “Edinstvo (Unity)” as the ruling party. At the same time, since in contradistinction to B. Yeltsin the new leader openly favors one of the political parties, the support of the regional authorities to Unity is much more apparent.

Another side of this process is that the upper chamber will rather again become a reliable mainstay of the head of state, what is very important both if the Duma is loyal, or there are conflicts. In the first case the legislation initiated by the government will surely pass, while in case of a conflict the authority will have a reliable barrier against unwanted legislation. These developments for the first time created a basis for a constructive cooperation between the executive and the legislative branches of authority, and between the upper and lower chambers.

Yet another factor strengthening the social stability is low social expectations resulting from the severe shock experienced after the crisis of August of 1998. A unique situation has formed in the country: subjective evaluations of the subsistence wage are lower than its level set by the government. The state social expenditures sharply devaluated by the government of Ye. Primakov and Yu. Maslyukov remain at a low level. All these factors permit to pursue a cautious and responsible macroeconomic course avoiding the danger of populism.

The character of the presidential election campaign was also a factor restraining populism. The following circumstances are important: first, during the short campaign there were no time for populist experiments in the area of budgetary and monetary policies. Second, the fact that there is an apparently leading nominee who is besides the acting President devalue populist steps as they appear unnecessary and even dangerous, since the same leader will have to overcome their consequences. Third, low social expectations and extremely low level of social expenditures permit to undertake attractive to voters measures aimed at increasing social expenditures in nominal terms while maintaining them at the same level in real terms.

V. Putin and Prospects of His Economic Course. In this situation it remains problematic if the new (post-Yeltsin) leadership is able and wishes to the full extent use the favorable opportunity in order to make the social and economic policies more dynamic. A characteristic feature of the objectively forming situation is the fact that practically any development is possible – from consistent economic liberalism to state interference to extreme populism.

V. Putin's first steps were aimed at concealing his economic and political preferences until the presidential election. This political tactics is understandable; however, it can not be the basis of a course, i.e. the new leadership will have to announce its preferences.

First statements of the acting President demonstrated his inclination to moderate political rhetoric, his trust in tough approach to the organization of government, and some enthusiasm for administrative levers in regulating the economy.

The populist rhetoric was apparent when V. Putin promised to substantially increase pensions and wages paid at the expense of the

budget (first of all for educators) that, however, being a rather natural step of a presidential nominee.

At the same time there were made statements about the necessity to improve law and order, about “the dictatorship of the law” as the most important dominant of the measures the state authority will undertake. Such statements may be interpreted in various ways and require a considerably more precise definition.

At last, over his first days as the acting President V. Putin demonstrated that he does not shun administrative measures in the economic sphere *per se*. An evidence of this was his support of the CBR suggestion to introduce 100 per cent sales of foreign exchange earned by exporters and to lower the discount rate. Notwithstanding the evaluation of the economic consequences of such measures, their approval permit to characterize the new authorities’ action plan.

Some problem may be posed by the fact that the new leader is somewhat inexperienced. In this regard his actions partly remind of those undertaken by Prime Minister V. Chernomyrdin in his two first months in office, when many hurried decisions (ranging from the state regulation of prices to the ban on cars with the right-side steering wheel) were soon repealed. The decisions on the sale of 100 per cent forex-denominated earnings and administrative lowering of the discount rate are in the same range. However, there is a substantial difference: while in late 1992 and early 1993 the decisions of the new Prime Minister had to be approved by B. Yeltsin, with his political experience and more or less strong opinions and preferences concerning the economic and political course.

However, real developments, including the formation of a real economic policy, will be driven by many factors other than subjective preferences of the new President.

While determining outlines of the economic course in a short-time outlook, it is easy to single out key characteristic features and constraints of its next stage. These parameters were set by the logic of the events occurring over the last decade and present the framework any Russian government will have to act within. To ignore this framework would result in a serious crisis. The key features of this situation, as seen in the beginning of 2000, are the following:

Small amount of investment due to persisting lack of confidence in political and economic institutions;

Extremely limited budgetary resources insufficient for state investment;

Persisting capital flight, including forex-denominated savings;

Persisting nominal inter-enterprise payment arrears in spite of sharply diminishing budgetary payment arrears;

Unreliable banking system, lack of confidence in the institutions of the financial market;

Persisting growth generated by improving utilization of capacities and the rationalization of production. Although considerable, this growth remains unstable due to the lack of necessary investment;

Necessity to maintain and somewhat increase the primary budgetary surplus;

Maintenance of a floating exchange rate at the current undervalued level. The maintenance of a stable real ruble exchange rate may be set as a guideline.

There is a number of factors other than these purely economic parameters, which will directly affect economic and political developments in the country.

First, the feasibility of budgetary targets to a considerable extent depends on the dynamics of world price of the Russian export staples (energy resources, metals, chemical products). The influ-

ence of this factor is not unambiguously positive. High prices of the Russian exports not only make the situation the authorities are in easier, but render the government to be less interested in pursuing the course of reforms.

Second, the foreign debt structure will depend on the authorities' capacity to improve relations with external lenders.

Third, the future developments will depend on whether international financial organizations, primarily IMF, resume the lending to Russia. This factor is in a sense an external one, since currently it is fully determined by political circumstances.

Fourth, an important factor is the prospects of the Chechen war; both in terms of its success and the time the campaign will take.

It is easy to see that all these factors are closely interrelated to each other and to the prospects the budgetary (and in a broader sense macroeconomic) stability in Russia. All these factors directly affect either budgetary expenditure or revenue and, therefore, the exchange rate policy.

Taking into account these factors directly affecting the economic policy of any Russian government the optimal course of action in a short time outlook (about 2 years) would be the concentration of efforts aimed at the creation of favorable prerequisites for future economic growth based on increasing investment. It is obvious that an economic growth is possible even in the absence of investment; however, it will be based on effective demand and on the considerable reserves of idle production capacities.

This circumstance determines the key aims of the macroeconomic policy the essence of which is the maintenance of the macroeconomic stability, i.e. the existing, although rather unsteady, balance. The government will face the problem to sustain the conditions favorable for growth generation, among them the

maintenance of a stable ruble exchange rate (the prevention of its fast growth in real terms); the rationalization of the budgetary expenditures; the stimulation of exports by employing instruments of the foreign exchange and budgetary policies. However, the ability of the monetary authorities to withstand the temptation of an inflationary expansion of demand both via too low discount rates, and CBR financing of the budgetary deficit. It will be much more difficult because the foreign debt repayment at the expense of the CBR reserves will inevitably cause a noticeable growth of the money supply.

Outside the macroeconomic sphere the government should concentrate its attention on two following key aims: first, to resolutely strengthen the institutions of the state authority, to overcome the syndrome and consequences of a weak state characteristic of Russia since end-1980s. Second, it should make the investment climate in the country much better. Both these tasks are closely intertwined. A favorable investment climate can not be established under a weak state, while stronger institutions of the state authority not supported by a more intensive investment activity may result in a poor police state.

Each of these two tasks may be divided into a number of concrete actions and decisions requiring a respective normative and political substantiation.

The strengthening of the institutions of the state authority is aimed at the creation of conditions, under which their decisions will to a much lesser extent depend on the economic interest groups, and at the restoration of state agencies' ability to rely on a broader public opinion while working out the economic policy. The government undertook such an attempt in 1997; however, at that time A. Chubais and B. Nemtsov, who initiated this attempt were defeated by the united lobbyist groups. This defeat was in part prede-

terminated by the structure of elites current at that time and in part by falling world oil prices, what objectively weakened the government.

Today the objective situation is quite different. First, the August crisis resulted in a profound restructuring of the Russian elite and the collapse of once powerful financial structures claiming the title of “oligarchies.” Second, the pattern of economic interests formed after the crisis (in part due to the devaluation) is less polarized and the lobbyist potential is more evenly distributed among the sectors of the economy. Third, the state much less depends on financial structures. At least, fourth, different groups inside the political elite somewhat consolidated their positions as a result of changes mentioned above. All these developments create objective prerequisites for the new attempt to consolidate the power to bring a sustainable result.

It may be expected that the President and government will concentrate the efforts to strengthen the state along the following guidelines.

First of all, an adequate financing of the law enforcement agencies, including courts and tax agencies shall be ensured. Exactly these institutions determine the stability of the state authority framework, including the stability of the economic system. At the same time, courts and tax agencies shall become really independent of the influence of the executive authorities in contradistinction to the current situation, especially at the level of the RF subjects.

It is of principal importance to carry out a number of measures in order to strengthening the position of the federal center as regards the RF subjects. Some ambiguity of the respective sections of the Constitution shall not hinder a more precise distribution of powers and the prevention of regional authorities’ violations of the

federal legislation. Key action guidelines in these areas may be set as follows:

- to bring regional legislation in conformity with federal laws, to revise the existing regional normative acts and agreements with regions;
- to work out and approve mechanisms permitting to discharge governors if their actions are inconsistent with the Constitution;
- to strengthen the role presidential representatives play in RF subjects;
- to deregulate the economy, to weaken the capacity of regional authorities to regulate markets (first of all in terms of setting barriers hindering market access);
- to strengthen local governments, including the formation of their independent financial base.

A reform of the government service, elaboration of a special anti-corruption program and approval of a number of normative acts (including some Constitutional laws) are among other instruments suitable for strengthening the state authority.

Measures aimed at the strengthening of the state authority the same time improve the investment climate. However, there is a set of special economic measures improving the country's investment attractiveness. Among them may be both a presidential statement on the inviolability of ownership rights and the authorities' readiness to protect these rights, and measures aimed at a settlement of a number of concrete cases of ownership rights violations committed by other legal persons or labor collectives widely publicized in 1999 and 2000. It would be useful to amend the RF Civil Code (in particular Article 181).

The approval of a number of key normative acts would facilitate the creation of a better investment climate. Among them are the

Tax Code (amendments to Part 1 and the approval of Part 2), the Land Code, the Labor Code, the Civil Code (Part 3), and the Administrative Code.

The strengthening and legislative substantiation of the fiscal federalism (taking into account municipal interest), the settlement of production sharing problem; and a more transparent accounting system are in the same range of measures.

Annexes to Section 1

Annex 1. Major Financial and Budgetary Indicators

TABLE 1

	Narrow base money, Rb billion	Narrow base money growth rate	NDA, Rb billion	NIR, Rb billion	Broad money, Rb billion	Broad money growth rate	M ₀ , Rb billion	M ₀ growth rate	Commercial banks correspondent balances at CBR, Rb billion	M ₁ , Rb billion	M ₁ growth rate	M ₂ , Rb billion	M ₂ growth rate	Broad money, Rb billion	Broad money growth rate	Money multiplier (M ₂ / base money)
Jan 98	151,4	-7,96%	146,2	5,2	187,8	-10,77%	116,7	-10,62%	20,7	272,7	-8,59%	361,2	-3,45%	429,4	-6,08%	2,39
Feb 98	152,8	0,92%	149,8	3,0	185,3	-1,31%	120,3	3,07%	16,3	270,4	-0,83%	362,9	0,47%	436,4	1,61%	2,38
Mar 98	152,9	0,07%	138,8	14,1	189,3	2,17%	119,1	-0,92%	16,5	266,0	-1,62%	360,4	-0,69%	436,2	-0,04%	2,36
Apr 98	161,6	5,69%	153,3	8,3	191,8	1,29%	128,6	7,94%	15,0	269,5	1,30%	368	2,11%	444,1	1,83%	2,28
May 98	163,2	0,99%	163,0	0,2	193,9	1,12%	129,9	0,97%	15,3	271,8	0,87%	370	0,54%	449,0	1,09%	2,27
Jun 98	163,2	0,00%	154,0	9,2	193,8	-0,07%	129,8	-0,04%	12,9	270,3	-0,58%	368,6	-0,38%	447,9	-0,24%	2,26
Jul 98	161,3	-1,16%	166,6	-5,3	194,2	0,22%	129,3	-0,37%	12,5	261,6	-3,21%	360	-2,33%	437,8	-2,25%	2,23
Aug 98	161,7	0,25%	202,3	-40,6	186,4	-4,04%	133,4	3,13%	10,6	252,4	-3,52%	343,6	-4,56%	434,3	-0,80%	2,12
Sep 98	175,2	8,35%	215,3	-40,1	208,8	12,02%	154,2	15,62%	19,7	274,1	8,62%	365,8	6,46%	520,0	19,75%	2,09
Oct 98	187,2	6,85%	221,0	-33,8	227,9	9,17%	166,5	7,94%	22,5	289,2	5,50%	377,6	3,23%	521,7	0,33%	2,02

	Narrow base money, Rb billion	Narrow base money growth rate	NDA, Rb billion	NIR, Rb billion	Broad money, Rb billion	Broad money growth rate	M ₀ , Rb billion	M ₀ growth rate	Commercial banks correspondent balances at CBR, Rb billion	M ₁ , Rb billion	M ₁ growth rate	M ₂ , Rb billion	M ₂ growth rate	Broad money, Rb billion	Broad money growth rate	Money multiplier (M ₂ / base money)
Nov 98	191,3	2,19%	229,5	-38,2	238,7	4,74%	167,3	0,49%	23,8	302,8	4,71%	396,9	5,11%	552,9	5,97%	2,07
Dec 98	207,3	8,36%	249,3	-42,0	263,7	10,45%	187,8	12,30%	28,2	342,8	13,20%	448,3	12,95%	628,6	13,70%	2,16
Jan 99	202,5	-2,32%	412,2	-209,7	261,5	-0,84%	178,0	-5,23%	30,0	330,0	-3,74%	444,2	-0,91%	637,4	1,40%	2,19
Feb 99	205,2	1,33%	416,8	-211,6	270,8	3,58%	180,8	1,56%	31,3	340,3	3,14%	463,9	4,43%	658,0	3,23%	2,26
Mar 99	205,9	0,34%	423,9	-218,0	289,2	6,77%	174,1	-3,68%	35,1	344,8	1,31%	473,8	2,13%	675,3	2,63%	2,30
Apr 99	224,5	9,03%	425,5	-201,0	310,7	7,44%	195,2	12,13%	38,7	371,9	7,86%	509,6	7,56%	717,6	6,27%	2,27
May 99	241,4	7,53%	412,0	-170,6	353,1	13,66%	205,3	5,14%	51,0	404,0	8,63%	542,4	6,44%	755,5	5,27%	2,25
Jun 99	258,4	7,04%	434,8	-176,4	362,7	2,72%	216,4	5,41%	55,0	418,1	3,49%	567,7	4,66%	786,1	4,05%	2,20
Jul 99	260,3	0,74%	417,8	-157,5	364,9	0,58%	218,2	0,82%	51,8	429,4	2,71%	583,2	2,73%	792,0	0,75%	2,24
Aug 99	264,1	1,46%	415,6	-151,5	369,9	1,39%	216,2	-0,91%	46,9	432,9	0,82%	590,8	1,30%	812,7	2,62%	2,24
Sep 99	259,0	-1,93%	405,9	-146,9	364,1	-1,56%	212,8	-1,56%	54,0	431,0	-0,44%	597,4	1,12%	823,5	1,33%	2,31
Oct 99	269,1	3,90%	390,1	-121,0	384,6	5,61%	222,0	4,30%	59,4	454,3	5,42%	625,1	4,64%	866,5	5,22%	2,32
Nov 99	272,0	1,08%	380,4	-108,4	393,8	2,40%	219,3	-1,19%	54,6	471,6	3,79%	646,5	3,42%	909,8	5,00%	2,38
Dec 99	308,0	13,24%	-	-	-	-	-	-	69,6	-	-	-	-	-	-	-

Note: NDA – net domestic assets, NIR – net international reserves.

Source: RF Central Bank, RTsER

TABLE 2

	CPI (% a month)	Official ruble exchange rate (Rub/\$)	Ruble exchange rate growth (Rub/\$)	Gold and forex reserves (\$ million)	Forex reserves (\$ million)	Gold (\$ mil., at 300\$/ 1 oz. tr.)	RTS-1 index	RTS-1 growth rate (% per month)	RTS trade volume (\$ mil.)	GKO/OFZ weighted average yield (% per annum)	GKO/OFZ secondary market trade (Rb mil.)	INSTAR (overnight) (% per annum)	Real effective exchange rate (\$/Rb, Jan. 1998 = 100)
Jan 98	1,4%	6,04	0,70%	15375	10480	4895	284,35	-28,35%	1269,2	38,70%	42733,2	25,86%	100,0
Feb 98	0,9%	6,045	0,08%	15034	10212	4822	309,56	8,87%	1268,1	31,83%	65422,5	30,64%	99,2
Mar 98	0,6%	6,089	0,73%	16859	11910	4948	325,50	5,15%	1838,7	27,35%	78221,1	25,86%	99,3
Apr 98	0,4%	6,109	0,34%	15953	10957	4996	312,37	-4,03%	1236,2	29,09%	64037,6	29,45%	99,3
May 98	0,5%	6,13	0,34%	14627	9625	5002	191,29	-38,76%	1202,6	47,73%	66038,8	48,29%	99,1
Jun 98	0,1%	6,225	1,55%	16169	11161	5008	151,35	-20,88%	689,8	54,58%	74353,7	64,29%	100,5
Jul 98	0,2%	6,272	0,76%	18409	13805	4604	149,65	-1,12%	752,2	64,55%	94933,2	64,22%	101,1
Aug 98	3,7%	7,905	26,04%	12459	8198	4262	65,61	-56,16%	233,3	74,48%	26867,9	44,85%	122,9
Sep 98	38,4%	16,064	103,22%	12709	8840	3869	43,81	-33,23%	27,7	-	-	153,93%	180,4
Oct 98	4,5%	16,01	-0,34%	13572	9656	3916	57,54	31,34%	44,8	-	-	33,16%	172,0
Nov 98	5,7%	17,88	11,68%	12480	8175	4306	71,46	24,19%	60,3	-	-	22,19%	181,8
Dec 98	11,6%	20,65	15,49%	12223	7801	4422	58,93	-17,53%	43,8	-	-	30,74%	188,1
Jan 99	8,5%	22,60	9,44%	11621	7078	4543	55,12	-6,47%	26,8	65,72%	244,8	26,08%	189,7
Feb 99	4,1%	22,86	1,15%	11437	7284	4153	70,03	27,05%	102,3	71,53%	991,6	24,99%	184,4
Mar 99	2,8%	24,18	5,77%	10765	6679	4086	80,36	14,75%	186,8	63,19%	4502,4	22,78%	189,7
Apr 99	3,0%	24,23	0,21%	11168	7074	4094	91,83	14,27%	161,2	80,39%	3346,6	19,87%	184,6

	CPI (% a month)	Official ruble exchange rate (Rub/\$)	Ruble exchange rate growth (Rub/\$)	Gold and forex reserves (\$ million)	Forex reserves (\$ million)	Gold (\$ mil., at 300\$ / 1 oz. tr.)	RTS-1 index	RTS-1 growth rate (% per month)	RTS trade volume (\$ mil.)	GKO/OFZ weighted average yield (% per annum)	GKO/OFZ secondary market trade (Rb mil.)	INSTAR (overnight) (% per annum)	Real effective exchange rate (\$/Rb, Jan. 1998 = 100)
May 99	2,2%	24,44	0,87%	11937	8034	3903	97,64	6,33%	197,3	75,90%	4278,4	6,19%	182,2
Jun 99	1,9%	24,22	-0,90%	12152	8188	3964	125,65	28,69%	272,1	57,45%	8102,2	5,39%	177,1
Jul 99	2,8%	24,19	-0,12%	11921	7827	4094	116,49	-7,29%	330,2	65,79%	9224,6	9,24%	172,1
Aug 99	1,2%	24,75	2,32%	11231	6824	4407	102,50	-12,01%	184,6	69,70%	14069,7	8,69%	174,0
Sep 99	1,5%	25,08	1,33%	11212	6634	4579	83,12	-18,91%	172,6	76,26%	14643,0	18,07%	173,7
Oct 99	1,4%	26,05	3,87%	11752	7081	4671	97,80	17,66%	151,7	83,56%	25769,0	13,31%	177,9
Nov 99	1,2%	26,42	1,42%	11504	7599	3906	112,36	14,89%	264,1	81,10%	9672,6	7,14%	178,3
Dec 99	1,3%	27,00	2,20%	12456	8457	3998	177,71	58,16%	289,3	65,81%	12132,4	13,39%	179,9

Source: RF Goskomstat, RF CBR, RTS, IA «Finmarket.»

TABLE 3

Enlarged Government Budget Balance in 1997

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
REVENUE									
1. Income and profit taxes	35650,3	1,4%	142825,0	5,5%			178475,4	6,9%	18,8%
1.1. Profit tax	33144,9	1,3%	69040,5	2,7%			102185,4	3,9%	10,8%
1.2. Personal income tax	1746,9	0,1%	73370,3	2,8%			75117,2	2,9%	7,9%
1.3. Other profit or income taxes	758,5	0,0%	414,3	0,0%			1172,8	0,0%	0,1%
2. Taxes on payroll			9147,1	0,4%			9147,1	0,4%	1,0%
3. Taxes on goods and services	171356,0	6,6%	73759,5	2,8%			245115,5	9,4%	25,9%
3.1. Value added tax on goods produced on RF territory	88572,1	3,4%	53815,8	2,1%			142387,9	5,5%	15,0%
3.2. Value added tax on goods imported to RF territory	28541,8	1,1%					28541,8	1,1%	3,0%
3.3. Excises, including Oil, including gas condensate	50399,4	1,9%	12423,6	0,5%			62823,0	2,4%	6,6%
4. Property tax	582,0	0,0%	46930,4	1,8%			47512,3	1,8%	5,0%
5. Fees for use of natural resources	6999,7	0,3%	28609,7	1,1%			35609,3	1,4%	3,8%
6. Taxes on foreign trade and foreign economic operations	27815,1	1,1%	0,1	0,0%			27815,2	1,1%	2,9%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
7. Other taxes, fees and duties	1144,7	0,0%	27716,8	1,1%			28861,5	1,1%	3,0%
8. Extrabudgetary fund receipts					231675,9	8,9%	231675,9	8,9%	24,4%
8.1. Extrabudgetary social insurance fund receipts					205661,0	7,9%	205661,0	7,9%	21,7%
8.1.1. Employees					5209,4	0,2%	5209,4	0,2%	0,5%
8.2.1. Employers					200451,6	7,7%	200451,6	7,7%	21,1%
Pension Fund					145863,5	5,6%	145863,5	5,6%	15,4%
Social Insurance Fund					28270,0	1,1%	28270,0	1,1%	3,0%
Employment Fund					7985,3	0,3%	7985,3	0,3%	0,8%
Compulsory Medical Insurance Fund (CMIF) and territorial CMIFs					18332,8	0,7%	18332,8	0,7%	1,9%
8.2. Contributions to territorial road funds					26014,9	1,0%	26014,9	1,0%	2,7%
9. Other extrabudgetary funds					1091,8	0,0%	1091,8	0,0%	0,1%
10. Revenue of budgetary funds	38322,0	1,5%	5969,9	0,2%			44291,9	1,7%	4,7%
Assignments to form target budgetary funds (-)	859,6	0,0%	113,7	0,0%			973,3	0,0%	0,1%
TOTAL TAXES AND PAYMENTS	281010,2	10,8%	334844,8	12,9%	232767,7	8,9%	848622,7	32,6%	89,5%
NONTAX REVENUES									
1. Revenue from government property or activity	6746,1	0,3%	4804,5	0,2%			11550,6	0,4%	1,2%
2. Proceeds from the sale of government property	18767,7	0,7%	4542,8	0,0%			23310,5	0,9%	2,5%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
3.Proceeds from the sale of national stockpile	5341,3	0,2%					5341,3	0,2%	0,6%
4.Proceeds from the sale of land and intangible assets	13,6	0,0%	175,4	0,0%			189,0	0,0%	0,0%
5. Capital transfers from non-state sources				0,0%					
6. Administrative charges	11,2	0,0%	671,7	0,0%			683,0	0,0%	0,1%
7. Penalties and indemnity	205,4	0,0%	913,1	0,4%	7819,7	0,3%	8938,2	0,3%	0,9%
8. Revenue from foreign economic operations	8547,3	0,3%	24,3	0,0%			8571,6	0,3%	0,9%
9. Other nontax revenue	2086,0	0,1%	9978,0	0,4%			12063,9	0,5%	1,3%
10 Transfers from other levels of government	105,0	0,0%	49903,5	1,9%			x	x	x
11. Other grants			213,2	0,0%			213,2	0,0%	0,0%
12. Revenues from state-owned enterprises and organizations	0,4	0,0%					0,4	0,0%	0,0%
13. Receipts in tax agencies accounts			959,9	0,0%			959,9	0,0%	0,1%
14. Receipts from government extrabudgetary funds			7894,5	0,3%			7894,5	0,3%	0,8%
15. Other government extrabudgetary fund income					19644,2	0,8%	19644,2	0,8%	2,1%
16. Funds transferred to extrabudgetary funds					24282,6	0,9%	x	x	x

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
TOTAL NONTAX REVENUE	41824,0	1,6%	80081,0	3,1%	51746,4	2,0%	99360,3	3,8%	10,5%
TOTAL REVENUE	322834,2	12,4%	414925,8	15,9%	284514,1	10,9%	947983,0	36,4%	100,0%
EXPENDITURES									
1. Government administration	9669,3	0,4%	18899,7	0,7%			28569,1	1,1%	2,5%
2. International activities	8177,0	0,3%					8177,0	0,3%	0,7%
3. National defense	79692,1	3,1%					79692,1	3,1%	7,1%
4. Law enforcement and security	43652,3	1,7%	13755,1	0,5%			57407,4	2,2%	5,1%
5. Basic research and promotion of scientific and technological progress	9548,9	0,4%	575,4	0,0%	17,4	0,0%	10141,7	0,4%	0,9%
6. Government services to the national economy, of which:	52342,0	2,0%	166177,7	6,4%	32311,4	1,2%	250831,0	9,6%	22,4%
6.1. Industry, power engineering and construction	26563,2	1,0%	18709,3	0,7%			45272,5	1,7%	4,0%
6.2. Agriculture and fisheries	12134,0	0,5%	19219,5	0,7%			31353,6	1,2%	2,8%
6.3 Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	2500,2	0,1%	1470,0	0,1%			3970,2	0,2%	0,4%
6.4. Transportation, road maintenance, communications and information technology	3811,9	0,1%	19504,8	0,7%			23316,7	0,9%	2,1%
6.5. Market infrastructure development	678,1		498,3	0,0%			1176,4	0,0%	0,1%
6.6. Housing and utilities			105991,0	4,1%			105991,0	4,1%	9,5%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
6.7.Preventing and/or eliminating the effects of emergencies and natural disasters	6654,6	0,3%	784,7	0,0%			7439,3	0,3%	0,7%
6.8. Expenditure by territorial road funds					32311,4	1,2%	32311,4	1,2%	2,9%
7. Social services	48484,5	1,9%	205854,8	7,9%	233627,2	9,0%	465101,9	17,9%	41,5%
7.1.Education	14385,4	0,6%	94466,6	3,6%	489,1	0,0%	109341,1	4,2%	9,8%
7.2.Culture and arts	1186,3	0,0%	10934,3	0,4%			12120,6	0,5%	1,1%
7.3.Mass media	1331,2	0,1%	1830,2	0,1%			3161,5	0,1%	0,3%
7.4 Health and physical fitness	8831,7	0,3%	66251,0	2,5%	32893,1	1,3%	107975,8	4,1%	9,6%
7.4.1. Subsidies to territorial Compulsory Medical Insurance Fund (CMIF)					946,9	0,0%	x	x	x
7.5.Social policy	22749,8	0,9%	32372,7	1,2%	200245,1	7,7%	232503,0	8,9%	20,7%
Including funds transferred to Pension fund to meet the expenditure for pensions and allowances	15372,6	0,6%					x	x	x
Including funds transferred to extrabudgetary funds	927,4	0,0%	6564,6	0,3%			x	x	x
8. Public debt servicing	117800,0	4,5%					116382,0	4,5%	10,4%
Including GKO, OFZ, KO servic-	87200,0	3,4%					x	x	x

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
ing									
8.1. Servicing debt to Pension fund	1418,0	0,1%					x	x	x
9. Replenishment of government stockpile and reserves	9733,6	0,4%					9733,6	0,4%	0,9%
10. Target government budgetary funds	29113,4	1,1%	5690,8	0,2%			34804,2	1,3%	3,1%
11. Other expenditure	52771,4	2,0%	30076,7	1,2%	20977,0	0,8%	53816,6	2,1%	4,8%
11.1. Financial aid to other levels of government	49903,4	1,9%	105,0	0,0%			x	x	x
11.2. Other expenditure unattributable to other subitems	2867,9	0,1%	29971,6	1,2%			32839,6	1,3%	2,9%
TOTAL EXPENDITURE	460984,4	17,7%	441030,2	16,9%	286933,1	11,0%	1114656,6	42,8%	99,4%
CREDIT MINUS REPAYMENT	18255,2	0,7%	5885,5	0,2%	-6381,0	-0,2%	6721,9	0,3%	0,6%
1. Budgetary loans	23988,9	0,9%	5885,5	0,2%	-6381,0	-0,2%	12455,7	0,5%	1,1%
2. Government credits to CIS countries	-1884,1	-0,1%					-1884,1	-0,1%	-0,2%
3. Government loans to foreign governments	-4371,2	-0,2%					-4371,2	-0,2%	-0,4%
4. Foreign credit resources granted to enterprises and organizations	558,8	0,0%					558,8	0,0%	0,0%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
5.Credits to meet conversion requirements	-94,1	0,0%					-94,1	0,0%	0,0%
6.Credits to meet investment requirements	138,2	0,0%					138,2	0,0%	0,0%
7.Owned by CBR	-81,3	0,0%					-81,3	0,0%	0,0%
8.Owned by RF subjects' budgets to target budgetary funds									
TOTAL EXPENDITURE AND CREDIT LESS REPAYMENT	479239,6	18,4%	446915,7	17,2%	280552,1	10,8%	1121378,5	43,1%	100,0%
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-156405,4	-6,0%	-31989,9	-1,2%	3962,1	0,2%	-173395,5	-6,7%	
TOTAL FINANCING									
1.Domestic financing									
1.1.CBR credits for financing budgetary deficit	-580,9	0,0%					-580,9	0,0%	
1.2.Changes in ruble-denominated budgetary accounts in banks	-9528,8	-0,4%	-4620,6	-0,2%	-4033,2	-0,2%	-18182,5	-0,7%	
1.3.GKO, OFZ-PK, OFZ-PD	112699,1	4,3%					112699,1	4,3%	
1.4. Government savings bonds	5107,1	0,2%					5107,1	0,2%	

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
1.5. Other governmental securities	1632,6	0,1%	5602,3	0,2%			7234,9	0,3%	
1.6. Budgetary loans from upper-level budgets			17016,8	0,7%			x	x	
1.7. Other domestic borrowing	-6392,8	-0,2%	14208,6	0,5%			14196,8	0,5%	
1.8. Credits and loans to extrabudgetary funds					71,1	0,0%	71,1	0,0%	
TOTAL DOMESTIC FINANCING	102936,3	4,0%	32207,2	1,2%	-3962,1	-0,2%	120143,6	4,6%	
2. External financing									
2.1. Loans from international financial institutions	24868,1	1,0%					24868,1	1,0%	
2.2. Loans from foreign governments, foreign commercial banks and companies to RF	28601,0	1,1%					28601,0	1,1%	
2.4. Changes in forex denominated balances of budgetary accounts in banks			-217,2	0,0%			-217,2	0,0%	
TOTAL FOREIGN FINANCING	53469,1	2,1%	-217,2	0,0%			53251,8	2,0%	
TOTAL FINANCING	156405,4	6,0%	31989,9	1,2%	-3962,1	-0,2%	173395,4	6,7%	

TABLE 4

Enlarged Government Budget Balance in 1998

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
REVENUE									
1. Income and profit taxes	34974,4	1,3%	132628,9	4,9%			167603,3	6,2%	18,0%
1.1. Profit tax	34883,9	1,3%	61495,0	2,3%			96378,9	3,6%	10,3%
1.2. Personal income tax	90,5	0,0%	71134,0	2,7%			71224,4	2,7%	7,6%
2. Taxes on goods and services. License and registration fees	158455,4	5,9%	72271,8	2,7%			230727,3	8,6%	24,7%
2.1. Value added tax	104749,0	3,9%	51763,1	1,9%			156512,1	5,8%	16,8%
2.2. Excises on excisable goods and selected mineral raw materials produced on RF territory	48272,0	1,8%	15317,9	0,6%			63589,9	2,4%	6,8%
Excises on oil, including gas condensate	7373,4	0,3%		0,0%			7373,4	0,3%	0,8%
2.2. Excises on excisable goods and selected mineral raw materials imported to RF territory	4181,5	0,2%		0,0%			4181,5	0,2%	0,4%
2.3. Sales tax			755,3	0,0%			755,3	0,0%	0,1%
3. Aggregate income tax	313,0	0,0%	1024,9				1337,9	0,0%	0,1%
4. Property tax	364,8	0,0%	46529,1	1,7%			46893,9	1,7%	5,0%
5. Fees for use of natural resources	3230,5	0,1%	19044,5	0,7%			22275,1	0,8%	2,4%
6. Taxes on foreign trade and foreign economic operations	36544,4	1,4%	0,1	0,0%			36544,4	1,4%	3,9%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
7. Other taxes, fees and duties	2101,5	0,1%	36622,0	1,4%			38723,5	1,4%	4,1%
7.1.State duty	602,7	0,0%	1067,9	0,0%			1670,6	0,1%	0,2%
7.2. Other taxes	1498,8	0,1%	35554,1	1,3%			37052,9	1,4%	4,0%
8. Extrabudgetary fund receipts	0,0	0,0%			251637,6	9,4%	251637,6	9,4%	27,0%
8.1. Extrabudgetary social insurance fund receipts	0,0	0,0%			207574,6	7,7%	207574,6	7,7%	22,2%
8.1.1. Employees	0,0	0,0%			5111,7	0,2%	5111,7	0,2%	0,5%
Pension fund	0,0	0,0%			5141,5	0,2%	5141,5	0,2%	0,6%
8.2.1. Employers	0,0	0,0%			202462,9	7,5%	202462,9	7,5%	21,7%
Pension Fund	0,0	0,0%			5141,5	0,2%	5141,5	0,2%	0,6%
Social Insurance Fund	0,0	0,0%			30600,8	1,1%	30600,8	1,1%	3,3%
Employment Fund	0,0	0,0%			7857,9	0,3%	7857,9	0,3%	0,8%
Compulsory Medical Insurance Fund (CMIF) and territorial CMIFs	0,0	0,0%			20043,5	0,7%	20043,5	0,7%	2,1%
8.2. Contributions to territorial road funds	0,0	0,0%			44063,0	1,6%	44063,0	1,6%	4,7%
9. Other extrabudgetary funds	0,0	0,0%			2248,7	0,1%	2248,7	0,1%	0,2%
10. Revenue of target budgetary funds	23734,9	0,9%	17603,5	0,7%			41338,5	1,5%	4,4%
TOTAL TAXES AND PAYMENTS	259718,9	9,7%	325724,9	12,1%	253886,3	9,5%	839330,1	31,3%	89,9%
NONTAX REVENUES									
1.Revenue from government property or activity	4065,0	0,2%	9209,7	0,3%			13274,7	0,5%	1,4%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
2. Proceeds from the sale of government property	15239,5	0,6%	2293,2	0,1%			17532,7	0,7%	1,9%
3. Proceeds from the sale of national stockpile	3537,8	0,1%					3537,8	0,1%	0,4%
4. Proceeds from the sale of land and intangible assets	12,5	0,0%	265,6	0,0%			278,1	0,0%	0,0%
5. Administrative charges	111,1	0,0%	835,0	0,0%			946,1	0,0%	0,1%
6. Penalties and indemnity	251,6	0,0%	1062,3	0,0%	4713,9	0,2%	6027,8	0,2%	0,6%
7. Revenue from foreign economic operations	15435,2	0,6%	45,3	0,0%			15480,6	0,6%	1,7%
8. Other nontax revenue	1014,7	0,0%	8522,0	0,3%			9536,7	0,4%	1,0%
9. Transfers from other levels of government	0,0	0,0%	43046,5	1,6%			x	x	x
10. Other grants	0,0	0,0%	261,8	0,0%			261,8	0,0%	0,0%
11. Receipts from government extrabudgetary funds	0,0	0,0%	5222,7	0,2%			5222,7	0,2%	0,6%
12. Receipts from government organizations	3000,2	0,1%	1254,2	0,0%			4254,4	0,2%	0,5%
13. Other government extrabudgetary fund income	0,0	0,0%			18017,9	0,7%	18017,9	0,7%	1,9%
14. Funds transferred to extrabudgetary funds	0,0	0,0%			22526,3	0,8%	x	x	x
14.1. Federal budget funds	0,0	0,0%			15433,9	0,6%	x	x	x

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
14.2. Local budget funds	0,0	0,0%			7092,3	0,3%	x	x	x
TOTAL NONTAX REVENUE	42667,6	1,6%	72018,5	2,7%	45258,0	1,7%	94371,4	3,5%	10,1%
TOTAL REVENUE	302386,5	11,3%	397743,3	14,8%	299144,4	11,1%	933701,5	34,8%	100,0%
EXPENDITURES									
1. Government administration	9703,5	0,4%	20291,4	0,8%			29995,0	1,1%	2,9%
2. National defense	56704,1	2,1%					56704,1	2,1%	5,5%
2. International activities	8533,8	0,3%					8533,8	0,3%	0,8%
4. Justice	3291,8	0,1%					3291,8	0,1%	0,3%
5. Law enforcement and security	30701,9	1,1%	11885,8	0,4%			42587,8	1,6%	4,2%
6. Basic research and promotion of scientific and technological progress	5172,4	0,2%	507,3	0,0%	660,7	0,0%	6340,4	0,2%	0,6%
7. Government services to the national economy, of which:	23943,7	0,9%	141464,7	5,3%	50487,1	1,9%	215895,6	8,0%	21,1%
7.1. Industry, power engineering and construction	11328,2	0,4%	10877,3	0,4%	483,8	0,0%	22689,2	0,8%	2,2%
7.2. Agriculture and fisheries	3256,3	0,1%	16192,7	0,6%			19449,0	0,7%	1,9%
7.3. Protection of the environment and natural resources,	2052,5	0,1%	1211,8	0,0%	1444,1	0,1%	4708,3	0,2%	0,5%

	Federal budget		Local budgets		Extrabudget-ary funds		Enlarged government budget		
	Rb. bil- lion	% of GDP	Rb. bil- lion	% of GDP	Rb. billion	% of GDP	Rb. bil- lion	% of GDP	% of budget
hydrometeorology, mapping and geodetic surveying									
7.4. Transportation, road maintenance, communications and information technology	1005,7	0,0%	17452,4	0,7%			18458,2	0,7%	1,8%
7.5. Market infrastructure de- velopment	0,0	0,0%	531,7	0,0%			531,7	0,0%	0,1%
7.6. Housing and utilities	0,0	0,0%	94419,4	3,5%			94419,4	3,5%	9,2%
7.7. Preventing and/or elimi- nating the effects of emergen- cies and natural disasters	6301,0	0,2%	779,4	0,0%			7080,4	0,3%	0,7%
7.8. Expenditure by territorial road funds					48559, 3	1,8%	48559,3	1,8%	4,8%
8. Social services	57161,1	2,1%	181710,2	6,8%	225020 ,5	8,4%	463891,8	17,3%	45,4%
8.1. Education	12928,1	0,5%	84095,7	3,1%	477,2	0,0%	97500,9	3,6%	9,5%
8.2. Culture and arts	1035,1	0,0%	9099,9	0,3%			10134,9	0,4%	1,0%
8.3. Mass media	1087,9	0,0%	1749,4	0,1%			2837,3	0,1%	0,3%
8.4. Health and physical fitness	5660,1	0,2%	58725,2	2,2%	28709, 4	1,1%	93094,6	3,5%	9,1%
8.5. Social policy	36450,0	1,4%	28040,0	1,0%	195834 ,0	7,3%	260324,1	9,7%	25,5%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
9. Government debt service	106571,4	4,0%					106571,4	4,0%	10,4%
10. Target budgetary funds	23617,7	0,9%	16021,9	0,6%			39639,6	1,5%	3,9%
11. Other expenditure	54034,5	2,0%	31336,7	1,2%	15584,8	0,6%	35383,2	1,3%	3,5%
11.1. Financial aid to other levels of government	43046,5	1,6%					x	x	x
11.2. Other expenditure unattributable to other subitems	10988,0	0,4%	31336,7	1,2%	15584,8	0,6%	35383,2	1,3%	3,5%
TOTAL EXPENDITURE	379435,9	14,1%	403218,1	15,0%	291753,1	10,9%	1008834,4	37,6%	98,7%
CREDIT MINUS REPAYMENT	9490,7	0,4%	3910,6	0,1%			13276,7	0,5%	1,3%
1. Budgetary loans	-1316,0	0,0%	3910,6	0,1%			2470,0	0,1%	0,2%
2. Government credits to CIS countries	-163,1	0,0%					-163,1	0,0%	0,0%
3. Government loans to foreign governments	-8981,8	-0,3%					-8981,8	-0,3%	-0,9%
4. Foreign credit resources granted to enterprises and organizations	20035,5	0,7%					20035,5	0,7%	2,0%
5. Credits to meet conversion requirements	-40,9	0,0%					-40,9	0,0%	0,0%
6. Credits to meet investment requirements	-43,0	0,0%					-43,0	0,0%	0,0%
TOTAL EXPENDITURE AND	388926,6	14,5%	407128,7	15,2%	291753,1	10,9%	1022111,1	38,1%	100,0%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
CREDIT LESS REPAYMENT									
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-86540,1	-3,2%	-9385,4	-0,3%	7391,2	0,3%	-88409,6	-3,3%	
TOTAL FINANCING									
1.Domestic financing									
1.1. Change in bank account balances of budget funds, in rubles	-30758,3	-1,1%	413,4	0,0%	-5075,6	-0,2%	-35420,4	-1,3%	
1.3. Short-term government debt	-57012,7	-2,1%					-57012,7	-2,1%	
1.4. Federal floating rate bonds	-4762,6	-0,2%					-4762,6	-0,2%	
1.5. Non-marketable government bonds	867,7	0,0%					867,7	0,0%	
1.6. Government (municipal) securities	0,0	0,0%	-364,2	0,0%			-364,2	0,0%	
1.7. Other government securities	23,9	0,0%	0,0				23,9	0,0%	
1.8. Federal fixed rate bonds	90614,6	3,4%	0,0				90614,6	3,4%	
1.9. Budgetary loans from other-level budgets			-2434,7	-0,1%			x	x	
1.10. Government savings bonds	1533,0	0,1%	0,0				1533,0	0,1%	
1.11. Other domestic borrowing	-4152,7	-0,2%	11770,9	0,4%			7618,2	0,3%	
1.12. Credits and loans to extrabudgetary funds	0,0				-2315,7	-0,1%	-2315,7	-0,1%	
TOTAL DOMESTIC FINANCING	-3647,0	-0,1%	9385,4	0,3%	-7391,2	-0,3%	-1777,6	-0,1%	
2.External financing	0,0								
2.1.Loans from international financial institutions	12164,5	0,5%					12164,5	0,5%	

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
2.2.Foreign government loans to RF	-5429,4	-0,2%					-5429,4	-0,2%	
2.3.Loans from foreign commercial banks and companies to RF	83452,1	3,1%					83452,1	3,1%	
TOTAL FOREIGN FINANCING	90187,2	3,4%					90187,2	3,4%	
TOTAL FINANCING	86540,1	3,2%	9385,4	0,3%	-7391,2	-0,3%	88409,6	3,3%	

TABLE 5

Enlarged Government Budget Balance in 1999.

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
Indicators									
REVENUE									
1. Income, profit, and capital gain taxes	101129,2	2,3%	236016,9	5,3%			337146,1	7,5%	20,8%
1.1. Profit tax	81201,1	1,8%	139005,4	3,1%			220206,6	4,9%	13,6%
1.2. Personal income tax	19928,1	0,4%	97011,5	2,2%			116939,6	2,6%	7,2%
2. Taxes on goods and services. License and registration fees	307383,5	6,9%	111307,3	2,5%			418690,8	9,4%	25,9%
2.1. Value added tax	221031,3	4,9%	65852,4	1,5%			286883,7	6,4%	17,7%
2.2. Excises on excisable goods and selected mineral raw materials produced on RF territory	80743,7	1,8%	24204,4	0,5%			104948,1	2,3%	6,5%
Excises on oil, including gas condensate	3938,1	0,1%					3938,1	0,1%	0,2%
2.2. Excises on excisable goods and selected mineral raw materials imported to RF territory	3468,0	0,1%					3468,0	0,1%	0,2%
2.3. Sales tax			19302,8	0,4%			19302,8	0,4%	1,2%
3. Aggregate income tax	1259,1	0,0%	5677,1	0,1%			6936,3	0,2%	0,4%
4. Property tax	749,3	0,0%	51850,5	1,2%			52599,8	1,2%	3,3%
5. Fees for use of natural resources	10496,0	0,2%	34079,5	0,8%			44575,5	1,0%	2,8%
6. Taxes on foreign trade and foreign economic operations	86261,8	1,9%	0,1	0,0%			86261,9	1,9%	5,3%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
7. Other taxes, fees and duties	2228,2	0,0%	54157,5	1,2%			56385,7	1,3%	3,5%
8. Extrabudgetary fund receipts					396337,5	8,9%	396337,5	8,9%	24,5%
8.1. Extrabudgetary social insurance fund receipts					312795,0	7,0%	312795,0	7,0%	19,3%
8.1.1. Employees					7853,6	0,2%	7853,6	0,2%	0,5%
Pension fund					7853,6	0,2%	7853,6	0,2%	0,5%
8.2.1. Employers					304941,4	6,8%	304941,4	6,8%	18,8%
Pension Fund					7853,6	0,2%	7853,6	0,2%	0,5%
Social Insurance Fund					44046,9	1,0%	44046,9	1,0%	2,7%
Employment Fund					11445,3	0,3%	11445,3	0,3%	0,7%
Compulsory Medical Insurance Fund (CMIF) and territorial CMIFs					29548,9	0,7%	29548,9	0,7%	1,8%
8.2. Contributions to territorial road funds					79263,3	1,8%	79263,3	1,8%	4,9%
8.3. Other extrabudgetary funds					4279,3	0,1%	4279,3	0,1%	0,3%
9. Revenue of target budgetary funds	55183,4	1,2%	42030,4	0,9%			97213,8	2,2%	6,0%
TOTAL TAXES AND PAYMENTS	564690,6	12,6%	535119,3	12,0%	396337,5	8,9%	1496147,4	33,4%	92,5%
NONTAX REVENUES									
1. Revenue from government property or activity	6772,9	0,2%	15939,6	0,4%			22712,5	0,5%	1,4%
2. Proceeds from the sale of government property									
3. Proceeds from the sale of national stockpile									
4. Proceeds from the sale of land and intangible assets	20,2	0,0%	609,7	0,0%			629,9	0,0%	0,0%
6. Administrative charges	456,9	0,0%	1392,4	0,0%			1849,2	0,0%	0,1%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
7. Penalties and indemnity	4219,2	0,1%	1518,9	0,0%	4883,3	0,1%	10621,4	0,2%	0,7%
8. Revenue from foreign economic operations	34722,4	0,8%	17,1	0,0%			34739,5	0,8%	2,1%
9. Other nontax revenue	817,9	0,0%	16105,3	0,4%	19485,0	0,4%	36408,2	0,8%	2,2%
10. Transfers from other levels of government	9,2	0,0%	62135,3	1,4%			x	x	X
11. Other grants	0,0	0,0%	2193,2	0,0%			2193,2	0,0%	0,1%
12. Receipts from government extrabudgetary funds			10702,6	0,2%			10702,6	0,2%	0,7%
13. Revenue from government institutions	0,1	0,0%	2155,2	0,0%			2155,3	0,0%	0,1%
14. Other government extrabudgetary fund income					31829,2	0,7%	x	x	X
14.1. Federal budget funds					22367,5	0,5%	x	x	X
14.2. Local budget funds					9461,7	0,2%	x	x	X
TOTAL NONTAX REVENUE	47018,8	1,1%	112769,3	2,5%	56197,5	1,3%	122011,7	2,7%	7,5%
TOTAL REVENUE	611709,4	13,7%	647888,5	14,5%	452535,0	10,1%	1618159,1	36,2%	100,0%
EXPENDITURES									
1. Government administration	14832,4	0,3%	31688,9	0,7%			46521,3	1,0%	2,8%
2. National defense	116127,5	2,6%					116127,5	2,6%	7,1%
3. International activities	58080,3	1,3%					58080,3	1,3%	3,6%
3. Justice	4987,3	0,1%					4987,3	0,1%	0,3%
4. Law enforcement and security	55445,5	1,2%	19005,1	0,4%			74450,6	1,7%	4,6%
5. Basic research and promotion of	11196,8	0,3%	706,0	0,0%	1612,4	0,0%	13515,3	0,3%	0,8%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
scientific and technological progress									
6. Government services to the national economy, of which:	37199,9	0,8%	206687,2	4,6%	79008,7	1,8%	322869,4	7,2%	19,8%
6.1. Industry, power engineering and construction	16921,3	0,4%	14081,9	0,3%	693,7	0,0%	31696,8	0,7%	1,9%
6.2. Agriculture and fisheries	9068,0	0,2%	26700,9	0,6%			35768,9	0,8%	2,2%
6.3 Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	2894,9	0,1%	2369,1	0,1%	1444,0	0,0%	6707,9	0,1%	0,4%
6.4. Transportation, road maintenance, communications and information technology	941,6	0,0%	25126,5	0,6%			26041,7	0,6%	1,6%
6.5. Market infrastructure development			12332,6	0,3%			12332,6	0,3%	0,8%
6.6. Housing and utilities			124580,2	2,8%			124580,2	2,8%	7,6%
6.7. Preventing and/or eliminating the effects of emergencies and natural disasters	7374,2	0,2%	1496,1	0,0%			8870,2	0,2%	0,5%
6.7. Expenditure by territorial road funds					76871,1	1,7%	76871,1	1,7%	4,7%
7. Social services	85059,4	1,9%	280397,5	6,3%	322897,2	7,2%	656551,3	14,7%	40,2%
7.1. Education	20945,4	0,5%	126071,5	2,8%	576,6	0,0%	147593,5	3,3%	9,0%
7.2. Culture and arts	2876,6	0,1%	15012,6	0,3%			17889,2	0,4%	1,1%
7.3. Mass media	2000,4	0,0%	3280,6	0,1%			5281,0	0,1%	0,3%
7.4. Health and physical fitness	10141,0	0,2%	92944,0	2,1%	37626,5	0,8%	131302,3	2,9%	8,0%
7.5. Social policy	49096,0	1,1%	43088,8	1,0%	284694,0	6,4%	354485,3	7,9%	21,7%

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
8. Target budgetary funds	55275,3	1,2%	37529,9	0,8%			92805,3	2,1%	5,7%
10. Government debt service	162582,7	3,6%					162582,7	3,6%	9,9%
11. Other expenditure	76460,3	1,7%	64576,8	1,4%			78892,6	1,8%	4,8%
11.1. Financial aid to other levels of government	62135,3	1,4%	9,2	0,0%			x	x	X
11.2. Other expenditure unattributable to other subitems	14325,0	0,3%	64567,6	1,4%			78892,6	1,8%	4,8%
TOTAL EXPENDITURE	677247,5	15,1%	640591,5	14,3%	403518,3	9,0%	1627383,6	36,4%	99,6%
CREDIT MINUS REPAYMENT	-12573,7	-0,3%	8325,0	0,2%			6958,3	0,2%	0,4%
Budgetary loans	-12573,7	-0,3%	8325,0	0,2%			6958,3	0,2%	0,4%
TOTAL EXPENDITURE AND CREDIT LESS REPAYMENT	664673,8	14,8%	648916,5	14,5%	403518,3	9,0%	1634341,9	36,5%	100,0%
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-52964,4	-1,2%	-1028,0	0,0%	49016,7	1,1%	-16182,8	-0,4%	
TOTAL FINANCING									
1. Domestic financing									
1.1. Change in bank account balances of budget funds, in rubles	-48099,5	-1,1%	-8476,8	-0,2%	-19936,1	-0,4%	-76512,4	-1,7%	
1.3. Short-term government debt	-11908,2	-0,3%					-11908,2	-0,3%	
1.4. Federal floating rate bonds	-136,0	0,0%					-136,0	0,0%	
1.5. Non-marketable government bonds	54,6	0,0%					54,6	0,0%	
1.6. Government (municipal) securities			-2211,3	0,0%			-2211,3	0,0%	

	Federal budget		Local budgets		Extrabudgetary funds		Enlarged government budget		
	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	Rb. billion	% of GDP	% of budget
1.7. Other government securities	15,1	0,0%					15,1	0,0%	
1.8. Federal fixed rate bonds	52945,4	1,2%					52945,4	1,2%	
1.9. Budgetary loans from other-level budgets			-4855,5	-0,1%			x	x	
1.10. Government savings bonds	-9188,2	-0,2%					-9188,2	-0,2%	
1.11. Other domestic borrowing	21861,1	0,5%	16571,6	0,4%			38432,7	0,9%	
1.12. Credits and loans to extrabudgetary funds					-29080,7	-0,6%	-29080,7	-0,6%	
TOTAL DOMESTIC FINANCING	5544,5	0,1%	1028,0	0,0%	-49016,7	-1,1%	-31237,1	-0,7%	
2.External financing									
2.1.Loans from international financial institutions	-55613,1	-1,2%					-55613,1	-1,2%	
2.2.Foreign government loans to RF	4311,0	0,1%					4311,0	0,1%	
2.3.Loans from foreign commercial banks and companies to RF	98721,7	2,2%					98721,7	2,2%	
TOTAL FOREIGN FINANCING	47419,7	1,1%					47419,7	1,1%	
TOTAL FINANCING	52964,2	1,2%	1028,0	0,0%	-49016,7	-1,1%	16182,5	0,4%	

Annex 2. Financial Markets

Government Bond Market

Domestic Debt Market. The market for ruble-denominated government bonds (GKO-OFZ bonds) was slowly recovering through all of 1999. Regular secondary market trading in bonds maturing after December 31, 1999 resumed on January 15, 1999. Bonds issued within the framework of novation of bonds frozen in August 1998 was floated on the market on January 28. From that day on, regular trading sessions have been held five days a week. All through the year, trading was contained by a ceiling on yield to maturity equal to doubled refinancing rate of the Central Bank, or 110 per cent to 120 per cent per annum, for which reason, transactions in many, mostly long, OFZ series were invalidated, so these bonds remained actually illiquid.

Domestic Debt Restructuring Program. Under the Russian Government's Directive of December 12, 1998, Novation of Government Securities, novation (restructuring) involved government bonds maturing between August 17, 1998 and December 31, 1999 and was to go on for a period between December 15, 1998 and March 15, 1999. The novation period was then extended to April 30, 1999. Restructuring was applied to GKOs and OFZs with a total value of almost Rub. 281 billion. The share of nonresidents in these bonds amounted to 30.42 per cent.

The Russian Government divided the GKO-OFZ holders into four categories according to different debt novation conditions:

1. individuals who were residents of the Russian Federation, press periodicals, obligatory medical insurance funds, and insurance companies;
2. GKO-OFZ holders who were required to make obligatory investment in government bonds at specified rates;
3. all other investors; and

4. the Central Bank of the Russian Federation.

Special conditions were offered to the first and fourth categories. The first category was refunded for the par value of their bonds in cash within terms corresponding to the bond redemption date. Bonds held by the Central Bank did not explicitly meet the novation conditions, and their restructuring procedures were negotiated under separate arrangements between the Ministry of Finance and the Central Bank.

The remaining investors were offered new discount and coupon bonds along with repayment of a certain cash amount. In particular, a majority of investors in the third group received 3.334 per cent of the bond par value in money, 6.666 per cent in discount (GKO) bonds with maturities of three to six months, 30 per cent as zero coupon OFZs, with three-year maturities, and 70 per cent as OFZs with a fixed coupon rate of 15 per cent to 30 per cent per annum and maturities between four and six years. The second group received 10 per cent of the amount due in money, 20 per cent in GKOs, 20 per cent in zero coupon OFZs, and 50 per cent in OFZ-FD bonds.

A Rub. 170.5 billion worth of bonds was issued within the novation framework, including Rub. 15.5 billion in GKOs, Rub. 35 billion in zero coupon OFZs, and Rub. 120 billion in OFZ-FD bonds. On balance, novation slashed the total domestic debt by almost Rub. 110.5 billion (or 4.12 per cent of GDP for 1998).

GKO/OFZ Secondary Market. Figure 1 demonstrates the dynamics of average weighted GKO/OFZ yields to maturity and the trade volumes. Over the whole 1999 GKO/OFZ yields fluctuated within the band from 60 to 90 per cent per annum that corresponding to real yields at about 1.5 to 3 per cent a month. The fact that yields fell to 50 per cent per annum in March and June of 1999 may be explained by the repayment of GKOs issued in the framework of

the restructuring. Over last two or three weeks before the repayment their yields fell below 20 per cent in annualized terms, while their share in the total trade volume made over a half of all transactions on certain trading days.

On the whole, over the year the yields of government bonds was determined by political factors and the ruble exchange rate fluctuations. For instance, a prolonged period of OFZ yield growth in August through November of 1999 may be primarily explained by increasing political risks related to the war in Dagestan and Chechnya. Sudden changes in ruble exchange rate determined a sharp growth of interest rates in end-March through April of 1999.

The volume of the GKO/OFZ secondary market trade was below Rub. 15 billion in 1999 (with the exception of October when the trade volume made about Rub. 25.8 billion) that being considerably below pre-crisis levels (Rub. 60 billion to Rub. 90 billion). At the same time, over the whole year a trend toward monthly growing turnover (from Rub. 0.25 billion to Rub. 15 billion) was perceptible.

Government short-term bonds (GKO) were first floated at two auctions taking place on December 17 and 21 of 1999 after July of 1998. Five GKO tranches maturing in 110 to 330 days and totaling Rub. 12.5 billion were offered at these auctions. Since non-residents having "C" accounts with Russian banks were permitted to participate, and the Russian government announced that the securities may be freely sold on the secondary market while no limit on profit repatriation was set, the demand was high. In the end, however, only sales of three GKO series maturing in 110, 148, and 197 days (totaling to Rub. 6.5 billion) were recognized to be valid.

The recorded demand was at about Rub. 5.76 billion, while the nominal worth of bonds was at about Rub. 3.8 billion; the Finance Ministry revenue equaled about Rub. 3.73 billion. The yields of the floated tranches ranged from 0.7 to 9 per cent per annum. These low yields, however, suits non-residents as their transaction costs related to GKO sales on the secondary market (apparently, at lower prices) and Ruble conversion costs are lower than costs involved in the purchase of foreign exchange at specialized auctions (due to padded exchange rates and uncertainties concerning auctions terms and foreign exchange supply). In this situation some investors was ready to pay a premium to the Finance Ministry in order to purchase the bonds (the maximum offering price was at 104 per cent of the nominal).

Since mid-November of 1999 the trend toward falling bond yields to maturity dominated the market. In January of 2000 GKO/OFZ yields across all maturity terms declined to 20 to 55 per cent per annum. The yields of new GKO series range from -1 per cent to 10 per cent per annum.

Forex-Denominated Government Bond Market (Eurobonds and OVVZ). As Figures 2 and 3 demonstrate, over 1999 the dynamics of Russian bonds denominated in foreign exchange permit to single out four stages: 1) from the beginning of the year till April, when prices stabilized at a low level; 2) from April till July, when bond prices grew; 3) from July till mid-November, when prices stabilized at a new level and demonstrated a smooth downward trend; 4) from mid-November till end-January of 2000, when quotations grew again. A special dynamics of the OVVZ (Minfin bonds) third tranche may be explained by the fact that this series should have been repaid in May, therefore quotations reflected even small changes in investors' expectations concerning the risk of default.

Since Russia coped with making the Eurobond coupon payments in January through December of 1999, it allowed the prices of the shortest Russian securities to stabilize at levels reached in early 1999. At the same time longer-termed OVVZ continued to fall to 5 to 6 per cent of their nominal values. This decline in prices was primarily related to statements that OVVZ might be given a status similar to that of other debts of the former USSR (no servicing of these debts was included in the federal budget for 1999) made by a number of officials. Besides, the question of a long-term restructuring and a partial write-off of this debt was risen. In this situation OVVZ holders risked a default on the bonds with no payments in sight. Besides, the Brazilian financial crisis affected the dynamics of Russian bond prices in mid-January.

Quotations of the third OVVZ tranche maturing in May of 1999 demonstrated strong fluctuations: in January the prices grew by 40 per cent of the face value, while the yield to maturity of these bonds fell from 800 to 1000 per cent (in November through December of 1998) to 400 to 450 per cent per annum in foreign exchange terms. However, in February through March of 1999 the third OVVZ tranche prices fell again to 27 to 28 per cent of the nominal value; taking into account the short time remaining to the repayment (May 14) the yields exceeded 1000 per cent per annum in foreign exchange terms, while by end-March the yields made 1100 per cent in annualized terms.

Prices of Russian Eurobonds remained at practically the same level in January through April of 1999, while demonstrating a slight upward trend. US dollar denominated Eurobonds due in 2001 fluctuated in the range from 25 to 35 per cent of the nominal value and longer-termed tranches – from 20 to 30 per cent of the nominal value.

As Russia announced its plan not to repay the third OVVZ series in mid-May of 1999 aiming to restructure the debt of the former USSR once again deteriorated the government's reputation on world financial markets. On the eve of this decision the market demonstrated extremely high volatility of quotations, especially of tranches representing the restructured USSR debt (3, 4, and 5 OVVZ tranches). In April of 1999 of longer fourth, fifth, sixth, and seventh OVVZ tranches maturing respectively in May of 2003, 2008, 2006, and 2011 divided into the "Russian" and "USSR" debts. As the First Deputy Finance Minister Mikhail Kasyanov assured investors that Russia will timely repay Russian debts and make respective interest payments the quotations of the "Russian" sixth and seventh OVVZ tranches grew considerably. In April the yields of the sixth OVVZ tranche fell from 65 - 67 per cent per annum to 49 - 51 per cent per annum, while the yields of the seventh OVVZ tranche decreased from 47 - 49 per cent per annum to 37 - 39 per cent per annum. At the same time the "Soviet" OVVZ tranches demonstrated an opposite trend. At end-April the yields of the fourth OVVZ tranche was at about 110 per cent per annum, while the yields of the fifth OVVZ tranche made about 56 to 58 per cent in annualized terms.

Even in spite of the actual default on the third OVVZ series, the prices of OVVZ and Russian Eurobonds demonstrated a robust growth since end-April - early May of 1999. The rise in the quotations of the sixth and seventh series ("Russian" debt) pulled along the fourth and fifth tranches ("USSR" debt) in May. By the last 10 days in May prices almost doubled across all series. On May 14 the Russian Federation made the coupon payments for all OVVZ tranches (including the third series) totaling to about \$ 333.6 million. The resignation of the Primakov's government caused a short-term price downfall in mid-May of 1999. In June of 1999 the

prices grew even faster. By end-June all OVVZ series were quoted at 20 per cent of the nominal value, while the prices of the shortest dollar-denominated Eurobonds maturing in 2001 were up to 65 to 70 per cent of the face value.

Since mid-July of 1999 the market of Russian forex-denominated government bonds was stabilizing at a relatively higher price level. By mid-month there appeared a trend toward closer quotations across all series. Apparently, at that time OVVZ prices were primarily determined by the general evaluation of the default risks, therefore the quotations were close in spite of their terms to maturity. For instance, the prices of the "Russian" debt (the sixth and seventh OVVZ tranches) were practically equal to prices of bonds representing the "USSR" debt. The IMF stabilization loan had no apparent effect on the market trends.

In August the Finance Ministry made public the plans on restructuring the third OVVZ series not repaid on May 14, 1999. In particular, the Finance Ministry offered to restructure the third OVVZ tranche (\$ 1322 million) via replacing these securities with new bonds (forex-denominated government bonds OVGZ at \$ 650 million and fixed coupon yield ruble-denominated federal loan bonds OFZ at Rub. 17606.4 million equal to \$ 672 million). New forex-denominated bonds should mature in 2007, the coupon yield was set at the same level as across all OVVZ series at 3 per cent per annum, coupons to be repaid twice a year. The new OFZ should mature in four years, the coupon yield was planned to be paid twice a year starting on May 14, 2000, the coupon yields should be at 15 per cent in annualized terms over two first years and at 10 per cent per annum over other coupon periods. The restructuring was to begin on November 14, 1999.

Since September of 1999 the quotations of OVVZ and Eurobonds had demonstrated a downward trend. The prices of the fifth

and sixth OVVZ series (“USSR” debt) fell more than other OVVZ tranches. Beside the internal Russian factors (terrorist attacks, the war in Dagestan and Chechnya, corruption and money laundering scandals) the Eurobond and OVVZ price dynamics was negatively affected by changes in the business situation of the world financial markets. The risk of default on the Ukrainian and Ecuadorian Eurobonds intensified investors’ reluctance to purchase bonds issued by emerging and transitional economies. The negotiations with London and Paris Clubs did not encourage the owners of Russian bonds. The conversion of the major part of the former USSR debt into Eurobonds suggested by London Club may result in a new price downfall, since in this case the supply of Russian securities would much exceed the potential demand for the Russian debt. Obviously, this segment of Russian bonds is of no interest to market gamblers, while the holders are not in a hurry to sell because of persisting low prices. In fact the market is represented only by Russian operators.

However, since mid-November Russian OVVZ and Eurobonds had demonstrated a perceptible growth. At end-December of 1999 the quotations of the sixth and seventh OVVZ tranches (“Russian” debt) were back at the same level as in early August of 1998 with short-term yields at mere 16 to 20 per cent per annum. Prices of bonds defined as the “USSR” debt (the fourth and fifth OVVZ tranches) grew less; however, their yields were below 25 to 40 per cent in annualized terms. Yield on Eurobonds maturing in 2001 fell to 20 to 22 per cent per annum, while the longer-termed series yields were even less (17 to 20 per cent per annum). Apparently, at current political risks and the persisting risk of default it is the minimal yield level Russia may rely on as a sovereign borrower. Given the absence of new serious shocks (a sharp deterioration of the ruble exchange rate, a fall of oil prices, an aggravation of the con-

flict between Russia and the West over Chechnya) this level of yields will persist until the presidential elections at end-March. The investment attractiveness of Russia will depend on the results.

It shall be noted that Russian bond prices started to grow faster immediately after December 19. Obviously, investors approved of the parliamentary election results and a high demand for Russian securities persisted in spite of a sharper disagreement between Russia and the West over Chechnya, the appeals of a number of European leaders to impose economic sanctions against Russia, and the IMF decision to indefinitely delay the next tranche of the stabilization loan. The Russian bond markets were also favorably affected by B. Yeltsin's resignation, the appointment of V. Putin as the acting President, and the early election set in March of 2000.

Stock Market in 1999

In 1999 the Russian stock market was again among the most quickly growing world markets. By end-year RTS Index grew from 58.93 to 175.26 points, therefore the Index grew by 197.42 per cent over the year. At the same time this increase in Russian stock quotations shall be reviewed in relation to their dynamics in 1996 through 1998. The growth of the stock market observed from March of 1996 through October of 1997 resulted from lowering political risks and the macroeconomic stabilization. The following fall of quotations occurring over the period from October of 1997 through August of 1998 related to aggravating crisis processes in the economic and financial sphere was an indicator of increasing risks on the eve of August of 1998. In 1997, in the situation of the emerging global financial crisis RTS-1 Index grew from 200.5 to 396.86 points (by 97.94 per cent, see Figure 4).

In fact, the Russian stock market degraded over 1998. Market operators getting accustomed to high yields on investment in the Russian stock market in 1997 were strongly affected by emerging market investment risks. By end-year the Russian stock market demonstrated the most profound stock index downfall in the world. The deteriorating economic and political situation in the country resulted in stock prices plummeting already in early 1998 (see Figure 4). The prices continued to fall until October (except of some short interruptions). RTS-1 Index stabilized at 50 to 60 points that being an extremely low level as compared with values of 1997. Therefore, in autumn of 1998 the prices of Russian stocks were back at the levels registered in late 1995 through early 1996. On the whole, in 1998 RTS-1 Index was down from 396.86 to 58.93. The index fell by 85.15 per cent in the annualized terms.

Lower investment attractiveness of the Russian stock market affected the turnover of the leading stock exchange (Russian Trading System). For instance, total trade volumes in 1998 and 1999 were considerably below 1997 levels (see Table 1).

TABLE 1

	RTS Index	Change in RTS Index (% a year)	Total RTS trade volume (\$ billion)	Change in total RTS trade volume (% a year)
1995	82,92	-	-	-
1996	200,50	141,80%	2,946	-
1997	396,86	97,94%	14,022	375,9%
1998	58,93	-85,15%	8,659	-38,2%
1999	175,26	197,42%	2,335	-73,0%

The developments on the Russian stock market over 1999 may be divided in three periods: from the year beginning till mid-July; from mid-July till mid-September; from mid-September to end-year (see Figure 6). The first period characterized by low prices was registered early in the year. In the second half of January RTS Index fluctuated at 54 to 57 points. The price level on the Russian stock market fell by about 90 per cent as compared with the maximum RTS Index value registered on August 11, 1997 (569.06 points).

The second important point in time is the local maximum (147.37 points) registered on July 8, 1999. This price level was below RTS Index on August of 1997 by only 74 per cent. A similar price level was last registered in early August of 1998 (see Figure 6).

The third moment is the local minimum (75.43 points), which occurred on September 21, 1999. At that time RTS Index was below its value on July 8, 1999 by about 28 per cent.

The fourth point in time is end-1999. On January 31, 1999, the RTS Index value (175.26 points) was by 69.2 per cent lower than on August 11, 1997. As compared with the local minimum on September 21, 1999, RTS Index was up by 132 per cent by end-year (see Figure 6).

The first period: from the year beginning till mid-July. Over this period RTS Index grew from 59.39 (December 31, 1998) to 147.37 points (July 8, 1999), i.e. by 148.14 per cent. Figure 5 demonstrates changes in prices of most liquid Russian stocks, some of which being rather profound.

In December of 1998 through January of 1999 the Russian stock market remained extremely sluggish. RTS turnover continued to decrease. In December RTS-1 Index diminished from 71.46 to 58.93 points, i.e. by 17.54 per cent. In January of 1999 the downfall

continued: the index decreased from 58.93 to 55.12 points. In other words, it fell by 6.46 per cent (see Figure 6).

Among the key factors behind risk shifts on the Russian stock market in January of 1999 were the following: first, the IMF position in regard of further lending to Russia. Although the State Duma was quick to approve the 1999 budget law, the IMF leadership was cautious about credits having found budgetary targets unrealistic. Second, it was a new development in the course of the global financial crisis (this time in Brazil). Apprehensions of the Russian-type crisis to be repeated on other emerging markets made investors to take a more cautious approach to such markets and to withdraw capitals from a country when noticing first dangerous signs. In January the Brazilian Central Bank had to abolish the foreign exchange corridor due to massive sales of Brazilian securities and conversion of real-denominated capitals into more reliable foreign exchange. A 30 per cent devaluation of real followed immediately. The devaluation of Brazilian currency resulted in a sharp volatility on the Brazilian and other financial markets. The stocks of banks and investment companies operating in short-time forex-denominated derivatives on the Brazilian market were most affected. At the same time shares in exporting companies being a leading segment of the Brazilian market sharply rose and pulling along aggregate Bovespa stock index (see Table 2).

After a three month slack period of the stock market investors demonstrated growing interest in Russian securities in February of 1999. Over the month RTS Index rose from 55.12 to 70.03 points. So, RTS Index grew by 27.06 per cent in February and by 18.85 per cent over two first months of 1999 (see Figure 6).

A hike in demand for Russian stocks resulted in growing RTS turnover. For instance, in December of 1998 the turnover was at \$ 43.58 million, in January of 1999 it declined to \$ 26.78 million, and

in February of 1999 rose over \$ 102.3 million. In February the amount of RTS transactions was over December of 1998 and January of 1999 levels by almost 1.5 times. Last time similar business activity was registered in August of 1998.

TABLE 2

	Jan 1999	Feb 1999	Mar 1999	Apr 1999	May 1999	Jun 1999	Jul 1999
Dow Jones (USA)	1,93%	-0,56%	5,15%	10,25%	-2,13%	3,89%	-2,88%
Bovespa (Brazil)	25,55%	4,63%	20,03%	5,96%	-3,50%	6,31%	-10,19%
IPC (Mexico)	-0,04%	7,65%	15,71%	12,10%	-1,18%	6,73%	-9,76%
Nikkei-225 (Japan)	4,75%	-0,91%	10,22%	5,46%	-3,53%	8,80%	1,89%
DAX-30 (Germany)	3,15%	-4,81%	-0,56%	10,42%	-5,99%	6,09%	-5,14%
CAC-40 (France)	7,84%	-3,74%	2,56%	4,94%	-1,23%	4,26%	-3,41%
	Aug 1999	Sep 1999	Oct 1999	Nov 1999	Dec 1999	Jan 2000	Feb 2000
Dow Jones (USA)	1,63%	-4,55%	3,80%	1,38%	5,58%	-4,74%	-9,86%
Bovespa (Brazil)	1,18%	5,12%	5,35%	17,67%	21,83%	-2,29%	8,53%
IPC (Mexico)	-1,97%	-2,06%	7,92%	12,59%	16,06%	-7,33%	10,67%
Nikkei-225 (Japan)	-2,38%	0,97%	1,91%	3,43%	1,36%	3,88%	1,42%
DAX-30 (Germany)	3,31%	-2,29%	7,29%	6,71%	16,34%	-0,35%	13,21%
CAC-40 (France)	4,73%	0,05%	6,47%	9,27%	9,29%	-3,05%	9,34%

A major factor behind the developments on the Russian stock market in February of 1999 was the speculative tone demonstrated by a number of domestic and foreign market operators on the eve of the Finance Ministry tentative decision to use Russian stocks in the restructuring of the debt on government bonds to non-residents.

As concerns the dependence of RTS Index behavior on international stock markets, an interesting fact is that in February the domestic stock index rose against the background of a downward dynamics registered for the leading international indices (see Table 2).

In March RTS-1 Index was up from 70.03 to 80.36 points, or by 14.74 per cent. In April of 1999 it grew from 80.36 to 91.83 points, or by 14.3 per cent. A characteristic feature of April was several U-turns registered for the dynamics of most liquid stocks. After RTS-1 reached the local maximum (91.11 points) on March 17, 1999, quotations steadily fell until April 9 (the minimum of the month being 66.43 points). Later the price dynamics showed an upward trend again and index was at 90 points by end-month.

The persistent growth of oil and oil product prices on world markets was a factor affecting the Russian stock market in April of 1999. By end-April prices of futures contracts for Brent oil to be delivered in June were up to \$ 15.69 per barrel. Russian Urals price increased to \$ 14.34 per barrel. Last time such price level was observed in January through February of 1998 (see Figure 7). The oil price hike had revived investors' interest in large Russian oil companies, especially LUKoil and Surgutneftegaz.

Another factor behind these developments was growing indices of the majority of foreign stock markets (see Table 2). For instance, Dow Jones Industrial Average was at record heights over the whole April having reached 10845.45 points by end-month (see Figure 8). Over the month it grew by 10.8 per cent. Meanwhile, investors changed the attitude toward emerging markets. In April Brazil was able to place a loan amounting to \$ 2 billion that being a signal of improving situation on emerging markets at large.

In May of 1999 the dynamics of Russian bonds was mainly determined by the political crisis in the country. Quotations grew only in the very beginning of the month driven by the preliminary agreement between the Russian government and IMF about a loan at about \$ 4.5 billion to be granted over two and a half years. Since April 26 till May 6 RTS-1 Index grew from 83.92 to 104.67 points, i.e. by 25 per cent (see Figure 6).

On May 12 the RF President dismissed Ye. Primakov as Prime Minister. The parliamentary hearings on the impeachment of the President initiated on May 13 aggravated the risk of further destabilization in Russia. The stock market responded by a fall in quotations. RTS-1 Index declined to 77 to 83 points, i.e. by about 20 to 26 per cent.

The State Duma failure to impeach the President allowed investors to expect a price growth at the expense of the premium as the political risk was avoided. On Monday, May 17, RTS-1 Index grew to 90 to 92 points. Since mid-May of 1999 quotations slightly fluctuated. By end-month RTS-1 Index was at 97 to 100 points. The overall increase was about 6 to 9 per cent over the month.

On the whole, since early in 1999 till end-May RTS-1 Index grew by 69.7 per cent. The increasing RTS turnover was an evidence that investors showed more interest in this market. While in December of 1998 the total amount of RTS transactions was at about \$ 43.6 million, in January of 1999 it made \$ 26.78 million, and in May this indicator was above \$ 197.2 million.

In June of 1999 Russian stock quotations surged. After a lull in the second half of May (RTS-1 Index fluctuated within 98 to 101 points) the situation on the market changed sharply in June (see Figure 6). RTS-1 Index rose from 100 to 130 points over the period from June 7 to June 22. During this period stocks grew at about 2.2 per cent a day. However, by June 29 the index was down at 122 to 123 points after a certain adjustment of quotations.

Among key factors behind the developments on the Russian stock market in June of 1999 are the following: first, a certain progress achieved during the negotiations between the RF government and IMF. S. Stepashin and M. Camdessus made statements confirming the intention of both parties to work further on the loan program for Russia during a meeting having place in St. Petersburg in early June. Second, in the second half of June in New York Russian Finance Minister M.

Kasyanov succeed in concluding a preliminary agreement with largest Western creditors about the restructuring of the former USSR debt. It somewhat improved the market tune; portfolio investors turned their attention to the stock market even in spite of the fact that Fitch IBCA changed the rating of IAN bonds (the converted Russian debt to London Club) from “CC” to “DD.” Third, since June 23 foreign investors were granted the right to purchase shares in Russian companies at the expense of GKO/OFZ payments. Besides, non-residents could now take part in primary placements of corporate stocks and purchase such stocks on the secondary market (MICEX).

Fourth, annual meetings of “EES Russii,” “Gazprom,” “LUKoil,” “Rostelekom,” “Tatneft,” “Aeroflot,” etc. stockholders took place at end-June. On the eve of these events the market demonstrated a growing speculative demand for stocks in these companies. Fifth, world oil prices declining over the whole May reversed the trend in June (see Figure 7). Sixth, the majority of leading world stock markets showed rising indices in June (see Table 2). Against this background Dow Jones Industrial Average demonstrated some interesting fluctuations (see Figure 8). To a certain extent its fluctuations were related to uncertainties concerning the expectations of US Federal Reserve System (FRS) to rise interest rates in order to curb inflation. Later on in 1999 and early in 2000 US and European market operated in the situation of looming risks of higher interest rates due to higher inflation.

Second period: from mid-July to mid-September of 1999. Over the whole second period the Russian stock market was in a rather pessimistic vein. Much higher risks existing over the second half of the summer affected the dynamics of Russian blue chips (see Figure 9). Over this period RTS Index fell from 147.37 points (on July 8) to 80.54 points (on September 20), i.e. by 45.35 per cent.

In July of 1999 the Russian stock market demonstrated a rather high volatility of quotations. A fast growth of RTS Index started in early June continued into two first weeks of July of 1999 (see Figure 6). From July 1 till July 8 RTS Index rose from 125.65 to 147.37 points, or by 17.3 per cent. However, later the market tone reversed. Over next days stock prices fell. From July 9 till 28 RTS Index declined from 147.37 to 123.66 points, i.e. by about 16 per cent. Over July RTS Index was down from 125.65 points to 116.49 points, or by 7.29 per cent.

The next stage of emerging political crisis determined quotation dynamics on the Russian stock market in August of 1999. However, the Prime Minister resignation was only an auxiliary factor as prices moved downward since July 8 of 1999 (see Figure 6). From July 8 to August 6 RTS Index (at closing prices) declined from 147.37 to 103.15 points, i.e. by 30 per cent. On August 9 the stock market responded to S. Stepashin resignation rather moderately. RTS Index grew from 91.59 to 101.72 points over August 9. On the first trading day after the government crisis the market could practically compensate its earlier 11 per cent fall. Over the whole August of 1999 RTS Index declined from 116.49 to 102.19 points, or by 12.28 per cent.

In opening days of August IMF announced its concern about incorrect information on Russia's gold and forex reserves provided earlier by the government and CBR and the activities of offshore company Fimaco. The scandalous allegations about mishandling of funds IMF loaned to Russia appearing in foreign mass media in the second half of August were among factors causing a delay of decision on the second tranche of IMF credit amounting to \$ 640 million.

The announcement made by Export and Import Bank of Japan about its intention to transfer first \$ 700 million out of a \$ 1.5 bil-

lion credit to Russia was an encouraging sign against the background of other developments.

On August 11, 1999, D. Vasiliev, Chairman of FKTSB (Federal Commission on Securities) signed directive "On Establishing the FCS Commission for Reviewing Cases of Violation of the Legislation of the Russian Federation on Protection of the Rights and Legal Interests of Investors on the Stock Market." Undoubtedly, in stable economic conditions this decision would be very significant. However, in August of 1999 negative factors dominated the Russian stock market.

World oil price were rather high in August. Between August 4 to August 30 the price of Dated Brent oil grew from \$ 19.13 per barrel to \$ 20.62 per barrel. Between August 3 to August 27 the price for the Russian Urals oil (c.i.f. Mediterranean ports) grew from \$ 18.82 per barrel to \$ 19.91 per barrel.

On August 24, 1999, the US Federal Reserve increased the discount rate by 0.25 percentage points to the level of 5.25% in annualized terms. Although investors expected this decision, the mere fact of the increase of the discount rate has led to some redistribution of investors' assets at the expense of developing markets. In addition, the outflow of assets from emerging markets was related to the risk of default on external debt in Ecuador and Ukraine.

From mid-August to September of 1999 prices continued to drop on the Russian stock market (see Figure 6). Unsuccessful negotiations between the Russian government and its foreign creditors, the intensification of the domestic problems, plus negative fluctuations on international financial markets led to a further fall in quotations of the Russian stocks against a background of a low level of trade volumes. In September of 1999 the RTS Index dropped from 102.19 to 83.12 points, i.e. by 18.67%.

In September 1999, the most important factors behind the change in quotations were the terrorist attacks in Moscow and other cities.

These attacks facilitated expectations of introducing of the state of emergency in the country, and the general toughening of the political and economic regimes. Though the threat of terrorism did not influence the policy of the Government and the Central Bank of Russia directly, all these developments contributed to the deterioration of Russia's attractiveness as a place suitable for carrying out investment projects. Military operations continued in Dagestan and near the Chechen border. Although the official attitude the authorities of leading Western countries to the situation in Russia remained neutral, the military operations negatively affected the general political and economic situation in the country. The Russian stock market was seriously affected by the conflict over corporate governance at "Transneft" company. A legally doubtful procedure applied to replace the company's President once again demonstrated that ownership rights in Russia remain unprotected. In spite of the fact that the government owned all voting stocks in "Transneft" this action circumventing the stipulations of Federal Law "On Joint-Stock Companies" might be easily seen as a negative precedent.

According to the OPEC expert group estimates, this trend should persist at least till spring of 2000, oil prices reaching about \$ 27 per barrel by that time. The forecast was favorable for Russian oil companies in spite of the fact that V. Putin signed a decree fixing export duties at the maximal rate of 10 ecu per metric ton.

In September of 1999 the situation on largest stock and emerging markets somewhat deteriorated . During the month the majority of main stock indices of the developed countries (Dow Jones Industrial Average, DAX-30, CAC-40) fell somewhat (see Table 2). At the same time, a number of emerging markets (e.g. Brazil) demonstrated growth in stock prices.

The most appreciable drop was experienced by the US stock market. The Dow Jones Industrial Average Index fell by about 10% as

compared with a maximum registered in mid-August 1999 (see Figure 8). The intensifying capital outflow from the USA to Japan might be a factor behind this development. The exchange rate of yen to US dollar reached the maximal value for the last three years (105 yen/dollar); however, the risk of a further yen strengthening persisted. Moreover, in the wake of the decision made by the US Federal Reserve, the Bank of England increased the discount rate by 0.25 percentage points, to the level of 5.25% per annum.

Third period: from end-September till end-1999. Over the last ten days of September the price trend demonstrated by the Russian stock market reversed. Quotations rose until end-1999 with some minor interruptions. Over the third period RTS Index grew from 80.54 (on September 20) to 177.71 points (on December 31), i.e. by 120.65 per cent. A vigorous growth was demonstrated by most liquid Russian stocks (see Figure 10).

In October of 1999, in spite of an ambiguous influence of a number of factors, prices of Russian stocks grew somewhat. Prior to this, from September 10 to September 30, RTS Index dropped from 103.84 to 83.12 points, i.e. by 19% (see Table3). This fall resulted from both external (downfall in the major international stock indices) and domestic reasons (continuing operations in Chechnya, a lack of real results in the negotiations between the Russian Government and foreign creditors represented by the Paris and London Clubs).

Since early October a rather rapid growth in quotations had begun at the Russian stock market. From October 1 till October 14 RTS Index grew from 83.12 to 100.31 points, i.e. by 20.69 per cent. As soon as the RTS index reached this level, its growth stopped. During the second half of October RTS Index ranged between 95 to 98 points (see Figure 6). On the whole, RTS Index grew from 83.12 to 97.8 points over October.

In October of 1999 international oil prices slightly dropped. In particular, from October 1 till October 28 the price of Dated Brent fell from \$ 22.98 to \$ 21.49 per barrel, i.e. by 6.48 per cent. This price correction in October, on the eve of the meeting of the OPEC members in Riyadh scheduled for November 17, 1999, did not result in a drop in the demand for Russian oil stocks, because the current level of international oil prices was still quite high.

Following the dramatic developments in September of 1999, the situation on developed and emerging stock markets began to improve in October. During the month the majority of main stock indices of the developed countries grew slowly (see Table 2). The Dow Jones Industrial Average Index, which dropped by 4.54% in September, in October grew by 3.80 per cent (see Figure 8).

The United States experienced a price drop in both stocks and Treasury bonds. By late October the yield to maturity of 30-years Treasury bonds reached the level of 6.37 per cent per annum. The growing risk of a further drop in prices of assets in the USA and other developed countries to some extent resulted from the uncertainty with respect to the FRS discount rate policy. According to a number of investors the factors behind this development were an extremely low unemployment level coupled with increasing consumer demand resulting in increasing risk of higher inflation rates. In case the discount rate were raised in the USA, it would be natural to expect similar steps on the part of European central banks resulting in a considerable redistribution of investors' assets at the expense of emerging markets.

In November of 1999 RTS Index grew from 97.80 to 112.36, i.e. by 14.89 per cent. The level Russian stock prices reached by end-November corresponds to the level registered in July of 1999. It is necessary to note that the growth in the stock index since the beginning of 1999 made about 90 per cent (see Figure 6).

The November situation at the Russian stock market was strongly affected by the OSCE summit in Istanbul. The Russian President took rather a tough position on Chechnya. The fact that the Russian leader attended the summit in person had impressed investors. However, the negative stand Western leaders took on the military operations in Chechnya deteriorated Russia's prospects for resumed lending from international financial organizations. Since mid-November investors expected IMF to make some announcement on the date next tranche of the loan would be granted. However, at the next round of negotiations IMF put forward new conditions concerning tax collection (in particular, taxes on natural monopolies), an independent audit of Sberbank and extra-budgetary funds, the banking system restructuring, the introduction of international accounting standards at Russian commercial banks. At the same time, the parties stressed positive shifts in the macroeconomic situation. The majority of investors anticipated the news as an evidence of IMF prompt decision on granting the loan. However, by late-November, the political pressure on IMF related to Chechnya increased that making the prospects of the next tranche more vague.

In spite of above mentioned problems, in November of 1999 the OVVZ market and the market of Russian Eurobonds demonstrated a significant growth in quotations (OVVZ prices grew by 35 to 40 per cent, while Eurobonds rose by 10 per cent). The growing interest of investors in this segment of the market improved the situation on the Russian stock market.

In November of 1999 the situation on international financial markets was mostly determined by decisions of the Central Banks of England, Europe and the US Federal Reserve. The Federal Reserve increased its discount rate; however this time the Central Banks of England and Europe were the first to increase their discount rates. On November 4, the Bank of England increased the

discount rate by 0.25 percentage points, up to 5.5 per cent. On the same day the Bank of Europe decided to increase the discount rate by 0.5 percentage points, up to 3 per cent, effective as of November 10. On November 16, the Federal Reserve increased the discount rate from 4.75 per cent to 5 per cent. All these decisions were made due to the same reason: the expectation of intensification of inflation processes. At the same time, it shall be noted that the steps of all Central Banks were coordinated in time that permitting to avoid a serious shock on stock markets.

In December of 1999 the Russian stock market demonstrated a sharp growth in quotations. The level Russian stock prices reached in late December corresponded to the maximal level registered in 1999. Such a price level was observed on the market only twice: in early July 1999 and in late July 1998 (see Figure 6). In December of 1999 RTS Index grew from 112.36 to 175.26 points, i.e. by 58.16 per cent. However, it shall be noted that on December 30 the index was at mere 150 points, or rose by 33.5 per cent since early in the month. Therefore, the growth from 150 to 175 points demonstrated by RTS Index on December 31 is rather a technical effect. On the whole, in 1999 RTS Index grew by about 197.42 per cent.

The State Duma elections outcome was more favorable from the view point of declining risks in the Russian economy than it was expected by investors. It is apparent that the presence of the strong pro-government group in the State Duma increases chances of passing the economic legislative package to be elaborated by the Government in 2000-2003. On the other hand, the election results showed that the Prime Minister's authority grew significantly during last months. This fact lowers the risk of unfavorable shifts in the economic and institutional policy related to the possible victory of Communists at the 2000 President Election.

In early January of 2000 the Russian stock market demonstrated a sharp growth in quotations. The level reached by the Russian stock prices in mid-January was last time observed in July of 1998 (see Figure 6). However, in late January the considerable correction in quotations took place on the market. The growth in stock prices, which continued during the last four months, was undoubtedly speculative. At the same time it shall be noted that a significant growth in the foreign capital inflow testifies to the falling level of risks in the Russian economy.

In January of 2000 the activity of the Russian investors grew significantly due to the arrival of a number of foreign portfolio investors on the market. In January the total RTS turnover made about \$ 489.2 million. Thus, in the last month the total turnover was by 71.4 per cent above the respective index value registered in December of 1999 and by 157.8 per cent exceeded the average monthly RTS turnover registered in 1999 (\$ 189.8 million).

The resignation of Boris Yeltsin on December 31, 1999, was likely the main political event in the end of 1999. The transfer of powers to the acting President V. Putin in compliance with the Constitution stabilized the internal political situation in the country, while the rating of Prime-Minister sky-rocketed demonstrating that V. Putin had a good chance to be elected the President in late-March. The re-scheduling of the presidential elections on March 26, 2000, undoubtedly increased Putin's chances. The appointment of M. Kasyanov as the only one First Deputy Prime-Minister became an additional factor, which increased the attractiveness of the Russian stocks market. The latter was due to the fact that the then Finance Minister had already become well-known to largest foreign investors.

However, market operators considered the situation in the State Duma to be ambiguous. On the one hand, the present composition

of the State Duma promises to be more co-operative towards the government than expected prior to the elections due to a high share of MPs representing the 'Unity' block and the Union of Right-Wing Forces. On the other hand, only a few experts had supposed that the pro-government factions 'Unity' and 'People's Deputy' would collaborate with the Communist Party and the Rural Party on crucial issues. The conflict between large and small factions on the issue of electing the Speaker of the House and the assignment of posts of the Duma's Committee Heads was a crucial factor driving quotations of Russian stocks down.

On January 6, 2000, the international rating agency Moody's Investor Service increased its rating of the Russian long-term ruble-denominated borrowings from **Ca** to **Caa2**. The forecast of its rating of the Russian long-term forex-denominated currency borrowings **B3** was also risen from negative to stable. Among the reasons explaining that fact, the agency singled out the improvement of the general economic situation in 1999 and growing tax revenues.

At the same time, declining political risks and some positive macroeconomic trends did not suffice to improve the rating of Russian forex-denominated securities (**CCC**) and ruble-denominated bonds (restructured GKO-OFZ) (**CCC**) registered by another largest rating agency, Standard & Poor's.

After the Christmas holidays a number of key stock markets demonstrated a sharp drop in quotations. Renewed investors' expectations of a further increase in the discount rate of the US Federal Reserve on February 1 or 2 led to the growth in the US treasury bond yields. In particular, in early January the yield to maturity of 30-year US treasury bonds grew up to 6.62 per cent per annum. At the same time, prices of stocks on US markets dropped (see Figure 8). On January 4, 2000, the Dow Jones Industrial Average Index fell from 11357,51 to 10997,93 points, i.e. by 3.17 per cent. Such a sharp drop in

quotations was observed on the US market as far back as in autumn of 1998. Similar problems troubled investors in Western Europe. In anticipation of higher inflation rates the Bank of England increased its interest rate from 5.5 per cent to 5.75 per cent. In January stock prices dropped in the United Kingdom and in France (see Table 2).

Recently the volatility rate at the major stock markets had grown. This development made investors look for alternative ways of portfolio investments. It shall be noted that investors' interest in emerging markets included Russia as the level of political risks in Russia fell significantly in early 2000. Moreover, a progress in negotiations between the Russian government and international financial organizations is to be expected.

In January through February of 2000 the Russian stock market demonstrated rather sharp fluctuations of quotations. A number of opposing factors resulted in the absence of a stable trend in stock price dynamics. During the first half of February RTS Index was growing and on February 9 it was at 196.64 points. Nevertheless, in the second half of February there occurred a price correction. On the whole, over February RTS Index dropped from 172.31 to 170.93 points, i.e. only by 0.8 per cent (see Table 3).

On the eve of the presidential elections investors intensified their speculative operations that being proved by a sharp growth in turnovers at the leading stock exchanges. Nevertheless, the uncertainty of foreign investors about two key problems persisted affecting the market situation. The first problem was whether the future Russian President maintains the course towards the market reforms, and whether he is in favor of protecting investors' rights. The second problem implied a high risk of the deterioration of relations between Russia and developed countries, particularly in the light of ongoing military operations in Chechnya.

In the first half of February the Russian Government and the London Club of creditors reached the agreement to write off 36.5 per cent of the total former USSR debt and to accomplish the restructuring of the remaining balance (for details see the section on the government securities market). Despite of the fact that investors consider the results of the negotiations ambiguously, the settlement of the debt problem between Russia and the largest private creditors made the chances for the renewal of the IMF lending higher. Moreover, the concrete parameters of the write-off and restructuring of the debt allow Russia to improve its standing at the negotiations between the government and the Paris Club of creditors scheduled for autumn of 2000. Thus, the Government's policy aimed at withdrawing Russia out of default on its foreign debt should facilitate the regaining of investors' confidence in Russian financial markets and the country's comeback to international capital markets.

The agreement between the Russian government and the London Club has encouraged Standard & Poor's to increase the rating of Russian Eurobonds and OVVZ from CCC to CCC+ (equal to Indonesia rating). Nevertheless, the improvement of the country's credibility practically did not change the Russian financial markets' investment attractiveness, because, according to Standard & Poors ratings, Russia is above only the Dominican Republic (SD).

In February of 2000 international oil prices continued to grow. From January 31 till February 28 prices of futures contracts for Brent oil to be delivered in March of 2000 at the NYMEX grew from \$ 26.84 to \$ 28.47 per barrel, i.e. by 6.1 per cent. Thus, since March of 1999 when the OPEC countries decided to introduce restrictions on oil production and sales, the international oil prices almost tripled. Although the OPEC member countries softened their constraints in March of 2000, the high international demand for oil resulting from the exhaust-

ed world oil reserves (due to the severe winter) rises no expectations of a sharp drop in oil prices during the nearest months.

In late February the favorable situation on international oil market allowed the Russian government to increase the export duty from 15 to 20 euro per metric ton on oil and from 10 to 15 euro per metric ton on diesel fuel effective in mid-April of 2000. Thus, investors regard the growth in oil prices both as a factor that increase the Russian oil companies' investment attractiveness and as a favorable precondition for an improvement of the situation in the sphere of budget revenues.

TABLE 3

	RTS Index at end-month	Change in RTS Index (% a year)	Total RTS trade volume (\$ billion)	Change in total RTS trade volume (% a year)
December 1998	58,93	-17,54%	43,58	-27,77%
January 1999	55,12	-6,46%	26,78	-38,55%
February 1999	70,03	27,06%	102,31	282,00%
March 1999	80,36	14,74%	186,82	82,61%
April 1999	91,83	14,27%	161,23	-13,70%
May 1999	97,64	6,33%	197,27	22,35%
June 1999	125,65	28,68%	272,13	37,95%
July 1999	116,49	-7,29%	330,25	21,36%
August 1999	102,19	-12,28%	177,09	-46,38%
September 1999	83,12	-18,66%	122,50	-30,82%
October 1999	97,80	17,66%	151,69	23,82%
November 1999	112,36	14,89%	264,10	74,11%
December 1999	177,71	58,16%	285,45	8,08%
January 2000	172,31	-3,04%	489,51	71,49%
February 2000	170,93	-0,80%	441,48	-9,81%

Annex 3. GDP End Use

Major shifts in GDP utilization were affected by the trend toward an increase in the share of net exports. The GDP utilization pattern has been changing dramatically since the third quarter of 1998 influenced by the financial crisis. According to preliminary estimates, the share of exports in the total amount of the final product increased by 8.8 percentage points as compared with 1998 figures, while the share of imports stabilized. A steady growth of the active balance of trade was registered over the year. As per the Ministry of Economy estimates, the active balance of trade was at Rub. 759.7 billion (16.3 per cent of GDP) as evaluated in terms of internal prices.

TABLE 1

GDP by End Use (current prices, % of the total)

	1992	1993	1994	1995	1996	1997	1998	1999
Gross Domestic Product, including:	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Expenditure for end consumption	49,9	64,2	69,6	71,2	71,4	74,2	77,1	68,6
Households	33,7	40,9	44,1	49,3	48,8	50,6	54,4	51,1
Government	14,3	17,9	22,5	19,5	20,2	21,4	19,2	14,8
Non-profit organizations	1,9	5,4	3,0	2,4	2,4	2,2	3,5	2,7
Gross accumulation	35,7	27,8	25,8	25,3	24,5	22,9	15,4	15,1
Gross capital accumulation	24,7	21,0	22,0	21,2	21,1	19,3	17,5	14,8
Change in stock of tangible floating assets	11,0	6,8	3,8	4,1	3,4	3,6	-2,1	0,3
Net exports	14,4	8,0	4,6	3,5	4,1	2,9	7,5	16,3

Source: Rosstatagentstvo

The most serious factor restraining the domestic demand is low real household income. It shall be noted that the shifts in GDP end use occurring in 1999 took place against the background of falling shares of both end consumption and gross accumulation. For the

first time over several years it was observed that end household consumption fell while GDP increased.

An analysis of the GDP end use dynamics in 1992 through 1997 by components demonstrate that a gradual slowdown of decline in the expenditure for end consumption had a favorable effect on the GDP dynamics. GDP growth by 0.9 percentage points in 1997 as compared with the preceding year occurred against the background of increasing consumer and investment demand. In 1998 through 1999 the expenditure for end consumption made 90.2 per cent as compared with 1997 level, while real household income and consumer demand demonstrated a general downward trend. Besides, as producers preferred to actively use the accumulated material resources and idle capacities, what did not require large investment, the trend toward falling gross accumulation became more perceptible in 1999. The negative effect these two components produced was compensated by a growth in net exports caused by ruble devaluation effect and higher world prices of raw materials.

In 1998 through 1999 the dynamics of end consumption was seriously affected by decreasing expenditure for government consumption resulting from the budgetary crisis effects. It shall be noted that in contradistinction to the preceding period the decline in government consumption was not compensated by changes in household consumption levels.

Household consumption accounted for almost 75 per cent of the total expenditure for end consumption. A trend toward deteriorating living standards was a most acute problems in 1998 through 1999.

The real household incomes fell by 29.4 per cent, real wages declined by 30.1 per cent, while real pensions dropped by 42.3 per cent as compared with pre-crisis levels registered in 1997 due to changes in price levels and structure caused by the financial crisis in 1998. The household expenditure structure demonstrated a trend toward a growing share of the expenditure for current consumption at the expense of falling share of savings. By end-1999 the expenditure for goods and services made 86.0 per cent of the total household income increasing by 11.4 percentage points as compared with 1997.

The expenditure for purchase of foreign exchange accounted for the major shift in household savings structure. While in 1997 the share of expenditure for purchase of foreign exchange in the income use was at 21.3 per cent and at 12.4 per cent in 1998, in 1999 it declined to 8.5 per cent. At the same time, the share of household savings as deposits and securities increased by 2.7 percentage points as compared with 1998.

The share of gross accumulation in GDP was at the eight-year minimum of 15.1 per cent in 1999. A trend toward declining stock of floating assets, which became perceptible since end-1998, resulted from higher business activity in the industry, an increase in sale volumes, and a decline in finished stocks. The persisting low investment demand accounted for the decreasing share of gross accumulation in fixed assets within the GDP structure. Although in 1999 a better financial standing of the real sector of the economy was registered and the investment potential rose alongside rising profits, producers still took investment decisions with an extreme reservation and cautiousness.

The positive output dynamics persisting over this year was mainly related to a more intensive use of working and reserve capacities. Investment expenditure for the reproduction of fixed assets

in the real sector was scarce, therefore it was directed in short-term fast recouping projects aimed at the production of competitive outputs. In the first half-year of 1999 the share of new investment in fixed assets made 12.0 per cent, the minimal value over last eight years. In the second half-year, as the investment demand recovered, the share of expenditure for the reproduction of fixed assets increased by 1.3 percentage points. However, these developments could not compensate for the negative trends persisting in late 1998 through the first half of 1999 and the share of gross accumulation in the GDP structure declined by 2.8 percentage points. Capital repairs of fixed assets accounted for 30 per cent of this decline.

The modernization of domestic industry is a necessary prerequisite for translating the import-replacing post-devaluation production growth into the sustainable economic growth. Companies should spend their extra profits not on current consumption, but on long-term investment projects. Unfortunately, the potential and incentives for savings accumulation in the present-day Russia are very limited, as it was mentioned earlier. Besides, the devaluation of the national currency resulted in growing prices of modern imported equipment and technologies necessary for the technical re-equipment and modernization of production. In 1998 through 1999 outputs grew mostly due to more intensive use of idle capacities. However, a large share of deteriorated fixed assets and the unfavorable age composition of machinery and equipment put rather tight constraints on this process.

Annex 4. Macroeconomic Characteristics of the Russian Banking System After August of 1998

The developments taking place in the second half of 1998 demonstrated that the Russian banking system was very vulnerable in regard to the devaluation of the national currency. In fact we

witnessed the “twin crises⁵²” (both in the banking and financial spheres). Yet in September through October of 1998 a number of largest Russian banks out of top twenty Russian banks encountered severe liquidity and/or solvency problems and ceased to exist: Inkombank, ONEKSIM, SBS-Agro, Menatep, Rossiyski Kredit, Promstroibank RF, Mezhkombank, Yunibest, etc. On the whole, from September of 1998 till end-2000 the number of working credit organizations fell from 1556 to 1349 (i.e. by 207).

The Agency for Restructuring of Credit Organizations (ARCO) created in October of 1998 could start to work with problem banks only in summer of 1999. Among its clients were largest commercial banks: Alfa-bank, SBS-Agro, Vozrozhdeniye, Rossiyski Kredit. However, the ARCO funds (Rub. 10 billion) are apparently insufficient for effective support of banks.

The shifts occurring in the asset structure of the banking system in 1998 through 1999 (see Figure 1) clearly demonstrate the Russian banks' behavior on the eve, during and immediately after the crisis broken out in August of 1998. Over the first half year the claims against the non-financial sector and the enlarged government grew. By August 1, 1998, their total share in the assets exceeded 75 per cent. The amount of claims accumulated both due to large credits the banks granted to enterprises (primary to those within financial and industrial groups (FIGs), and the increasing RF public debt⁵³. The share of foreign assets was below 12 to 13 per cent in this period.

⁵² Kaminsky, G., Reinhart, C. (1999) “The twin crises: The causes of banking and balance-of-payments problems,” *American Economic Review*, 89, pp.473 – 500.

⁵³ A decline in the share of claims against the enlarged government in May through July of 1998 is explained by a lesser amount of GKO/OFZ circulation over this period.

In autumn of 1998 the asset structure started to change dramatically. First, foreign assets grew in formal terms (up to 20 to 25 per cent) due to the ruble devaluation. Second, the freezing and the restructuring of the Russian public debt accounted for a temporary decline in the share of claims against the enlarged government. Third, commercial banks further limited lending in the situation of high inflationary expectations and the falling ruble exchange rate. The shares of claims against private enterprises and public non-financial enterprises declined from 43 to 44 per cent to 32 to 33 per cent, and from 5 per cent to 3 to 3.5 per cent respectively. Fourth, the share of reserves fell from 10 to 7 – 8 per cent mainly due to the ruble devaluation and the increasing share of foreign assets.

In summer of 1999 a trend toward a change in the banking system became perceptible. Since August of 1999 there was registered some growth in the share of claims against non-financial private enterprises (from 32 to 34 per cent), stabilization of the share of claims against public enterprises (at about 3.5 to 4 per cent), and foreign assets (25 per cent). The share of reserves was back at the pre-crisis level. Besides, by August of 1999 the growth in the share of claims against the enlarged government resulting, primarily, from the lending to regional and local authorities stopped.

Similarly, the dynamics of commercial bank liability structure may be divided into three periods (see Figure 2). Over the pre-crisis period there was observed a growth in the share of time and savings deposits (from 26 to 30 per cent), a decline in the share of demand deposits (from 26 to 15 per cent), while shares of foreign liabilities, deposits of the enlarged government, and instruments of the money market remained relatively stable. A decreasing share of demand deposits against the background of a growth in the share of time and savings deposits reflects the declining confidence of people to the Russian national currency: forex-denominated deposits accounted for 45 per cent

of the total amount of time and savings deposits, while demand deposits represented mostly ruble accounts. Besides, the high liquidity of demand deposits permitted to withdraw the funds before the crisis, in particular in order to purchase cash foreign exchange.

A growth in the share of foreign liabilities from 17 to 25 per cent and a decline in the share of the instruments of the money market (bank bills, bonds, and deposit certificates) were direct consequences of the currency crisis in August of 1998. The share of forex-denominated deposits in the total amount of time and savings deposits increased from 45 to 65 per cent. At the same time, the aggravation of the banking crisis resulted in growing shares of deposits with temporarily limited access (from 2.5 – 3 per cent to 3.5 – 4 per cent) and credits of the monetary authorities. The share of the RF CBR credits increased 7.5 times (from 2 to 15 per cent of the banking system assets) in October of 1998 through August of 1999. By end-summer of 1999 the total amount of CBR credits was up at Rub. 190 to 195 billion. In case CBR credits are reviewed as the price to be paid for the restoration of the national banking system, in the first half year of 1999 this indicator was at about 10 per cent of GDP, therefore the Russian banking crisis is among the most severe crises of the last 30 years⁵⁴.

Since August of 1999 the liability structure of the banking system has reversed its trend of change. The share of demand deposits and money market instruments showed a slight tendency to grow. Over the whole post-crisis period the share of foreign liabilities steadily declined; by end-1999 it made about 14 per cent in the total amount of liabilities. In autumn of 1999 the share of CBR credits demonstrated a downward trend (from 15 to 13.5 per cent). It shall be noted that the share of deposits of the enlarged government remained relatively stable

⁵⁴ Caprio, J., D. Klingebiel (1996) 'Bank insolvencies. Cross-country experience', World Bank Policy Research Working paper, 1620.

(2 to 3 per cent) over two years, notwithstanding the increasing money revenues of at all budget levels.

In the first quarter of 1999 net foreign assets of Russian commercial banks were positive (at about \$ 1 billion) for the first time over last two years. This trend became more perceptible over 1999 and in the third quarter of 1999 foreign assets exceeded foreign liabilities by \$ 4 billion. This process resulted from both a decline in foreign liability amounts, and foreign gross assets growing up to practically pre-crisis level (see Figure 3).

An increase in the amount of foreign assets in the second half-year of 1998 through 1999 mainly resulted from increasing funds at current accounts and deposits in banks outside Russia. By the end of the third quarter this amount made \$ 7.3 billion (as compared to \$ 4.5 billion in the first and \$ 3.45 billion in the third quarter of 1998). At the same time, the volume of portfolio and direct investment outside Russia declined (from almost \$ 2 billion to \$ 500 million and from \$ 530 million to \$ 240 million respectively), the amount of outstanding debts increased (from \$ 50 million to \$ 120 million). The amount of forex cash in vaults remained at practically the same level (about \$ 650 million).

Over the period from July of 1998 through October of 1999 foreign liabilities of Russian commercial banks declined by almost 62 per cent (from \$ 20.5 billion to \$ 7.9 billion, see Figure 4). The amount of loans and credits granted to Russian banks by foreigners and the funds in current accounts and on deposits diminished most (from \$ 10.9 billion to \$ 3 billion and from \$ 6.6 billion to \$ 3.1 billion respectively). In spite of a considerably higher debt burden resulting from a fourfold ruble devaluation banks punctually carried out their obligations to foreign creditors: the maximum amount of Russian bank arrears (\$ 1.3 billion at the end of the second quarter of 1999) was below 13 per cent of fulfilled obligations, while by the end of the third quarter of 1999 it was down to 6 per cent.

Annex 5. Internal Price Structure, Real Ruble Exchange Rate, and Arrears⁵⁵

As it was mentioned above, payment arrears demonstrated a downward trend over the post-crisis period most probably related to ruble devaluation effects. A major effect of changes in the real ruble exchange rate is shifts in the internal price structure.

The problem of price proportion transformations has been studied by V. A. Bessonov⁵⁶. It shall be noted that according to his study the most serious shifts in the price structure occurred during the liberalization of prices and foreign trade in 1992. The growth in raw material prices outpaced the increase in prices of consumer goods. Obviously, this process negatively affected many domestic industries. This could be a factor initiating payment arrears⁵⁷ at enterprises turned ineffective. Indices calculated in the above mentioned work reflect the dynamics of prices and finished product (processing-intensive products) outputs. The respective “qualitative index of structural shifts in producers’ prices” reflects the relative movement of prices of different commodity groups (“raw materials” and “finished” (processing-intensive) products) on the Russian domestic market.

⁵⁵ The authors express their gratitude for the calculations and consultations provided by Vladimir A. Bessonov.

⁵⁶ See: Bessonov V. A. “Issledovaniye transformatsii tsenovykh proporsiy v protsesse rossiyskikh ekonomicheskikh reform” (A Study of the Transformation of Price Proportions in the Course of Russian Economic Reforms), GU VShE, Diskussionnye materialy (Materials for Discussion), Issue 3, 1998; Bessonov V. A. “O transformatsionnykh strukturnykh sdvigakh rossiyskogo promyshlennogo proizvodstva” (On Transformational Structural Shifts in the Russian Industrial Production), *Economicheskij zhurnal VshE*, Vol. 4, No. 2, 2000 (manuscript).

⁵⁷ High prices of energy resources and the necessity of tough government control over price formation were noted in: Karpov (1997) and Alekseev (1998).

This index was used for the testing of the hypothesis about changes in price structure affecting payment arrears. According to this hypothesis a relative increase in prices of raw materials (a decline in the index) decreases the efficiency of industries oriented toward the domestic consumer market by deteriorating their solvency. These price movements shall not negatively affect raw material industries. Therefore, the hypothesis is that in case a growth in payment arrears and a relative growth in energy resources are related, the production of processing-intensive goods (consumer goods, mechanical engineering, etc.) is a factor behind payment arrears.

Changes in the domestic market price structure were also influenced by world prices in the course of the liberalization of foreign trade. Therefore the real exchange rate was an important regulator of the price structure. The ruble appreciation started in early 1992 resulted in cheaper imported goods competing with domestic commodities⁵⁸. While over the pre-liberalization period the Russian consumer market was dominated by the general merchandise shortage, after the liberal market reforms the supply and demand were close to an equilibrium one of the factors being a more active involvement of Russia in the international trade. The growth of the real ruble exchange rate deteriorated the competition situation for domestic producers lowering their economic returns and rendering some products unprofitable. A falling profitability against the background of an upward real exchange rate is characteristic also of raw material industries (exporters).

So, taking into account the fact that ruble appreciation in real terms negatively affected the profitability and financial standing of the major-

⁵⁸ Some problems of the real ruble appreciation are discussed in: Montes, M. F., Popov V. V. "Aziatskiy virus" ili "Gollandskaya bolezn"? ("Asian Virus" or "Dutch Disease"?). From our view point the authors seriously overestimate the role of the ruble as a factor in the Russian financial crisis of 1998. See: Russian Economy in 1998. Trends and Prospects. (Issue 20). M.: IEPP, 1999.

ity of enterprises producing goods for domestic use, as well as export-oriented ones, it should generate a growth in payment arrears.

A model of payment arrears dynamics basing on the hypotheses about budgetary failures⁵⁹ initiating arrears in payment flows, about shifts in price structure and real exchange rate.

Model 1

$$\Delta C_t = c_0 + c_1 \cdot \Delta D_{t-1} + c_2 \cdot B_{t-1}^{F-P} + c_3 \cdot \Delta E_{t-1} + c_4 \cdot q_{t-1} + \varepsilon_t \quad (1)$$

where

ΔC_t is the current increment of outstanding debt to suppliers (industrial, agricultural, constructing and forwarding enterprises and organizations deflated by the consumer price index);

c_i – coefficients, parameters of regression equation ($i = \overline{0;4}$);

ε_t – random variable.

We assume that a **growth in outstanding debt to sellers** is influenced: **positively** – by a prior growth in purchasers' outstandings⁶⁰ (ΔD_{t-1});

⁵⁹ The problem of budgetary failures resulting in arrears in payment flows was discussed in IET publications: “Razvitiye rossiyskogo finansovogo rynka i novye instrumenty privlecheniya investitsiy” (Development of the Russian Financial Market and New Instruments for Attracting Investment), 1998; “Ekonomika perekhodnogo perioda” (An Economy in Transition), 1998. The hypotheses state that contracting parties failing to meet their obligations render enterprises unable to pay to their creditors and initiate arrears in the payment flow. Both enterprises and the state may act as “unscrupulous” contractors failing to meet their obligations. In case the state (for purposes of this study federal authorities) do not fulfill obligations on expenditure stipulated by budget laws, it renders the potential recipients unable to pay to their suppliers.

⁶⁰ It shall be noted that the testing of this hypothesis is not strict, since the creditor indebtedness of an enterprise is the debtor indebtedness of some other enterprise. These indebtedness types partly coincide in the process of data aggregating. Therefore an element of autoregression was present while testing this hypothesis.

negatively – by a prior excess of actual budgetary expenditure over the target⁶¹ (B_{t-1}^{F-P});

negatively – by a prior depreciation of the real ruble exchange rate⁶² (ΔE_{t-1});

negatively – by a prior rise of consumer goods prices relative to raw materials (q_{t-1}).

All effective factors in the model are lagging in order to render them exogenous and exclude the possibility of arrears influencing the explanatory factor. For the results of the model coefficient evaluation see Table 1.

TABLE 1.

Results of the Model Coefficient Evaluation Based on Monthly Data (from 2/1993 till 6/1999, 77 observations, MNK)

Variable	Coefficient	Standard error	t-statistics	P-value
C	13.008	5.169	2.516	0.014
ΔD_{t-1}	0.374	0.069	5.433	0.000
B_{t-1}^{F-P}	-0.073	0.029	-2.548	0.013
ΔE_{t-1}	-0.023	0.011	-2.115	0.038
q_{t-1}	-23.833	10.053	-2.371	0.020
R^2	0.494	F-statistics		17.550
DW-statistics	2.105	P-value.(F-statistics)		0.000

⁶¹ In case actual state expenditure exceeds targets payment arrears may decrease (due to repayment of accrued arrears). Vice versa, actual budgetary expenditure lagging behind targets generates inter-enterprise payment arrears (since the state does not pay for ordered products).

⁶² In Rub./\$ terms a decline in the exchange rate means a growth of the variable.

According to the evaluation results all coefficients are statistically significant at 95 per cent confidence level that being consistent with the hypotheses. Taking into account both the fact that the explained variable was modeled in residuals, and a rather large number of observations, it shall be noted that the percentage of explained variance is rather high. Moreover, it is probable that the dependencies under review appear not only at one lag, but are distributed over time. In this case high significance of factors proved at one lag only confirms the intrinsic character of the dependencies.

Basing on the evaluation results it is possible to draw some conclusions:

Failures to meet federal budgetary expenditure targets and debtors' failures to meet their obligations are a significant factor in the generation of payment arrears thus initiating a chain of non-performed obligations (the results are in accordance with those obtained earlier over a shorter interval, see: IET, "An Economy in Transition," 1998).

Outpacing growth of prices of energy resources and raw materials relative to consumer goods prices (basing on the model) increase payment arrears. It seems that the factor behind this development is deteriorating financial standing of enterprises manufacturing consumer goods. The results of the calculations favor the hypothesis about payment arrears originating in the sector manufacturing processing-intensive products. At the same time, the accrual of payment arrears in the fuel and energy complex is primarily of involuntary character and is caused by the administrative coercion of FEC enterprises to supply their products to insolvent customers.

The real ruble appreciation is an important factor in the process of the generation of non-performed obligations. It may be explained by increasing competitiveness of imported goods as they become

less expensive. It is important to note that strong competition facilitates sustainable growth, since it creates incentives to enhance the effectiveness of production. However, in a short-term outlook the competitive pressure deteriorates the financial standing of enterprises even further, thus generating payment arrears. The real ruble appreciation causes relative costs to grow also at enterprises of export-oriented (raw material) industries. Therefore, profitability and financial standing deteriorate across practically all industries. The mechanism of stimulating growth via competition implies extra investments. In the present situation in Russia characterized by absent working capital markets investments may be financed only at the expense of enterprises' internal funds. In this situation competition as an incentive facilitating growth loses in importance as stronger competition results in less economic profits, which are a source of investment.

Annex 6. Interbudgetary Relations in Russia in 1999

Reforms in interbudgetary relations initiated in 1997 and 1998 continued vigorously in 1999. To remind, a Concept of Reform in Interbudgetary Relations approved in 1998 mapped out a reform to be completed in relations between budgets at all levels in the period up to 2001.⁶³

Development and approval of a methodology to be used in allocating resources from the Federal Fund of Support to the Regions (FFSR) was an important milestone in efforts to streamline interbudgetary relations. For the first time since transfers started to be made to Federation members, the FFSR shares of the different regions as calculated by the Ministry of Finance using the new meth-

⁶³ The main points of the Conception and the progress of reforms in Russian budgetary federalism in 1997-1998 were examined in close detail in the IET survey "The Russian Economy in 1998: Trends and Prospects."

odology and submitted to the State Duma, were approved in toto during the Duma debates on the draft budget. The Federal Budget Law also contained provisions motivating the regions into adopting additional measures to raise funds and restructure their spending, tighten criteria for budget loans, grants and resources exchanged under mutual settlement arrangements. The legislators have toughened conditions for the granting of tax benefits by authorities in closed administrative territories.

It must be said that, generally, beginning in 1999, the Federal Government took a relatively firm line in its relation with Federation members. During Yevgeni Primakov's premiership, proposals were frequently voiced for abolition of elections of heads of regional administrations, for a greater concentration of powers over revenues, and a more effective control over the performance of regional authorities. In February 1999, the Government issued a directive on reform in housing and utility services,⁶⁴ setting maximum rates of charges for housing and utility services, which was differentiated by economic regions and provided a mandatory benchmark in financial support distribution to the regions. For all the imperfections of these rates, the directive was one of the few attempts so far launched to put budgetary relations with the regions within a legal framework.

These developments were bound to affect the quantitative aspects of relations between the Federal Center and the regions. For a second year running, federal budget loans cannot, in general, be regarded as channels for the flow of financial aid - the balance in these operations has been unfavorable for the regions in both 1998 and 1999, which means that more loans were repaid than received

⁶⁴ See: The Federal Government's Directive No. 205, February 24, 1999, "Federal Standards of Transition to a New System of Payments for Housing and Utility Services in 1999."

throughout the year. It is a notable fact that the share of outstanding federal budget loans in total funds transferred into the budgets of Federation members in 1996 and 1997 was 10 per cent and 25 per cent, respectively. In 1999, the Ministry of Finance discontinued its practice of transferring funds from the FFSR by setting them off against the federal share in value added tax receipts. Previously, the amounts flowing through these channels reached nearly 17 per cent of total federal financial support (including outstanding loans from the budget), creating a favorable field for federal and regional authorities to bargain over VAT amounts to be set off against federal transfers.

TABLE I

Federal financial aid to RF constituent members 1994 through 1999 (in per cent of GDP)

	1994	1995	1996	1997	1998	1999
Total transfers from FFSR	0,36 %	1,17 %	1,04 %	1,22 %	1,12 %	0,99 %
of which:						
Transfers	0,36 %	0,86 %	0,68 %	0,86 %	1,00 %	0,99 %
VAT refund	0,00 %	0,31 %	0,36 %	0,36 %	0,12 %	0,00 %
Subsidies	0,09 %	0,06 %	0,09 %	0,13 %	0,10 %	0,06 %
Grants	0,42 %	0,12 %	0,12 %	0,09 %	0,02 %	0,20 %
Funds transferred under mutual settlement	2,54 %	0,42 %	0,81 %	0,43 %	0,36 %	0,14 %
Total financial aid to budgets of RF constituent members	3,40 %	1,76 %	2,05 %	1,87 %	1,60 %	1,39 %
FFSR transfers as a share of total federal financial aid to the regions	10,49 %	66,32 %	50,49 %	65,44 %	69,83 %	71,37 %
Loans to budgets of RF constituent members net of repayment	0,02 %	0,04 %	0,23 %	0,64 %	-0,03 %	-0,28 %
Total transfers to budgets of other levels of government (balance)*	3,43 %	1,82 %	2,33 %	2,50 %	1,57 %	1,11 %

* This indicator includes the amount of federal budget loan disbursements net of repayment

Source: RF Ministry of Finance, and estimates by authors of this review

Table 1 contains data on financial support provided to Federation members from the Federal Budget in 1994 to 1999. These data show that financial assistance to the regions continued to shrink in

1999. More specifically, the total amount of financial support transferred into regional budget declined to 1.4 per cent of GDP, and even further down, to 1.11 per cent, taking account of the balance between federal budget loans made and repaid. This notwithstanding, there was a steady, if only insignificant, growth in the share of transfers from the FFSR in the total federal financial support to the regions: on year-end results, this share registered 71.4 per cent in 1999. A point to note was a growth (up to 0.2 per cent of GDP) in funds transferred into regional budgets in the form of grants. The growth was caused, in the first place, by changes in the content of this budget item: the special-purpose grant fund set up in 1999 brought together funds allocated to finance the so-called Northern Program, additional financial aid to regions most heavily dependent on subsidies, and compensation for the difference in electricity tariffs in Russian Far Eastern areas and the Arkhangelsk Oblast. Meanwhile, grants previously financed under this heading to Moscow to maintain its functions of the Russian Federation's capital city were allocated in non-cash form in 1999. As a response to the tight federal policy of reshuffling its budgetary resources, the regions, one and all, actually suspended the operation of some federal legislative and statutory acts proposing support to selected categories of the population. In particular, Federation members started, early in 1999, to target public benefits at people with children (known as child care benefits), even though federal laws did not provide for this kind of social support. The Federation members' moves forced the State Duma, which had been holding up adoption of an appropriate federal enactment, to approve changes in federal laws which allow authorized regional authorities to establish eligibility criteria for child care benefits.⁶⁵

⁶⁵ See: *Federal Law No. 171-FZ, July 17, 1999, "Amendments to Article 16 of the Federal Law on Public Benefits to People with Children."*

These positive changes in interbudgetary relations in Russia failed to work off the backlog of problems that had built up in this area. The methods of allocating federal transfers and the basic principles and conditions of federal financial support allocation to the regions were badly in need of updating. The principal areas where reforms could start in methods of aid disbursement from the Fund of Financial Support to the Regions included the need for a fuller account to be taken of the tax potential and spending needs, methods to be developed to motivate the regional authorities into stepping up their efforts to collect taxes and restructure their budgetary spending, the process to be further formalized, and bias to be eliminated in the elaboration of initial data and setting of actual amounts of financial support. Such reforms were critical at the time work started on a draft federal budget for the year 2000.

The new methods of assessing the budgetary spending needs in Federation members was, in contrast to those used in previous years, based on differentiation of average countrywide forecasts taking account of factors characterizing the magnitude of demand for specific kinds of budgetary spending. Standard budgetary requirements were calculated in the following groups of expenditures: education, health care, housing and utility services, government administration, transport and communications, culture and the arts, social policy, and law enforcement.

Interregional differentiation coefficients of countrywide spending average (calculated as a GDP share) characterized the objective factors of growing costs of public services such as wages and prices of goods and services in a region, climate, and transport infrastructure. Moreover, these coefficients were calculated from open statistical data that are not, normally, handled by the Ministry of Finance (such as the proportion of the population receiving “northern” allowances, in addition to their wages, the cost of living, existence of

direct access to a motor or rail network, the share of the population living in areas reachable by goods suppliers for a limited season only, and so on). For this reason the initial spending plan data could not be agreed on with each region separately.

The chief positive result of the adoption of a new methodology to estimate standard spending rates was that it was ultimately approved by the tripartite working group set up to enhance the inter-budgetary relations, and that the budgetary spending indexes used to make FFSR disbursements under the 2000 Federal Budget Law were obtained on its basis. For the first time in the history of the budgetary system of the independent Russian state, the attempt to formalize regional budget spending rates has proved successful. In addition, it has helped to considerably enhance the transparency of calculations of regional budget rates, deprived regional authorities of influence over the size of regional budget spending rates by bargaining over individual financial numbers separately, as was the case previously, and gave the Federal Center an opportunity to set priorities in the Federation members' spending policies by enlisting, in this way, yet another tool for implementing the regional budget policy at the federal level.

In addition to the methods of estimating the regions' spending needs in drafting a 2000 federal budget bill, a new technique was developed and applied for calculating the tax potential of Federation members. The need for an impartial approach to estimating the tax potential was outlined already in the Concept of Reform in Interbudgetary Relations. At the time the transfers were calculated for 1999, an approved mechanism for calculating the regions' tax resources was non-existent, and FFSR disbursements were made on the basis of adjusted base year reports.

The new methods of assessing territorial tax potentials used in making disbursements from the Fund of Financial Support to the

Regions in 2000 is based on the average tax load on the gross value added in the leading sectors of the economy in the base period. In other words, the average countrywide tax load calculated as a ratio of an industry's actual tax liabilities to the value added in that industry in the base period is used to determine the region's tax potential with account for the expected volume of value added in that industry in the region during the plan period. Calculations are made for manufacturing, construction, agriculture, and market services.

Major alterations were also made, at the drafting stage of the 2000 Federal Budget, in the method of disbursements from the Fund of Financial Support to the Regions. Grouping Federation members for purposes of transfer calculations was one of the serious flaws of the FFSR disbursement methods, which had been pointed out during discussions of the Concept of Reform in Interbudgetary Relations by both fiscal federalism experts and representatives of regional authorities. In calculating the regions' shares in the FFSR for 1999, the Ministry of Finance proceeded from the weighted average spending and income rates in Federation members according to groups of regions, which, in general, duplicated the traditional arrangement of Federation members according to economic regions, from which the autonomous *okrugs*, Far North territories, mountainous areas of the Caucasus, and the City of Moscow were taken out as separate entities. It was obvious that under this calculation system, a decision to place a region in a particular group could have a major effect on the end result, especially when that region was, by a combination of characteristics, at the borderline between any two groups. But then, the methodology developers were compelled to base their calculations on group averages, for in the absence of objective methods they could use to calculate the tax potential and spending needs of a group of Federation members, this approach was necessary to eliminate any possible

distortions occurring through occasional reconciliation of some initial data.

The development and approval of methods to calculate gross tax resources (GTR) and the budgetary spending index of Federation members allowed the transfers to be calculated on the basis of individual values of the GTR and budgetary spending index. Aside from a higher accuracy of calculations from the viewpoint of the leveling effect of transfers, this adjustment allowed frictions between the Federal and regional authorities over the inclusion of a region in a particular group to be minimized.

The mechanism of the approved methodology of FFSR disbursements in 2000 is illustrated in Figs. 1 to 3, where the regions' adjusted GTR values before and after transfer disbursements from the FFSR arranged in the order of magnitude are given as tentative examples. Fig. 1 illustrates the transfer calculation principle used in 1999. It is clear from the figure that transfers go to Federation members whose adjusted gross tax resources are below a certain equalizing line that is, in turn, determined from the FFSR size. If, under these circumstances, the adjusted GTRs of a region rise above that line (the region shifts to the right along the adjusted GTR curve to equalization), the equalizing line remains actually unchanged, and the amount of transfer made to that region is reduced by the amount of GTR growth.

FIG. 1

The equalizing principle applied in the methodology of FFSR resource allocation for 1999 (a hypothetical example)

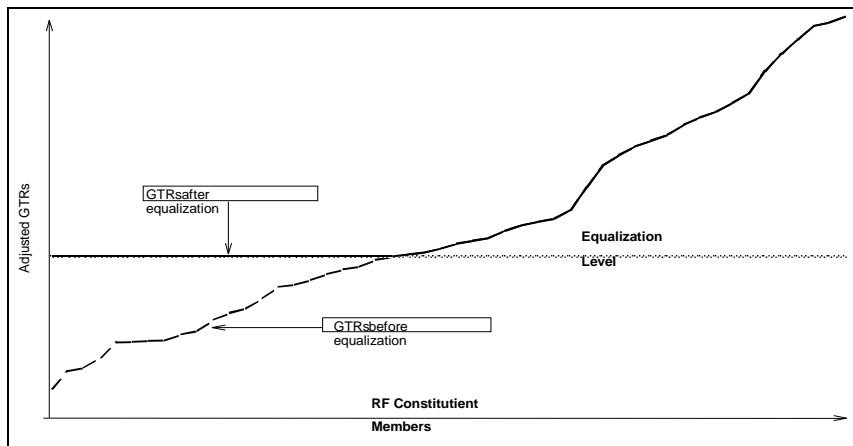


Fig. 2 illustrates another equalizing principle, under which the Fund of Financial Support is disbursed in proportion to the deflection of adjusted GTR values from the median level. The figure clearly shows that in this situation, the number of transfer recipients does not depend on the FFSR volume and that a growth in adjusted GTRs causes the amount of a transfer to decrease in proportion to the total growth. This method is disadvantageous because of a possible fragmentation of the Fund among a large number of financial support recipients.

FIG. 2

The principle of equalization in proportion to adjusted GTRs' deviation from average values applied in the allocation of 80 per cent of the FFSR for 2000 (a hypothetical example)

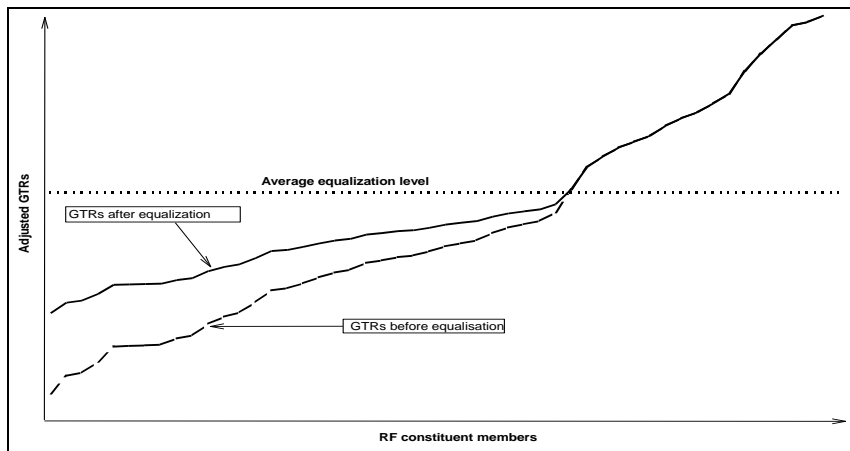
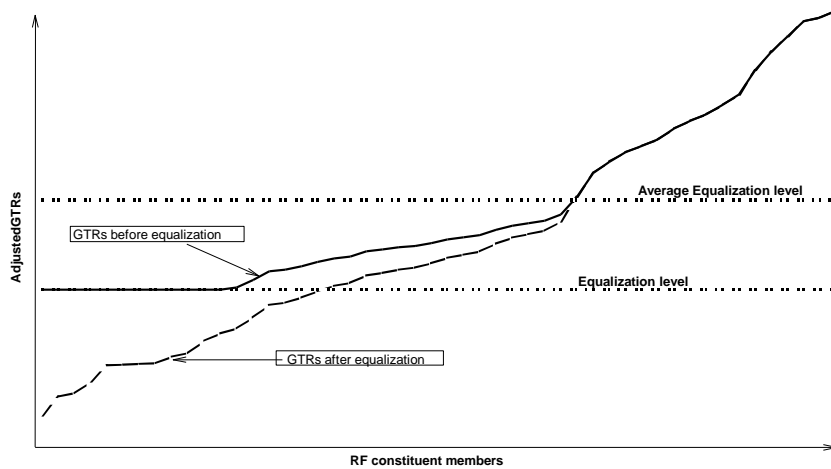


Fig. 3 illustrates a combined principle of FFSR disbursements, which was used in calculating transfers in 2000. According to the figure, the number of FFSR transfer recipients does not depend on the Fund size, where this principle is applied, and financial support is disbursed proportionally among them. In this case, however, a region is guaranteed a certain minimum of budgetary support, that is, a tax potential adjusted for the magnitude of demand for budgetary spending.

FIG. 3

The combined equalizing principle applied in the methodology of FFSR resource allocation for 1999 (a hypothetical example)



One of the problems facing the system of federal financial support to Federation members has, to this day, been the existence of numerous support distribution channels. In particular, earmarked sums were allocated to the regions within the framework of the federal Northern Program aid, which the Russian Government calculated and transferred during the fiscal year without regard for any approved methodology. Meanwhile, the implementation of the Northern Program (financial livelihood aid to areas in the Far North and areas that can be supplied with provisions for only a few months during a year) amounts to a problem of unsupported higher spending requirements in the budget of respective regions.⁶⁶ This is

⁶⁶ Irrationality of separate financing for the Northern Program can be illustrated by the following example: hardly anyone will find federal financial support to such Northern regions as the Khanty-Mansi or Yamal Nenets autonomous okrug,

why taking financial aid for these purposes out of the FFSR framework appears unjustified.

An attempt was made, at the preparatory stages of the 1999 Federal Budget Law, to integrate funds to finance the Northern Program within the FFSR transfers (it was proposed to allocate funds for these purposes in proportion to the actual sums transferred in the preceding year), but this proposal was never approved by the State Duma. The method of FFSR disbursements through 2000 was designed so that the budgetary spending index (spending requirements) takes account of the Northern location and remoteness of a region, making it possible to transfer sums to Federation members in need of financial assistance under the Northern Program. In 2000, therefore, a separate line for aid under the Northern Program and livelihood provision has been added to the amount of transfers to regions in the Far North.⁶⁷

While the 2000 Federal Budget bill was studied by the State Duma, a decision was adopted to supplement the budget receipts with additional revenues the Government could raise in 2000. The Ministry of Finance could use the additional receipts to pay compensation, in addition to the principal transfers calculated by an

which is accessible to outside provisioning for only a limited period of the year, unjustified.

⁶⁷ Strictly speaking, this portion of the transfer was placed in a separate line more likely by inertia and through realization of the fact that the Northern Program was to be financed with account for the seasonal nature of supply provisioning under the program, rather than in accordance with the general principle of FFSR disbursements. In our view, season-related disbursement of federal aid under the Northern provisioning program is a task to be handled at the regional budget management level, even though the 2000 Federal Budget Law provides for at least 70 per cent of the funds allocated under the provisioning program for Northern areas to be transferred to the recipients before July 1, with the remainder to follow before November 1, 2000.

identical method, to individual regions so that the total sum of the standard transfer and compensation was at least as large as the transfer amounts received by those regions in 1999, adjusted for expected price rises (18 per cent).⁶⁸ This measure appears sooner to be a way of influencing regional leaders into approving the new transfer calculation methodology than a really necessary measure dictated by the need for more funds to be added to the regional budgets.

The 2000 disbursements from the FFSR include partial aid as targeted transfers to the regions to enable them to pay benefits to people with children and to compensate for differences in electricity tariffs in Far Eastern territories and the Arkhangelsk Oblast.

Also, the FFSR disbursement methodology provided, with consent of the tripartite working group members, that transfers to all regions were to be cut by 2 per cent, and that the resultant saving (Rb353.7 million) be used as financial aid to the Republic of Dagestan. The transfer to the Chechen Republic that could not, for obvious reasons, be reckoned with in FFSR disbursements by the standard technique, was calculated directly, on the basis of financial support for previous years.

The new methodology of FFSR disbursements led to a reduction in the number of Federation members eligible for transfers. Whereas the 1999 Federal Budget Law named 13 regions that were ineligible to disbursements from the Fund of Financial Support to the Regions in 1999, the number of ineligible Federation members rose to 18 under the 2000 Budget. The regions struck off the 1999 disbursements list included Moscow and St. Petersburg, the Krasnoyarsk Krai, the Lipetsk, Moscow and Perm oblasts, the republics of Bashkortostan, Komi and Tatarstan, the Samara and Sverdlovsk oblasts, and the Khanti-Mansi and Yamal Nenets autonomous

⁶⁸ See: Article 46 of the 2000 Federal Budget Law.

okrugs. In 2000, they were joined by the Vologda, Nizhny Novgorod, Tyumen, Chelyabinsk, and Yaroslavl oblasts.

TABLE 2

**Financial aid to lower-level budgets from the Federal budget
for 2000, in Rb '000**

Financial aid to other-level budgets	69148595
of which:	
Federal Fund of Financial Support to RF Constituent Members	57350930
of which:	
Partial targeted aid to RF constituent members to help them deliver government child benefits	2700000
Government financial support to procurement and delivery of crude, oil products, fuel and foodstuffs (other than exciseable goods) in regions of the Far North and equivalent areas with limited time schedules for cargo delivery to households, enterprises and organizations providing social services and housing and community amenities	3000000
Electricity tariff compensation to areas in the Russian Far East and the Arkhangelsk Oblast	1000000
Regional development fund	2542482
of which:	
Financing of federal programs for regional development	2200000
Additional financial aid to heavily subsidized RF constituent members	342482
Regional Finance Development Fund	1920000
of which:	
Funds to promote the financial rehabilitation of budgets of RF constituent members, facilitate a reform of the budgetary system and of the budgeting process and stimulate economic reforms	1920000
Subsidies and grants	7315183
of which:	
Subsidies and grants to budgets of closed administrative-territorial units with sites of facilities owned by the RF Defense Ministry and the RF Ministry of Atomic Energy	6070586
A subsidy and grant for the maintenance of infrastructure for the town of Baikonur (Republic of Kazakhstan) related to a lease of the Baikonur spacedrome	590897
A subsidy to the health resort city of Sochi	300000
A subsidy to Republic of Daghestan	353700
Other measures related to regional development	20000
of which:	
Other expenditure unattributable to other items of expenditure (a federal earmarked program of government support to municipalities and for creating conditions to enforce the constitutional powers of local government)	20000
Memorandum item: Federal budget expenditure	855073000

Source: RF Law on the Federal Budget for 2000.

A total of Rb69 billion has been allocated from the Federal Budget to provide financial support of all types into Federation members' budgets, or an equivalent of 8 per cent of Federal budget outlays, with 83 per cent of this amount channeled into the Fund of Financial Support to the Regions. In 1999, the planned financial support to the regional budgets amounted to Rb43 billion, or 7.6 per cent of the federal spending. At the same time, the share of the FFSR, including Northern Program funding, support for regions dependent on large subsidies, and other outlays included in transfers beginning in 2000, was nearly as large as 90 per cent. Table 2 shows the amounts and composition of financial support to lower-level budgets under the 2000 Federal Budget.

To draw a line under the next successive stage in efforts to improve the system of federal financial support to Federation members in the form of transfers from the Fund of Financial Support to the Regions, it must be said that a big stride was made in this area in 1999. In addition to the above-mentioned advantages of the FFSR disbursement methodology in economic terms, the Government may be said to have found an efficacious form of cooperation with representatives of the legislatures and executives in the regions. For two years already, the mechanism of coordinating decisions on financial aid disbursements through the tripartite working group has acquitted itself well: after the Governments proposals have been endorsed by the working group, the Federal Budget bill faces an easier passage (and gets fewer amendments) in the Federal Assembly than it used to previously.

Also, in the last two years, progress in reform of interbudgetary relations has manifested itself as a gradual transition from coordination of individual figures at the time of transfer calculation to coordination of methods to arrive at these figures with members of the tripartite working group and representatives of regional finan-

cial agencies. This approach has helped to reduce the probability of some regions receiving very generous financial aid exclusively through persuading the Ministry of Finance of their need of additional funding.

Another point to note is the gradual switch from calculation of input data for FFSR disbursements on the basis of socioeconomic and financial statistics (such as gross regional product, size of the population and principal consumers of budgetary services, arrears in taxes and levies, etc.) calculating which are the responsibility of respective ministries and agencies. The Ministry of Finance is, therefore, slowly losing control over input data preparation, which is a further factor operating against the regions' influence on individual figures.

It must be said that the 2000 Federal Budget Law makes the financial relations between the Federal Center and the regions significantly more rigid. In particular, the Law requires the Federal Government to introduce, in 2000, a treasury budget execution system for such Federation members as the republics of Altai, Daghestan and Tyva, the Kemerovo Oblast, and the Komi-Permiak and Evenki autonomous *okrugs*, along with regions that fail consistently to pay wages to employees of budget-dependent organizations in time. As the Ministry of Finance becomes technically prepared, the Law says, the treasury system is to be applied to cash execution of budgets in the other regions.

Also, the Law gives the Federal Government two months to bring all agreements on budgetary relations it has with the regions in line with uniform rates of tax revenue distribution between the Federal Budget and regional budgets, as specified in the Law.⁶⁹ The Law refers, in the first place, to bilateral agreements made with some Federation members (for example, Tatarstan) in the early

⁶⁹ See Article 47 of the 2000 Federal Budget Law.

1990s, establishing special conditions, inapplicable to the remaining regions, for transferring federal taxes to regional budgets. Besides, the Law provides that transfers will be made from the FFSR to regions complying with the Federal budgetary and tax laws on their territories without any exceptions or special conditions, and that the Federal Government and Audit Chamber will have the right to conduct audits and random checks on the budgets of Federation members receiving financial aid from the FFSR.

Significantly, the 1999 Federal Budget Law contained a requirement that the Government could reduce the amounts of aid transferred from the FFSR to the regions by the amounts of unfair benefits paid by the regional authorities. Actually, however, this requirement was not fulfilled last year for lack of methodology to quantify the benefits paid. For this reason, the 2000 Federal Budget Law directs the Ministry of Finance in more articulate phrases to stop transferring aid to regional authorities breaking federal laws.

The federal financial aid appropriated under the 2000 Budget also includes resources of Regional Development Funds, regional finance development funds, and resources used in providing additional financial assistance to highly subsidized territories.⁷⁰ As regards financial support for depressed regions, the allocations made under the budget for these purposes are, unlike the funds allocated in previous years, more specifically intended for emergency payments to the regions worst off in socioeconomic terms. The best indication of this is the amount of emergency funds (Rb342.5 million against Rb1,611 million in 1999) and the fact that support for highly subsidized Federation members is proposed in the methodology of FFSR disbursements.

⁷⁰ For more about the objectives and tasks of these funds, see: the IET survey "The Russian Economy in 1998: Trends and Prospects."

Among other high points of the 2000 Federal Budget Law, note must be made of the tightening of discipline in mutual settlements between the Federal Budget and regional budgets and in budgetary loan repayment.⁷¹ Beginning in 2000, reciprocal claims of the Federal Budget and regional budgets on one another can only be set off through territorial federal treasury bodies. Wherever loans made or any other funds, whether repayable or not, provided from the Federal Budget are overdue or misused, the Federal Government has the right to suspend the transfer of any financial aid to the regions or to withhold the amounts due or misused from the monies transferred to the regions within the framework of financial aid or as set-offs.

An important provision of the Law is termination of federal budget funding under legislative acts and bylaws lacking financial backing and the recommendation it contains for regional and local authorities to apply a similar principle in formulating their own budgets.⁷²

Against the background of stricter rules governing the relations between federal and regional authorities in 1999, therefore, the interbudgetary relations continued to be improved, and the results of this process were incorporated in the 2000 Federal Budget Law, and yet, the Government's next steps will be reforming relationships between budgets at various levels, but it still has not developed an approach to deal with this problem. In this context, its tasks now are, above all, combining the principles of evaluation of regional spending needs and spending rate systems, which are currently being developed by the ministries and departments concerned; monitoring finance management in heavily subsidized regions; allocating, on a long-term basis, taxing powers and tax

⁷¹ See: Articles 72 and 73 of the 2000 Federal Budget Law.

⁷² See: Article 129 of the 2000 Federal Budget Law.

receipts between different-level budgets; separating spending powers; and reducing the number of unfunded spending mandates. The Government also needs to formulate the underlying principles of relationships between regional and municipal budgets. These are the tasks the Federal Center is to fulfill within the framework of its reform in interbudgetary relations in 2000 and 2001.

Annex 7. Subfederal and Municipal Borrowing

In 1999, and in the second half of 1998 for that matter, a key factor determining conditions on the loan market maintained by regional and local authorities was the crisis of investor confidence that halted the growth in budget debt.

The trend set off by the crisis in August 1998 continued to reduce in absolute terms the backlog of debt accumulated by regional and local authorities in the securities and of loans received from higher budgets. Growth in other types of borrowing was offset by a still greater growth of balances of regional and local budgetary funds in accounts with commercial banks and treasury branches. The excess of budgetary fund balances over net borrowings amounted to Rb1.726 billion, or 0.02 per cent of GDP.⁷³ The net borrowings of regional budgets ended up at only 0.15 per cent of GDP, a record low for the past several years (Table 1).

⁷³ A deficit of Rb1.028 billion (or 0.02 per cent of GDP) in the total volume of regional budgets was disclosed only as a result of a change in budget classification: in 1999, the budgetary receipts from privatization of state-owned and municipal enterprises and from the sale of state shareholdings (a total of Rb2.754 billion, or 0.06 per cent of GDP) started to be recorded as a source of budget deficit financing, instead of budget revenues. At the same time, receipts from the sale of land and intangible assets continue to be recorded as non-tax revenues.

TABLE I

Borrowings by regional and local budgets

Year	1995	1996	1997	January-August 1998	January- December 1998	1999
Aggregate borrowings by subfederal and local authorities, of which :	0,38	0,87	1,43	0,71	0,33	0,15
<i>Reimbursable loans from federal budget</i>	0,07	0,23	0,66	0,05	-0,09	-0,11
Subfederal (municipal) bonds	n/a	0,16	0,22	0,08	-0,01	-0,05
Other debt	0,31	0,48	0,55	0,58	0,43	0,31
Decrease in balances of budgetary accounts	...	0,03	-0,18	0,09	0,02	-0,19
Deficit financing through borrowing and reduction in balances of budgetary accounts	0,31	0,9	1,25	0,8	0,35	-0,04

Source: IET estimates based on RF Ministry of Finance data.

To a certain extent, the growth in budget account balances has a salubrious effect, allowing local administrations to meet their demand for liquid funds. In a situation when budgetary expenditures are not financed in full, however, a situation typical of most regions (with much of their wage arrears still outstanding, an excessive demand for funds to finance infrastructure projects, and, not infrequently, overdue debt to creditors), such growth is anything but a welcome development.

Occasionally, growth in budget account balances is to be explained by the desire shown by administrations to support friendly commercial banks, which held, as at December 1, 1999, as much as 58.3 per cent of all budget account balances. Despite the rapid, almost twofold growth in the share of local budget balances in accounts opened, through the Treasury system, with the monetary au-

thorities, the balances in commercial bank accounts rose more than 50 per cent in real terms over the 11 months, to Rb21.60 billion, or more than 3.3 per cent of the total regional budget balances.

Whereas in January 1999, therefore, the claims commercial banks had on local government authorities were Rb14.03 billion larger than the respective budgetary funds deposited with them, the situation turned around beginning in September 1999, when the budgetary balances came gradually to exceed commercial banks' total claims. For the first time since December 1997, local government authorities became the net creditors of the banking system. On December 1, 1999, local budget funds deposited with commercial banks exceeded the claims commercial banks had on them by Rb2,530.7 million, or 006 per cent of GDP.

TABLE 2

**Debts of spending agencies financed from territorial budgets
(in Rb millions)**

	Accounts payable		Accounts receivable	Balance of accounts payable and receivable	Balance of stretching accounts payable and receivable
		Of which in arrears			
01.12.98	88 061	63 508	5 430	82 631	58 078
(as per cent of annual expenditure*)	22.64	16.33	1.40	21.25	14.93
01.12.99	92 853	71 720	8 102	84 751	63 618
(as per cent of annual expenditure*)	14.31	11.05	1.25	13.06	9.80
01.01.00	86 486	66 760	9 192	77 294	57 568
(as per cent of annual expenditure*)	13.33	10.29	1.42	11.91	8.87

*As per cent of the annual expenditure of consolidated regional budgets

Source: IET estimates based on RF Goskomstat data

Throughout the year, the territorial budgets' liabilities (accounts payable) continued to decrease (in real prices), leading directly to reductions in the liabilities of budget-financed organizations. As a result, the budget-financed organizations' liabilities shrank from 16.3 per cent to 11.05 per cent of the territorial budgets' outlays between December 1, 1998 and December 1999.

In December 1999, there was an abrupt drop in budget account balances. One of the key reasons for this drop was the need to step up social expenditure in the run-up to the parliamentary elections. Wage arrears built up through underfinancing from territorial budgets were worked off by 18.7 per cent in the month preceding the elections and the total accounts payable of budget-financed organizations had decreased by another 0.8 per cent of the territorial budgets' annual outlays.

As the budget deficit swelled, the authorities' deposits with commercial banks shrank by Rb5,970.8 million, or more than 27.6 per cent, over the same month, so regional and local government authorities again, on January 1, 2000, found themselves net borrowers of the banking system.

Overall, however, the regional and local authorities' total debt to Russian commercial banks continues to decline rapidly, after having peaked in the months before the August 1998 crisis.

In the second half of 1998, the debt owed by subfederal and local government authorities to commercial banks diminished, in real terms, by 42.5 per cent. In 1999, the debt was slashed by another 40.5 per cent. In all, the commercial banks' claims on subfederal and local government authorities were reduced, in real terms, by two-thirds over the 18 months after the crisis.

TABLE 3

**Commercial bank financing of regional and local authorities
(in Rb millions)**

Date	Commercial bank claims on local government*	Local government deposits with commercial banks	Balance of claims and deposits
01.01.97	2 790,4	4 210,6	-1 420,2
01.04.97	3 232,6	6 602,9	-3 370,3
01.07.97	4 876,0	10 790,4	-5 914,4
01.09.97	9 594,9	12 491,8	-2 896,9
01.12.97	12 073,8	12 765,2	-691,4
01.01.98	12 514,5	8 467,1	4 047,4
01.04.98	23 039,6	10 015,8	13 023,8
01.07.98	24 002,0	9 401,8	14 600,2
01.10.98	25 225,2	8 987,9	16 237,3
01.01.99	24 445,6	10 145,9	14 299,7
01.04.99	24 506,5	13 640,8	10 865,7
01.07.99	22 946,4	18 723,6	4 222,8
01.10.99	20 750,8	21 490,2	-739,4
01.12.99	19 066,9	21 597,6	-2 530,7
01.01.00	19 870,5	15 626,8	4 243,7

*Government authorities of RF constituent members and local authorities

Source: IET estimates based on RF Central Bank data.

Domestic Bond Loan Market

In 1999, the Federal Ministry of Finance registered bond issuance and circulation terms and conditions in eight Federation members and six municipalities (less by two-thirds and one-third from the previous year, respectively). During the year, Rb14,017.9 million was floated in bonds and Rb16,229.2 million worth of bonds was redeemed. The principal of the ruble-denominated securities,

therefore, decreased by more than Rb2,211.3 million. The total domestic debt owed by the Federation members on securities was estimated by the Ministry of Finance at around Rb13 billion at end-1999.

The securities market crisis resulted in a reduction by over one-third in the holdings of municipal and subfederal securities, from 0.47 per cent of GDP in 1998 to 0.31 per cent of GDP in 1999. As compared with 1997, the issuance of securities declined by almost 60 per cent (Table 4). The number of issues fell significantly from 1997-1998, actually back to the level registered in 1993 and 1994.

TABLE 4

**Issues of subfederal and municipal securities
(in per cent of GDP)**

Year	1996	1997	1998	1999
Issue	0,63	0,77	0,47	0,31
Repayment	0,47	0,56	0,48	0,36
Net financing	0,16	0,22	-0,01	-0,05

Source: IET estimates based on RF Ministry of Finance data

As in previous years, the regions were issuing securities, through 1999, to either close their budget deficits (as in St. Petersburg, Kostroma, Cheboksary, Volgograd, the Chuvash Republic, the Volgograd Oblast, the Republic of Mary-El, and the Pskov Oblast), or implement their investment projects (as was the Government of Moscow) or housing programs (as in the Chuvash Republic and the cities of Arkhangelsk and Dzerzhinsk, in the Moscow Oblast), or else to restructure their liabilities to budget-dependent organizations (as in St. Petersburg and Novocherkassk). Last year was different from the years before for registration of securities issuance terms and conditions undertaken to restructure, under agreements with investors, the debts built up on previous bond issues (as in the Novosibirsk and Orenburg oblasts).

TABLE 5

Issues of municipal and subfederal securities in 1999

Issuer	Term of maturity	Purpose of issue
St. Petersburg	1 to 5 years	Restructuring of debts payable to spending agencies
	up to 1 year, 1 to 5 years, 5 to 30 years	Fiscal deficit financing
Moscow	2 months to 5 years	Financing the City Investment Program for 1999
Chuvash Republic	up to 1 year	Development program financing (housing construction)
	1 to 2 years	Fiscal deficit financing
Orenburg Oblast	12 months to 36 months	Debt restructuring on earlier bonds
Novosibirsk Oblast	6 to 24 months	Fiscal deficit financing
Volgograd Oblast	6 months to 1 year	Fiscal deficit financing
Pskov Oblast	6 months to 5 years	Fiscal deficit financing
	12 months to 60 months	Fiscal deficit financing
Orenburg Oblast	12 months to 36 months	Debt restructuring on earlier bonds
Volgograd Oblast	6 months to 1 year	Fiscal deficit financing
	1 to 5 years	Restructuring of debts payable to spending agencies
Novocheboksarsk	3 months to 1 year	Fiscal deficit financing
Cheboksary	1 to 5 years	Fiscal deficit financing
Arkhangelsk	1 to 5 years	Development program financing (housing construction)
Volgograd	90 days to 1 year	Fiscal deficit financing
	1 to 5 years	Fiscal deficit financing
Dzerzhinsk	5 to 10 years	Development program financing (housing construction)

Source: RF Ministry of Finance.

The majority of regions that borrowed heavily in 1997 and through the first half of 1998 could not meet their domestic liabilities, with such exceptions as St. Petersburg, Moscow, and the Chelyabinsk Oblast. By mid-year 1999, however, the Irkutsk Oblast and Chelyabinsk City could regain the investors' confidence on the domestic loan market.

Whereas prior to the 1998 crisis, auctions to place bonds were held by 12 issuers (Moscow, St. Petersburg, the Orenburg, Omsk, Leningrad, Sverdlovsk, Novosibirsk, Irkutsk, and Chelyabinsk oblasts, the republics of Sakha (Yakutia) and Tatarstan, and Chelyabinsk City), only four issuers (St. Petersburg, the Irkutsk and Chelyabinsk oblasts, and Chelyabinsk City) held regular auctions in 1999. Occasional auctions were held for bonds of Moscow, the Republic of Buryatia, and the Volgograd Oblast. In November and December, auctions were revived to place bonds issued in the Orenburg Oblast within the framework of a restructuring program.

In contrast to the Orenburg Oblast, which invigorated its bond market by restructuring its bonds, the Leningrad Oblast opted to shut down its own debt securities altogether, managing to reduce its debt on securities during the year from Rb270 million to Rb48 million by both direct repayment and, mostly, various set-off schemes. The Novosibirsk Oblast, too, is leaning toward this option, and plans to fully redeem all the bonds it has issued and to refrain from further borrowing. Absence of demand for its bonds has periodically plagued the Chelyabinsk Oblast, which called off some of its auctions for this reason. The Irkutsk Oblast administration used to call off its auctions because their actual returns exceeded the administration's plans.

Secondary stock market trading involved securities of issuers active in initial public offering of new securities issues and bonds of the Novosibirsk and Yaroslavl oblasts and the Republic of Sakha

(Yakutia). St. Petersburg alone, however, could hold on to the liquid secondary market. In the first 11 months, its bonds accounted for around 95 per cent of the total stock market trading in all Russian subfederal and municipal securities. It was only in December that trading in Orenburg Oblast bonds bounced from Rb11.2 million in November to Rb387.9 million in December, cutting St. Petersburg share to just above 60 per cent.

The financial market sharply reduced stock market trading in subfederal securities. Whereas secondary market trading in St. Petersburg's bonds, at Rb5.875 billion in 1999, was less than a quarter of what it was in the pre-crisis year 1997, in real terms, secondary market transactions in the securities of most other issuers were mostly made from time to time, and even under occasional contracts.

St. Petersburg's Bond Market

As opposed to Moscow, which was compelled, in the fall of 1998, to offer domestic bond holders redemption in non-cash form, in violation of the issuance terms and conditions, St. Petersburg was able to meet its liabilities in full. As a result, whereas the secondary market in Moscow's bonds was closed down, it continued to operate successfully in St. Petersburg.

The principal steps the city Administration took following the August crisis were:

- reducing the turnover of its securities to between one and three months (to make the bonds more attractive to legal entities as the main investors);
- periodically calling off auctions to reduce yields and vigorously buying up its debt securities on the secondary market before term to lower the debt servicing costs;

- conducting an active policy to raise the liquidity of its obligations on the secondary market (by establishing a REPO market and developing the forward contracts market).

The city Administration initiated a policy of diversifying debt servicing instruments. In late February 1999, for example, the issuer released on to the stock market St. Petersburg's registered treasury bonds with variable quarterly coupon, redeemable on call. These bonds have a circulation period of nine months. At the end of a coupon period, investors can turn in their bonds to the issuer for early redemption. When bonds are redeemed before term, the coupon rate is lowered.

Registered discount medium-term government bonds (SGOs), with turnovers of 20 and 22 months, were launched in mid-March 1999. According to the SGO turnover rules, only organizations that were owed debts by the city's budget-financed institutions for any products delivered, services provided or jobs performed could become first bondholders. An SGO holder could present his bonds to the issuer for early redemption only provided the bondholder had two-month arrears in payments of some taxes and duties to St. Petersburg's budget. Demand for these securities from investors outstripped supply.

The St. Petersburg bond market remains the largest in the country. As at January 1, 2000, more than Rb1.53 billion worth of St. Petersburg's securities was traded at market value on the secondary market. As confidence in the market rose, the city Administration could nearly double the maturity of its securities, from 180 to 305 days during a year.

In 1999, St. Petersburg became Russia's first region to receive a credit rating awarded by international agencies on ruble-denominated bonds. The Standard & Poor's and Fitch IBCA rating agencies gave St. Petersburg a long-term ruble rating at the CCC level.

The relative stability achieved on the city's bond market gave a healthy boost to the market of derivative forward contracts and REPO transactions. The forward contracts turnover reached Rb620.467 million, or 9.1 per cent of the bond market turnover, and the annual scale of deals on the REPO market set up at the very end of 1998 amounted to Rb374.697 million, or 6.4 per cent of the turnover of the base assets market.

Growth of the REPO market has a positive effect on the liquidity of the spot market, for dealers have an opportunity to contract loans against bonds for purchasing securities at secondary tenders and auctions, which make St. Petersburg's bond market still more attractive. Besides, the REPO market offers additional opportunities to commercial banks, which acquire here a new bank liquidity management instrument. It may be argued, therefore, that St. Petersburg now has a new loan market as an alternative to the interbank loan market.

Interest rates on the St. Petersburg REPO market are, on average, 3 to 5 percentage points below the interest rate on the interbank loan market. This spread is explained by St. Petersburg's liquid and reliable bonds being offered as loan security on the REPO market. Short-term REPO transactions with maturities under seven days enjoy the greatest popularity among market participants.

St. Petersburg plans to spend Rb2,262.2 million to service its public debts in 2000, including Rb866.6 million to be spent to service the city's domestic debt and Rb1,395.6 million on external debt servicing. In 2000, the debt servicing costs are not to exceed 6.6 per cent of St. Petersburg's municipal budget receipts, below the costs the city bore in previous years.

Forward contracts segments of the St. Petersburg loan market started developing vigorously in 1999. Stability of the rules of the game and liquidity of St. Petersburg's government bond market

served as a precondition for turnover growth in forward contract (Rb620.467 million in 1999, up from Rb499.68 million a year before) and in REPO transactions (Rb374.697 million and Rb14.064 million, respectively).

Moscow's Bond Market

Following the August 1998 crisis, Moscow was faced with problems in its efforts to sell debt securities. The problems were so severe that by early 2000 it had only Rb1 billion raised from the sale of securities out of 9 billion re-denominated rubles in debt. After a train of defaults on domestic bonds, many large commercial banks ceased purchasing municipal and subfederal securities of the majority of issuers, including Moscow. The remaining Rb8 billion Moscow borrowed in 1999 were bank loans, most of them from government-controlled Sberbank.⁷⁴

A specialized state-owned unitary undertaking, the Moscow City Financial Agency, was registered in July 1999. The Financial Agency was set up by a directive issued by the Moscow Government in March 1999, in an effort to improve the borrowing system, in place of the existing four institutions run by the Moscow Government's Municipal Loan and Stock Market Development Board (in particular, the Moscow Loan Market, Moscow Loan and Investment Project, Moscow Loan Finance, and Moscow Loan Regional Project). The Agency was routinely run by the Municipal Loan Board and vested with "narrowly defined functions of issuing municipal debt instruments against the city's security and investing all borrowed funds into municipal economy development."

As a result of this reorganization, the city suspended debt issuance until October 15, 1999, when the floating of a new issue of

⁷⁴ S. Drobyshevsky and A. Shadrin, "Moscow's Debt Management in 1999-2003." IEP Special Project. "Analysis of Regional Finances. Moscow." http://www.iet.ru/special/special_r.htm

Moscow's bonds was combined with redemption of a previous bond series. Even though the terms and conditions of the new issue stipulated the establishment of a secondary stock market, this stipulation was not fulfilled until the year-end. Demand for these securities was so low that only a small part of the issue could be sold.

Creation of the Financial Agency was one in a series of attempts made to reform the city's debt market. It coincided with the resignation of the Municipal Loan Board's head, who had been blamed for the payment squeeze in the city's debt servicing. A change in the city's borrowing ideology was a significant event. Whereas in the peak period of debt-making in 1997 and 1998, an idea of committing the city's debt to finance commercial projects (either rivaling private business or expectedly inefficient) which was assiduously trumpeted and pushed, it is planned, in 2000, to use the borrowed funds to finance urban infrastructure projects through earmarked budgeting mechanisms.

In reality, however, things do not go any further than formal budget outlay reshuffling, with the city's expenditures to service domestic and external debts exceeding its total borrowings. With Rb20.3 million (or 13.3 per cent of the city budget outlays) devoted, under the 2000 budget appropriations, to service the city's debts, Moscow will only be able to raise Rb13.0 million, if everything goes according to plan. The city budget's investment potential this year has, therefore, been reduced by over Rb7 billion (or 4.7 per cent of budget outlays).

Federation Members' External Borrowings

As confidence in Russian borrowers took a deep plunge in the aftermath of the August 1998 crisis, Russian regions found themselves cut off from foreign private loan sources. By existing records, not one of the Federation members has managed to raise a foreign loan by selling its bonds. Foreign bank loans, too, were ac-

tually shut off, with the exception of money available from international financial organizations such as the World Bank and the EBRD. The shortage of funds put a number of regions in a tight corner.

In October 1999, the Nizhny Novgorod Oblast failed to service its loan interest in time and to begin partial redemption of eurobonds as planned. In October 1997, the Oblast issued \$100 million in eurobonds at an interest rate of 8.75 per cent per annum. Under the issue terms and conditions, redemption of the Nizhny Novgorod eurobonds was to start in the fall of 1999 and continue until sometime in 2002.

After its officially registered default, the oblast administration succeeded in reaching a debt restructuring agreement with representatives of the creditors. Under the restructuring plan, redemption of the Nizhny Novgorod eurobonds was put off by another three years and the oblast was given a grace period on coupon payments.

The Nizhny Novgorod Oblast paid 50 per cent of the coupon it failed to pay on October 3 in the weeks before December 15. In 2000 and 2001, it is to pay coupons at a rate of 35 per cent of the amount specified in the issue prospectus. In 2002, coupon payments are to be made at 50 per cent and in 2003-2005, at 100 per cent of that amount, respectively. Repayment of the principal and the deferred part of coupon payments are to start in April 2003.

Moscow, too, has been driven to the wall over foreign debt repayment. In April through May 2000, it is to pay off approximately \$350 million, an equivalent of the city's total outlays budgeted for six weeks. In all, foreign debt servicing in 2000 will require \$380 million.

A point to note is that the total debt to be repaid was cut by \$220 million after the Moscow Administration had bought up, at a considerable discount, its own bonds on the secondary market from

funds earned from the Moscow Government's lucrative projects and additional municipal budget receipts.

The first half of 1999 saw a heavy flow of Moscow's dollar-denominated debt to Russian investors. According to estimates from the Moscow Commercial Loan Agency, foreign interests actually held between 25 per cent and 30 per cent of the debt. The remainder was in the hands of Russian market players or their overseas subsidiaries. This allowed the Moscow Commercial Loan Agency to withdraw a significant proportion of bonds of a total nominal value of \$219.330 million from circulation and to exchange them for the bondholders' arrears to the Moscow Government.

Even though the loan burden has been eased, rating agencies give high marks to the city's insolvency risk. In particular, Standard & Poor's gives Moscow a credit rating of CCC-, as compared to CCC for St. Petersburg.

TABLE 6

Long-term credit ratings as at 1 January 2000

	Fitch IBCA		Moody's Investors Service		Standard & Poor's	
	Forex	Ruble	Forex	Ruble	Forex	Ruble
St. Petersburg	CCC	CCC	Caa1	—	CCC	CCC
Moscow	CCC	—	Caa1	Caa1	CCC -	—
Nizhny Novgorod Oblast	—	—	Caa3	—	—	—
Russian Federation	CCC	—	B3	Ca	SD	CCC

Source: Fitch IBCA, Moody's Investors Service, Standard & Poor's

Similarly, Moody's Investors Service reversed, in early 2000, its long-term foreign exchange rating forecasts for St. Petersburg and the Samara Oblast from negative to stable, but stuck to its negative rating forecast for Moscow (only Caa 1). The rating agency

puts its position on Moscow to the remaining eurobond payment problems the city is likely to run into in 2000.

Over the year, the spread in yields on Moscow's eurobonds and St. Petersburg's securities fluctuated between 800 and 3,200 base points, lending credence to the rating agencies' assessments of St. Petersburg's relatively high creditworthiness.

St. Petersburg's relatively favorable status is explained, in the first place, by the fact that its debt servicing costs will peak in 2002. Unlike Moscow, St. Petersburg placed its first eurobond issue for a term of five years, against Moscow's three years, in 1997. But then, paying \$300 million in a lump sum is quite a burden on the city's shoulders.

It must be said here that most of the Russian regions that had access to the foreign loan market have already defaulted on their debts and are presently in the midst of talks over debt restructuring. One of such defaulters among Federation members is Tatarstan, which is currently engaged in talks over restructuring of its \$285 million in foreign debt and Rb800 million on domestic republican bonds held by foreign investors. Characteristically, by late 1999, it had redeemed the bond series held by domestic investors.⁷⁵ The administrations of the Yamal Nenets Autonomous *Okrug* and the Republic of Sakha (Yakutia) are engaged in similar talks. Arrangements reached elsewhere are not always implemented in full.

⁷⁵ Significantly, Central Bank and Finance Ministry statistics in Russia do not record foreign debts contracted by the regions, because none of them received a loan directly from a nonresident bank. Foreign exchange loans were transferred to a Russian bank that, in turn, made a ruble-denominated loan to the administration of a Federation member, upon converting the foreign exchange received at the current exchange rate. Interest on the loans was assessed on the basis of a floating exchange rate pegged to the growth rate of the dollar. For this reason, all these bank loans were, in the eyes of the end borrower, loans from Russian banks and were recorded accordingly in public finance statistics.

The Leningrad Oblast, for example, was over a month behind in interest payments on a syndicated loan.

Legislative Regulation of Borrowing and Debt Policies of Russian Federation Members

The Budget Code of the Russian Federation, effective beginning on January 1, 2000, has enacted standards regulating the borrowing and debt policies of Federation members and local government authorities. Under the Budget Code, a budget deficit of a Russian Federation member may not exceed 5 per cent of its budget outlays, disregarding financial aid from the Federal Budget, the requirement being a maximum of 3 per cent for a local budget.

The Code proposes that the maximum amount of public debt a Federation member can build up or the largest debt to be run up by a municipality should not exceed the total receipts of a respective budget, less any financial aid from a higher-rung budget. The Code sets a ceiling of 30 years on borrowings by Federation members and 10 years on loans to be contracted by municipalities.

If a Federation member is unable to service or repay its debts, even if its debt servicing costs are in excess of 15 per cent of its budget expenditures, or if it exceeds a lawfully established borrowing limit, "a duly authorized federal government agency" may appoint an audit of that Federation member's budget and place execution of its budget in the hands of a Ministry of Finance comptroller. Similar measures are stipulated for municipalities, except that budget execution control is vested in the respective Federation member.

Important factors enhancing the transparency of borrowings are the Budget Code requirements for consolidation in the budget of all extra-budgetary funds active at the regional level; a provision requiring all subfederal and municipal borrowings to be made exclusively to finance the budget deficit; and keeping of a State Debt

Ledger to enter details about the scale of Federal debts, and debts incurred by Federation members and municipalities on securities they have issued.

Recently, the Federal Government has submitted to the State Duma draft amendments to the Budget Code, providing for a total ban on external borrowing by all Federation members (according to the existing version, such borrowings are permitted for regions receiving no financial aid to achieve budget sufficiency).

This amendment has already run into resistance from Federation members that plan, in the medium run, to revert to foreign loans. It must be said, however, that even if eventually passed, this amendment will not guarantee regional budgets against foreign exchange risks because of the widespread practice of debts, formally denominated in rubles, but actually tying coupon payments and principal to a foreign exchange equivalent, being issued by the regions.

Development Prospects for Subfederal and Municipal Debt Market and Financing of the Housing and Utility Services System

The high level of accumulated debts is the main barrier to Federation members continuing to run up debts. Most of the economically advanced regions that had contracted large foreign loans in 1997 and 1998 were forced, following the ruble devaluation in August 1998, to enormously increase their debt servicing costs.

Any further build-up of accumulated debts proved impossible because of the investors' suspicions, and so the regions had either to stabilize their accumulated debts at the existing level by refinancing the loans borrowed (as in St. Petersburg) or to reduce them (as in Moscow, which plans, under its 2000 budget, to spend at least Rb20.3 billion to service its debts, given its borrowing level of Rb13.0 billion)

A hypothetical growth in borrowings by municipal authorities unencumbered by foreign exchange debts is restrained by potential instability of their financial standing. Municipal budget receipts are largely dependent on the rates of deductions from regulating taxes, which may be changed arbitrarily for each municipality over a fiscal year by the will of the respective Federation member's authorities.

The risk of a municipality's receipts being reduced at the discretion of subfederal authorities, a situation fully appreciated by creditors, remains one of the principal obstacles to municipalities borrowing fresh loans. This risk rises frequently in Russia, where a fairly common situation is political stand-off between the governor and the mayor of a Federation member's central city (who is, as a rule, the incumbent governor's principal potential contender at elections and a focus of attraction for business interests competing against groups supported by the governor). In these conditions, subfederal authorities tend to unreasonably and unpredictably lower the deduction rates of regulating taxes in large cities in favor of subsidized agricultural areas.

Contracting new loans also appears to be an extremely important issue from the view-point of territorial authorities' ability to finance local social and economic infrastructure development programs. This problem becomes ever more urgent from one year to the next. In particular, the annual scale of water supply network construction in 1999 decreased by a factor of nine from 1999, and that of heating and sewage lines, by more than 7.5.

As a result, the attrition of the housing and utility infrastructure exceeds permissible rates, and is approaching the critical 60 per cent level, when the accident rate of equipment and engineering lines shoots up high, as is already happening in several of the country's regions. In some regions, the accident rate of utility lines has doubled or grown even higher since 1990.

TABLE 7

Start-up of community amenities

Year	Water line, km	in per cent of 1990	Sewerage systems, km	in per cent of 1990	Heat networks, km	in per cent of 1990
1990	7524,3	100,0	984,5	100,0	1456,5	100,0
1994	2397,1	31,9	515,9	52,4	800,4	55,0
1995	2647,3	35,2	491,6	49,9	544,9	37,4
1996	1330,1	17,7	417,3	42,4	634,3	43,5
1997	1513,6	20,1	274,4	27,9	388,5	26,7
1998	1340,7	17,8	249,6	25,4	205	14,1
1999	841,8	11,2	130,3	13,2	193,9	13,3

* IET estimates based on RF Goskomstat data

In the absence of needed investment, which cannot, in the prevailing situation, be always accumulated from own regional or local budget receipts, most regions will, in a medium term already, be confronted with the need to appreciably increase their running expenses to ensure accident-free operation of the housing and utilities sector.

It is particularly disturbing that the slowdown in the construction of utility networks was gathering speed even in 1999, a propitious year in terms of economic growth dynamics: construction of water supply lines slumped by 37.2 per cent and that of sewerage lines plunged by 47.8 per cent. Throughout the year, no work to build such lines was carried out in the Orel, Tula, and Kostroma oblasts and in the republics of Karelia, Komi and Kalmykia.

For lack of investments that were to be raised, before the August 1998 crisis, on the subfederal and municipal debt market, the investment part of the Power in Housing and Utilities Program, was actually frozen. It was approved by the Federal Government in its Directive No. 80 on January 24, 1998, as the core of another Federal target program, Energy Economy in Russia (1998-2005), which proposed saving tentatively between 65 and 75 million tonnes of oil

equivalent fuel a year and investment of Rb17 billion in prices of January 1998.⁷⁶ As a result, implementation of the power saving program is so far confined to basically organizational measures of a limited potential (the effect yielded by the resource-saving programs in 1998 was held to a lowly 3.7 million tonnes of oil equivalent fuel).⁷⁷

The high transaction costs keeping investors away from regional infrastructure projects are reinforced by such inhibitions as absence of effective incentives toward implementation of investment programs in housing and utilities for territorial administrations.

Quite the other way, a peculiar “consensus” appears to have developed between regional and local authorities over the renovation of the utility infrastructure.⁷⁸ What is more, the available free funds are used to finance commercial undertakings, in which the local administrations have some kind of interest. In particular, loans equal to 0.45 per cent of GDP, or over 3.1 per cent of territorial budget outlays, were made to enterprises from the territorial budgets in 1999.

This problem can only be solved by Federal authorities through targeting their efforts on offering effective incentives to territorial administrations in drawing investments into housing and utilities. Such incentives may be created by amending the Budget Code to include constraints on the commitment of borrowed funds by regions and municipalities and loans and loan guarantees they can issue to private enterprises.

⁷⁶ A. Shadrin, “Prospects for Financing Housing and Utilities During a Crisis.” In: *Securities Market*, No. 8, 1999, pp. 15-17 (in Russian).

⁷⁷ *Finansy*, No. 1, 2000, pp. 3-6.

⁷⁸ Here, analogs are recognized in the behavior of territorial entity heads and managers of Russian enterprises, whose actions to consume the capital goods, an option acceptable in the existing inefficient institutional structure, are in direct conflict with the interests of the electorate and shareholders, respectively.

Or else, steps may be undertaken to induce commercial banks into making loans for infrastructure projects in the housing and utilities sector by refinancing such loans from Central Bank funds. In particular, the Central Bank plans, on the basis of the Guidelines for an Integral Government Monetary Policy in 2000, to expand the list of assets to be accepted in pledge against its loans by including bills of financially stable, creditworthy enterprises, mortgages, and liens under loan agreements.

While acknowledging the importance of stimulating consumer demand, the Central Bank announced promotion of consumer and mortgage loans as a priority. Developing a system of loan financing for infrastructure projects in housing and utilities appears at least as effective, in terms of demand stimulation, and more important, considering positive external effects of reductions in current outlays of territorial budgets on the utilities and social housing subsidies and prevention of industrial accidents.⁷⁹

The organizational aspect of investment projects in the public sector of the economy must be elaborated through the implementation of projects supported by international financial organizations. In Russia, for example, the World Bank is carrying out two major projects, Improvement in Energy Use Efficiency and Transfer of Departmental Housing Stock, against Federal government guarantees. The foreign loan program of the Russian Federation for 2000 includes a project, Renovation of Urban Heat Supply Systems, within the framework of which consideration will be given to eight projects in the participating cities.

Along with stronger incentives for territorial administrations, the investment attraction problem requires mechanisms to be set up to reduce credit risks. Whatever strategy is followed to develop

⁷⁹ The operations planned by the Central Bank to refinance commercial bank loans should certainly be carried out within natural macroeconomic bounds.

housing and utilities, encouraging direct investors on the basis of concession agreements or developing a loan system, it is important to enhance the credibility of financial guarantees issued by municipalities and Federation members. This can be achieved, for example, by enacting into law the right of municipalities to have tax allocations fixed for three years and to legislatively settle arguments over measures to be taken to protect creditor rights in situations when Federation members and municipalities fail to fulfil their debt obligations and honor their guarantees.⁸⁰

⁸⁰ Enactment of procedures for after-court exercise of lien by creditors of subfederal and municipal authorities is a critical condition for Central Bank refinancing of liabilities guaranteed by territorial authorities. The urgency of such a law is dictated by the widespread practice of ignoring court rulings requiring regions to meet their liabilities to their creditors in 1998 and 1999.

Section 2. Institutional Change and Status of Selected Sectors of the Economy

2.1. Institutional Problems of Corporate Sector Development

2.1.1. Results of 1999 as a Mirror of Unstable Post-Crisis Development of the Corporate Sector

The year 1999 and the beginning of 2000 give some hope for optimism about development prospects in Russia's corporate sector. Propitious estimates contained, for example, in the report of the UN Economic Commission for Europe have been prompted, above all, by industrial recovery in the wake of ruble devaluation and rise of world prices for oil and natural gas that, in their turn, have increased the flow of tax receipts into the budget and beefed up the exporters' sales. Positive dynamics has been registered in a majority of industries, including those that had been chronically depressed for years (such as electrical engineering, the light industry, agribusiness, and so on). According to Russian Goskomstat figures, the number of loss-making enterprises and organizations has declined from 48.3 per cent of the countrywide total in 1998 to 40.6 per cent in 1999. The UN Economic Commission for Europe expects the year 2000 to be the best in the last decade in terms of economic growth in Eastern Europe. Moreover, economic upsurge in Russia is, according to the UNECE, to spearhead recovery in all countries in the region.

The post-crisis economic resurgence continuing in Russia in late 1998 through 1999 (GDP up 3.2 per cent and industrial output 8.1 per cent higher), relative stability of the macroeconomic situation (at least, hyperinflation has been avoided, contrary to some

forecasts) and political changes at the watershed between 1999 and 2000 have had a favorable effect on the Russian securities market. According to most rating agencies and solid financial publications, the Russian stockmarket was among the three fastest growing markets in the world in 1999. Russian debts have grown in value in 1999, to between 60 per cent and 70 per cent of par. Yields on Russian bonds ended at 130 per cent per annum (leaving Brazil far behind, with 39 per cent). Capitalization of the blue chip market rose by 182 per cent over the year. The RTS-Interfax index was the second fastest growing (after Turkey) in 1999. In January 2000, investors turned their eyes again toward second-echelon companies, a sign of investors switching from merely speculative short-term investments to a longer-term strategy.

Unit investment funds have improved their earnings significantly. The highest profits for the year were earned by unit investment funds that had been investing in government securities and made most of the novation and rising quotations of OVVZs (as, for example, Ilya Muromets that gained 1,877 per cent and Templeton with 854 per cent). Even though a few unit investment funds were wound up in an aftershock of the crisis, their total number hardly changed at all, with more, corporate unit investment funds created toward the end of 1999. What is more, the quite a few unit investment funds saw a four- to fivefold increase in the number of shareholders in 1999. It is significant, though, that the rush of private investors to the stockmarket (including unit investment funds and the Moscow Fund Center) can be put down not so much to the advantage of a particular investment option as to the absence of high-yield instruments on the financial market in 1999.

On year-end results, foreign funds investing in Russian stocks reaped a 150 per cent profit in 1999. These figures encourage expectations of investors showing interest toward Russia after the

presidential election. Most of them regard political stability as an important factor, while market growth rates are no less significant for many unit investment funds, their managers being plainly bound to invest in the fastest growing markets.

In 1999, some major Russian corporations (such as Sibneft and RAO UES of Russia) announced their intention to issue depository receipts, for the first time after the financial crisis. Another significant fact, a majority of Russian corporate borrowers on the euro-bond market were trying to meet the deadlines for running payments on their liabilities. The year 1999 will go down as a period when interest was revived toward the Russian corporate debenture market. Some leading companies floated issues in 1999 (as, for example, in connection with the novation of government securities) and others have similar plans for 2000.

It is not improbable, against the background of these shifts, that Russia's international credit rating should improve gradually (considering the errors of judgment and overcaution of leading rating agencies in 1998), a development that may have a direct effect on the possibility of the government and corporations attracting funds from the international financial market. The arrangements the Russian Government made with the London Club of creditors in February 2000 reinforce optimistic moods for the medium term, especially because they may become a trump card in settling the debts it owes to the Paris Club and the IMF.

This is about all to be optimistic about. On the surface, this situation is reflected (as also in the case of favorable evaluations) in ratings Russia is given on the prospects of its financial markets and corporate development. In particular, in its review of country credit ratings for 1999, the influential *Institutional Investor* magazine gave Russia 20 points, out of a maximum 100 (the lowest probability of default on sovereign debt), or 105th place among 135 coun-

tries. The first place among transitional economies went to Slovenia (28th in general rankings) and, among the former Soviet republics, to Estonia (51st in general rankings).

In an outlook for 2000, the “economic freedom index” published traditionally by the American Heritage Foundation evaluates the investment climate in 161 countries of the world. Russia places 121st, in the group of “mostly unfree countries” (which also includes, even if with higher ratings, almost all countries of Eastern Europe and the CIS). In 2000, Russia’s index is 3.7 (up from 3.5 in 1999 and 3.35 in 1998), a visible deterioration in the situation. A major role in index determination is assigned to ownership rights and barriers to free movement of capital. The 2000 evaluation was swayed, in particular, by quotas introduced for foreigners in the authorized capital of RAO UES (25 per cent), RAO Gazprom (20 per cent), and aerospace companies (25 per cent), constraints on foreign insurers, legislative and judicial aspects of ownership rights protection (including independent resolution of commercial disputes), tax collection practices, and corruption.⁸¹ A special survey of 99 countries for their corruption record (Transparency International, 1998) places Russia 82nd and 83rd (together with Ecuador) in a group of countries with “extraordinary corruptibility” in the company of most CIS countries.

Allowing for the conventionality (subjectivity) of such studies, which frequently reflect only the outward concepts of a real situation, they are a prominent benchmark for private investors in evaluating a country’s investment climate.

⁸¹ For all that, China places 100th. This allows (at least in respect of unorthodox ideological conclusions) this study to be interpreted in the sense that a strong legal system counts for economic growth far more than the type of political system (see *Novosti AKM*, November 30, 1999).

The annual survey of Russia's economy in 1999 drafted by the OECD is conspicuous for its analysis of this country's budgetary problems and arrears, leaving out the strident problems facing the corporate sector (financing of corporations and post-crisis aggravation of conflicts over property) as, probably, hopeless. The competitiveness rating for 47 countries (International Institute for Management and Development, Switzerland, based on 288 evaluation criteria) and the competitiveness rating for 59 countries (World Economic Forum 1999) put Russia in last place in 1999.

A key conclusion made in the efficiency survey of 10 sectors of the Russian economy, undertaken in 1998 and 1999 by McKinsey company (involving Nobel laureate Robert Solow), was admission of the fact that labor productivity in the Russian economy was not linked to profitability, meaning that medium-size businesses have no stake in restructuring or productivity gains, and that more efficient businesses lose out in competition with less efficient ones and lack incentives to invest (provided they have the wherewithal).⁸² This phenomenon originates from unequal operation (competition) conditions for enterprises: virtually identical enterprises pay different tax rates and have different taxation regimes, pay different prices for fuel and energy, apply different claims against debtors, are exposed to unequal administrative requirements, have different opportunities in export trade, are unequal before the law, and meet different opposition from local authorities in their restructuring attempts (which gives rise to social tensions), have unequal access to land, government contracts, and economic information, different exposure to corruption, and much else.

⁸² The survey makes a special note that labor productivity in Russian manufacturing was 17 per cent of the US level in 1997, down from 30 per cent in 1991. For a 50 per cent fall in productivity, employment was reduced by 10 per cent only.

The company experts' conclusions are not all without a gleam of hope: at least, they have not found any purely economic obstacles to economic growth (of up to 8 per cent per annum, with an eventual doubling of GDP per capita). Moreover, they hold that 75 per cent of manufacturing equipment at "Soviet" enterprises built before 1992 is completely viable, provided it is modernized and modern management systems are adopted. These enterprises will then average a 40 per cent growth, at a cost of pinpoint investments aggregating 5 per cent of GDP for five years (or around \$7.5 billion at the exchange rate of early 2000, significantly less than Russia's investment needs requested, for example, by the Ministry of Economy). In other words, the core conclusion is that economic growth (on launch, at least) in today's Russia must be fueled not so much by huge investments (understood by many as a hard-to-come-by panacea and, not infrequently, as a finishing post), as hard, largely political, efforts to create a general favorable environment for enterprises.

These conclusions are certainly important in making plans for continued reforms in the Russian economy – emphasis must be placed specifically on institutional aspects (such as legislation, protection of property rights, financial markets open to all, equal competition conditions, and law enforcement), modernization, and attraction of investment. Russia's lackluster performance in this area in the 1990s has become a major roadblock for **long-term** economic growth. Accordingly, the inconsistency and extremes, from unrestrained optimism to manifestly cheerless evaluations of development prospects for the Russian corporate sector (and the economy as a whole), of the above conclusions are nothing to be surprised about in their straightforwardness.

There is no denying the fact that Russia has been moving toward the market economy and democratic values all through the

1990s. The immanent features of its forward movement, leaving aside its financial meltdowns, investment famine and recurring scandals over property rights, included chronically unfinished institutional reforms; a system of soft budgetary restrictions; hierarchic bargaining between the government and large corporations; overlapping property distribution stages; virtually complete lack of protection for property rights; inefficiency and corruption of the existing governance system, law enforcement as a selective measure in government hands, and law enforcement by private interests as a criminal variety of sorting out differences.

These limitations have blocked positive advance in several key areas. Progressive corporate laws passed in 1996, a potential effective bankruptcy mechanism enacted in 1998, a regulation system for the corporate securities market, and antimonopoly laws in effect since 1998 could all have served their useful purposes in full. This has come into a particularly sharp focus by early 2000. A majority of programs for institutional reforms in these areas adopted in the second half of the 1990 have actually remained on paper.

This legacy of the 1990s has either to be accepted as is, or ground is to be cleared for a new bout of tough institutional reforms (Putin's "institutional dilemma").

This brings to mind an obvious association with the resurgence and newfound vigor of principal lobbies in Russia in the early 1990s. In 1991 and 1992, their vigor was sapped by the collapse of the USSR, and the government had every chance of playing an "independent arbiter" role. It missed its chances in 1993, with inevitable consequences for the economy (budget deficit, inflation, failure of money-based privatization, a pyramid of government securities, pseudo-banks, capital export, non-transparent deals involving public property, and so on). The popular term "crony capitalism" pro-

vides the most superficial characterization of the system that had shaped up in Russia.

The financial crisis in 1998 has, in a sense, again wiped the slate clean to write a new set of rules of the game, with the giant Moscow financial groups hamstrung and a new alignment of forces in place.⁸³ Meanwhile, new “**oligarchs**”, linked to the real sector (including the property expansion of natural monopolists) or to the regional elite, have stepped forward in the post-crisis period. A few examples will be enough to illustrate this point.

According to available estimates, the annualized market price of oil in 1999 was \$19 a barrel, while the Customs Committee’s statistics gives as little as \$13 as the annualized selling price of export-bound oil. The difference adds up to an estimated aggregate capital drain of some \$7.5 to \$8 billion in the oil sector. The oil industry had (as of October 1999) a capitalization of \$4 to \$5 billion. In winter and spring 1999, however, the exodus of foreign investors speeded up sharply. In actual fact, all these developments heralded a new modification of the ownership structure in the industry (even though the exported capital proves, at one time or another, insufficient to buy up the industry as a whole).

Among the 12 vertically integrated oil companies, the best-placed, according to estimates, are LUKOIL and Surgutneftegaz, which gave thought to various expansion options in 1998 and 1999. An instructive example was obviously the attempts launched in 1998 and 1999 by Tyumen Oil Company (TNK) of the Alfa group to gain control over the Sidanko group oil companies (Chernogorneft and Kondpetroleum) by initiating bankruptcy proceedings (to impose outside management).

⁸³ For more, see: Radygin, A., and Entov, R., “Institutional Problems of Corporate Sector Development: Property, Control, Securities Market,” IET, Moscow, 1999 (in Russian).

A similar process was characteristic of the steel industry as well (where property partitioning came suddenly to a head in 1999, just as in oil). Whereas in the oil sector resources could be mobilized to consolidate control as a result of the two- or threefold price rise after March 1999, in steel the funds needed for consolidation (recarving) of property were derived after production costs denominated in dollars had plummeted deeply following the turmoil of August 1998, with prices unchanged. The consolidation process had, therefore, the following typical features: displacement of foreigners, buy-ups at very low prices (which was impossible in 1996 and 1997), leading role of insiders (managers and co-owner partners), and heavy reliance on bankruptcy proceedings and debt schemes.

A **greater role of the regions** in property reallocation was another logical post-crisis process, in particular:

- formation of regional holding companies under the sponsorship of local authorities (a Bashkirian fuel and energy company was set up in Bashkortostan, four holding companies were established in the glass, linen, cotton and defense industries in the Vladimir Oblast, the Central Fuel Company was created in Moscow, for example);

- attempts to revise privatization deals won by representatives of the Center (federal groups), other regions or foreign investors (for example, the sale by Philips, under pressure from the Voronezh regional authorities, of 89 per cent of shares in Voronezh Cathode-Ray Tubes Company, at one ruble per share, to the Russian Electronics financial-industrial group in 1999, or a dispute in 1998 between the German firm Knauf, which had acquired the Kuban Cement works, and the local authorities and works managers, that was, however, resolved in the investor's favor, and so on);

- withdrawal of trust-managed shareholdings in regional enterprises (in Tatarstan, a decision was made in 1998 to withdraw shareholdings in nine large companies from the trust administered by Tatinvest-Ross investment company registered in Moscow);

- attempts to cancel new share issues that have changed the ownership structure of regional corporations in favor of “outsiders” (as in Moscow or Samara), and so on.⁸⁴

Persistent attempts to impose regional controls (frequently jointly with the “victims” competitors) were launched in 1998 and 1999 by the authorities of regions having oil industry enterprises. Examples include a conflict between the Irkutsk Oblast authorities and Sidanko over the ANHK petrochemical plant, demands for local YUKOS enterprises to be placed under the control of the Samara Oblast, a conflict between the Yamal Nenets Autonomous Okrug and Rosneft Company over Purneftegaz company, a conflict between the Nenets Autonomous Okrug and Kombineft Company, and many more.

Against the background of the crisis that hit many leading banks and financial groups, it was natural to see more power being seized by federal **natural monopolies** and “autonomous empires” that had arisen around major corporations originally set on “self-sufficiency” and, therefore, escaping the financial crisis with relatively minor losses. Understandably enough, their power can be augmented largely from the assets and goodwill of their former rivals.

In particular, RAO UES is studying projects for new power-coal and power-steel companies. Gazprom has scrutinized several alternative designs for a new steel holding company, Gazmetal,

⁸⁴ Another notable trend typical for both federal and regional levels in 1998 was formation of family (clan) relationships within the framework of large corporations or within a regional authority–regional company system.

which could have controlling interest in the Lebedinsk, Mikhailovsky and Stoilensky mining and process complexes acquired from the Russian Credit group, along with shareholdings in the Oskol electric steel plant, and possibly in the Novolipetsk steel plant as well. This may signal an end simultaneously to several scandal-ridden corporate entities that have been going on for years (over the Lebedinsk mining and process complex, the Novolipetsk steel plant, etc.). Work is under way to establish a countrywide petrochemical holding company with support from Gazprom.

The situation is different today (from what it was in 1993) not only because of the emergence of a new political leader who is not yet bound by any links to the entrenched and new financial groups. The year 2000 must become a watershed for several reasons: first, there is now a chance to pursue a single-minded and well-defined policy for at least eight years in an environment of a potential political stability (even expectations of such stability have had a telling effect on the stockmarket early in 2000): second, it is only at the **starting point** of a new economic policy and headway made in the institutional area that it is basically possible to reject, in principle, the model of oligarchic (crony or criminal) quasi-capitalism. Given the backlog of economic and institutional problems building up since the 1990s, intensification of government regulation (from declaration of intent and development of legal standards to direct intervention in the more outrageous conflicts) appears to be inescapable.

A certain position has already been stated in very broad terms, and it can be reduced (at least in the area surveyed here) to four points: protection of ownership rights; rejection of deprivatization and criminalized recarving of property; an efficient public sector; and the “dictatorship of law.” More specific steps include some measures (such as tax surcharges on the basis of the market prices

of goods) against transfer pricing turned by oil holding companies actually into a guise to take capital away into offshore companies.

And yet, the new administration is confronted with the need to define its stand in more clear terms on at least three basic issues.

First, **reprivatization**. The term is immaterial in this context. It may be a regular nationalization, or deprivatization (that is, restitution of privatized properties to public ownership), or reprivatization (deprivatization followed by the privatization of the “right” kind).

Essentially, the problem is that nationalization has been going on, **for a long time already**, in all conceivable forms:

- at the level of general ideology and political struggle (the most striking illustration of this is Federal Law No. 74-FZ, enacted on May 7, 1998, dealing specifically with the disposal of shares in Russian Joint stock Power and Electrification Company Unified Energy Systems of Russia, and shares in other power companies held by Federal agencies. Under Article 3 of the Law, foreign states, international organizations, legal entities and their affiliated Russian legal entities, and foreign individuals may own up to 25 per cent of all classes of RAO UES shares. Significantly, at the time the law was enacted, foreign interests held almost 30 per cent of RAO UES shares.⁸⁵ Also in this category are populist versions of the draft nationalization law prepared in the State Duma in 1999);

- revision of existing privatization deals (intention of the Russian Federal Investment Fund and the Federal Prosecutor General’s Office to review the results of 17 per cent tenders held under investment terms in effect before July 31, 1997,⁸⁶ restitution to public

⁸⁵ The law notwithstanding, some estimates put the share of foreign investors at up to 33 per cent in 1999, in anticipation of the prohibitive quota being lifted and the company’s shares posting a considerable growth in price.

⁸⁶ It is an open secret that investment tenders were among the least fortunate privatization formats. Investment programs have not been fulfilled in an overwhelm-

ownership of shareholdings in two ports in the Leningrad Oblast, deprivatization plans for some 50 Transport Ministry operators, a court ruling to deprivatize the Stavropol joint stock airline, among others);

- restitution of shareholdings to public entities in debt settlement (the most celebrated examples in 1999 involve Kamaz truck manufacturing company, with 26.7 per cent of its shares handed back to the Russian federal government and 27 per cent to Tatarstan in September, and AvtoVAZ, the controlling interest in which was transferred to the government in December as collateral under a debt restructuring program);

- formation of new (including public) holding companies that are handed state-owned shareholdings. Whereas previous a state-owned shareholding was not actually managed by anyone or was *de facto* privatized for voting purposes, the role of government agencies is reinforced in formal or real terms through formation of new entities or merger of existing ones. This approach is especially typical of corporations of the military-industrial complex (MIC). Uncertainty over the creation of Gosneft, a public oil company, is a good example of the authorities' inarticulate position;

- the use of deprivatization by business managers as a tool in corporate struggle (as exemplified by the notorious scandal over the Lomonosov porcelain factory in 1999). Also known are attempts to have privatized companies restituted to the public voluntarily;

ing majority of deals. In all, 1,084 shareholdings were sold at investment tenders in 1992 to 1997, and 328 of them were eventually restituted to public ownership by court. The intention now is to apply the provisions of the new 1997 privatization law to deals made before that year. Collusion to have the shareholdings resold immediately (before an investment program could be carried out) could certainly take place, but the shareholdings cannot be restituted unambiguously because of the *bona fide* purchaser problem still outstanding.

- efforts by regional authorities to assume control over budget-contributing enterprises (most frequently, by appointing outside managers). Another aspect of the problem is accentuated by restitution through courts of federal property transferred to the regions (for example, 40 per cent of the shares in the Irkutskenergo power company, federal shareholding in four businesses that have not been privatized by the local authorities in the Krasnoyarsk Krai, and so on).

Many forms of unofficial nationalization are fully justified. Besides, hardly any large-scale decisions are likely to be adopted at the top official level, if only for the government's interest in having its foreign debts restructured as favorably as possible and in obtaining loans from international organizations and selling more shareholdings.

The general uncertainty (non-transparency) of government policy in this area is, however, one of key factors preventing projection of a propitious investment-friendly image of Russia. Today, at least two decisions are necessary to mitigate the problem: first, in the short term, a firm and substantiated declaration of intent by the government, and second, in legislation, passage of a Law on Nationalization in the Russian Federation, outlining principal procedures and describing measures to protect the interests of investors, who are *bona fide* purchasers (see also paragraph 2).

Second, an **abrupt acceleration of property reallocation processes** in Russia and aggravation (intensification) of corporate conflicts after the financial crisis in 1998.

In some instances, sharp depreciation of corporate securities provided reasons for control consolidation or corporate aggression. Meanwhile, some stakeholders, including issuers, were attempting to improve their financial positions by unloading their shares. Many commercial banks and financial groups, having found themselves at

the brink or in the process of bankruptcy, met their liabilities by assigning their shareholdings in the real sector. Some stakeholders were attempting to consolidate their shareholdings within the framework of privatization sales to strengthen their control at minimum costs.

The crisis has, in its turn, stimulated additional issues of shares and derivatives, debt schemes (debt securitization), bankruptcy proceedings, and company reorganization. In these conditions, attempts by regional elites to win control over key enterprises in their regions have become more conspicuous and successful.

The most notorious corporate conflicts in 1999 and 2000 were the standoffs between Sidanko and TNK, Transneft, Lomonosov porcelain factory, Vyborg pulp and paper mill (armed seizure), Achinsk alumina plant (armed seizure), Kuznetsk integrated steel plant, Kachkanar mining and process complex (armed seizure), Nizhnesandinsk integrated steel plant (armed seizure), coal strip mines in the Krasnoyarsk Krai and Kuzbass, aluminum plants, Moscow chemical pharmaceuticals plant (a unitary enterprise, an attempt at armed seizure), Orsko-Khalilovsky integrated steel plant (where alternative, additional shares were issued in what is actually the first experience in Russia's corporate history).

Struggle is waged basically by procedural methods: keeping of two registers, electing two sets of governing bodies in companies (two general meetings, two boards of directors, two general directors, adoption of a single share format, and so on). In some instances, however, armed seizure is becoming once again, as in the "lawless" years 1993-1995, one of the most favored methods to assert corporate control. Most frequently, these conflicts are highlighted by legal nihilism, with the usurper of corporate power ignoring the real share capital structure and the fine procedural points of corporate governance.

According to some experts, this exacerbation of the situation at some major enterprises is linked to the desire to complete property redistribution by whatever methods possible before the presidential election, so the new federal administration is put before a *fait accompli*. There probably is some truth in this conjecture, but there also are more deep-lying causes: the corporate aggressor reckons on support from the regional authorities and on the general institutional crisis in law enforcement.

The root of the problem is that these conflicts are only the tip of an iceberg. Whereas in 1996 struggle for power was completed in 25 per cent of Russian corporations, and in 50 per cent in early 1998, the process was rolled back after the August 1998 crisis. The mass-scale redistribution of property that started in the corporate sector in 1998 and 1999 is evidenced by registration books: first, in fall 1998 and in 1999, the registrars handled practically the same number of share deals requiring renewed registration; second, the number of registrars that provided services to over 500,000 holders of registered securities decreased actually to zero in 1999 (from 20 in 1998). Add to this the fact that almost 19,000 securities issues were registered in the Russian Federation in 1999 (down from 20,000 in 1998), with the number of closed subscriptions having doubled and that of open subscriptions having gone down by a factor of seven (from 1998). To put it in general terms, the ongoing redistribution process is attended by consolidation of corporate property.

Property redistribution is certainly a normal and effective mechanism of corporate governance and control over managers within the framework of civilized procedures, if such redistribution translates into a company's improved performance at the microeconomic level and stimulates economic growth on a countrywide scale. In Russia's specific conditions, this mechanism fulfills

slightly different functions. The current trends will (because of the objective processes of a transition economy and by reason of numerous subjective factors) continue for a few more years, a prospect that might add to the instability of ownership rights and require a rigid policy to be taken to protect the interests of investors (shareholders). Creating a clear legal environment for such redistribution is, therefore, a high priority.

It probably makes sense to undertake a detailed analysis of typical corporate conflicts and methods used to settle them (especially that most of such settlement tools are well known). Its results must be used to, first, make adequate amendments to the existing laws and, second, develop a typical model of response on the part of appropriate government authorities.

The existing basic laws and statutes are fragmentary so far, unable to provide adequate protection for investors' rights. Among their blind spots, the following are more serious than others:

- they do not define rigid sanctions that could be applied against unlicensed business operators and issuers of surrogate securities (public offering of securities that have not been registered by government agencies);

- they have not established legal mechanisms to detect, prevent and punish fraud;

- they are inarticulate in regulating relationships arising in connection with insider deals;

- there still is the problem of how to prevent (punish) price rigging on the market;

- legislation to regulate deals between affiliated persons is still in its embryonic phase.

Third, **enforcement** continues to be an urgent problem closely related to corporate conflicts. Forming a legal environment for a

civilized succession of property owners is an effort wasted in the absence of infrastructure and political will to enforce the law.

In terms of “coverage” of its economic laws, Russia has, in effect, joined the leading group of countries (with its expert rating of 4-, it is closely behind Bulgaria, the Czech Republic, Hungary, Poland, Romania, Lithuania, and Croatia, all rated 4, and industrially developed countries, with a rating of 4+).⁸⁷ Its record is much worse in the “efficiency” of economic laws (rated 2 by experts, against 3 or 4 for the leaders). Overall, this classification puts Russia in the middle of countries with transition economies.

There is an obvious need for a continued tightening of enforcement rules on the securities market by a regulatory authority. It is dictated, above all, by the scale and number of various offenses. The most typical infringements of the law discovered in 1998 and 1999 were the following:

- securities are floated without registration by a government agency;
- trading on the securities market is carried out without a proper license required for professional securities market participants;
- no register is kept to record holders of outstanding registered securities;
- entries about assignment of ownership rights are unlawfully refused or such entries are made in registers of registered securities holders unlawfully by specialized registrars;
- securities are traded without a proper instruction from their holder or are not traded even with a holder’s instruction in hand;
- infringements of statutory corporate governance procedures are committed by joint stock companies;

⁸⁷ See: Transition Report 1998, EBRD, 1998.

- infringements of statutory rules of disclosure are committed by securities issuers and professional securities market participants.

There are, within the current legislative framework, numerous barriers to effective enforcement in the interests of investors and shareholders. Limited opportunities open to a regulatory agency is a typical problem of enforcement. The problem was, in part, resolved in 1999, with the passage on March 5, 1999, of Federal Law No. 46-FZ, on Protection of the Rights and Legal Interests of Investors on the Securities Market. Among the more important, new provisions, it focuses, in particular, on the following rights of the Federal Securities Commission: holding public hearings, issuing orders, imposing penalties, initiating lawsuits and requesting for court action to protect the interests of private investors and the public.⁸⁸

The problem has not been resolved in full as yet. A system of sanctions against offenses on the securities market is to have a maximum flexibility with penalties taking into account the severity of offenses, from fines charged for minor offenses, to suspension of licenses or refusal of document registration for medium infringements, to penalties of criminal nature for grave offenses. So far, the last package of measures is not lawfully available to regulatory agencies.

⁸⁸ The need for such specific legislative act is still debatable, however, as regards the formation of a general legal structural framework for the securities market (the problem can be resolved, under certain political conditions, by amending the existing Securities Market Law). Accordingly, similar amendments will have to be made to the Administrative Offences Code to give them a “permanent” character.

2.1.2. Traditional Privatization Process Dynamics

Privatization as an element of economic reform is gradually fading in importance. This applies both to its system-forming role (crucial for the early 1990s) and to the budgetary orientation of privatization sales (dominant, with a varying measure of success, in the late 1990s). The declining role of privatization in the development of a transition economy was manifested, in particular, in the growing criticism, most conspicuous in 1999, of the models used (scathing attacks were again launched against the Russian mass privatization model and the Czech coupon scheme, in its time a standard in Western eyes).

From the perspective of continued systemic reforms, privatization was obviously taking second place to such issues as corporate governance and restructuring of privatized enterprises. In terms of budget revenue growth (budget deficit financing since 1999), top priority is being given to rational uses and improved management of public assets. Finally, the investment component of privatization deals has traditionally been near zero. And more, many investment-clause deals have been, in 1999 and 2000, for various reasons, under investigation with the purpose of the shareholdings being restituted to public ownership.

According to the Public Property Ministry, the sector of privatized enterprises had, as of January 1, 2000, almost 130,000 enterprises (58.9 per cent of the total in the Russian Federation at the outset of privatization). Besides, privatization in 1992 through 1999 left the government with a large number of shareholdings in privatized enterprises (3,100 shareholdings under the Golden Share rule and between 7,000 and 8,000 unsold shareholdings), selling which became a core problem for the privatization policy proper between 1995 and 1999.

The slowdown in the privatization process was caused by many objective and subjective factors. The most significant of them was lack of demand for a majority of the remaining shareholdings on sale (for lack of interest toward those economic units in general or because of formal and/or informal corporate control poles existing at a particular enterprise). The continuing privatization sales were objectively dominated by the desire to establish control (or to complete consolidation) that was typical of the post-privatization period in all countries with transition economies. Unresolved problems of land ownership, unfinished projects, mobilization capacities, and the large number of government-held (actually unmanageable) shareholdings were a further drag on the privatization process and a factor for under-pricing of the deals made.

A note must be made of two trends restraining the privatization process in the regions: on one hand, the privatization decisions made in recent years have not been fulfilled and, on the other hand, the regional authorities are striving to gain control over the largest possible number of enterprises in their respective regions, including those in federal ownership.

The crisis that swept the financial markets in 1997 and 1998 was an objective negative factor affecting the efficiency of privatization deals of key importance for the budget. With oil companies having lost much of their attractiveness for investors in the conditions of falling world markets, the options for a budget-oriented privatization policy were (at least until mid-1999) extremely limited.

The adoption of a new Federal Law (No. 123-FZ) on Privatization of Public Assets and on Principles Governing Municipal Property Privatization in the Russian Federation (signed into law by the Russian President on July 21, 1997, effective from August 2, 1997) did not add much vigor to the privatization process in 1998 and 1999. The rejection by the State Duma of a draft law approving the

government program for public property privatization in the Russian Federation certainly acted as a constraint.

Another significant fact was that, in 1999, privatization proceeds (Table 1) were not included in federal budget revenue for the first time, and were credited among sources to finance the budget deficit. This measure helps avoid a rigid budget orientation in decisions made about privatization deals and give more consideration to the real market situation.

TABLE 1

Privatization 1995 through 1999

	1995	1996	1997	1998	1999	2000
No. of privatized enterprises	6000	5000	3000	2583	595	-
Approved budget	4,991 trillion ^a	12,3 trillion	6,525 trillion	8,125 billion ^c ^d	15 billion ^{cf} (total 18,5)	18 billion ^c (total 23,7)
Actual proceeds	7,319 trillion	1,532 trillion	18,654 trillion ^b	14,005 billion ^e	8,33 billion ^c (total 17,3)	-
Dividends on federal stockholdings	115 billion	118 billion	270,7 billion	574,6 million	6,15 billion	Plan target: 3,5 billion

^a – The approved budget was revised in December 1995, and 70.8 per cent of total actual proceeds came from loans-for-shares auctions.

^b – \$1.875 billion of which came from sales of Sviazinvest holding company shares.

^c – From property sales only.

^d – Revised to Rb15 billion in April 1998 (at the federal government level).

^e – Rb12.5 billion of which came from sales of 2.5 per cent of RAO Gazprom shares.

^f – Not included in budget revenue.

Two latest circumstances (approval of lists of eligible enterprises bypassing the State Duma and possibility of financial flexibility in respect of particular units) resulted in three lists of enterprises eligible for sale in 1999 being produced at one time. The first list contained some giant companies (LUKOIL, Gazprom, and Aeroflot), the second offered shareholdings in enterprises (around 60 enterprises in several industries, including oil and metals) that could together contribute heavily to the budget, and the third list included some 1,200 remaining shareholdings in small and medium-size enterprises to be sold by regional offices of the Russian Federal Investment Fund.

In 1999 privatization actually grossed an income of Rb17.3 billion (short of the Rb18.5 billion planned).

The proceeds from the sale of enterprises (shares) were just over half of the plan figure: Rb8.33 billion rather than Rb15 billion as planned for 1999. In formal terms, this amount turned out to be significantly smaller because of the government's refusal to sell a number of shareholdings (25 per cent + 1 share in Rosneft, 19.68 per cent of the shares in Slavneft, and smaller shareholdings in RAO Gazprom and RAO UES, and 25 per cent minus 2 shares in Sviazinvest). These aborted sales can be carried over to 2000.

As a result, sales proceeds came (as in the years past as well) from a few successful individual deals.

A commercial investment-clause tender was held to sell 9 per cent of shares in LUKOIL (under Government Directive No. 1423-r) on October 29, 1999. The investment proceeds were to be used in "... developing and introducing a system to reduce contingency losses at subsidiary enterprises." The starting price of the shareholding was put at \$200 million and the investment program was estimated at \$240,420,509. As a result, the gross price of one share worked out at \$6.55 (its RTS quotation at the time was \$7.5). The

tender results did not break with tradition: the shareholding went to a Cyprus-based offshore company that paid \$5,000 over the starting price (its formal competitor, another Cyprus-based offshore company, erred by offering a mere \$1,000 over the starting price of the shareholding). The government actually earned \$3 on each share sold.

These results point, with a 100 per cent certainty, to a continuation of a share repurchase strategy by the issuer (alternatively, the shareholding could be yielded up to its American partners). The remaining 16.6 per cent of the shares still held by the Russian Federation may be sold by a variety of methods in 2000 (possibly, without giving up the Golden Share). Consideration is also given to plans to sell these shares on stock exchanges in other countries.

Portfolio investors could pick up 1 per cent of shares in the company at a special auction on November 29 (at a gross starting price of \$46 million, or Rb170 per share, selling at a market price of Rb250). With 29 bids received from individuals and legal entities, 0.647 per cent of the company's authorized capital was sold for Rb820.8 million.

The sale of 49.806 per cent of shares in TNK (pursuant to Presidential Decree No. 1413) was another major deal of 1999. The starting price was set at \$66.7 million, and the investment program was put at \$185.256 million (as a result, the gross price of a share came out at \$0.16, market quotation not available). The set of requirements for a would-be buyer (including acquisition of 55.5 per cent of shares in Ryazan Oil Refining Company) suggests that, as also in the case of LUKOIL, the deal was tailored to a specific purchaser associated with the private holder of controlling interest in TNK.

This is only too natural for the specific Russian market, where, given rigorous control in a company, strategic investors generally

do not bid for anything but the controlling stake (while the controlling stake is unacceptable for portfolio investors). Everybody knew about TNK's current problems having a direct effect of the price of the shareholding: the need to make large investments in the Samotlor oil field (yielding three-quarters of the company's current output), loss of majority control in a number of subsidiaries (which did not pay dividends because of financial problems and were forced to convert preference shares into voting stock), and other headaches. The remaining shareholders may, in this situation, bargain the government into lowering as much as possible the price of the privatization deal. For its turn, the government does not feel bound to accept the terms imposed on it and may put off the sale.

The final price of the shareholding (after the tender results were toted up on December 22, 1999) was around \$90 million. The shareholding went to a company representing the interests of TNK shareholders. This sudden rise in the shareholding price over the starting price could probably be explained by Sidanko's unexpected last-minute attempt to make its own bid to thwart TNK's aggressive push. In this connection, it was interesting to learn about the Ministry for Anti-Monopoly Policy's rejection of a request from a representative of the Interros Group for the Ministry's preliminary consent to the Group's purchase of the shareholding. The Ministry's rejection could be interpreted as an efficient tool in corporate struggle.

Proceeds from the sale of other public assets, however, proved much higher than planned (Rb8.99 billion against Rb3.5 planned). For example, whereas the 1999 federal budget provided for Rb1.5 billion to be received in dividends to be paid on government-held shares, the actual receipts amounted to Rb6.15 billion. Another Rb2.165 billion was received in rent for federal real estate (against Rb2 billion under plan). Rent from federal property situated in oth-

er countries contributed Rb315 million (against Rb200 million under plan).

It is obvious, however, that the dividend windfall was the result of the government's pressure targeted against major companies. In 1999, in particular, it succeeded in expanding the source base, with 600 companies being compelled to pay dividends to the government, a threefold increase from 200 payers in 1998. It was much more difficult to rationalize receipts from federal real estate in Russia and other countries, even if because of its wide dispersion and difficulties of identifying actual beneficiaries.

The year 2000 has inherited many problems related to privatization. They may cause many worries to, primarily, those investors who are either real outsiders or "*bona fide* purchasers." The more urgent of these problems may be identified as follows:

- the danger, we already spoke of above, of reprivatization in Russia as a whole, as a factor lowering the country's attractiveness for investors (in particular, in 1999 an unofficial source put the proportion of enterprises privatized with little regard for the law at almost 40 per cent of the total number privatized);

- absence of nationalization laws (which, in an investor's opinion, are to codify procedures for compensation payment to investors and for protecting the interests of *bona fide* purchasers, considering numberless changes of hands over recent years);

- a dual approach to offenses committed in privatization deals is to be legalized: (1) penalties (including punishment under criminal law) must be applied against officials and their partners for any uncovered and proven offenses regardless of the time of offense commission; and (2) the absolute principle of "inviolability" of a *bona fide* purchaser's property must be enforced (which is tantamount to the government's noninterference in the existing owner-

ship structure). Absolute indemnification of the *bona fide* purchaser for losses may be the only alternative to this approach;

- an informal ten-year limitation period applied by tradition to privatization deals is a problem in its own right (Article 181 of the Federal Civil Code could probably be invoked to reduce and legislatively formalize the period for action for the application of the consequences of invalidation of a void deal);

- transparency remains an unresolved problem for a majority of privatization deals (that is, the terms of an investment process are incomprehensible to outsiders);

- the sale of minority shareholdings (up to 25 per cent) is in many cases (especially those involving foreign investors) is restricted by decision-making in the company being subsequently influenced by majority holders;

- discrimination persists between insiders and outsiders regarding the sale terms of specific shareholdings (according to Brunswick Warburg, for example, the sale terms of 9 per cent of shares in LUKOIL in 1999 were openly discriminatory against outsiders who were to pay at least \$6 per share, including the investment requirement, as compared with \$3 per share for insiders. The sale of TNK shares and many other deals in previous years can be interpreted in similar terms);

- there still is discrimination between insiders and outsiders as regards the degree of severity of penalties for breach of the terms of privatization deals;

- problems of dual approach in privatization decisions and public property management, a legacy of 1991 when the Public Property Management Committee and the Federal Investment Fund were set up, have still not been resolved. In 1999 and 2000, for example, the Public Property Ministry ventured into new areas (by masterminding projects aimed at subordinating the Federal Council of Fi-

nancial Organizations, the Federal Securities Commission, appraisal business, etc.). In turn, the Federal Investment Fund envisions itself, in the long term, as a state investment bank, with the right to trade on the stockmarket, a vision hardly justified in reality.

What are the prospects for privatization policy?

The Concept of Public Property Management and Privatization in the Russian Federation (approved by the Federal Government in its Directive No. 1024 on September 9, 1999) may probably be viewed as a program for the next few years. Moreover, there is a high probability that this document may (because of its approval by the most likely presidential candidate and also because it clearly cannot be amended radically in essence) become a commandment for a longer period as well, until 2010. The general goals and principles of privatization are routinely declarative, so the new approaches to tender organization deserve a closer attention. In particular:

- a differentiated approach has to be applied to the privatization of enterprises depending on their liquidity ((a) high-liquidity enterprises are privatized where there is a need to maintain balance between the amount of attracted investments and the sums transferred into the budget, also considering their real valuation as close to world level as possible; (b) low-liquidity enterprises may be sold to “effective proprietors” at low prices upon presentation of a business plan and implementation of measures to monitor the enterprise performance data system);

- when high-liquidity shareholdings are privatized with a view to derive considerable resources for the budget, the fee to be paid to financial advisers must depend on the amount of funds obtained through privatization;

- a broader range of privatization tools is to be used, such as (a) issue of derivatives secured by public assets that could be traded on

foreign securities markets (deferred right to purchase shares in public ownership); (b) share trading on the stockmarket and the secondary market to optimize government involvement; (c) sale on the basis of direct talks with investors, including instances when an auction (tender) is considered aborted (in which case the price of the property must be equal to at least its starting price at the aborted auction); and (d) sale of public assets, with payment to be made by installments against bank guarantees;

- privatization decisions are to be made on the basis of long-term enterprises development plans submitted by potential investors and privatization agreements containing detailed obligations assumed by the investors;

- pre-sale preparation of enterprises must involve assistance from financial advisers, auditors, appraisers, legal advisers, and management consultants;

- commercial tenders are to be held on social development terms:

- decisions are to be made on an optimal number of unitary enterprises (tentatively between 1,500 and 2,000, against 13,786 in 1999) and their reorganization into joint stock companies (except socially important cases);

- unfinished construction projects, and building and structures that are not used for public needs, are preferably to be sold for setting up new production facilities at low prices (provided that the new owners assume obligations in accordance with a performance monitoring system, now at the development stage);

- decisions are to be made on the expedience of new vertically integrated industrial entities using public assets under trust arrangements;

- subject to investment clause sale, priority is to be given to industries promising quick returns (investment programs being limited in time to technologically acceptable periods).

Many of the foregoing considerations will require amendments to be made in the privatization law (such as, for example, sale of 9 per cent of share in LUKOIL on the stock exchange, as was the Federal Investment Fund's idea, and direct sales), so the application of many of these methods may be put in doubt in 2000. It is no less cumbersome, from the legal point of view, to issue derivatives against the security of public assets (amendments would be required to the budget, discrepancies between the Privatization Law and the Law on the Specifics of Issue and Trading of Government and Municipal Securities would have to be removed, and so on)

Unsold minority shareholdings (less than 25 per cent) remain a traditional problem for both privatization programs and public management arrangements. Leftover shareholdings were unloaded virtually at token prices in 1997 and 1998 already, and yet their total number is still considerable. Beginning in 2000, the following decisions may tentatively be taken in respect of these shareholdings:

- they may be contributed to the authorized capitals of other joint stock companies;

- they may be used to augment the publicly held block of shares to at least the size of the blocking shareholding by contributing public assets to the authorized capital of a company or by purchasing shares in that company on the secondary market and then selling a block of shares to a strategic investor;

- a publicly held block of shares may be transferred to the issuers or to a member of the Russian Federation (or a municipality) against budget financing, on the condition that it would be repaid

and no arrears would accumulate in wage payments or in mandatory payments to budgets at all levels, or in any other parameters;

- publicly held blocks of shares may be sold at preferential prices to enterprise employees, including those of newly established nationalized enterprises.

An understanding of the fact that Russia today does not have a single economic unit for any new integral privatization model to be tried on is a key prerequisite for identifying future privatization goals. Accordingly, what is needed today is only a new privatization concept covering the largest possible number of various aspects (offering solutions to problems) of the operation of enterprises, a majority of which has been incorporated and privatized in full and/or in part.

This also means that, given the broad differentiation of the great multitude of existing enterprises, privatization as such has to rely on a great diversity of approaches (or their combinations), a vast majority of which has been incorporated into existing laws in Russia.

A basic task today is optimizing the ownership structure (from the perspective of economic proportions and at the microeconomic level) in order to create permanent conditions for economic growth. The budgetary and social aims of privatization must, in the obtaining situation, be objectively of derivative nature, or, for some groups of enterprises, supplement and complement the basic task.

2.1.3. Public Property Management

As of November 1999, Russia had 13,786 unitary enterprises and 23,099 institutions. The Russian Federation participates (as a shareholder) in 2,500 joint stock companies, in which it holds an interest in excess of 25 per cent of the authorized capital, in all core industries (including 382 companies with 100 per cent of the shares

in government hands, 470 companies with more than 50 per cent of the shares, and 1,601 companies with stakes ranging from 25 per cent to 50 per cent of the shares). Besides, it exercises its Golden Share rights in 580 companies.

There are federal shareholdings in 697 companies producing goods and services of strategic importance for the country's national security (a list of such companies is contained in the Federal Government's Directive No. 784 (July 17, 1998) on a List of Joint stock Companies Producing Goods and Services of Strategic Importance for the Country's National Security, which are held in federal ownership and the shares of which are not subject to sale before time). Under the core legislation and other statutory acts, the federal government owns shares in a total of 847 companies.

The federal government received Rb574.6 million in dividends on its shareholdings in 1998, Rb270.7 million in 1997, Rb118 million in 1996, and Rb115 million 1995 (at 1998 prices).

This study does not aim to make a detailed analysis of all aspects of the public property management problem. We will, therefore, confine ourselves to a brief description of the existing tools and to an assessment of their efficiency.⁸⁹

The *institution of government representatives* can be named as the principal component of government policy in this area. Presidential Decree No. 1200 (June 10, 1994) on Selected Measures to Administer Public Management of the Economy, specified: (1) framework requirements to a contract between the government (federal agency) and the chief executive of a federal public enterprises, and (2) framework requirements to agents representing public interests in joint stock companies. Representatives were divided

⁸⁹ This summary is based on the Proceedings of the National Conference, "The Public Property Management System in the Russian Federation," Moscow, November 1999 (in Russian).

into two categories: (1) civil servants and (2) any other Russian citizens (representing public interests in joint stock companies under contract).

Today, there are approximately 2,000 government representatives, of whom 92 per cent are employees of federal executive agencies and the remaining 8 per cent are employees of various departments. Only a few professional managers have been hired to manage publicly held blocks of shares (mainly because of compensation problems and complex formalities involved in establishing trusts).

According to available facts, this institution may not be considered efficient for the following reasons: as a rule, each representative is involved with several companies at a time, representatives lack the required qualifications or material (legal) incentives, their missions are ill-defined (are not intelligibly formulated in contracts), no mechanisms exist to enforce their accountability for the property in trust so as to reduce risks for the government, representatives are not accountable for the affairs of companies or decisions made, and so on. Besides, identical requirements are made of companies with different government stakes, although government influence on them is widely different.⁹⁰

⁹⁰ Considerable damage has been inflicted to public interests where a federal shareholding has been diluted with approval of a public representative. Some strategically important enterprises with a bearing on national security have not been spared the damage either, for example: Delta R&D Company (where the public stake dropped from 25.5 per cent to 17 per cent) and Irkutsk Aircraft Industry Corporation (from 25.5 per cent to 14.5 per cent) in 1996, and Perm Motors Company (from 14.25 per cent to 6.7 per cent) in 1997. A few examples can, of course, be cited of public representatives actively intervening the affairs of the companies to which they have been assigned. In 1997, they were behind the replacement of chief executives in 22 companies in various industries for arrears in wages and budget payments.

The *tools* that the government used, even if on a limited scale and selectively, in 1992 to 1999, include:

- taking selected “strategically” important actions (for example, an individual trust agreement involving 35 per cent of government shares in Gazprom);

- setting up boards of government representatives in major holding companies;

- “reinforcing” an enterprise (a holding company) with government interest by contributing government shares in other enterprises to its authorized capital (coal companies, Svyazinvest, etc.);

- creating trusts to manage government shareholdings (oil, coal and power in 1992, general Rules of Trusts Established to Manage Blocks of Shares Held by the Federal Government Formed During Privatization and Trust Agreements Signed to Manage Such Shares, in 1997 and 1998);

- giving blocks of shares in trust to management (central) companies of financial-industrial groups (FIG’s) or holding companies (Ruschim FIG, RAO Biopreparat, Nosta-Gas-Pipes, Russian Joint Stock Meat and Dairy Company, specialized civil engineering companies, and so on);

- making personal appointments to company boards of directors by a resolution of the Federal Government or by Presidential decree (RAO Gazprom, RAO Norilsk Nickel, oil companies, and so on);

- establishing a voting procedure for publicly held shares at shareholders’ meetings (in oil companies, by directives of the Federal Government, and in RAO UES and AO Rosgazifikatsia, by a resolution of the board of government representatives);

- re-certification of government representatives, disclosing cases of government representatives voting for dilution of federal shareholdings.

In the present situation, the principal *complaints the government* as a shareholder has against the performance of such joint stock companies are, in principle, identical to those expressed by other categories of shareholders. Essentially, they are:

- lack of business transparency for general shareholders and the government;
- a declining proportion of “outside” shareholders due to additional share issues without their consent, for the benefit of “friendly” investors;
- transfusion of material and financial assets from parent companies to subsidiaries controlled, as a rule, by their managers or their allied firms.

Neither are *public unitary enterprises* (including “quasi-holding companies” having unitary subsidiaries) without their own, specific management problems:

- a complete register of unitary enterprises is not kept to record movements of their assets and main financial and business performance results;
- the number of unitary enterprises does not match up to the government’s capacity to manage them and to supervise their operations;
- precise criteria are lacking to justify the establishment and operation of unitary enterprises;
- the enterprises’ core activities do not always meet public interests (many such enterprises have kept their unitary status largely because of their low-liquidity assets);
- unitary enterprise management functions (as also the proprietary authority) are not clearly apportioned between different federal executive agencies;

- the legal organizational form of a number of unitary enterprises set up before the enactment of the Civil Code of the Russian Federation does not fit in current laws;

- contracts have not been signed with a majority of unitary enterprise managers, and whichever contracts exist do not specify the managers' responsibilities. Moreover, while labor laws contain effective safeguards for the managers' rights, they create considerable problems where the managers' accountability for their enterprises' performance is concerned;

- the legal construction for the right of business management vests the beneficiary of this right (in real terms, the chief executive of an enterprise) with broad powers in respect of proprietary assets (including undivided authority to manage financial flows and utilize profits).⁹¹ By contrast, the proprietor's powers are exhaustively outlined;

- no requirement is made for periodic mandatory audits, so monitoring the financial and business performance of enterprises is really difficult.

In practical terms, the broad powers of unitary enterprise chief executives, in the absence of effective management tools and established routines, supervision and motivation, result in some financial flows being diverted from unitary enterprises to satellite firms, insider deals in the interests of chief executives, and shortchanging of the federal budget.

⁹¹ Still, another possible reason for unaccountable utilization of profits is, probably, lack of interest (or will) among government bureaucrats in dealing with the problem in official terms (within the framework of corporate bylaws). They are empowered accordingly by the Civil Code of the Russian Federation (under Articles 294 and 295 of which the proprietor is entitled to a portion of the profit).

Little surprise, therefore, that the Law on Public and Municipal Enterprises in the Russian Federation (intended to supplement the relevant provisions of the RF Civil Code) has not been passed to this day.

It was assumed, with the adoption of the new privatization law in 1997 (its Article 20 specifically), that public unitary enterprises could be reorganized into joint stock companies, in which 100 per cent of the shares would be held in public (municipal) ownership following stock taking and audits. The government is, therefore, given a further opportunity to sell some of the property, a hypothetical proposition, though, it is as long as the unitary enterprise exercises its right of “undivided business management.”

The above makes it plainly clear that it is desirable to achieve positive breakthroughs in the public assets management system within the framework of a full-scale, comprehensive reform of the public property management system as a whole.⁹² The political and economic constraints on such reform are also well known.

⁹² Certain measures are specified in the Concept of Public Property Management and Privatization in the Russian Federation (approved by the Federal Government in its Directive No. 1024 of September 9, 1999).

2.2. The Oil and Gas Sector

The situation in the oil and gas sector of the Russian economy is decidedly influenced by developments on the world petroleum market. Since 60 per cent of the oil produced in the country is exported as crude or refined products, external demand for oil and world oil prices are in effect the principal factors dictating domestic production levels and the financial situation in the oil industry.

In 1999, the world market was recovering from the deep price crisis into which it had been plunged in 1998, when the world oil price fell from \$135.1 per tonne (\$18.5 per barrel) to \$88.3 per tonne (\$12.1 per barrel), or by 35 per cent. As the world oil price dynamics computed in real terms shows, that was a record low for the past 25 years. In December 1998, the world oil price plummeted even deeper, to a mere \$9.6 per barrel. In March 1999, though, the prices bottomed out and started to rebound. In July, the averaged world oil price shot up to \$18 per barrel, capping the late 1997 level for the first time in months, and surged up to \$24.8 per barrel in December (Table 1). On balance, the annualized average price of oil worked out to \$17.4 per barrel for the whole of 1999, or 44 per cent above the preceding year's level.

TABLE 1

World oil prices 1998 to 1999, in \$US/barrel

	1998	1999 Jan.	1999 March	1999 June	1999 Sep.	1999 Dec.
Average world oil price	12,1	10,6	11,9	15,4	21,9	24,8
Brent oil price, UK	12,8	11,2	12,5	15,8	22,5	25,7
Urals oil price, Russia	11,9	10,9	11,7	14,9	21,9	25,4

Source: U.S. Department of Energy.

The abrupt turnaround on the world oil market was due to several factors. The main factor behind the plunge of world oil prices in 1998 was a considerable growth in the production and export of oil by OPEC countries, which account for the bulk of world oil exports. The rapid growth in oil production by OPEC countries in 1997 was reinforced by their decision to raise export quotas by 10 per cent and, in fact, continued through the first quarter of 1998. Meanwhile, demand for oil and petroleum products was reeling under the adverse effect of the crisis in Southeast Asia and the uncommonly warm winter in the Northern Hemisphere. The net result was oil overproduction, unbalancing of the world oil market and collapse of the prices.

To end the price crisis, OPEC countries succeeded in 1998 in limiting production, but the production cuts actually made did not force the prices back to the pre-crisis level. Prices were depressed because, first, the OPEC countries did not fulfill their commitments to cut oil production in full. Second, oil production went up sharply in Iraq, whose six-month export quota was raised by the UN Security Council from \$2 billion to \$5.26 billion, considerably thwarting the efforts of other OPEC countries to reduce oil production. Third, oil production by non-OPEC countries continued to climb, primarily in the North Sea, South America, and Africa. Fourth, surplus stocks of oil and petroleum products built up in industrially developed countries had a depressing effect on oil price dynamics. Fifth, the slowdown of worldwide demand for oil, because, above all, of its decline in Southeast Asian countries and Japan, had an extremely adverse effect.

In 1999, oil supply was definitely influenced by the OPEC countries' decision on an additional coordinated reduction of oil production. Meeting in March in an OPEC session, the organization's member countries (except Iraq) agreed to cut oil production

by 1.7 million barrels a day, in addition to the cuts under the two agreements reached the year before. Overall, the OPEC countries' commitments to cut oil production came to 4.3 million b/d. Four countries (Mexico, Norway, Russia, and Oman), which are not members of OPEC, announced their intention to reduce oil production by another 0.4 million b/d. As in the year before, the announced cuts were effected in part only. They made it possible, however, to significantly lower oil supply on the world market, denting commercial oil inventories and sending world oil prices steeply up.

The OPEC countries' actual behavior did not, therefore, justify some analysts' pessimistic predictions that leading oil exporters would be firmly set on maintaining world oil prices at an extremely low level (below \$10 per barrel). This was a theoretical possibility, for that would lead to reductions in oil production in areas of high oil production costs (such as North America, Europe, Russia, and so on) and a significant growth (in the long term) in the world oil market share of OPEC countries incurring much lower oil production costs. The leading OPEC countries' apparent dependence on oil exports, however, makes fulfillment of such predictions highly improbable.

The radical change on the world oil market and devaluation of the ruble combined to produce highly favorable conditions for the Russian oil industry. The year 1999 may be singled out for a recovery of oil production and refining in the aftermath of the crisis-ridden year 1998, when production, profits and investments tumbled. In 1999, the production of oil and gas condensate totaled 305.0 million tonnes, or 100.5 per cent of the preceding year's figures, and preliminary oil refining volumes went up to 103.0 per cent (Table 2). Production of motor gasoline rose 2.2 per cent and diesel fuel 4.2 per cent, while that of fuel oil dropped by 5.2 per

cent. After years of continuous contraction, the operating well stock stabilized, with the proportion of inactive wells in it decreasing from 26.3 per cent in late 1998 to 24.4 per cent in late 1999. The scale of producing and exploratory oil well drilling rose for the first time in recent years (by 6.6 per cent and 8.8 per cent, respectively). Simultaneously, the number of new oil wells put on production dropped by 8.5 per cent from the year before, which may be regarded as a delayed effect of the crisis in the preceding year.

TABLE 2

**Russia's energy production, consumption
and exports 1990 to 1999**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Oil, millions of tonnes										
Production	516,2	462,3	399,3	353,9	317,8	306,8	301,3	305,6	303,4	305,0
Total exports	220,3	173,9	137,7	122,6	129,8	122,3	126,0	126,9	137,1	134,5
Exports to non-CIS countries	99,7	56,5	66,2	79,9	91,7	96,2	105,4	109,8	117,9	115,7
Exports to CIS countries	120,6	117,4	71,5	42,7	38,1	26,1	20,6	17,1	19,2	18,8
Net exports	201,5	155,8	127,0	112,2	121,6	113,8	117,2	119,0	129,2	126,6
Domestic consumption	269,9	266,2	231,4	196,5	151,4	150,4	129,7	130,0	123,2	128,6
Net exports as per cent of production	39,0	33,7	31,8	31,7	38,3	37,1	38,9	38,9	42,6	41,5
Oil products, millions of tonnes										
Total exports	50,6	46,1	43,0	47,4	47,3	47,0	57,0	60,6	53,8	50,8
Exports to non-CIS countries	35,0	27,0	25,3	35,3	39,1	43,5	55,0	58,4	51,2	47,8
Exports to CIS countries	15,6	19,1	17,7	12,1	8,2	3,5	2,0	2,2	2,6	3,0
Net exports	44,8	40,3	40,9	45,2	44,8	42,6	54,4	56,6	51,0	49,8
Crude and oil products, millions of tonnes										

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Net exports of crude and oil products	246,3	196,1	167,9	157,4	166,4	156,4	171,6	175,6	180,2	176,4
Net exports of crude and oil products as per cent of oil production	47,7	42,4	42,0	44,5	52,4	51,0	56,9	57,5	59,4	57,8
Natural gas, billions of cu m										
Production	640,6	643,4	641,0	618,4	607,2	595,4	601,1	571,1	591,0	590,7
Total exports	249,2	246,8	194,4	174,4	184,3	192,2	198,5	200,9	200,6	206,4
Exports to non-CIS countries	96,0	91,0	87,9	95,9	109,3	121,9	128,0	120,9	125,0	131,1
Exports to CIS countries	153,2	155,8	106,5	78,5	75,0	70,3	70,5	80,0	75,6	74,3
Net exports	179,2	177,8	187,4	168,4	180,3	188,3	193,9	196,4	197,6	202,4
Domestic consumption	461,4	465,6	453,6	450,0	426,9	407,1	407,2	374,7	393,4	388,3
Net exports, in per cent of production	28,0	27,6	29,2	27,2	29,7	31,6	32,3	34,4	33,4	34,3
Aggregate indicators										
Oil and gas production, in millions of tonnes of oil equivalent	1092,7	1041,4	976,2	910,5	864,3	842,7	842,3	819,6	835,3	836,6
Net exports of oil, oil products and gas, in millions of tonnes of oil equivalent	407,6	356,1	336,6	309,0	328,7	325,9	346,1	352,4	358,0	358,6
Domestic consumption of oil and gas, in millions of tonnes of oil equivalent	685,1	685,3	639,6	601,5	535,6	516,8	496,2	467,2	477,3	478,0
Net exports of oil, oil products and gas as per cent of oil and gas production	37,3	34,2	34,5	33,9	38,0	38,7	41,1	43,0	42,9	42,9

Note: Data on the geographic distribution of exports for 1990 and 1991 capture non-FSU and FSU exports.

Source: RF Statistics Agency, OECD's International Energy Agency, RF Ministry of Fuel and Energy, RF State Customs Committee, and estimates by authors of this review.

Oil refining also showed an improvement in both quantity and quality. The oil conversion rate rose from 64.7 per cent in 1998 to 67.4 per cent last year and the manufacture of petroleum products by improved techniques increased by 12.6 per cent.

Domestic prices for oil and petroleum products bottomed out in the first few months of 1999 at the lowest level after ruble devaluation. In particular, a metric ton of oil sold for around \$19 in January to April, actually as little as it brought in mid-1993. In the following months, however, oil prices, in dollar terms, rebounded quickly (Table 3). Later on, as world oil prices climbed, the ratio of domestic oil (producer) prices to export prices slumped from 30.8 per cent in late 1998 to 22.2 per cent late last year.

TABLE 3

Domestic prices for oil, oil products and natural gas in dollar terms (average wholesale producer prices, \$US/tonne)

	1997 Dec.	1998 Dec.	1999 March	1999 June	1999 Sep.	1999 Dec.
Oil	63,1	16,4	15,6	20,7	27,7	37,0
Motor gasoline	169,6	63,4	55,1	76,0	150,9	171,9
Diesel fuel	170,0	52,9	48,4	78,2	118,7	125,0
Furnace fuel oil	73,8	22,0	21,5	24,2	39,7	46,1
Gas, \$US/1,000 cu m	6,6	2,1	2,3	2,3	2,2	2,2

Source: estimated from RF Statistics Agency data.

Estimates show that domestic oil consumption in Russia rose from 123.2 million tonnes in 1998 to 128.6 million tonnes in 1999, or by 4.4 per cent. This uptrend is probably connected with economic growth, primarily with recovery of industrial production and increasing transportation. In the meantime, though, net exports of oil and petroleum products edged down from 180.2 to 176.4 million tonnes, or by 2.1 per cent. As a result, the share of net exports of oil and petroleum products in oil production fell from 59.4 per cent to 57.8 per cent. The oil exports structure continued to be

dominated by crude oil. Diesel fuel and fuel oil accounted for the bulk of petroleum products. The share of exports in diesel fuel production in 1999 amounted to 48 per cent, that of fuel oil, 42.7 per cent, and motor gasoline, 7.2 per cent. Natural gas exports moved up by 1 per cent, being heavily restrained by the CIS countries' insolvency. The bulk of energy resources (86 per cent of oil, 94 per cent of petroleum products, and 64 per cent of natural gas) were, as previously, exported beyond the CIS.

In 1999, Russian exports posted considerable growth in terms of value because of rising world oil prices. Where there was a roll-back in physical volumes, the total value of Russian exports of oil and basic petroleum exports (motor gasoline, diesel fuel and fuel oil) rose from \$14 billion in 1998 to \$18.3 billion in 1999, or by 30.7 per cent.

Imports of petroleum products, however, were brought down sharply because of ruble devaluation and higher world prices. In particular, imports of motor gasoline plunged by more than 90 per cent, to 9.3 per cent of the preceding year's level, the share of imported gasoline in the total gasoline resources dropped from 8.7 per cent in January to June 1998 to 0.9 per cent the following year. Analysis shows that the import factor, together with constraints imposed on domestic prices of petroleum products, in particular, in a cartel agreement signed in June by the government and major Russian companies, was the chief cause of the so-called gasoline crisis that struck a number of regions in summer 1999.

Falling gasoline production and rising gasoline exports put forward as an explanation for the crisis sound little convincing. According to official statistics for the period from January to July 1999, motor gasoline production was 99.8 per cent of the corresponding period of the year before, and motor gasoline sales by oil refineries on the domestic market rose from the preceding year's

seven-month period to 102.1 per cent. Motor gasoline exports dropped by 5.4 per cent in the first half-year, rather than increasing. The total sales of motor gasoline on the domestic period in that period, however, fell by 11.2 per cent, almost 80 per cent of the fall being, by some estimates, attributable to its plunging imports.

Other factors that contributed to the shrinking of commercial gasoline inventories were, in our view, a rise in demand, largely fueled by industrial recovery, regional differences in sale volumes, and holding back of gasoline sales in anticipation of price hikes. A certain role was probably played by unofficial gasoline exports, but, because of their insignificant volumes, this factor can hardly be regarded, as some experts do, as one of the main causes of the gasoline crisis.

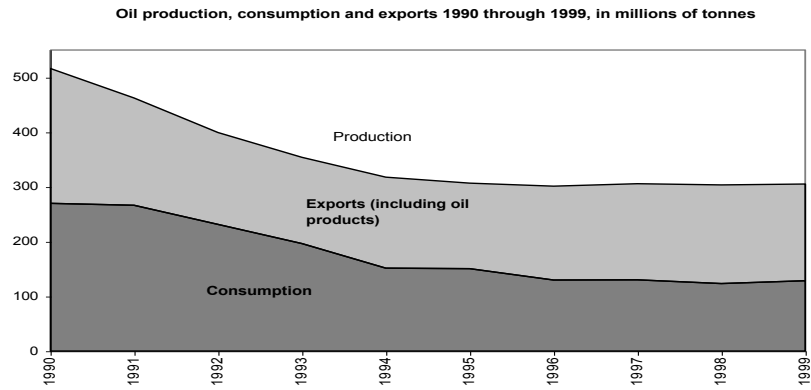
Administrative constraints on gasoline exports (banned completely in August and September) and a sharp rise in domestic gasoline prices helped restore the balance between demand and supply on the market.

As an analysis of the dynamics of Russian exports of energy resources over a long period shows that even though the total net exports of oil and petroleum products have shown an upward trend in recent years they are still much smaller than they were before the start of reforms. According to statistics, they fell off from 246.3 million tonnes in 1990 to 176.4 million tonnes in 1999, or by 28.4 per cent. Because of the steep decline in domestic consumption, however (in our estimate, it dropped from 269.9 million tonnes in 1990 to 128.6 million tonnes in 1999, that is, by more than a half), the share of exports of oil and petroleum products in the oil output rose in the same period from 47.7 per cent to 57.8 per cent. In natural gas, there has been a growth in both physical exports and the share of gas exports in the output. Again, in our estimate, the total net exports of oil, petroleum products, and natural gas decreased

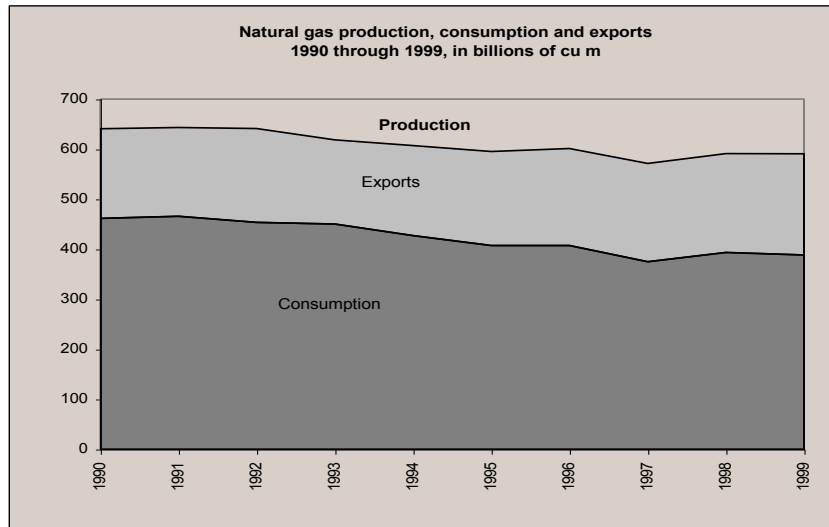
from 407.6 million tonnes of oil equivalent in 1990 to 358.6 million tonnes of oil equivalent in 1999, or by 12 per cent. The share of net exports in the total oil and natural gas production, however, went up from 37.3 per cent to 42.9 per cent. In a sense, this points to intensified export orientation of the oil and gas sector. It is to be noted, however, that this does not suggest an increase in absolute volumes of exports (which have actually fallen), but rather is explained by a fall in hydrocarbon production because of deteriorating production conditions, and falling domestic demand and exports to the former Soviet republics.

Figures 1 to 6 illustrate changes in the principal oil industry growth factors characterizing the production of oil and petroleum products, their sale on the domestic and foreign markets, prices, investment activity, and the state of payments and mutual settlements.

FIG. 1

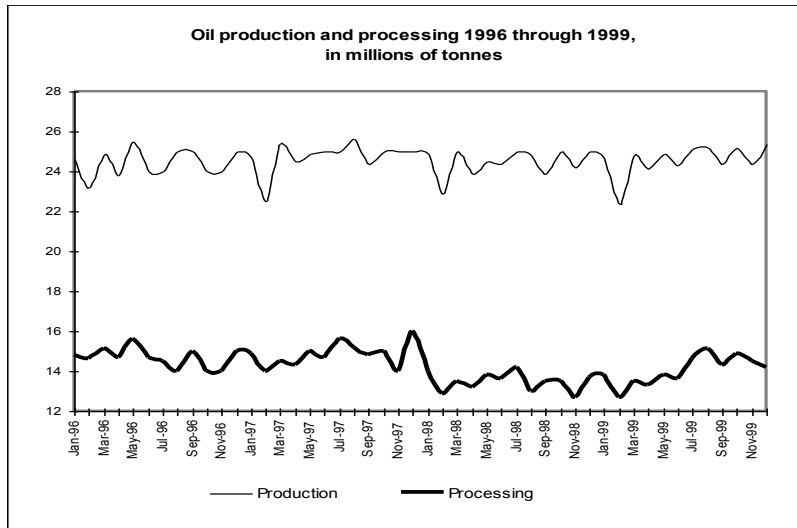


Source: RF Statistics Agency, RF State Customs Committee, International Energy Agency, and estimates by authors of this review.

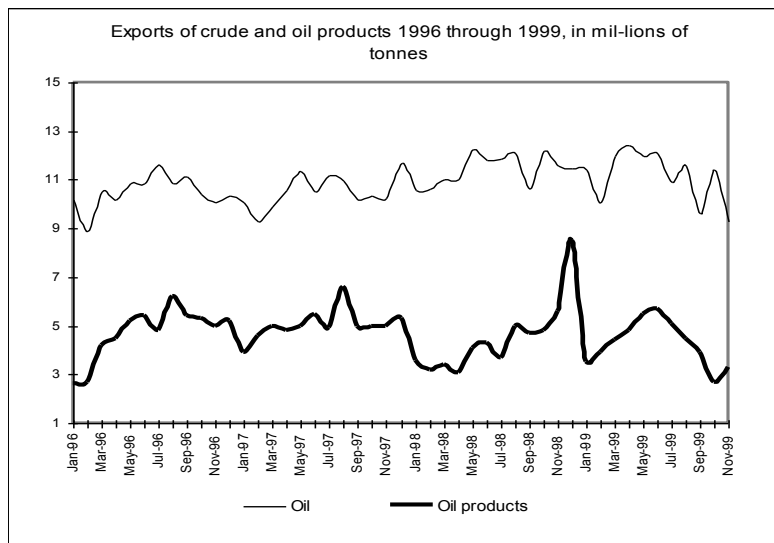


Source: RF Statistics Agency, RF State Customs Committee, International Energy Agency, and estimates by authors of this review.

FIG. 2

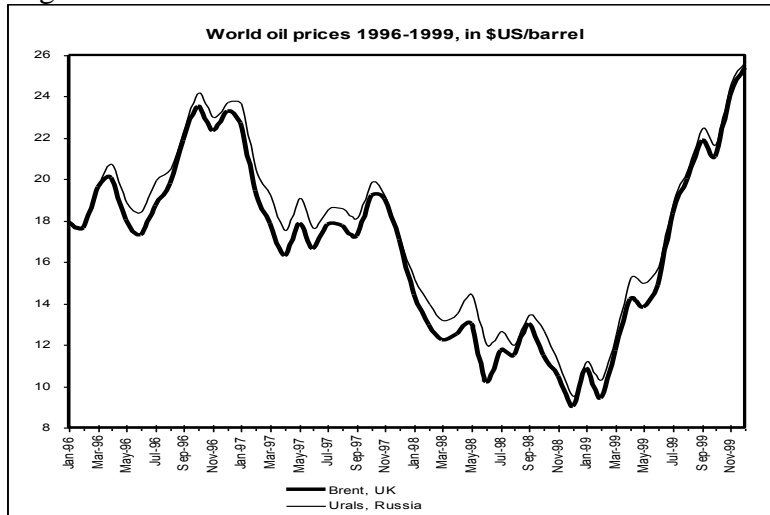


Source: RF Statistics Agency

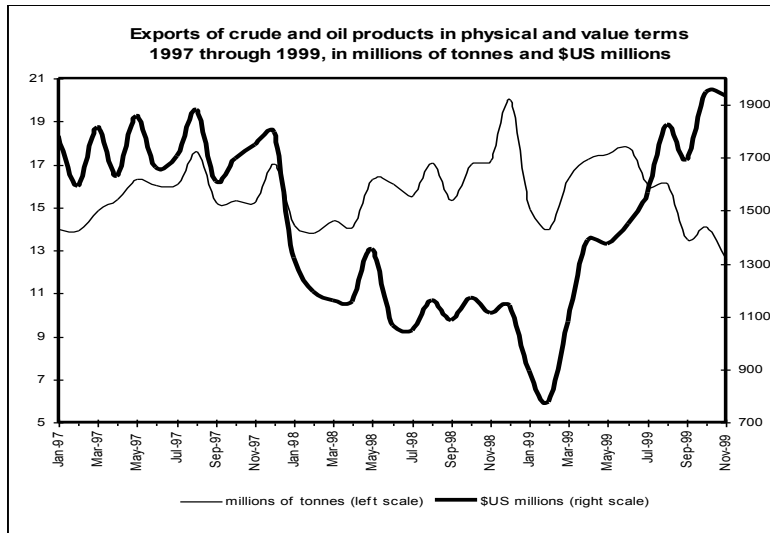


Source: RF Statistics Agency.

Fig. 3

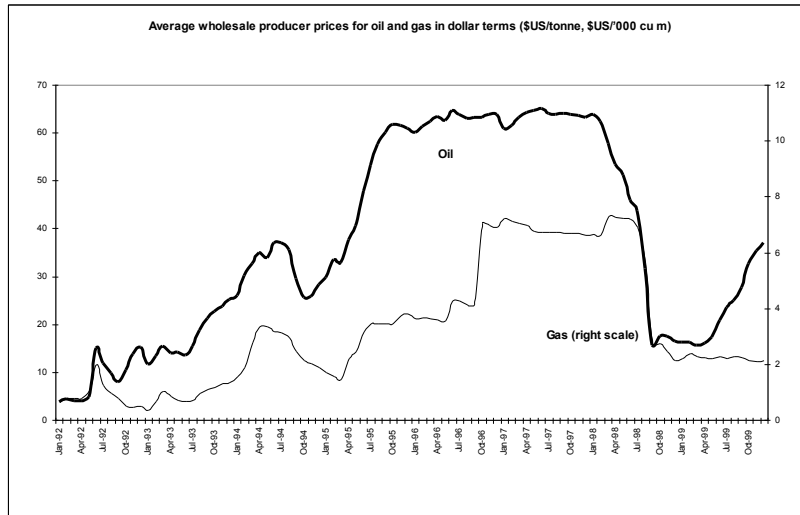


Source: U.S. Department of Energy

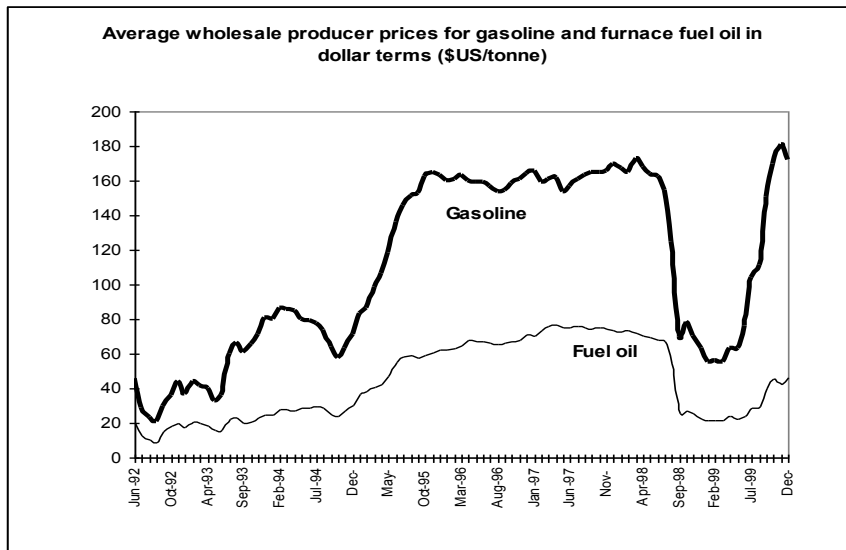


Source: estimated from RF Statistics Agency data.

FIG. 4

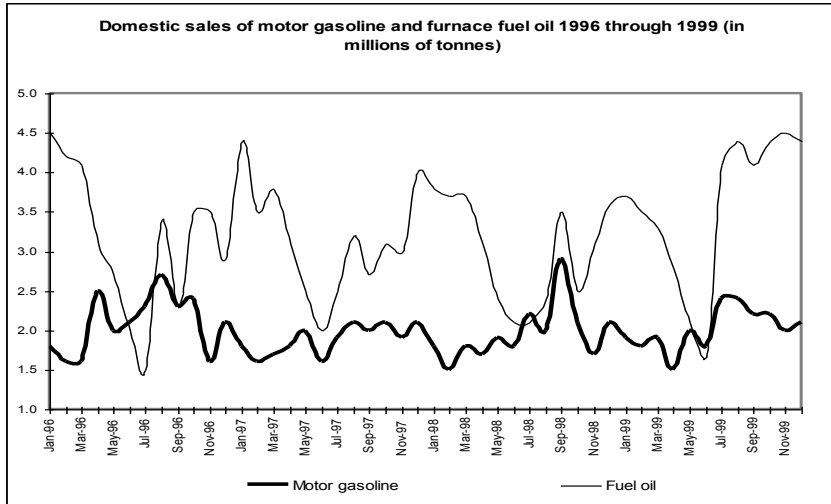


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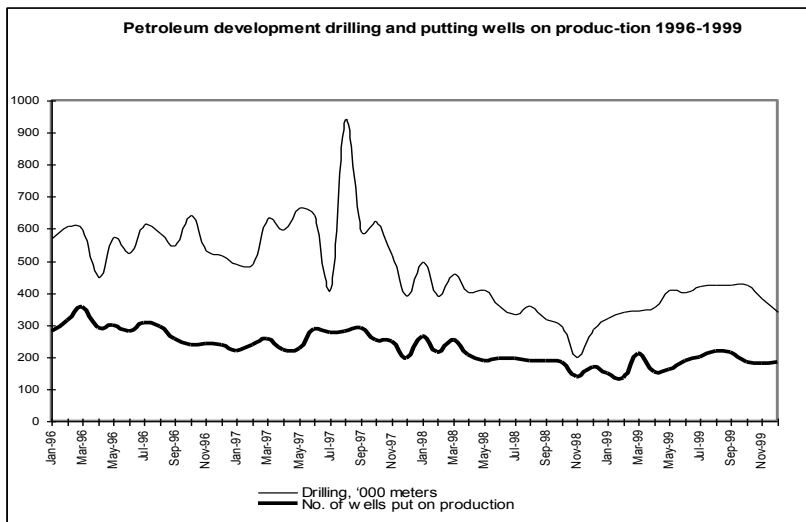


Source: estimated from RF Statistics Agency data.

Fig. 5

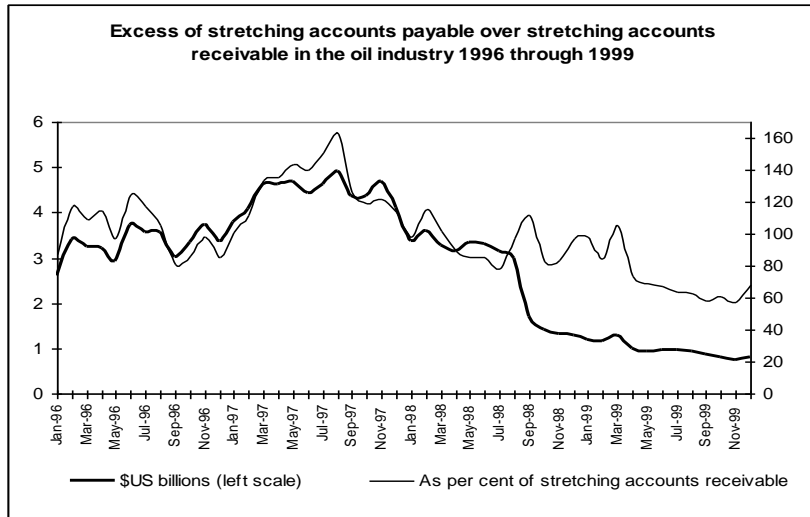


Source: RF Statistics Agency.

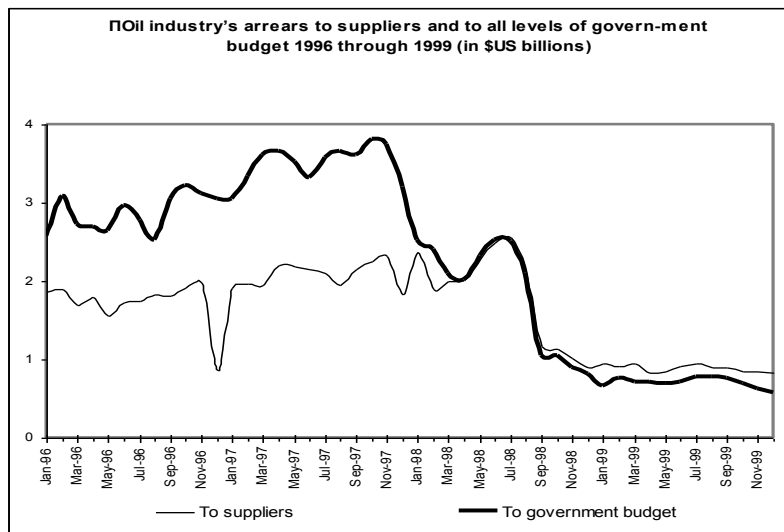


Source: RF Statistics Agency.

FIG. 6



Source: estimated from RF Statistics Agency data.



Source: estimated from RF Statistics Agency data.

In 1999, significant changes occurred in the organizational structure of the oil and gas sector of the Russian economy. In September, the leaders of LUKOIL oil company made an official announcement about the purchase of the controlling interest in KomiTEC company, which produced 3.5 million tonnes of oil and refined 2.1 million tonnes in 1998. This purchase significantly reinforced LUKOIL's positions in the oil sector and broadened its lead ahead of other oil companies: the company's oil reserves were boosted by 33 per cent, oil production rose by 6.5 per cent, and oil refining jumped by 12.6 per cent.

In October, Tyumen Oil Company (TNK) acquired an oil production operation, Kondpetroleum, producing 2.5 million tonnes of oil a year, which is part of SIDANKO Company, itself involved in bankruptcy proceedings. In 1999, SIDANKO was \$452.6 million in arrears, and in May 1998, it had to accept external control.

Table 4 contains key data characterizing the actual organizational structure of the oil and gas sector of the Russian economy and the structure of the market for oil and petroleum products as it was at the end of the year (according to officials reports for 1999). These data illustrate the actual integration (institutional consolidation) of oil companies: LUKOIL and KomiTEC, YUKOS and VNK (Eastern Oil Company), Tatneft and Nizhnekamsneftechim, and TNK and Kondpetroleum.

TABLE 4

Indicators of Russian oil companies' production and economic activities and respective market shares in 1999

	Oil and gas condensate production, millions of tonnes	Company's share of oil and gas condensate production, per cent	Gas production, billions of cu m	Company's share of gas production by oil companies, per cent	Oil processing, millions of tonnes	Company's share of oil processing, per cent
LUKOIL+KomiTEK	57,0	18,7	3,4	11,5	20,4	12,1
UKOS+VNK	44,7	14,7	1,5	5,1	25,8	15,3
Surgutneftegaz	37,6	12,3	11,1	37,6	17,1	10,1
Tarneft+Nizhnekamskneftechim	24,1	7,9	0,7	2,4	5,5	3,3
THK+KondPetroleum	22,6	7,4	2,2	7,5	11,2	6,6
SIDANCO- KondPetroleum	17,1	5,6	1,7	5,8	13,7	8,1
Sibneft	16,3	5,3	1,3	4,4	12,5	7,4
Rosneft	12,6	4,1	4,9	16,6	6,5	3,9
Bashkirian Fuel Company	12,3	4,0	0,4	1,4	21,8	12,9
Slavneft	11,9	3,9	0,7	2,4	9,6	5,7
ONAKO	8,0	2,6	1,6	5,4	4,0	2,4
Total for Russia	305,0	100,0	590,7	100,0	168,6	100,0
Total for VIOCs	264,2	86,6	29,5	5,0	147,9	87,7
Memorandum items:						
LUKOIL	53,4	17,5	3,0	10,2	18,6	11,0
KomiTEK	3,6	1,2	0,4	1,4	1,8	1,1
UKOS	34,2	11,2	1,2	4,1	19,9	11,8
VNK	10,5	3,4	0,3	1,0	5,9	3,5
THK	20,1	6,6	1,8	6,1	11,1	6,6
SIDANCO	19,6	6,4	2,1	7,1	13,8	8,2
Gazprom	9,9	3,2	556,5	94,2	5,0	3,0

Source: RF Ministry of Fuel and Energy, and estimates by authors of this review.

It is clear from the above figures that vertically integrated oil companies (VIOCs) predominate in the Russian oil industry. They account for 86.6 per cent of Russia's total oil output and 87.7 per

cent of oil refinery products. Oil production is spearheaded (with 18.7 per cent of the total output in Russia) by LUKOIL company, which also leads in proven oil reserves. LUKOIL also has the lowest depletion rate of available reserves, the lowest water content of oil recovered, and a high oil conversion rate. Second in oil production (with 14.7 per cent of Russia's output) and first in refining volumes (15.3 per cent of total refinery products in Russia) comes YUKOS, which also controls Eastern Oil Co. (VNK). Third in oil production (12.3 per cent of total Russian output) is Surgutneftegaz, which is also distinguished by a high utilization rate of its oil producing and refining capacities. Joint ventures active in the Russian oil industry produced 6.9 per cent of Russia's total oil output last year.

Gas production is unquestionably dominated by Gazprom, which produced 94.2 per cent of Russia's total output in 1999 (gas production in Russia is, therefore, characterized by a tremendously high concentration). Another 5 per cent of the Russian gas output is recovered by oil companies (normally, this is casing-head gas associated with oil production), and approximately 1 per cent is accounted for by other gas producers.

In a possible option for continued transformation of the organizational structure of the oil and gas sector, a government-owned oil company (Gosneft) could be formed on the basis of the public oil companies, Rosneft, Slavneft, and ONAKO. This option would signal a drastic realignment of forces in the oil sector. Proceeding from the 1999 statistics, the integrated company would produce 32.5 million tonnes of oil and gas condensate a year, or 10.7 per cent of their total output in Russia, and refine, through primary distillation, 20.1 million tonnes a year, or 11.9 per cent of total refinery output. Gosneft would, therefore, place fourth among the Russian vertically integrated oil companies in oil production and

refining and oil reserves. Today, however, the Gosneft project, which had run into heavy resistance from major oil companies that came out with their own alternatives for public property redistribution, has virtually been shelved. It is not improbable, however, that attempts to put it through will resume after the presidential election.

In another scenario, the public oil companies could be privatized, with their assets taken over by the biggest Russian oil producers. In particular, the YUKOS company sets its sights on the controlling stake in ONAKO. YUKOS has of late been snatching up shares in ONAKO's subsidiary, Orenburgneft (and today YUKOS holds 31 per cent of the subsidiary's shares).

It is to be expected that the biggest Russian oil and gas companies will expand further by acquiring production assets in other countries, in Eastern Europe and the CIS, in the first place. Gazprom and LUKOIL have actually developed into large transnational companies. LUKOIL, for example, already owns the Bulgarian Neftochim company, including that country's only oil refinery in Burgas, with a capacity of 10.5 million tonnes of oil a year, Romania's biggest oil refinery, Petrotel, 4.7 million tonnes capacity, and the oil refinery in Odessa, Ukraine, with 3.8 million tonnes capacity.

Oil and gas companies are, in effect, the core of Russia's large-scale industry, standing as they are in the top lines of the list of the country's biggest enterprises. More specifically, Gazprom is firmly entrenched in second place among Russia's industrial enterprises in terms of sales, with LUKOIL following closely in third place. The oil and gas sector comprises seven of the top ten and 12 of the top twenty of the country's leading industrial enterprises (in terms of sales).

International comparisons show that Russian oil companies are very large businesses by world standards as well. Today, there are about 100 integrated oil companies around the world, the largest units in the oil industry (the number of specialized companies is

much greater). Russian and foreign integrated companies may be compared, however, in a limited number of areas. This is explained by both the lack of complete data on some foreign companies and incompatibility of some data available about Russian and foreign vertically integrated oil companies. They are incompatible because of different accounting methods and also essential differences in quality. Quality differences center on refinery capacity that disregards technological quality differences between the refining equipment of companies in different countries. In particular, the Nelson complexity index, an aggregated reflection of the technological level of oil refining operations, is equal to around 3.9 for Russia, which is only higher than the Nelson index for African countries and much lower than the refining complexity index in developed countries. In the United States, for example, the Nelson index is 9.5, 7.1 in Canada, and 6.5 in European countries. Besides, Russian companies operate their oil refining plant today much more under capacity than their foreign counterparts (in some Russian companies, refineries operates less than 50 per cent below capacity).

It is possible, however, to compare Russian and foreign integrated companies, with sufficient accuracy, in such basic terms as oil and gas production, proven recoverable oil reserves and adequacy of reserves to sustain ongoing operations. It is difficult in some instances, however, to rely on reserves figures, because some Russian companies have not taken stock of their reserves in accordance with international standards. Table 5 shows data for 20 of the world's biggest integrated oil companies ranked by oil production. Since systematized accounting data for 1999 have not yet been published on foreign companies their data are given for 1998. These data, however, reflect recent organizational changes (in 1998 and 1999) in the world oil industry, such as the merger between British Petroleum and Amoco and subsequent takeover by the combined

company of ARCO (Atlantic Richfield Corp.), the merger of Exxon and Mobil, the biggest American companies, and the Russian companies LUKOIL and KomiTEC.

TABLE 5

**The world's largest integrated oil companies
(Russian companies - 1999, non-Russian companies - 1998)**

Ranking by oil production volume	Company	Oil production, millions of tonnes	Gas production, billions of cu m	Oil reserves, millions of tonnes	Guaranteed oil production, in years of extractable reserves
1	Saudi Arabian Oil Co., Saudi Arabia	412,5	35,1	35334,2	85,7
2	National Iranian Oil Co., Iran	179,7	33,5	12237,4	68,1
3	Petroleos Mexicanos, Mexico	174,4	49,0	3874,4	22,2
4	Petroleos de Venezuela, Venezuela	171,7	40,5	10383,1	60,5
5	China National Petroleum Co., China	159,3	21,5	3274,2	20,5
6	BP Amoco+ARCO, UK/USA	131,4	80,2	1384,2	10,5
	BP Amoco, UK/USA	98,6	58,7	996,5	10,1
	ARCO, USA	32,7	21,5	387,7	11,8
7	Exxon Mobil, USA	122,0	115,3	1494,3	12,3
	Exxon, USA	75,4	71,4	847,9	11,2
	Mobil, USA	46,5	43,9	646,4	13,9
8	Royal Dutch/Shell, The Netherlands/UK	117,2	78,3	1368,5	11,7
9	Nigerian National Petroleum Corp., Nigeria	105,4	3,8	3069,6	29,1
10	Iraq National Oil Co., Iraq	105,1	6,5	15347,9	146,1
11	Kuwait Petroleum Corp., Kuwait	103,3	5,8	12824,0	124,1
12	Abu Dhabi National Oil Co., United Arab Emirates	94,4	24,9	12578,4	133,2
13	National Oil Corp., Libya	69,3	6,3	4024,6	58,1
14	Pertamina, Indonesia	64,7	67,2	679,4	10,5
15	LUKOIL+KomiTEK, Russia	57,0	3,4	2932,0	51,4
16	Chevron, USA	55,3	24,4	640,8	11,6
17	Petroleo Brasileiro, Brazil	52,3	11,2	1991,8	38,1
18	Texaco, USA	47,9	24,6	487,4	10,2
19	UKOS+VNK, Russia	44,7	1,5	2518,0	56,3
20	Sonatrach, Algeria	41,0	57,8	1255,1	30,6

Source: *Oil & Gas Journal*, RF Ministry of Fuel and Energy, and estimates by authors of this review.

The data in the table clearly show that LUKOIL and YUKOS, of all Russian vertically integrated companies, are among the top twenty integrated companies of the world (15th and 19th in the world for oil production, respectively). Surgutneftegaz and Tatneft among the next ten biggest companies (in 23rd and 30th slots, respectively). Russian oil companies are far behind their foreign counterparts, however, in gas production. Whereas natural gas production in the United States and Europe is spread among many oil companies, contributing a large share to their output, gas production in Russia is, as we have said above, highly concentrated, almost entirely in the hands of a single gas producing company, Gazprom. This reduces the share of gas in total hydrocarbon production (in terms of oil equivalent) by Russian oil companies to an unimportant minimum. By our estimates, it is a low 4.5 per cent in LUKOIL, for example, and 3.0 per cent in YUKOS, piling into insignificance next to the figures for Western oil companies, reaching 40 per cent to 50 per cent in, for example, Royal Dutch/Shell, Exxon and Mobil. The only Russian exception here is Surgutneftegaz, whose share of gas reaches almost 20 per cent of its total hydrocarbon production (almost as much as the share of gas in British Petroleum's production).

Most of the world's biggest oil companies, in particular, those in petroleum exporting countries, are today held in public ownership. Russian vertically integrated oil companies are closer to Western integrated joint stock companies, such as Royal Dutch/Shell, Exxon or British Petroleum in type of ownership and management structure. Table 6 contains data for the world's 12 largest integrated non-public oil companies ranked according to oil production totals. The data in the table place LUKOIL, YUKOS and Surgutneftegaz in the 4th, 7th and 9th slots among the ten biggest non-public oil companies in terms of oil production. Russian

vertically integrated oil companies are far ahead of Western companies in terms of oil reserves, but trail far behind them in the output and sales of petroleum products.

A comparative analysis shows that a considerable excess of sales of petroleum products over oil production figures is a distinguishing feature of oil importing countries and regions, including the United States and Western Europe. In the case of Royal Dutch/Shell, for example, the ratio of sales of petroleum products to oil output is approximately equal to 2.7, for Exxon it is 3.0, and for Mobil 4.0, which is evidence of oil refining and marketing being their core operations. In the case of oil exporting countries, this ratio lies within the range of 0.2 to 0.9. Russian integrated oil companies fall within that range, too.

TABLE 6

**The world's largest non-public sector integrated oil companies
(Russian companies - 1999, non-Russian companies - 1998)**

Ranking by oil production volume	Company	Oil production, millions of tonnes	Gas production, billions of cu m	Oil reserves, millions of tonnes	Guaranteed oil production, in years of available reserves
1	BP Amoco+ARCO, UK/USA	131,4	80,2	1384,2	10,5
2	Exxon Mobil, USA	122,0	115,3	1494,3	12,3
3	Royal Dutch/Shell, The Netherlands/UK	117,2	78,3	1368,5	11,7
4	LUKOIL+KomiTEK, Russia	57,0	3,4	2932,0	51,4
5	Chevron, USA	55,3	24,4	640,8	11,6
6	Texaco, USA	47,9	24,6	487,4	10,2
7	UKOS+VNK, Russia	44,7	1,5	2518,0	56,3
8	Elf Aquitaine, France	39,8	12,3	351,4	8,8
9	Surgutneftegaz, Russia	37,6	11,1	1464,0	38,9
10	Petronas, Malaysia	35,9	23,7	532,1	14,8
11	ENI, Italy	32,5	22,2	393,0	12,1
12	Total, France	28,0	15,8	416,1	14,8

Source: *Oil & Gas Journal*, RF Ministry of Fuel and Energy, and estimates by authors of this review.

All these facts, therefore, put leading Russian integrated oil companies in the group of the world's biggest oil producers. In terms of institutional structure, they are close to Western oil companies, and yet, their vast reserves and predominantly oil pumping operations draw Russian integrated oil companies closer to companies in other oil exporting countries. Figures 7 to 9 show selected data for Russian and foreign vertically integrated oil companies.

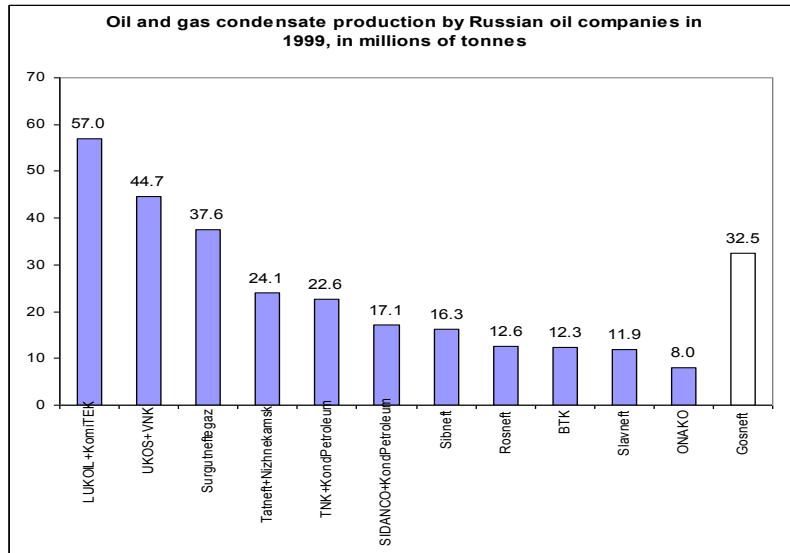
World oil price dynamics and, therefore, the economic position of Russian oil and gas producers will, in the short run, be affected by, above all, the levels of oil production by OPEC countries. Having made good the losses they sustained during the price crisis in 1998, the OPEC countries will probably be disinclined to maintain world oil prices at the current unreasonably high level for any long time, as this would encourage oil production in high-cost regions that would inevitably cut into OPEC's share of the world oil market. It is to be expected, therefore, that OPEC countries will, as early as next year, step up oil production significantly by either raising production quotas or relaxing existing quotas (actually, production picked up late last year already). According to a forecast from the US Energy Department, a leading organization in world energy analysis and forecasting, oil production by OPEC countries in 2000 is to gain approximately 3.4 per cent (after a drop of 3.6 per cent last year), with another 5.0 per cent in 2001. Oil production is expected to grow outside OPEC as well, spurred on by high world prices (oil production in non-OPEC countries fell in 1999 because of production and investment downscaling in some regions under the squeeze of extremely low world prices rampant through 1998 and the beginning of last year).

Overall, oil production worldwide, which declined by 1.8 per cent in 1999 from the year before, is, according to the US Energy Department's forecast, to go up by about 2.6 per cent in 2000 from

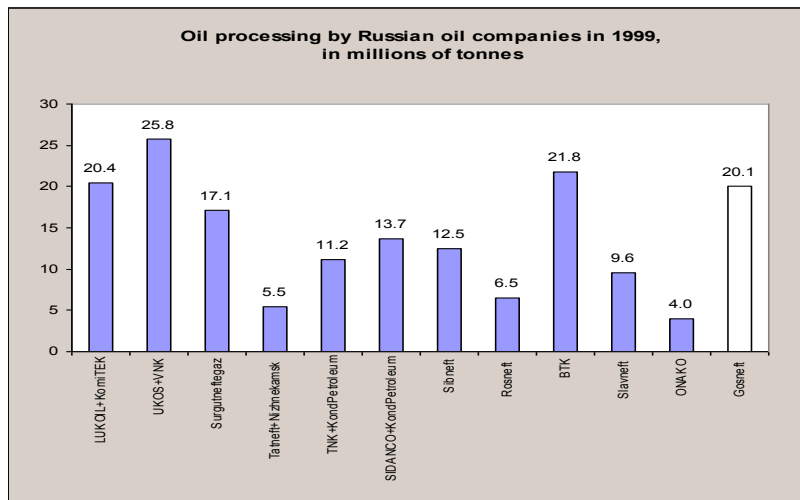
the year before, and by another 3.3 per cent in 2001. Growing oil production would push down world oil prices through 2000 and 2001 from their current high levels. It is to be expected that the United States, the world's biggest oil consumer, will move in the same direction, for very high oil prices restrain economic growth.

World oil prices will, however, remain at a sufficiently high level. According to the latest (February 2000) update of the US Energy Department's forecast, the world oil price specified as the average price of oil imported by the United States will stay above \$20 per barrel through 2000 and 2001. In 2000, the annualized average oil price will, according to the basic forecast version, be at \$24.2 per barrel, or \$7 above the 1999 average and actually twice the 1998 average. This, too, is considerably higher than the average world oil prices over the past decade (annualized nominal world oil prices averaged \$17.6 per barrel through the 1990s). In 2001, the average oil price is projected to end at about \$21.4 per barrel. This will, hopefully, allow the Russian economy to continue exploiting the favorable effect of high world prices for energy resources.

FIG. 7

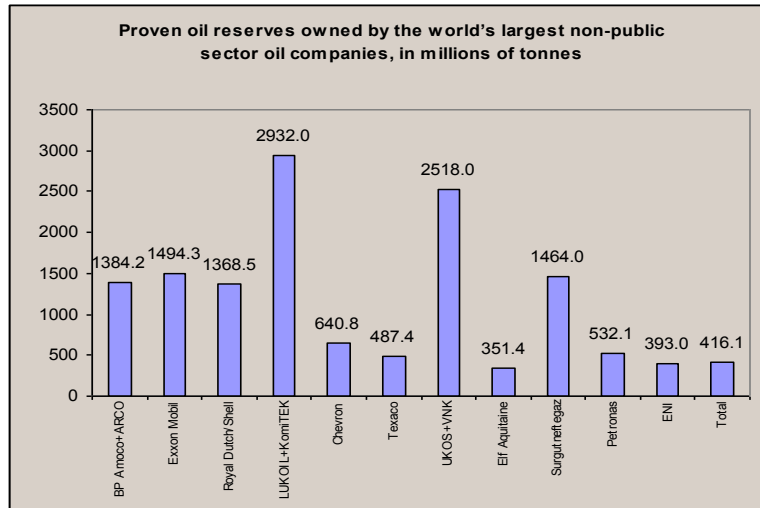


Source: RF Ministry of Fuel and Energy, and estimates by authors of this review.

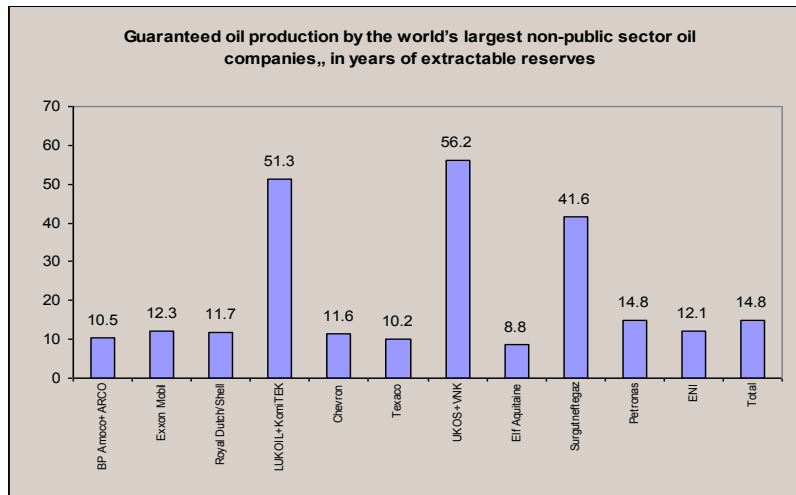


Source: RF Ministry of Fuel and Energy, and estimates by authors of this review.

FIG. 8

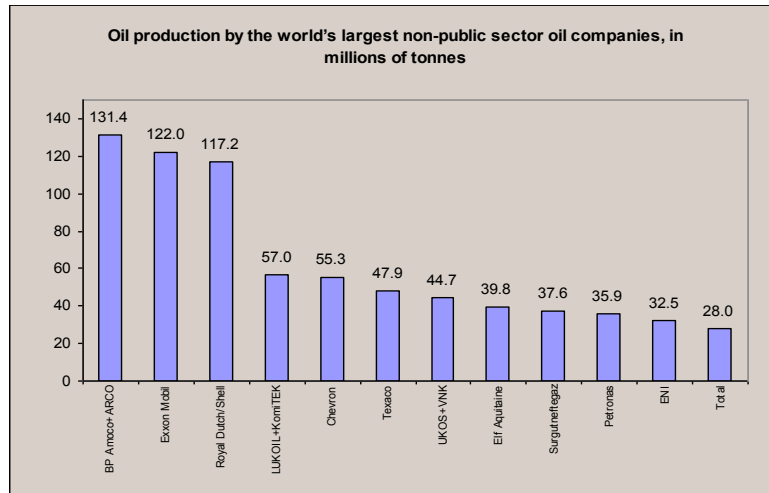


Source: *Oil & Gas Journal*, RF Ministry of Fuel and Energy, and estimates by authors of this review.

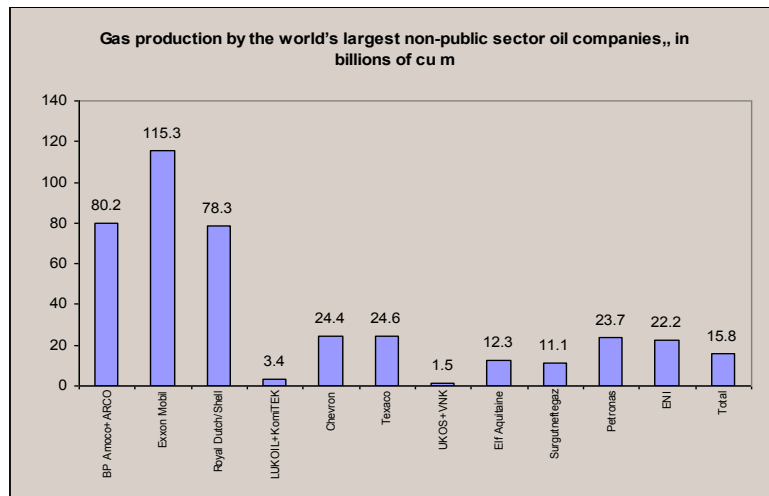


Source: *Oil & Gas Journal*, RF Ministry of Fuel and Energy, and estimates by authors of this review.

FIG. 9



Source: *Oil & Gas Journal*, RF Ministry of Fuel and Energy, and estimates by authors of this review.



Source: *Oil & Gas Journal*, RF Ministry of Fuel and Energy, and estimates by authors of this review

2.3. Agriculture and Food Production

Agriculture and food production in Russia in 1999 developed under the impact of two factors - the 1998 crisis and relatively good weather in the 1999 growing season.

Ruble devaluation made food imports significantly less lucrative, while exports of Russian farming produce more profitable than they had been before the crisis. Good opportunities were, therefore, created for domestic agricultural producers as a result of, first, import substitution on the domestic market and, second, expanding exports. On the other extreme, however, falling real incomes reduced public demand for income-sensitive products, livestock products in the first place.

Reduced opportunities for financial market speculation and restrictions on capital export have, in a measure, strengthened the investment trend in short investment cycle industries, including, of course, the food processing industry.

These factors have set off a relatively strong import substitution process in the food and processing industries, which spread, beginning in the second half-year, to agriculture as well. There were no other incentives to stimulate growth here - neither visible changes in the government's agricultural policy, nor growth in budget support for the sector, nor significant institutional changes. The year 1999 added weight to the hypothesis that low demand was the principal constraining factor in agriculture and food production.

The gross farming product rose by 2.4 per cent, with crop farming showing a growth of 9.0 per cent and cattle farming declining by 3.7 per cent. The food processing industry raised its output by 7.5 per cent.

The growth numbers in themselves tell little about agriculture. They are largely at the mercy of the weather, as is evidenced by the pickup in crop farming and the continuing slide in cattle farming.

Agriculture, however, has seen momentous changes. First, growth in demand and, therefore, sales have helped farms to improve their financial position significantly. Second, the flow of cash into farming has sparked off demand for farming machines and mineral fertilizers. In other words, the decapitalization trend has reversed. Third, productivity started to rise in the sector, with milk yields and egg production per hen going up and incidence of deadly cattle diseases falling. More cash available to farmers meant fewer barter deals (whatever form they might take) and, therefore, continued improvement in the agricultural producers' financial standing, for whom barter was not, as a rule, a particularly gainful way of doing business.

Growing output on personal subsidiary farms was another significant trend of post-crisis agriculture. Subsidiary farm owners planted more potatoes and other vegetables than they did in 1998 and produced more meat and milk. Plunging personal incomes, rising unemployment, accelerating inflation and social instability caused opportunity costs of labor to drop. As a result, two years of relative shrinking were followed by an increase in food production by households. On one hand, this held back a sharp fall in food consumption in the country and, on the other hand, further restricted demand for the output of the food and farm produce processing industries.

By provoking a consumer panic on food markets, the 1998 crisis encouraged a broader application of price regulation policies in practically all of the country's regions. In most regions, price regulation was more of a temporary and socio-psychological than strategic character. In some regions, however, it survived into 1999, mostly in respect of bread and a few other "socially explosive" food products. Again, a majority of net farm produce exporters tightened controls over food exports. The regional authorities' policies of this

kind led to bread shortages in a number of grain-deficient regions in the first half of the year. Foreign food aid only worsened food shortages in a most paradoxical way: expectations of cheap “humanitarian” flour from centralized resources only inspired regional authorities’ hopes of maintaining low bread prices by administrative fiat, and again, as it happened so often in Soviet times, cheap bread and multiplying hog numbers on private subsidiary farms led to bread being used to fatten the animals, intensifying shortages and throwing consumers into panic.

Production

Agriculture

According to official statistics, total sown areas have shrunk significantly, by more than 4 per cent. Decreasing areas under cereals, particularly wheat, were the principal reason (Table 1).

Considering the high and steady cash-earning capacity specifically of food grain in the country, however, an assumption can be made about a significant understatement of areas under cereal crops, and wheat in particular, in official reports. Areas under other crops, however, have grown, or remain unchanged, or decreased very insignificantly (such as feed crops).

Expansion of areas under sugar beet is a particularly notable fact. It was probably stimulated by the imposition of temporary duties on raw sugar imports, timed accidentally for ruble devaluation. Sugar refineries rushed to make contracts with domestic sugar beet producers.

Despite a dwindling of sown areas, production of chief crops rose from the previous season (Table 2). Nearly all crops improved yields because of clement weather. Production of sunflower seeds and vegetables continued to climb, with record-high crop harvests in Russian conditions.

TABLE 1

Russian land under major crops, in thousands of hectares

	1992	1996	1997	1998	1999	1999 B % к 1998	1999 B % к 1992
Total sown area	114,6	99,6	96,6	91,6	87,9	95,96	76,7
Cereal crops	61,9	53,4	53,6	50,7	46,8	92,3	75,6
of which : wheat	24,3	25,7	26,1	26,0	23,0	88,5	94,7
Sunflower seeds	2,9	3,9	3,6	4,2	5,5	130,95	189,7
Sugar beet	1,4	1,1	0,9	0,8	0,9	112,5	64,3
Fiber flax	0,3	0,2	0,1	0,1	0,1	100	33,3
Potatoes	3,4	3,4	3,4	3,4	3,3	96,5	97,1
Vegetables	0,7	0,7	0,7	0,7	0,8	114,3	114,3
Feed crops	42,5	35,6	33,3	30,1	29,4	97,7	69,2

Source: RF Statistics Agency data.

Cereal production slipped largely because of a slump in feed crops. The total share of wheat, rye, and meal crops rose significantly in cereal production.

TABLE 2

Gross yields of Russia's major crops, in millions of tonnes

	1986-90	1992	1997	1998	1999	1999 B % к 1998	1999 B % к 1986-90
Grain (post-processing weight)	104,3	106,9	88,6	47,8	54,7	114,4	52,4
of which wheat	43,5	46,2	44,3	27,0	31,0	114,8	71,3
Sugar beet	33,2	25,5	13,9	10,8	15,2	140,7	45,8
Sun-flower seeds	3,1	3,1	2,8	3,0	4,2	140,0	135,5
Potatoes	35,9	38,3	37	31,3	31,2	99,7	86,9
Veget-ables	11,2	10,0	11,1	10,5	12,3	117,1	109,8

Source: RF Statistics Agency data

The livestock population, except hogs and poultry, continued on its downtrend last year (Table 3). Significantly enough, hog and poultry populations grew on large agribusiness farms.

TABLE 3

**The livestock population on all types of farm, as at 1 January,
in millions of head**

	1996	1997	1998	1999	2000	2000 in per cent of 1999
Cattle	39,7	35,1	31,5	28,5	27,5	96,5
of which cows	17,4	15,9	14,5	13,5	12,9	95,6
Swine	22,6	19,1	17,3	17,2	18,3	106,4
Sheep and goats	28,0	22,8	18,8	15,6	14	89,8

Source: RF Statistics Agency data

Pork and poultry meat, subsectories capable of rapidly responding to changing markets and dependent on cereal feeds, have shown a particularly fast growth among other meats. Poultry meat production rose by 10 per cent. Annual pork production did not grow on balance, but a considerable increase in hog numbers bodes well for rapid meat production. Egg production was growing for two years in succession. In 1999, Russia restored its egg production approximately to the 1995 level, and poultry meat production to the 1994 performance.

TABLE 4

**Output of major livestock products by all types of farm,
in millions of tonnes**

	1998	1999	1999 in per cent of 1998
Meat (livestock and poultry for slaughter, dressed carcass weight)	7,4	6,9	93,2
of which			
Cattle	3,8	3,5	92,1
Swine	2,0	1,9	95,0
Poultry	1,0	1,1	110,0
Sheep and goats	0,4	0,4	100,0
Milk	33,2	32,1	96,7
Eggs (in billions)	32,6	33,3	102,1

Source: Russian Statistics Agency data.

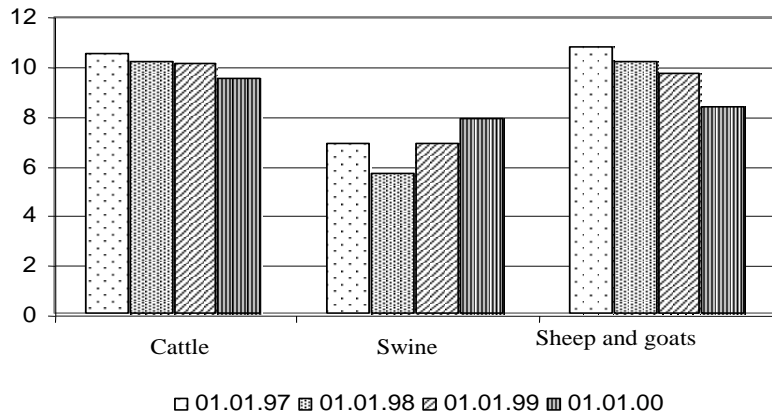
Cattle numbers continued to fall. October 1999, however, showed a rebound in milk production. Trends in early 2000 will show how stable this rebound may prove.

Intensive factors have come to play a more prominent role in the incipient growth in agriculture. In crop farming, for example, mineral fertilizers are being used on a broadening scale: the sale of mineral fertilizers on the wholesale market has gone up by 22.5 per cent as fertilizer exports have fallen off. Farmers have started buying increasing quantities of farming machines.

Animal productivity is rising in cattle farming. Fatal diseases of all animal species dropped from 1998 on all types of farm, milk yields per cow edged up by 2.3 per cent, egg production advanced 5.5 per cent, and 3.5 per cent to 6.3 per cent more offspring, depending on animal species, was produced.

FIG. 1

**The livestock population on subsidiary farms,
in millions of head**

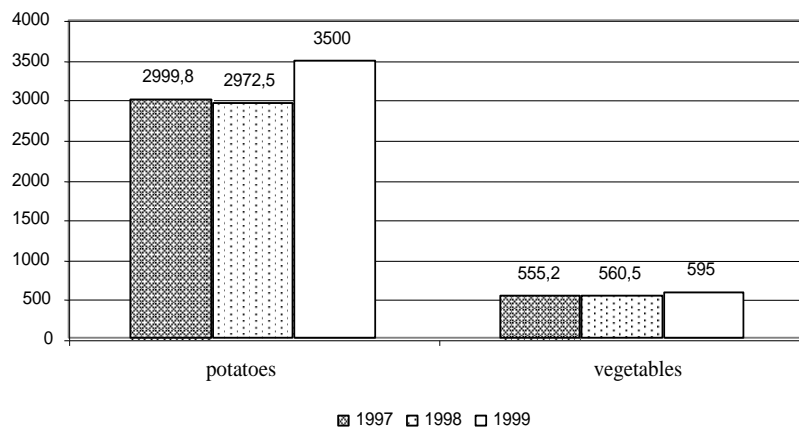


Source: RF Statistics Agency data

Opportunity costs of labor have grown appreciably in the aftermath of the August 1998 crisis. The traditional response has been growth of food production by households. In particular, more hogs have been raised on subsidiary farms (Fig. 1), and areas under potatoes and other vegetables have expanded (Fig. 2). Accordingly, the share contributed by households to total agricultural output has risen. In absolute terms, though, no growth has been registered in livestock products on subsidiary farms (Fig. 3). The physical volume of gross output produced on subsidiary farms tends to increase in periods of socioeconomic instability and to decline on early signs of stabilization (Fig. 3), fully vindicating the adjective “subsidiary.”

FIG. 2

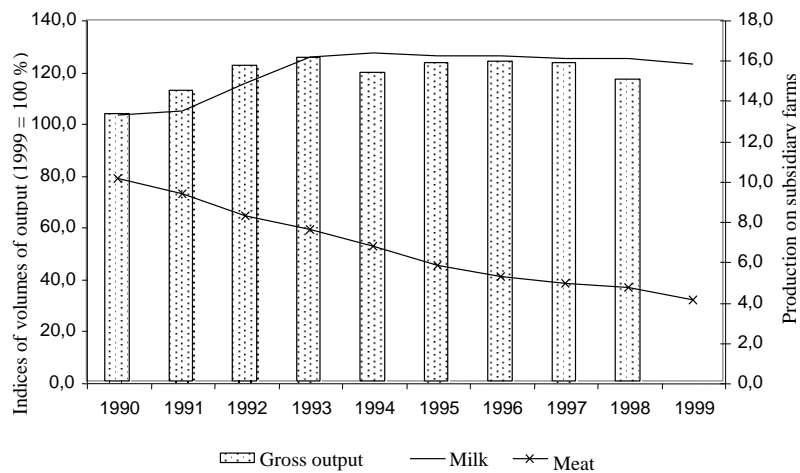
**Areas under potato and vegetable crops on subsidiary farms
(in thousands of hectares)**



Source: RF Statistics Agency data

FIG. 3

Indices of physical volumes of gross output and meat and milk production on subsidiary farms



Source: RF Statistics Agency data

Production of Resources for Agriculture

The growth of production and marketing in agriculture has pushed up farmers' effective demand for primary resources. This factor alone has contributed, without extra government programs for agriculture, to a considerable growth in the manufacture of tractors and farming machinery, and in the production of mineral fertilizers and chemical plant protection agents, and protein and vitamin-enriched additives (Table 5). Even more significantly, production of primary resources for agriculture is growing at faster rates (108 per cent) than the average for manufacturing. In absolute terms, output is far too low, but the uptrend inspires hope for a gradual reconstruction of the agricultural producers' potential.

TABLE 5

Dynamics of volumes of output of producer goods for agriculture

	1998 in per cent of 1997	1999 in per cent of 1998
Mineral fertilizer	97,5	122,88
Plant protection agents	45,7	161,4
Tractors	79,0	156,9
Grain harvesters	44,9	186,4
Tractor-driven mowers	79,0	114,2
Tractor-driven ploughs	15,2	107,5
Tractor-driven sowers	16,7	210,0
Protein and vitamin-enriched additives	33,0	220,0

Source: RF Statistics Agency data

Farmers have been supplementing the primary resources they were buying from domestic producers with imported machines. In the nine months of 1999, imports of farming machines and equipment for the dairy subsector went up (in cash terms) by 41 per cent and 69 per cent, respectively. Besides, the Republic of Byelorussia supplied Russian farmers with Rb2.46 billion worth of farming machines to clear its arrears in natural gas payments. The growth in the number of agricultural machines was more significant last year than could be expected from the growth figures for domestic farming machine production.

Food processing

The downturn of food imports has given domestic producers an opportunity to augment their share of the domestic food market and step up food production accordingly. In 1998 and 1999, the food processing industry was posting relatively high growth rates (Table 6). The meat packing industry continued to slide, however, be-

cause of its continuing dependence on imported raw materials.⁹³ Moreover, falling real incomes reduce demand for animal farming products in the first place. The meat packing industry, therefore, found itself squeezed between plunging imports of essential resources and falling effective demand.

The dairy industry, too, continued to depend on imported primary materials and to struggle with declining demand. Consumption of dairy products, however, is less elastic than that of meat products. Accordingly, the growth of personal incomes that took off in the second half-year led to a rise in effective demand for dairy products. Beginning in August, the dairy industry was showing signs of recovery, and in October, as we have said above, milk production started to rise. This pattern of dairy industry dynamics vividly shows that, first, farming is given a boost by the food processing industry, which, in turn, receives an impetus from rising demand. Second, it demonstrates agriculture's sufficiently rapid responsiveness to mounting demand.

In June, a number of food processing sub-sectors stepped up their growth rates. Had advances in the food processing industry been related to import substitution efforts alone, it would be bound to wane instead of picking up, particularly in view of imports of selected food products having started a recovery of their own in 1999. Rather, this uptrend is evidence of rising domestic demand.

⁹³ Out of the total sales of livestock and poultry by farms, 62 per cent was marketed through alternative channels, rather than supplied to meatpackers, and 38 per cent of the milk bypassed dairy factories. The fact that production in the meat packing and dairy industries declined at lower rates than did production of domestic primary materials is evidence of meatpackers and dairy operators being supplied with imported primary materials.

TABLE 6

**Dynamics of production of staple foodstuffs,
in millions of tonnes**

	1985	1990	1998	1999	1999 in per cent of 1998	1999 in per cent of 1985	1999 in per cent of 1990
Meat	5334	6629	1336	1072	80,2	20,1	16,2
Sausages	1944	2283	1113	944	88,5	48,6	41,3
Butter	721	833	276	258	93,5	35,8	31,0
Whole milk products	17,9	20,8	5,6	5,45	97,3	30,4	26,2
Vegetable oil, in '000 tonnes	775	1159	782	845	108,1	109,0	72,9
Granulated sugar, in '000 tonnes	3642	3758	4812	6781	140,9	186,2	180,4
Flour	22,5	20,7	12	12,2	101,7	54,2	58,9
Groats	2600	2900	1089	868	79,7	33,4	29,9
Noodles, in '000 tonnes	946	1038	554	679	122,5	71,8	65,4
Margarine	822	808	185	377	158,1	45,9	46,7
Canned meat, in millions of standard cans	7057	8202	344	490	154,5	6,9	6,0

Source: RF Statistics Agency data

In general, production of staple foods is so far growing at very modest rates, in absolute terms, far below the pre-reform level. An important development, however, is the dynamics of vegetable oil and sugar production. Russia has always imported half of its sugar requirements (mainly from Ukraine). Today, it produces enough sugar to meet its requirements in full (sugar production in Russia having risen by 80 per cent from the pre-reform level). Sugar beet production, however, is still less than the average for the period 1986 to 1990, even though it went up noticeably last growing season. This fact suggests that Russia manufactures its sugar mostly from imported raw stock. The desire to keep its own sugar refining

industry busy at any price, without efforts being made to promote domestic sugar beet growing, is hardly justified.

The situation in vegetable oil production is an exact reverse of sugar. Sunflower seed production increased by more than one-third during reform years, but sunflower oil output grew by 10 per cent only (and mayonnaise production even dipped). The explanation is large-scale exports of the crop because of insufficient capacities to have it processed at home.

Another notable fact is a sharp increase in the production of pasta, flour, meals, bread, and baked products. With grain and flour imports going down, this increase may only be attributed to steady supplies of domestic grains and flour, which means, in turn, that grain shortages in 1998 and 1999 were greatly exaggerated.

Growth in the food processing industry has been maintained by increasing investment, which we predicted in the fall of 1998 already. Total capital investment in the food processing industry (not counting small businesses) shot up by 45.3 per cent in the first half-year 1999, surpassing significantly the average growth rate of investment in the economy in general. The food industry's share in accumulated investments more than doubled, from 3.6 per cent in 1998 to 7.3 per cent in July 1999. Its share in foreign direct investment amounted to 15 per cent in the first six months, a percentage second only to the fuel industry with a still larger share. As expected, the contraction of financial markets and more stringent capital export regulations produced a growth in investment in short investment cycle industries, the food processing industry in the first place.

The Financial Position of Agricultural Producers

Swelling farm produce sales and improved price parity have drastically altered agricultural producers' financial position. Without much government support to rely on, the number of profit-earning farms and the profitability of the agricultural sector as a whole have risen sharply.

The prices of farming produce marketed in 1999 soared by 91 per cent, while those of manufactured capital goods went up by 58 per cent⁹⁴ and 63 per cent in the food processing industry.

Also as expected, import substitution trends in 1998 and 1999 made farming a more profitable industry. On October 1, 1998, a little over 87 per cent of farms in Russia were loss-makers, and by the same date in 1999 this figure had dropped to 52 per cent. Whereas in the nine months of 1998 farming produce was marketed at a loss (at 21.7 per cent loss), in the nine months of 1999 sales were earning a margin in excess of 14 per cent. Considering the fact, however, that capital assets have been amortized in agriculture for several years on end and the money put aside has not been used for its direct purpose, apart from raising costs, the actual profit margin would be past 20 per cent.

Sales have almost doubled (193.3 per cent) in cash terms, at a farming produce price index of 163.2 per cent (for three quarters of 1999), that is, sales have grown by almost 30 per cent in physical terms. Domestic demand that has risen in response to falling imports of farming produce has been the principal driving force behind this growth.

An analysis of agricultural producers' books shows the share of barter to be upward of 50 per cent of their total sales. A comparison

⁹⁴ For the time being, the authors are not in possession of official data on the growth of prices of capital goods acquired by farmers.

between money receipts from the sale of goods, works and services and total sales of farming produce that include non-monetary transactions shows that the share of barter increased from 30 per cent in 1995 to 55 per cent in 1998 (Table 7). Growth in money receipts from sales in 1999 may suggest a considerable reduction in barter (manufacturing already exhibits this trend⁹⁵).

TABLE 7

Estimates of barter's share of agricultural transactions

	1995	1996	1997	1998
Cash receipts from sales (1)	41,2	39,2	38,8	40,8
Sales (2)	59,1	81,6	90,1	90,1
Barter's share of sales [(2-1)/2]	30,29	51,96	56,94	54,72

Source: Estimated from data contained in annual reports compiled by agricultural enterprises.

Agricultural producers' bank accounts more than doubled over the year. Considering the significant, and growing, shadow turnover in agriculture, farms' money receipts are even greater. This means that agricultural producers will have a lower demand for seasonal loans next summer and fall and that tied credits within the agro-industrial complex will be less widespread. All other conditions unchanged, this factor is bound to have a favorable effect on next year's financial performance. As we already emphasized on several occasions, barter transactions, tied credits and set-offs normally involve prices disadvantageous for farmers and, eventually, unjustified drain of funds from agriculture. Cash money will allow farms to evade unprofitable deals in the ongoing season.

A positive trend emerged in changes in accounts payable and receivable. By October 1, 1999, the annual growth rates in accounts

⁹⁵ See: "The Economic and Political Situation in Russia," IEPP, August 1999, p. 22; *Russian Economic Barometer*, No. 4, 1999, p. 65

payable had been half that of accounts receivable. Moreover, customer debt is the fastest growing element of accounts receivable, which is only too natural for growing sales. The balance of accounts payable and receivable rose by 120 per cent (at a consumer price index of 136 per cent).

Despite growth in money receipts in agriculture, however, farmers still owe enormous debts to their creditors - more than Rb150 billion, for the net proceeds of almost Rb6 billion for the industry as a whole for the year.

Another new turn in the financial position of agriculture is that it is becoming attractive for investors, foreign investors first and foremost (Table 8).

TABLE 8

Total fixed investment and foreign currency-denominated foreign investment in agriculture

	1996		1997		1998		1999
	1st half-year	year	1st half-year	year	1st half-year	year	1st half-year
<i>Total investment, in Rb billions</i>							
Total	2,6	11,8	2,3	10,3	2,8	10,4	5,2
<i>Foreign investment, in \$US millions</i>							
Total	2,4	3,7	3,7	5,5	1,5	4,2	8,6
of which direct	2	3,3	3,7	5,2	1,4	3,6	6,3
As per cent of total investment in the economy	0,12	0,06	0,06	0,05	0,02	0,04	0,24
As per cent of total direct investment in the economy	0,36	0,16	0,17	0,13	0,14	0,17	0,34

Source: *Ekonomicheskyy Zhurnal VShE* (The Economic Journal of the Higher School of Economics), Vol. 3, No. 4, 1999. pp. 631, 633.

Agricultural Markets

Domestic Markets for Selected Farming Products

The situation on agricultural markets was determined, above all, by rising demand for staple products and, accordingly, by growth in procurement prices. Shrinking demand for more expensive products and expanding demand for cheaper foodstuffs was another contributing factor. Finally, market regulation by regional authorities remained as important as it had been previously.

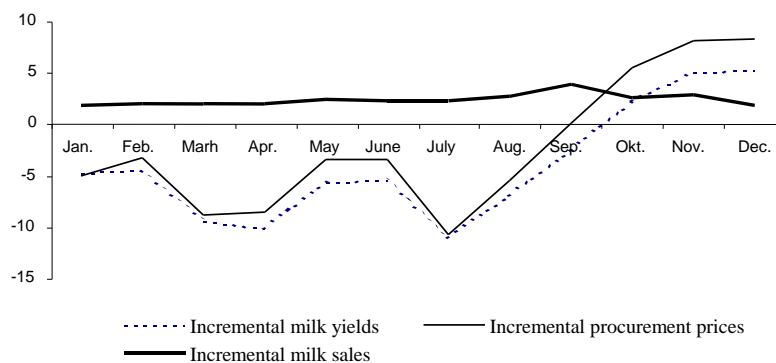
Grain shortages on the domestic market after the crop failure in 1998 and the interregional trade barriers on the grain market sharply inflated grain prices. Grain procurement prices rose higher (by nearly 160 per cent) than market prices of any other farming produce (for the inflation index of 136 per cent). All this was happening against the background of the lowest grain prices on the world market for years. Grain deliveries under humanitarian aid programs had little impact on prices, but altered the structure of Russian grain exports - whereas in 1998 Russia was a net exporter of wheat, the ban on export of commodities received under humanitarian aid programs led to an expansion of wheat flour exports. Growing flour exports became a further factor responsible for the growth of ruble-denominated grain prices.

A curious situation arose on the meal crop market. Producers responded to shortages of meal crops in 1998 by significantly raising their production: gross output of millet doubled, that of buckwheat rose by 24 per cent and that of rice went up by 8 per cent. The growth in meal crop production was not, however, followed by a respective increase in the output of meals by grain processors. Two reasons may probably be cited to explain the rising production of meal crops and simultaneous drop in the output of meals by the food processing industry. Either producers are storing their grain crops, without taking them to the market in expectation of more

favorable prices, or are processing their crops themselves and selling the finished products on the market themselves. The second conjecture is borne out by data about rising meal crop processing capacities. Last year, there was a more than sixfold rise in the commissioning of new meal crop processing facilities. The slump in industrial production of meals was, therefore, offset by supply of ready meals by agricultural producers themselves. The producers' desire to market their ready products testifies to market underdevelopment.

FIG.4.

**The movement of milk prices, yields and sales volumes in 1999
(1999 in per cent of 1998)**



Source: Online information on milk yields and sales, <http://94.58.47.62>

In the dairy subsector, milk sales had a better dynamics than milk production through the year. Even a creeping growth of milk market prices was enough to lure sales out of the shadows - milk producers could make a good bargain by supplying milk to dairies rather than marketing it at their own cost. The upturn that that began in the dairy industry in August and the immediate surge of market prices triggered growth in milk production and marketing

(Fig. 4). More milk was now supplied to the dairies because, on one hand, of higher cow productivity and, on the other, sales were growing faster than production did. Future expansion of milk production in agriculture will, however, be constrained by technological factors (the number of dairy cows cannot be increased fast enough) and a relative shortage of feeds. Raising imports may, however, reverse the recent uptrend in the dairy subsector.

In the meat subsector, falling imports and rising beef and pork market prices in early 1999 were not enough to really spark off production. The reasons were, first, that growth in beef production is held back by a natural technological lag. Second, demand for meat (especially beef) was curtailed by declining purchasing power. Third, livestock farmers stepped up meat deliveries through alternative marketing channels. In 1999, livestock farmers sold 65.1 per cent of their cattle and poultry to buyers other than meatpackers (up from 60.7 per cent in 1998), with shadow deals claiming a significant proportion of this quantity. This forced meatpackers again to turn to imports, which had about completely recovered after the 1998 crisis.

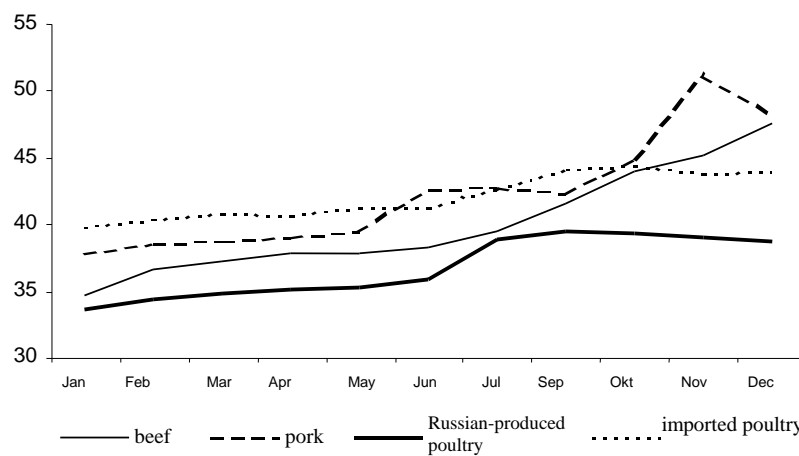
Poultry farming is faring best, having taken advantage, in part at least, of the absolute competitive edge it acquired after the crisis. First, the plummeting ruble sharply reduced poultry imports on the end consumer market. Second, domestic poultry production had started building up sometime before the crisis, so the investment made in domestic production had been yielding returns by the time crisis struck.

As a result, prices of domestically produced poultry held much below imports all year long. Third, sufficient supplies of feed grain and protein ingredients for feeds were an added incentive to step up domestic production, considering the short poultry production cycle (three to four months). Finally, retail prices of poultry meat on the domestic market remained considerably lower than those of pork or

beef, so with consumption of meat products in general going down, demand shifted toward less expensive animal protein sources.

FIG. 5

The movement of retail prices for selected meats, in Rbs per kg



Source: Online information from the Ministry of Agriculture and Food Production; *The Social and Economic Situation*; and RF Statistics Agency data for the corresponding months of 1999.

Food Market

The second half of 1999 marked the beginning of growth in personal incomes and, as a result, an uptick in demand for food products. Rising demand has had two consequences. First, it was a renewed incentive for food processing as a whole and, second, domestic production growth being far too slow to meet the food processing industry's demand for farming produce, imports of food-stuffs, as well as primary products, started to climb in the second half of the year.

Despite an unmistakable recovery of the food markets in 1999, however, the drop in consumer demand and change in its structure were the key factors affecting the situation in the food sector. Real personal incomes failed to rise to the 1998 level (staying approximately 15 per cent below), even though the shortfall was largely offset beginning at mid-year. Falling demand cut into retail food sales, which went down by 8.4 per cent from 1998. Sales declined simultaneously with a trimming of inventories held by retailers in the first half of 1999, but by year-end inventories had torn ahead of the 1998 level. Finally, a shift in the structure of retail sales was another sign of consumer market deterioration. Compared with the year before, more foodstuffs were bought on wholesale/retail markets and food stalls, as purchases in large and medium-size outlets fell off. Moreover, consumers developed a stronger tendency to be self-sufficient in food products raised on their household farms.

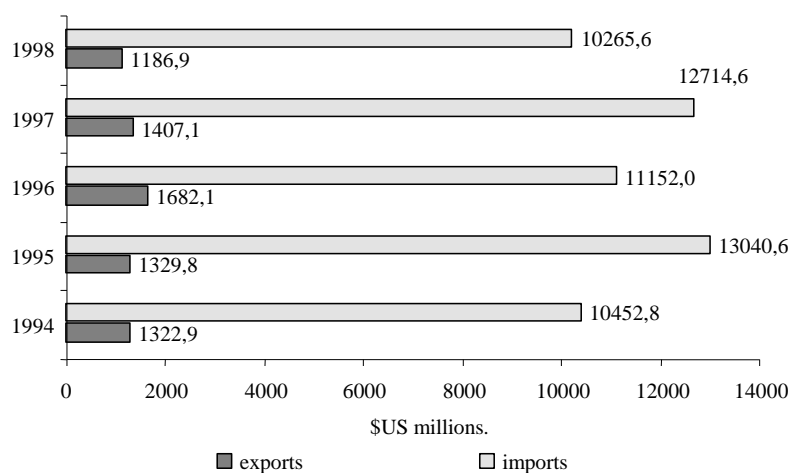
Foreign Trade in Farming Produce and Foodstuffs

The financial crisis in August 1998 significantly altered the dynamics of Russia's foreign trade in farming produce and foodstuffs. Last year, exports and imports of agricultural products and foodstuffs were the lowest in the past five years in value terms (Fig. 6). More specifically, in 1998 imports of farming produce and foodstuffs fell by 19 per cent and exports by 16 per cent from 1997 in terms of value.

In 1998, Russian foreign trade decreased in actually all commodity groups. The share of foodstuffs in exports and imports, therefore, remained at the 1997 level, 1.8 per cent and 26.3 per cent, respectively. The trade balance in the farming produce and food group rose by \$2,228.8 million, however, because of farming produce imports having dropped faster than exports, but was still unfavorable for Russia.

FIG. 6

Dynamics of Russian external trade in farm produce and food-stuffs 1994 through 1998



Source: Customs statistics of RF external trade.

Depressed world prices for agricultural products brought down the value of Russian exports of farming produce and foodstuffs, although they rose in physical terms (Table 9).

TABLE 9

Dynamics of exports major farm produce and foodstuffs 1997 through 1998, in '000 tonnes*

	1997	1998	in per cent of preceding year	
			1997	1998
Frozen fish	186,7	301,3	209,1	161,4
Wheat and muesli	543,3	1523,7	151,0	280,5
Sunflower, safflower or cottonseed oil	25,9	34,5	60,7	133,2
Sunflower seeds	1049,2	1107,2	59,0	105,5

*- Data on Russian trade with Byelorussia not included.

Source: Customs statistics of RF external trade.

The financial crisis caused a sharp reduction in Russia's imports of essential kinds of farming products and foodstuffs (Table 10).

TABLE 10

**Dynamics of imports of major farm produce and foodstuffs
1997 through 1998, in '000 tonnes***

	1997	1998	in per cent of preceding year	
			1997	1998
Beef	618,1	419,5	137,7	67,9
Pork	308,9	282,0	101,6	91,3
Poultry meat	1146,6	814,5	152,0	71,0
Butter	169,7	79,6	150,4	46,9
Sunflower, safflower or cottonseed oil	322,1	232,0	184,9	72,0
Wheat and muesli	2143,0	1095,2	104,1	51,1
Wheat flour	386,9	216,1	53,7	55,9
Raw sugar	2519,2	4060,2	148,5	161,2
Refined sugar	949,9	385,1	66,1	40,5
Citrus fruit	570,1	541,9	128,5	95,1
Coffee	27,8	4,9	110,8	17,6
Tea	158,2	150,2	133,5	95,0

*- Data on Russian trade with Byelorussia not included.

Source: Customs statistics of RF external trade.

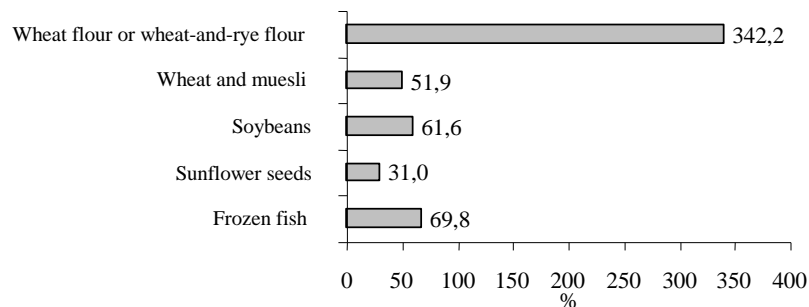
The 1998 trends continued well into the year 1999. In January through September 1999, exports of Russian farming products and foodstuffs were, in value terms, 36 per cent smaller than they were in the same period of the year before, with imports down by 40 per cent.

Our previous suggestion that, because of the narrow mix of Russian exports and limited domestic production, devaluation of the ruble would not lead to a significant expansion of exports is corroborated by the data in Figure 7. Export duties imposed on soybeans and sunflower seeds early in 1999 were a further factor restraining Russian exports of farming products and foodstuffs. Grain exports fell after the government banned export of grain and other kinds of foodstuffs supplied to Russia under food aid pro-

grams. Russian exporters, however, bypassed this ban by expanding flour exports. Between January and September 1999, flour exports more than tripled from the same period of the preceding year.

FIG. 7

Change in exports of selected types of farm produce and food-stuffs from January-September 1998 to January-September 1999

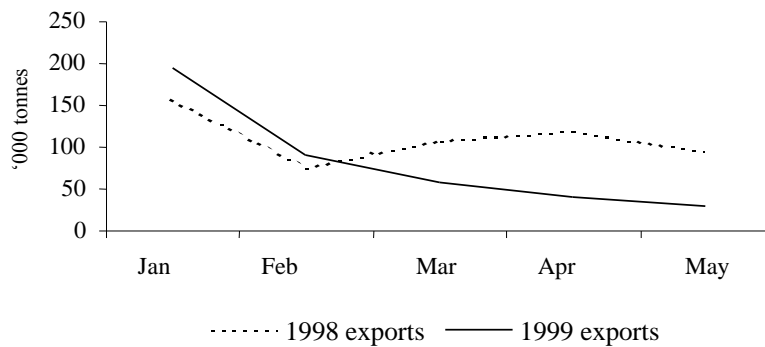


Source: Customs statistics of RF external trade.

A significant fact is that despite poor harvest in 1998 and the ban on exports of grain received under food aid programs, Russia continued to export wheat to other countries at the start of this year (Fig. 8). In the period from January through May, exports slowed down by only 30 per cent from the same period of the year before. Since Russian exports of wheat and muesli were in the first quarter of 1999 only 17 per cent of the preceding year's figure and grain deliveries under food aid programs did not start before April only, it may be assumed that the real grain production volumes and carry-over grain inventories had been underestimated.

FIG. 1

**Dynamics of wheat exports from January to May 1998
and from January to May 1999**

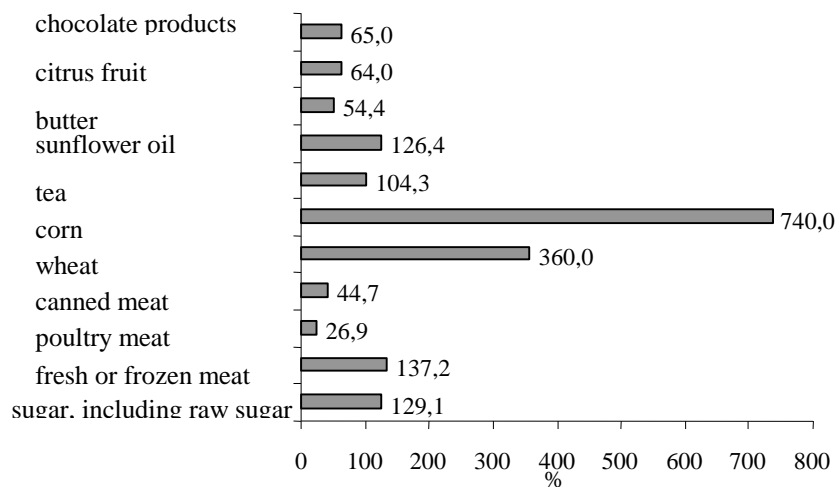


Source: Russian Statistics Agency data

Russia's foreign trade early last year shaped up under the direct impact of the crisis, which essentially caused imports of all food varieties to fall. After the ruble stabilized toward the end of 1998 already, imports of some foods to Russia resumed. In particular, more meat, sunflower oil, cereals, tea and sugar, including raw sugar, was imported between January and November 1999 than for the whole of the preceding year (Fig. 9). The growth of imported meat is explained by lack of potential to build up domestic meat production rapidly enough. The expansion of domestic vegetable oil production (up 9 per cent in 1999 from the preceding year) proved insufficient to meet domestic demand, so it had to be supplemented by imports.

FIG. 9

Change in imports of selected types of farm produce and food-stuffs from January-November 1998 to January-November 1999



Source: RF Goskomstat.

Russian grain imports from CIS countries diminished, as Russia bought 74 per cent of its grain imports between January and November 1999 elsewhere. This happened because Russia received grain shipments from the United States and the European Union under food aid programs. Countries outside the CIS were the principal suppliers of raw sugar last year as well - its share in total sugar imports, including raw sugar, was 94 per cent. By giving preference to raw sugar imports over refined sugar Russia, therefore, continues environmentally harmful sugar production in its territory.

Meanwhile, imports of canned meat, butter, poultry meat, citrus fruit and chocolate products dropped sharply because of changes on the domestic markets of these products. The 54.5 per cent growth in the production of canned meat in 1999 over 1998 allows an as-

sumption to be made that domestically manufactured products have substituted for imported canned products. Poultry meat production started to rise in 1997 already. Moreover, rising prices of imported poultry meat after the eruption of the financial crisis and lower retail prices of poultry meat in comparison with other meats have swung consumer demand to domestically produced poultry meat, providing an additional incentive to domestic producers. Between January and May 1999, poultry meat import substitution translated into a 73 per cent reduction in imports of this food product group. These developments knocked the United States, the main poultry meat supplier to Russia for years, out of its leading position on the Russian food market. Between January and September 1999, American poultry meat exports to Russia dwindled by 89.4 per cent from the same period of 1998. A change in consumption patterns was, more than anything else, a factor behind a drop in butter imports. Falling purchasing power and rising prices of imported butter in the wake of the crisis compelled consumers, low-income segments of the population in the first place, to switch from butter to margarine-base products.

Changes in the country's economic situation reflected on the geographical structure of its foreign trade. The decline of Russian imports from the countries of the Commonwealth of Independent States that went on through all of 1998 resulted in the CIS countries' share of Russia's farming produce and foodstuffs group of commodities declining from 20.6 per cent in 1997 to 15.8 per cent in 1998 (Table 11). EU countries remain, as they have been for years, the principal sources of Russia's food imports, even though imports from those countries dropped significantly in months immediately following the 1998 crisis.

As exports of farming products and foodstuffs to countries of Central and Eastern Europe, mainly the Baltic countries, plunged

deeply in 1998, the share of those countries in Russian exports of these products shrank drastically. As in 1997, OECD countries retained their leading positions in the structure of Russia's exports of farming products and foodstuffs.

An expansion of trade in farming products and foodstuffs with China was registered in 1998.

TABLE 11

The geographic structure of Russian foreign trade in farm produce and foodstuffs by group of countries 1997 to 1998

	Exports		Imports	
	1997	1998	1997	1998
<i>Total</i>	<i>100</i>	<i>100</i>	<i>100</i>	<i>100</i>
of which				
<i>CIS*</i>	<i>26,1</i>	<i>26,7</i>	<i>20,6</i>	<i>15,8</i>
<i>OECD**</i>	<i>45,8</i>	<i>51,6</i>	<i>47,8</i>	<i>45,1</i>
of which EU	20,5	18,7	30,1	28,4
North America	4,1	4,5	12,5	12,6
<i>Central and Eastern Europe</i>	<i>21,1</i>	<i>7,7</i>	<i>10,3</i>	<i>10,1</i>
of which the Baltic countries	15,9	4,7	1,7	1,6
<i>China</i>	<i>3,2</i>	<i>5,1</i>	<i>2,6</i>	<i>3,5</i>
<i>other</i>	<i>3,8</i>	<i>8,9</i>	<i>18,7</i>	<i>25,5</i>

*- Data on trade with Byelorussia not included.

** - Data on trade with Hungary, Poland and the Czech Republic (bracketed with the Central and Eastern European region) not included

Source: Customs statistics of RF external trade.

Even though year-end statistics of Russia's foreign trade geography has not been published yet, figures for the first three quarters of 1999 justify the conclusion that the share of CIS countries has not changed much. Between January and September 1999, 33.6 per cent of Russian exports of farming products and foodstuffs went to CIS countries. The share of CIS countries in Russia's total imports of farming products and foodstuffs amounted to 15.7 per cent.

Agrarian Policy

Agrarian policy of the year was highlighted by a succession of three cabinets and, accordingly, replacement of the minister of agriculture and vice premier for agriculture. In February and March, the Government made public a package of documents on agriculture, which was clear evidence of the course agrarian policy was about to take. Foremost among those documents were the Government's Directive No. 228 of February 26, Leasing of Engineering Products in the Agro-Industrial Complex of the Russian Federation Using Federal Budget Funds; Directive No. 256 of March 4, Measures to Accelerate Delivery of Agricultural Chemical Agents to Agricultural Producers in 1999; Directive No. 259 of March 5, Measures to Supply Agricultural Producers with Fuels and Lubricants for Spring Field Work in 1999; and Directive No. 295 of March 16, Price Policy in Agro-Industrial Production.

The principal conclusion that can be drawn from an examination of these documents is that the Government is attempting to intensify its interference in the agro-industrial economy and to resurrect some of government regulation methods used in Soviet times.

Budget Support

By December 1, 1999, Rb7.8 billion had been transferred from the federal budget to help agriculture, or less than 84 per cent of what is provided in the budget (overall, 94 per cent of budget outlays had been expended, and the corresponding figure for industrial development spending was 81 per cent). Unlike they were in 1998, the budget authorities were more punctual in transferring funds to agriculture, but without the typical adherence to priorities in agricultural outlays given in previous years (until 1998). The increase in federal budget outlays on agriculture resulted in the federal authorities' share of outlays for the sector having grown from 17.5 per

cent in 1998 to 27.6 per cent in 1999 (still short of the 30 per cent to 35 per cent the federal authorities had in the mid-1990s).

Because of its season dependence, agriculture needs most of support funds at the start of planting that begins as early as February in the majority of Russia's grain-producing areas. What is important, therefore, is not only the total amount of budgetary assistance for the sector, but also its disbursement schedule spread over the year. As shown in Table 12, the flow of budgetary funds last year was the heaviest in April, and from then on it was more or less well-coordinated through the year, even somewhat more advantageously in season-adjusted terms than in either 1997 or 1998. Before April, however, budget funds were coming in a thin trickle.

TABLE 12

Allocation of consolidated budget funds to agriculture and fisheries by month, in per cent of annual expenditure

	1996	1997	1998	1999
January	6,3	2,4	2,3	2,3
January-February	12,7	5,9	6,8	4,8
January-March	19,4	12,2	9,6	10,8
January-April	29,0	18,9	17,9	26,4
January-May	37,7	24,6	25,8	37,9
January-June	44,8	30,5	35,6	45,0
January-July	51,6	42,6	44,0	50,3
January-August	59,5	53,0	51,8	61,8
January-September	64,2	63,5	59,9	n/a
January-October	75,2	71,8	64,4	n/a
January-November	83,7	80,0	73,1	100,0
Total year	100,0	100,0	100,0	

Source: Estimated from *Ekonomicheskyy Zhurnal VShE* (The Economic Journal of the Higher School of Economics), Vol. 3, No. 4, 1999, pp. 619, 621.

In addition to budgetary funds, agriculture was granted Rb4.6 billion in low-interest loans (after Rb5.8 billion in 1998). We already spoke of farming machines from Byelorussia, which also

were provided to farmers on easy-term lease (Rb2.41 billion). Besides, 34 regions were given loans in the form of fuels and lubricants for farmers' needs (Rb0.8 billion).

Budget support for agriculture in 1999 had grown from 1998, but it still was well below the average for 1992 through 1997 (both in direct budget subsidies and under other support programs).

Regulation of Agricultural Markets

The Primakov cabinet issued a few traditional season-timed directives on agriculture with outlines of the Government's major programs for the agro-industrial complex. It made attempts to impose meaningful controls over prices in the agricultural and food sector. In its general Price Policy Directive, the Government raised the issue of price disparities and measures to control them. Predictably, no real steps were actually made to establish control over price ratios, and still less to bring them back to the 1990 level.

Once again, guaranteed prices were introduced for federal procurements of farm commodities. Actually, though procurement prices were not fixed in 1998 only (at the insistence of the Ministry of Economy), such prices have never, in all previous years, had an appreciable impact on the markets as they were always set below the level of market prices.

A reduced 10 per cent VAT rate on a wide range of farming products was introduced in late 1998. The list of eligible commodities was amended on July 1, 1999, to drop meat and meat products, eggs and egg-base products, live fish, and seafood and fish products. As also in mid-1998, these changes did not affect retail prices of these products.

In 1999, mounting pressure for a return to government regulation of food markets was not relaxed. Rather the reverse, it was clamped even tighter, spreading to both food-producing and food-deficient regions. The local authorities' policy in net food-

consuming regions was aimed at gaining control over the consumer market, in particular, at regulating prices of socially sensitive foodstuffs in order to prevent price rises. Bans on food exports were imposed to block the outflow of foodstuffs from local consumer markets to regions with higher price levels. Artificially low retail prices caused serious dislocations in the price structure. In some regions, fixed retail prices of bread imposed by local authorities (in Kuzbass and Saratov Oblast, for example) provoked a situation reminiscent of the age of shortages: livestock farmers were eagerly buying up bread priced cheaper than mixed cattle feeds.

By mid-year, when harvesting time arrived, bans on farming produce exports had been in effect in more than 20 oblasts, most of them agricultural producers. As a rule, direct bans are only temporary, being introduced until farmers have delivered their produce to regional stocks. But even the several months when bans are in effect is enough to produce a strong destabilizing effect on both local and national markets in several ways. First, because such bans are accompanied by fixed regional procurement prices that are generally below prices in neighboring regions. Unable to take their produce to regions with higher prices, local farmers suffer losses by selling it locally at fixed prices. Second, local trading companies capitalize on local low prices and lack of marketing alternatives for local producers, buying up foodstuffs at low prices for resale after export bans are lifted.

In August 1999, the Federal Government, too, made an attempt to revert to the old practice of fixing guaranteed procurement prices. Rather, it was an echo of the habit of regulating prices for commodities supplied under food aid programs and the government's devotion to its own assurances that it would not allow prices of bread products to grow. Its guaranteed prices, like regional procurement prices,

proved to be lower than real market prices and served as another potential destabilizing factor on the national food market.

Resource Sufficiency Programs for Agriculture

An attempt was undertaken in early 1999 to set prices of key agricultural resources (fertilizers, fuels and lubricants, and farming machines) “at an economically justified level” (a phrase strongly reminiscent of “socially necessary costs”). The intention was to set prices of resources themselves and dealer markups.

The mechanism of government support in supplying resources to farmers was slightly modified. In mineral fertilizers, the Soviet dual-pricing system was restored, with farmers being given a 20 per cent discount from producer prices and the producers receiving refunds from the budget. In the Soviet economy, however, producers were given quotas of how much fertilizer they had to supply to which consumers. Direct quotas are very unlikely in the Russian economy today. It was, therefore, suggested that elements of competition among fertilizer suppliers be introduced.

The mechanism, under which fuels and lubricants were to be supplied to farmers, required a return to the tied loan system of the type used at the federal level in 1995 and 1996, even though debts on loans made in those years have not been repaid to this day. These debts formalized as regional bonds were to be accepted from oil companies and their creditors in payment of taxes and mandatory transfers. Besides strengthening non-monetary (barter) relationships within the agro-industrial complex itself, this mechanism reduced still further the money components of Russia’s budget receipts.

Foreign Trade Policy

Foreign trade policy in the agricultural and food sector last year was molded under the impact of the crisis. Duties on food exports

were reimposed, for the first time since 1996. In January to July, export duties were only applied to sunflower seeds, rapeseeds and soybeans. In March, crustaceans and mollusks, some fish species, crabs, shrimps, lobsters, and ethyl alcohol were added to the list of commodities subject to export duties.⁹⁶

Restrictions on food imports continued to relax. This policy was inaugurated in October 1998, with reductions in import duties on meat, powdered milk and cream, butter, vegetable oil, baby foods, and soybeans. The new duties remained in effect until October 1999. Also, import duties on edible poultry offals were lowered in March, and in September on cattle fat, sheep or goats for commercial uses. More import restrictions are to be eased in 2000 as well. The present ruble exchange rate offers a more varied protection for the domestic market against food imports, so consumers of imported commodities could successfully lobby for their interest in import duty reductions.

Sugar is still at the center of foreign trade regulation. In 1998, imports of sugar from Ukraine were substantially below the quota imposed on duty-free Ukrainian sugar imports. The validity of the duty-free quota was, therefore, extended to the end of March 1999. Seasonal 45 per cent duties were imposed on raw and refined sugar, effective between August 1, 1999 and January 31, 2000 in support of domestic sugar beet industry. Seasonal duties help avoid the annual risk of the raw sugar refining period overlapping with sugar beet processing and a glut of imported raw sugar at the time. This measure will probably help expand sugar beet production in Russia.

Active regulation of the alcohol products market took the shape of a ban imposed on ethyl alcohol imports.

Food Aid

⁹⁶ Duties applied to products exported from Russia beyond CIS territory.

In November 1998, the Russian Government signed an agreement with the US Government on food aid and a tied credit for food purchases. A similar agreement was signed with the EU in January 1999.

The signing of these agreements was officially explained by acute shortages of food and impending famine. Poor harvest in 1998 was stated as the chief reason for food shortages.

Year-end results showed, however, that Russia was not threatened with acute food shortages at all. Besides, the bulk of food aid started to reach Russia in the second half-year (beginning in September), that is, after harvest at home. Before food aid was coming in, however, Russia had in no way been confronted with grain shortages, but had even been stepping up its flour exports, expanding the output of bread and baked products, pasta, and meals, and increasing its poultry and hog stocks (the most voracious grain consumers in the livestock industry). Moreover, humanitarian aid deliveries of powdered milk and pork in the fall of 1999 coincided with the lift-off of domestic production and clearly had a price depressing role in some regions. As we have said already, humanitarian food aid altered the structure of Russia's farm commodity and food exports.

Nor did humanitarian aid achieve its purported goal - supporting the poorest segments of the population. Audits of the food aid distribution program in 1999 showed⁹⁷ that the government's regional quotas of humanitarian food aid distribution were largely broken by the authorized companies, so the bulk of aid foodstuffs wound up with private companies in Moscow and St. Petersburg. Aid receiving regions would resell the foodstuffs to other regions. The Pension Fund entitled to Rb6 billion in monetized food aid had received only 80 per cent of that amount by December 1.

⁹⁷ *Interfax*, No. 4, 2000

Despite the mismanaged distribution of food aid in 1999, the Russian Government is negotiating a “minor aid” package with the US Administration. Even though food deliveries under this package are really insignificant (about 500,000 tonnes), the agreement shuts off Russian grain and flour exporters from world markets.

2.4. Foreign Trade

The year 1999 marked a turning point in the downtrend, holding for several previous years, in prices on world commodity markets, above all because of a sharp climb of prices for oil and other energy resources. Among the factors that helped end depression on goods and commodity markets foremost were a rebound of domestic demand in Asian and Latin American countries emerging from the crisis of 1997 and 1998, the stability of the US economy; and a significant reduction in the existing excess of supply over demand in most commodity groups, petroleum products in the first place. OPEC member countries succeeded in enforcing most of the decisions they had taken at the March 1999 OPEC session to cut back oil production by lowering country quotas.

The world metals markets, too, showed significant recovery. The situation on the markets for nickel and aluminum, the export of which brings Russia its largest hard currency receipts, was shaping up particularly well. During 1999, the price of nickel at the London Metal Exchange nearly doubled, from \$4,126 per tonne in December 1998 to \$8,118 in December 1999. In 2000, demand for this metal will, most likely, lead supply because of cuts in nickel exports by the metal’s two biggest producers, Inco, Canada, and Norilsk Nickel Company in Russia. Nickel producers have been given substantial support from the metal’s principal consumers, steel companies, whose demand for the metal rose by over 5 per cent in 1999.

TABLE I

**Average monthly world prices as at December
of the corresponding year**

	1996	1997	1998	1999
Oil (Brent), \$US/tonne	171,8	128,9	75,8	183,4
Natural gas, \$US/'000 cu m	141,8	87,1	80,4	87,5
Gasoline, \$US/tonne	180,7	148,0	98,8	188,2
Copper, \$US/tonne	2291,1	1768,7	1477,7	1826,3
Aluminum, \$US/tonne	1498,1	1532,4	1252,1	1559,2
Nickel, \$US/tonne	6649,9	5957,4	4125,8	8118,5

Source: estimated from London Metal Exchange and New York Mercantile Exchange data.

The situation is very similar on the aluminum market, where aircraft and auto companies are the most active purchasers.

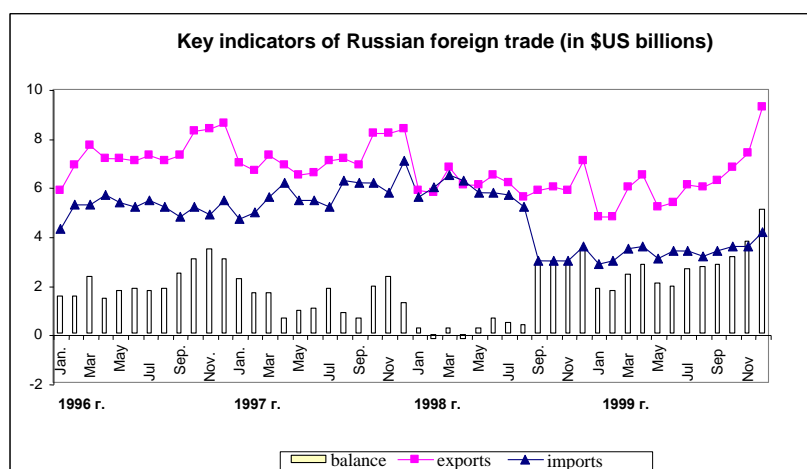
Forecasts of worldwide economic growth and trends in the situation on world commodity markets do not so far provide an unequivocal picture, but, most probably, the world markets will not turn sharply against Russia in the short term.

Russia's share in world exports in 1999 was estimated at 1.2 per cent, which puts it in the 19th place in the world (up from the 21st place in 1998). A significant lag in growth rates of export prices from those of prices on world markets, lower natural gas prices in the European region than they were in 1998, and significant reductions in exports to CIS countries last year have had an adverse effect on Russia's total exports.

In 1999, Russia had a significant trade surplus. Its exports were \$33.2 billion larger than imports, a more than twofold improvement on 1998 (with \$15.1 billion). True enough, no positive structural changes in Russia's foreign trade activities occurred last year, and the improvement in Russia's trade balance was almost completely attributable to a growth in world commodity prices and sharp cuts in imports following the catastrophic devaluation of the ruble.

In practical terms, exports held at the 1998 level, at \$74.3 billion (growth of 0.2 per cent), while imports fell by 30.5 per cent, to \$41.1 billion. In imports, Russia stepped down to 27th place in the world in 1999 (from 25th in 1998).

FIG. 1

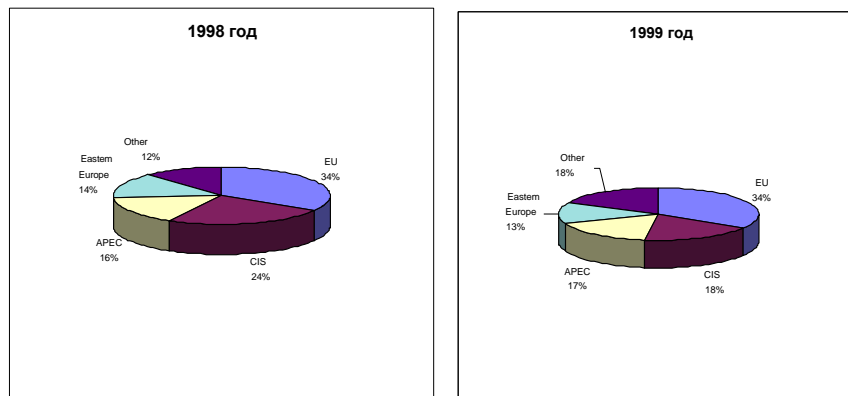


Source: Russian Statistics Agency

The contracting share of CIS countries in Russia's overall trade - from 24 per cent in 1998 to 18.7 per cent in 1999 - was a characteristic trend in the geographical structure of Russia foreign trade.

Russia's principal foreign trade partners are, as they have been for years, Germany, Ukraine, the United States, Byelorussia, Italy, China, the Netherlands, the United Kingdom, Finland and Poland, which account for 54 per cent of this country's foreign trade volume.

FIG. 2



Source: Russian Statistics Agency

In 1999, Russia's foreign trade with countries other than CIS members ran up to \$93.4 billion in current prices, down 10.6 per cent from 1998. The decrease was due to cuts in imports. Exports to these countries rose 5.7 per cent to \$62.3 billion.

In 1999, Russian exports were under the beneficial effect of two factors: devaluation of the ruble and rise, that took off in the second half of the year, in prices of natural resources that are the core of Russian exports (nearly 40 per cent of the total). All through the year, exports were growing both in physical volume and in value terms. Growth was the fastest toward the year-end: in October, Russia's exports rose 21.3 per cent from the same months of the year before, in November they were up 33.9 per cent, and in December, 32.9 per cent. Significantly, there was only an uptrend in exports to countries outside the CIS.

TABLE 2

**Dynamics of physical volumes of critical exports
to non-CIS countries**

	1994	1995	1996	1997	1998	1999
Crude oil, millions of tonnes	91,7	96,2	105,4	109,8	117,9	115,7
Oil products, millions of tonnes	39,1	43,5	55,0	58,4	51,2	47,8
Natural gas, billions of cu m	109,3	121,9	128,0	120,9	125,0	131,1
Black coal, millions of tonnes	17,7	21	20,3	18,9	18,6	22,0
Iron ore, millions of tonnes	9,8	11,4	7,8	8,2	10,1	7,6
Ferrous metals, in \$US millions	4371	5646	6208	6018	4464,1	3885,0
Aluminum, '000 tonnes	2301	2250	2616	2693	2790,4	3113,5
Copper, '000 tonnes	451	467	524	533	550,3	632,9
Nickel, '000 tonnes	124	153	166	220	214,1	211,1
Machinery and equipment, in \$US millions	32000	5314,5	5554,2	5598,7	5760,5	5953,6
Mineral fertilizer, millions of tonnes	13,1	16,2	15,1	14,4	15,9	18,8
Timber, millions of cu m	13,5	17,9	15,4	17	19,8	27,5

Source: Russian Statistics Agency

Exports of Russian crude oil dipped by 2 per cent in 1999 from 1998, to 134.5 million tonnes. These crude oil exports earned \$14.1 billion in receipts, or 37.4 per cent more than the previous year.

Over the 12 months of 1999, Russia exported 115.7 million tonnes of oil worth \$12.7 billion to countries outside the CIS, and another 18.8 million tonnes worth \$1.3 billion to CIS countries. The largest quantities of crude oil were shipped from Russia to Germany (19.4 million tonnes), Poland (15.3 million tonnes) and the Virgin Islands (12.36 million tonnes).

Although oil exports in 1999 fell in comparison with 1998 in physical terms their share in Russia's total exports went up from 14.9 per cent to 20.3 per cent in value terms.

Natural gas exports rose 5 per cent, but foreign currency earnings dropped by 15 per cent because of low gas prices in the first half-year 1999, when they plunged to a record-low level of less than \$60 per 1 million cu m of gas. Today, gas prices have rebounded to \$72 per 1 million cu m, and are expected to rise to \$80 per 1 million cu m in 2000.

In volume terms, gas exports to East European countries declined by 8 per cent from 1998 as a result of those countries' efforts to diversify their sources of energy imports. Meanwhile, gas sales to Western Europe moved up 10 per cent. Germany remains the biggest Russian gas customer, with a share of almost 40 per cent of Russian gas exports.

The share of natural gas in total exports went down from 18.6 per cent in 1998 to 13 per cent 1999.

In 1999, nonferrous metal manufacturers stepped up their copper exports by 15 per cent (to 632,900 tonnes) and primary aluminum by 11.5 per cent (to 3.113 million tonnes). Nickel exports, however, slipped by 1.4 per cent (to 211,100 tonnes). Exports of base metals (except pig iron) fell by 13.8 per cent in value terms, to \$3.885 billion.

The share of base and nonferrous metals in commodity exports dropped from 24 per cent the year before to 22 per cent. In physical terms, exports of rolled basic metals decreased because of anti-dumping measures imposed against Russian manufacturers.

Russian primary industries maintained their heavy orientation on the world market in 1999. Some industries have, however, started to expand their supplies to the domestic market, in response to the Russian Government's measures to restrict exports. In particular, Russia exported 44.2 per cent of its total oil output and 41 per cent of its petroleum products in 1999, down from 47 per cent and 43 per cent, respectively, exported the year before.

Export contract prices of some commodities are frequently underpriced in comparison with world market prices. To give an example, the average export price of oil was 12.3 per cent below the world price in December 1999, aluminum drew 20.9 per cent less, copper 21.7 per cent less, and nickel sold 17.9 per cent below the world price.

The underpricing of Russian exports is explained, in part, by the fulfillment of obligations under medium- and long-term contracts. More likely, however, commodities are often exported through intermediary firms so as to conceal part of foreign currency receipts outside Russia.

TABLE 3

Average export prices for critical goods (\$US per tonne)

	1994	1995	1996	1997	1998	1999
Crude oil	100,6	108,2	133,5	118,6	74,2	105,8
Oil products	86,2	103,5	129,9	115,8	90,0	108,3
Natural gas, for 1,000 cu m	72,8	80,1	84,2	88,6	66,3	54,5
Black coal	33	36,2	38,8	35,7	27,3	16,5
Iron ore	19,6	23,1	26,7	23,9	21,5	15,1
Nitrogen fertilizer	80,9	119,8	128	90,3	60,5	38,0
Potassium fertilizer	69,7	71,9	77,2	79,8	87,4	86,5
Round timber, for 1 cu m	53	58	59,4	57,5	50,5	43,4
Newsprint	291,5	591,8	473,7	383,4	398,9	358,0
Pig iron	112,8	130,4	136,8	124,3	108,5	69,4
Ferrous alloys	832,7	1090	1114	818,9	733,8	562,0
Copper	2042	2550	2143	2102	1655,0	1429,8
Nickel	5973	8057	7272	6733	5148,4	5355
Aluminum	1029	1519	1500	1402	1349,4	1152,4
Motor cars, per unit	3046	3417	3940	3806	4336,2	3223,2
Trucks, per unit	8494	11915	12833	17900	11908,7	10446,4

Source: Russian Statistics Agency

Antidumping measures introduced by some non-CIS countries against Russian exports are having a negative effect on Russian foreign trade. As of early January 2000, a total of 119 lawsuits had been filed for restriction of Russian exports in 26 countries. Besides, considering the drop in domestic prices (denominated in dollars) after the 1998 crisis, there is a higher probability of more restrictive measures to be imposed on Russian exports. The Ministry of Commerce estimates the damage from these measures at \$2,574.59 million a year. Countries invoking restrictive measures against Russia more frequently than others include EU members, the United States, Mexico, Brazil, Turkey, India, the Republic of Korea, and Poland. The commodities involved include metals products, chemical goods, and textiles.

Antidumping measures are used most frequently against the Russian metal industry, over 70 per cent of the total, and have caused a 10 per cent drop in the industry's output.

In 1999, Russia succeeded in obtaining a predictable treatment for its metals on the American market. Some 90 per cent of metal trade between Russia and the United States is regulated by a steel trade agreement and an agreement on conditions for the entry of Russian hot-rolled steel to the American market, both signed in 1999, and an agreement signed in January of this year, on trade in cold-rolled steel. Under the last agreement, all Russian producers can supply the American market with a maximum of 340,000 tonnes of cold-rolled steel for five years, beginning in 2000 (6,480,000 tonnes of this commodity was sold in the United States in 1998). Unless the agreement had been signed, the United States could impose a 100 per cent antidumping duty on this commodity beginning on December 19, 1999). These agreements may be called a compromise, but no alternatives for them exist today.

The financial crisis in August 1998 and the collapse of the Russian national currency against the dollar have had a restraining effect on Russian imports. In 1999, low effective demand for imported goods among the population and businesses held back recovery of imports.

In 1999, Russian imports from countries outside the CIS fell by 31.6 per cent, to \$31.1 billion, from 1998.

The strengthening of the national currency in 1999, however, stimulated a timid recovery of some imports. Whereas imports were more than halved in the weeks immediately following the August 1998 crisis, they started to recover in the second half of 1999, reaching 117.4 per cent in October, 122.9 per cent in November, and 114.7 per cent in December 1999 of the figures for the same months of 1998.

TABLE 4

**Dynamics of physical volumes of Russian critical imports
from non-CIS countries**

	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
Piping, '000 tonnes	631	367	385	239	154,1	366,6
Machinery and equipment, in \$US millions	10696	12804	10172	13511	12789,4	7881,7
Medical drugs, in \$US millions	1184	969	1083	531	1198,0	763,0
Textile clothing and knitwear, in \$US millions	861	511	298	313	211,9	89,0
Footwear, millions of pairs	41,7	26	45,8	15,4	2,9	1,2
Flashfrozen meat, '000 tonnes	358	506	540	694	595,8	806,8
Flashfrozen poultry meat, '000 tonnes	496	824	748	1117	814,1	234,8
Raw sugar, '000 tonnes	1081	1166	1680	2511	3002,9	5774,2
Refined sugar, '000 tonnes	369	377	147	367	331,4	
Alcoholic and nonalcoholic beverages, in \$US millions	695	1017	379	700	390,4	145,6
Grain, '000 tonnes	2100	193,7	307,3	226,8	103,9	432,7

Source: Russian Statistics Agency

The Russian economy found itself heavily dependent on imports of foodstuffs and materials for their manufacture: the share of foodstuffs in total imports has steadily held at about 26 per cent.

On year-end results, foodstuff imports from non-CIS countries fell to a level of \$6.3 billion (a drop of 28 per cent) in 1999. In value terms, poultry meat imports were slashed by a factor of 3.8, butter by a factor of 2.3, chocolate products by 46,6 per cent, and fish by 14 per cent. Grain imports rose by a factor of 4.2. Food aid accounted for around 70 per cent of grain imports.

Medicines, two-thirds of which are imported, are another important import commodity. In 1999, imports of medicines from non-CIS countries declined by a factor of 1.6.

Substituting imports of these commodities with domestic products soon has proved an unrealistic task. The market is filled gradually through recovery of imports of some kind of foodstuffs and basic food materials (cereals, raw sugar, meat and vegetable oil) and medical drugs.

TABLE 5

Average import prices (\$US/tonne)

	1993	1994	1995	1996	1997	1998	1999
Flashfrozen meat	1364	1158	1478	1357	1468,4	1500,4	998,1
Poultry meat	987	889	843	671	712	676,2	665,9
Butter	1358,5	1292	1779	1653	1668,6	1887,3	1650,4
Citrus fruit	465	586,7	522	436	329,4	297,2	269,5
Coffee	2740	3734	3281	1318	946,4	2312	1761,9
Wheat	147	136,5	185,8	207,2	-	98,3	81,4
Sunflower oil	750,2	1113	999	897	634,8	614,1	589,5
Leather footwear (per pair)	10,7	9,2	7,9	6,07	12,6	16,7	13,1
Steel pipes	686,2	800,6	910	947	785,2	913,2	635,7

Source: Russian Statistics Agency

Some 40 per cent of imports from non-CIS countries are made up of machines and equipment. In 1999, imports of these goods decreased by 40 per cent. Reduction in imports of equipment that is not manufactured in Russia and is essential for development and modernization of domestic industries is certainly a negative trend.

A negative effect on the value characteristics of imports is exerted by the downtrend in average contract prices, which is a sign of importers giving increasing preference to inexpensive goods.

No one expects a sharp jump in imports, because the price competitiveness gap between Russian and imported goods remains wide enough and cannot, in regard of many types of goods, be offset by higher quality. Nor can we underrate the improved quality of Russian goods as a result of import-substituting efforts.

Informal (shuttle) trade carried on by individuals is waning. In 1999, this type of trade grossed \$11.5 billion, of which private individuals exported \$1,398 million worth of goods and imported goods worth \$10,074 million. Informal trade accounted for 10 per cent of Russia's total foreign trade turnover - 1.9 per cent in exports and 24.6 per cent in imports.

Fuels and energy claimed 42.4 per cent of total exports, metals and metalware accounting for another 15.11 per cent, leaving engineering goods with only 10.8 per cent. In imports, the proportion reversed, with machines and engineering equipment taking up 40 per cent, followed by food, with 26 per cent.

Foreign Trade with CIS Countries

For all its adversities, the principal of which was a significant drop in trade between Russia and the CIS countries, last year ended with a favorable balance in Russia's favor. Disregarding the officially unregistered trade, Russia's trade turnover with CIS countries in 1999 was estimated at \$19.4 billion, including \$10.7 billion in exports from Russia and \$8.7 billion in imports to Russia. (Adjust-

ed figures for January to November 1999 show Russia's trade with CIS countries to have decreased by 27.4 per cent, to \$19.3 billion, from the same period of 1998.) Russia, therefore, runs a surplus of \$2 billion in its trade with CIS countries.

TABLE 6

Dynamics of Russian foreign trade with CIS countries

	1997	1998	1999
Goods turnover (in \$US billions)	35,4	28,6	19,4
Exports (in \$US billions)	17,9	14,9	10,7
Imports (in \$US billions)	17,5	13,7	8,7
Trade surplus	0,4	1,2	2,0
Rate of increment (per cent)	1,2	- 19,3	-32,0
CIS countries' share of total goods turnover (per cent)	22,8	21,5	18,8

Source: Russian Statistics Agency

The dynamics of trade between Russia and CIS countries were affected by such adverse factors as the monetary crisis; low competitiveness of the goods traded; large mutual arrears against the backdrop of an acute shortage of funds; falling real personal incomes and low effective demand in Russia and in most CIS countries; CIS countries' preference for trade with developed countries ready to grant commercial credits to them; and changes on world commodity markets.

Russia's exports and imports in its trade with CIS countries do not exceed 60 per cent, or 65 per cent at most, of last year's level in value terms (in contrast to trends in Russia's trade with Western countries, in which exports tended to rise in some months of 1999, compared to 1998). September alone witnessed a seasonal improvement of 16.6 per cent in foreign trade on the preceding year, which can be attributed to preparations for wintertime and rising demand for fuel and energy.

The structure of Russian foreign trade remains unchanged since the Commonwealth of Independent States was first established: fuel and energy resources account for over 60 per cent of its exports and consumer goods make up almost a quarter of its imports from neighboring countries.

This country-specific structure of Russia's trade within the Commonwealth is sharply focused on three countries - Ukraine, Byelorussia and Kazakhstan, which account for almost 90 per cent of Russia's total trade turnover with CIS countries.

Exports. According to 1999 figures, Russian exports to CIS countries were worth \$12.0 billion, down 21.1 per cent from 1998. Depression of export prices by more than 30 per cent was the principal cause of the drop in Russian exports in value terms, even though the physical volumes of the exports edged up 5 per cent.

The physical volumes of Russian exports to CIS countries grew not only because exports had been made more efficient by ruble devaluation, but also because of their structure being dominated by energy resources, vitally essential for the neighboring states, so their governments are going out of their way to have Russian resources promptly paid for and to comply with previous agreements in this area.

In 1999, exports of petroleum products grew by 10.2 per cent from the year before. Deliveries of motor gasoline rose by 30.1 per cent, those of diesel fuel by 24.1 per cent and fuel oil by 21.8 per cent.

In physical terms, oil exports in 1999 remained at practically the previous year's level (retreating by a mere 2.7 per cent), but declined by as much as 20.9 per cent in value terms. As oil prices shot up on world markets through 1999, average contractual prices of oil supplied to neighboring countries went in the opposite direction, falling approximately 15 per cent from 1998, because a considera-

ble proportion of oil is supplied on cut-rate terms under inter-government contracts.

TABLE 7

Selected exports to CIS countries

	1999	In per cent of	
		1998	1997
Crude oil, millions of tonnes	18,8	97,3	109,9
Oil products, '000 tonnes	2964,9	110,2	134,4
of which:			
motor gasoline	473,9	130,1	...
diesel fuel	758,4	124,1	...
fuel oil	1050,8	121,3	...
Natural gas, billions of cu m	74,3	94,8	92,9
Black coal, '000 tonnes	5727	97,9	168,9
Machinery and equipment, in \$US millions	1893,5	78,4	6,4 times
Iron ore, '000 tonnes	3203,8	86,9	94,8
Ferrous metals (other than pig iron, ferroalloys and scrap), in \$US millions	344,8	71,8	99,3
Calcium phosphate, '000 tonnes	1071,3	103,0	81,2
Synthetic rubber, '000 tonnes	89,4	140,1	117,0
Chemical wood pulp, '000 tonnes	55,3	135,1	150,3
Newsprint, '000 tonnes	96,8	98,0	104,8
Fresh and frozen fish, '000 tonnes	12,2	119,5	3,1 times
Wheat, '000 tonnes	484,2	73,5	195,6

Source: Russian Statistics Agency

Oil exports to the region will probably continue to fold, because customs duties were imposed on exports to CIS countries that are not members of the Customs Union in 1999, for the first time in the standing practice of trade within the CIS borders (under the Russian Government's Directive introducing customs duties on exports of crude oil and petroleum products from the Russian Federation beyond the contracting states of the Customs Union Agree-

ment). Export duties are also imposed on such commodities as alcohol, metals, timber, and nonferrous metals.

Natural gas exports slipped insignificantly (by 6.6 per cent) from the year before. In general, gas exports show a downward trend, because Gazprom is put off by the CIS countries' enormous long-standing arrears and is increasingly looking to European countries that guarantee payment in hard currency and are, therefore, more attractive business partners.

The weighted average price of Russian exports to CIS countries is generally at least a third below prices charged for exports to other countries. On the contrary, the prices of some commodities were occasionally 25 per cent above those of the same commodities exported to Western countries, which made CIS markets more attractive for Russian exporters.

In particular, diesel fuel was exported to CIS countries at a weighted average price of \$129 per tonne, while it went to other countries for \$101 per tonne, and gasoline prices were \$107 per tonne and \$116 per tonne, respectively.

The situation on the basic metals market was the reverse of oil - here the prices of exports to CIS countries were below the average prices under contracts with Western countries. For example, ores and iron concentrates were selling at \$11 per tonne, much below the \$17 per tonne in non-CIS countries. On top of that, the local resources of principal Russian partners and the protectionist measures they had imposed led to reductions in both the value and physical volumes of Russian exports. According to statistics for January to November 1999, exports of basic metals plunged 31.5 per cent from the preceding year and those of iron ores dropped by 11.5 per cent.

Exports of machines and equipment went down in value terms. In the eleven months of 1999, their exports earned \$1.65 billion, or

25.9 per cent less than in 1998. Exports to the CIS area went down largely because of the poor quality of Russian goods that made them uncompetitive, particularly as world prices for finished products were falling.

Imports. Imports from the CIS countries were worth \$10.0 billion, or 26.9 per cent less than the previous year. One of the principal reasons for imports falling in value terms was a reduction in import prices, which was almost 20 per cent for the CIS countries. Unlike exports, the physical volumes of imports dropped as well, by 17 per cent.

TABLE 8

Imports of selected goods from CIS countries

	1999	In per cent of	
		1998	1997
Machinery and equipment, in \$US millions	2058,4	73,3	59,5
Fresh and frozen meat, '000 tonnes	186,6	134,9	71,2
Fresh and frozen fish, '000 tonnes	13,9	107,1	110,3
Grain, in \$US millions	201,9	132,9	51,5
Sunflower oil, '000 tonnes	96,0	2,5 times	2,6 times
Alcoholic and nonalcoholic beverages, in \$US millions	210,0	45,5	34,4
Uncombed cotton fiber, '000 tonnes	223,2	2,0 times	110,2
Ferrous metals (other than pig iron, ferroalloys and scrap), in \$US millions	353,2	64,0	64,2
Piping, '000 tonnes	486,6	77,5	54,5
Oil products, '000 tonnes	531,8	31,9	22,8

Source: Russian Statistics Agency

In 1999, importers continued to experience hard currency shortages that compelled them to turn to the nearest neighboring countries for least expensive and poor-quality goods, so import prices declined.

Yet, the prices of some imports from CIS countries were up to 30 per cent above those of similar Western goods. This difference is due to the high proportion of barter deals, reliance on domestic prices in some settlements, the use of bills of exchange in some import deals, and so on. For example, the average price of fresh frozen meat imported from CIS countries was \$1,164 per tonne last year, while Western imports averaged \$895 per tonne; sunflower oil was imported at \$776 per tonne and \$514 per tonne, respectively; and white sugar was imported at \$312 and \$424 per tonne, respectively. Price differences apart, meat exports from CIS countries rose nearly 25 per cent last year, white sugar imports gained 10 per cent, and sunflower oil imports as much as 150 per cent.

Despite the price disadvantage as compared to non-CIS countries, imports from CIS countries are largely affected by the fact that many trade partners deliver foodstuffs to Russia as payment for the energy resources they receive and by the low costs of transporting the commodities to individual Russian regions.

Imports of machines and equipment from CIS countries plummeted by 50.9 per cent from the previous year. This leads to a further structural deterioration of Russian imports, namely, a fall in the share of machines and equipment and growth in that of foodstuffs in total imports.

Russia's Trade with Major CIS Countries

Ukraine. Ukraine is a leading trading partner for Russia, with its share in Russian trade turnover amounting to about 8 per cent. Russian exports to Ukraine are dominated by natural gas, oil, petroleum products, coal, calcium phosphate, asbestos, iron ores and concentrates, and rubber automobile tires. Russian imports from Ukraine consist largely of meals, dairy products, sunflower oil, sugar, basic and nonferrous metals, and pipes. According to preliminary esti-

mates, trade between Russia and Ukraine in 1999 will hardly exceed \$10 billion, or 25 per cent below the previous year's level.

Arrears in payments for natural gas, different approaches to VAT assessments, and changes on the world markets for sugar, one of Ukraine's principal exports to Russia, are having an adverse effect of the two countries' bilateral trade.

Sugar customs duties were raised in April 1999 (by the Russian Government's Directive No. 444 of April 16, 1999) from 25 per cent to 30 per cent. The new customs duties could have restricted sugar imports, because the agreement providing for duty-free imports of 600,000 tonnes of Ukrainian sugar a year had been prolonged to the end of March 1999. Already in 1998, however, despite the agreement still in effect, 34,000 tonnes of sugar only was imported because it could not be marketed by reasons of its high costs (on average, \$70 to \$80 per tonne higher than in Russia), which make it difficult to sell. Besides, prices of raw cane sugar collapsed on the world markets, so cane sugar can elbow Ukrainian sugar out of the Russian market as well.

Talks continued all through 1999 over repayment of the debt Ukraine owes for Russian gas supplies. The Ukrainian side voiced doubts about its real ability to supply foodstuffs on so large a scale to repay the debt and suggested a discussion of alternatives to solving the long-standing repayment problem. Besides, the Ukrainian Government asked Gazprom to lower its gas prices, because the Ukrainian side considered gas supply terms discriminatory and contemplated to turn to Western suppliers, should Gazprom refuse to grant the request. In 1999, Russian gas was supplied to Ukraine at an average price of \$80 per 1,000 cubic meters, while in trade with Byelorussia it was priced at \$ 32 for the same quantity of gas.

In fall, Russia suspended oil deliveries altogether because of Ukraine's unauthorized pumping of Russian gas piped to Western

countries. In November, for example, Ukraine exceeded its gas quota from transit gas shipments by over 60 per cent. To deal with these problems, talks are going on to correlate the two countries' fuel balances.

VAT assessment is still unresolved in Russia's relations with Ukraine. Ukraine, for example, does not charge VAT on outgoing commodities and Russia does not assess VAT on incoming Ukrainian goods. This practice makes Ukrainian imports (cigarettes, in particular) unjustifiably 20 per cent cheaper than similar commodities imported from other countries.

In its desire to import Russian energy sources and a number of other commodities duty free and, in this way to resolve the outstanding problems, Ukraine is vigorously campaigning for the establishment of a free trade area within the CIS framework.

Byelorussia. Russia's trade with Byelorussia in the eleven months of 1999 amounted to \$615.6 million, or 15.5 per cent below the figure for the previous year. Exports, however, remained at the 1998 level, while imports dropped by nearly 40 per cent. In 1999, Byelorussia' share in Russia's total foreign trade turnover equaled 6.5 per cent.

Commodities of the minerals and primary materials group have traditionally been at the core of Russian exports to Byelorussia - crude oil, natural gas, and basic metals account for 39.8 per cent of total exports. Some 31 per cent of the exports are taken up by machines and transport vehicles, chemical products, and nonferrous metals. Russia, in fact, meets 100 per cent of Byelorussian requirements for coal, gas, and grain harvesters, 90 per cent of its needs in crude oil and timber, and almost 70 per cent of that country's requirements for basic and nonferrous metal products.

Imports from Byelorussia are structurally dominated by machines and transport vehicles, foodstuffs, chemical industry products, and textiles.

Byelorussia is running a considerable deficit in its trade with Russia. According to trade statistics, the deficit built up to \$434 million between January and December 1999.

Significantly, more than 50 per cent of the two countries' trade takes the form of barter. This form of trade will probably predominate over a longer term, with the efficiency of foreign trade transactions falling because of Byelorussian importers' lack of hard currency and Byelorussian exports having become more expensive, while Russian imports have gone down in value after the collapse of the Russian ruble exchange rate.

Held in the grip of a financial crisis, the Byelorussian Government imposed a rent on foreign trade barter transactions so as to stimulate the inflow of hard currency earned from foreign trade. The receipts will be channeled into the republican fund to support exports. The new duties are hardly likely to make a dent in Russian barter, for Russian exports are, in particular, on the lists of duty-free barter.

Implementation of the Treaty of Union Between Russia and Byelorussia, signed in 1999, may also have an unequivocal effect on trade between the two countries.

Kazakhstan. Russian goods make up about a half of Kazakhstan's imports. Russian imports help Kazakhstan to meet almost 50 per cent of its requirements in power, over 90 per cent in petroleum products, and about 60 per cent in machines and equipment. In turn, Russia receives over 40 per cent of Kazakhstan's exports, which include ores and concentrates of iron, aluminum, chromium and zinc, and also grain and meat.

To bring its trade into balance, Kazakhstan continued its policy of restricting Russian imports in 1999 as well. Measures to prohibit imports of a considerable range of Russian foodstuffs were followed up with restrictions on Russian medicines. The lifting of restrictions on imports of 21 Russian commodities is still far from restoring Russian exports to their previous levels, because, as of October 1, 1999, only goods provided with labels in the Kazakh language were allowed to enter the country, which created more problems for Russian exporters in terms of fulfilling their commercial contracts with their Kazakhstan partners. In November of last year, Kazakhstan introduced special licenses for tobacco and tobacco substitutes imported from Customs Union countries.

Also, Kazakhstan imposed temporary restrictions on exports, in particular exports of diesel fuel, chiefly required in Russian areas adjoining Kazakhstan, aggravating the fuel crisis that hit those areas in summer 1999.

Kazakhstan also plans to launch an antidumping investigation into Russian exports (against the rules of the Customs Union), claiming Russian domestic prices of energy resources and rail freight rates to be artificially reduced to erode the competitiveness of Kazakhstan's national producers and operators.

VAT assessment rules continue to be uncoordinated. Russia is adhering to the principle of VAT assessment in the country of destination, while Kazakhstan insists on VAT being charged in favor of the exporting country. At present, Kazakhstan assesses VAT on imported goods, taking up the difference in tax rates (where the tax rate in the country of origin is smaller than 20 per cent) at the customs clearance point. Besides, that country owes Russia the largest debt (\$410 million) of all CIS countries for Russian energy resources. To prevent the debt problem evolving into a factor slowing down trade between them, the two countries are searching for new

areas of cooperation in energy development. In particular, RAO UES is setting up, together with Kazakhstan, an industrial complex to mine and transport coal and to generate electric power.

All these differences were, apart from other reasons, behind a sharp reduction in trade between the two countries, by more than 40 per cent in the first half of 1999 alone.

Institutional Problems

September 1999 was six years from the signing of a treaty establishing an Economic Union among the CIS countries. Over that period, the CIS member states failed to implement in practice the ideas of a multilateral free trade area, or a full-blooded Customs Union, or a common economic area. Foreign trade is carried out among them on the basis of bilateral intergovernmental agreements, or by individual businesses within the framework of existing production links that are gradually growing less efficient in the context of crisis-ridden economies and, therefore, leading to a contraction of trade between them.

The CIS countries have started out in differing economic conditions, so a three-tiered integration model has taken shape within the CIS framework: the Commonwealth itself consists of 12 countries; associations of several countries each, such as the Customs Union and the Central Asian Economic Community; and a bilateral association, the Union of Russia and Byelorussia.

Whereas previously, their cooperation was based on a common legacy, and cooperation and production links, today priority is given to sovereign economic interests and interest in the neighboring countries' markets because of their economies' uncompetitiveness on world markets. Many problems could today be tackled more efficiently on a bilateral basis, taking into account the realities of each of these countries, many of which are not yet ready for multi-lateral negotiations.

Admittedly, positive trends have emerged last year in multilateral relations as well. One is, in the first place, the prospect of a free trade area on the whole territory of the CIS. From the time the free trade area starts operation, no country will be free to breach the free trade regime, so trade and economic ties within the area will grow more stable. Abolition of customs duties on CIS territory would, despite a reduction in national budget revenues, offer indisputable advantages in the longer term, because this measure would boost trade, stimulate growth in a number of industries, create new jobs, and so on.

The CIS countries are also working together on an Action Program for CIS development in the period till 2005. The Action Program is a realistic document specifying both the tasks and the practical steps needed to achieve them in the next six years. Work is also under way on a working version of a concept of cooperation in raising the competitiveness and quality of export products.

Standardization of rail freight rates and assessment of value added tax were the principal priorities facing the Customs Union members last year. They agreed to adopt, as of January 2000, a principle under which VAT is to be assessed in the country of destination, to be adhered to by all the five member countries of the Customs Union. Previously, these problems had been dealt with on a bilateral basis. Differences in approach to taxation of goods moving from country to country within the Customs Union bounds, for example, from Kazakhstan to Byelorussia, across Russia result in the price of goods rising by nearly 50 per cent.

Efforts continued in 1999 to put together a legislative framework for the CIS countries' Customs Union, which has now been joined by Tajikistan. An agreement was endorsed by all Customs Union members to facilitate customs clearance of goods shipped within the Customs Union.

The Customs Union is clearly losing its effectiveness under the impact of the crisis in Russia. In particular, Kyrgyzstan is increasingly turning its sights on non-CIS countries. It has cut significantly (by about 55 per cent) its trade with Russia and has failed to win support for its domestic anti-crisis economic policy from its Customs Union partners.

The free trade area, currently on the drawing board, is to become, within the next few years, a more effective form of trade within the CIS framework, because the rules and principles of the Customs Union are to be thoroughly reviewed following Kyrgyzstan's admission into the WTO.

With debt repayment for Russian energy resources a common and actually an intractable problem, CIS countries are taking two different approaches. Those of them that have their own energy resources are seeking to redirect their exports, while others that lack their own energy resources are trying to earn revenues by providing their territories for the transit of other countries' goods. The CIS countries today owe Russia a total of over \$4.4 billion and, judging by their current financial and economic situation, their debt is likely to grow. Russia is ready to look for alternative ways to have this debt settled, one of which is to supply Russia with foodstuffs and primary products it needs.

Whichever way it is looked at, the complex financial and economic situation in the former Soviet republics is still having a negative effect on trade between them as well. In Russia's relations with individual CIS countries, foreign trade tends largely to be influenced by the financial and economic situation and political stability in these countries, Russia in the first place.

2.5. Foreign Investment in the Russian Economy

At January 1, 2000, foreign accumulated capital invested in the Russian Federation's economy amounted to approximately \$29.25 billion, including investments from CIS member states.

A total of \$9.56 billion in foreign investments, including ruble-denominated investments converted into US dollars, was received in 1999 by the non-financial sector of the Russian economy, not counting the monetary authorities and commercial and savings banks. The year 1999 was basically distinct from previous years due to a slowdown in foreign investment during the year. Generally, the trend set in 1998 for foreign investment in Russia to wane survived through 1999.

TABLE 1

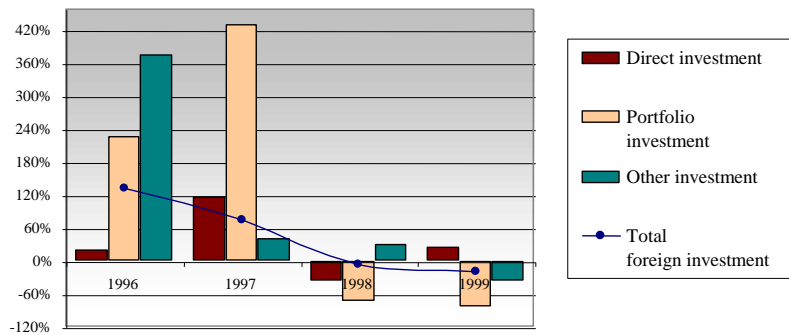
The structure of foreign investment in the Russian economy

	1996		1997		1998		1999	
	\$US millions	percent- age share	\$US millions	percent- age share	\$US millions	percent- age share	\$US millions	percent- age share
Total	6970	100	12295	100	11773	100	9560	100
of which:								
- direct	2440	35,01	5333	43,38	3361	28,55	4260	44,6
- portfolio	128	1,84	681	5,54	191	1,62	31	0,3
- other	4402	63,16	6281	51,09	8221	69,83	5269	55,1

Source: RF Goskomstat.

In particular, there was a significant fall in both portfolio and other investments in 1999, by a factor of 6.2 and by 35.9 per cent, or by \$31 million and \$5.27 billion, respectively, from 1998.

Increment in foreign investment from the preceding year



All investments registered a decline by 19 per cent. The inflow of foreign direct investments exerted an offsetting effect on their dynamics in 1999.

The decrease in non-portfolio foreign investments, which are raised mostly from foreign borrowings, indicated how unattractive the Russian investment climate had become, even in such traditionally investment-friendly industries around the world as oil and gas. Project financing, in which investments are returned from financial flows emerging in the course of project implementation, provides real opportunities for attracting investment. Not the kind made in financial transactions, generally for speculative purposes, but direct long-term inputs.

As in 1998, the sectoral structure of investments flowing to Russia in 1999 was punctuated by the leading role of manufacturing, which absorbed \$4,876 million, or 3.8 per cent more than in the preceding year, on year-end results. With diminishing foreign investments in commercial operations on the market, in finances, insurance and pension plans, the share of manufacturing in total foreign investments in the Russian economy rose by 11.1 per cent.

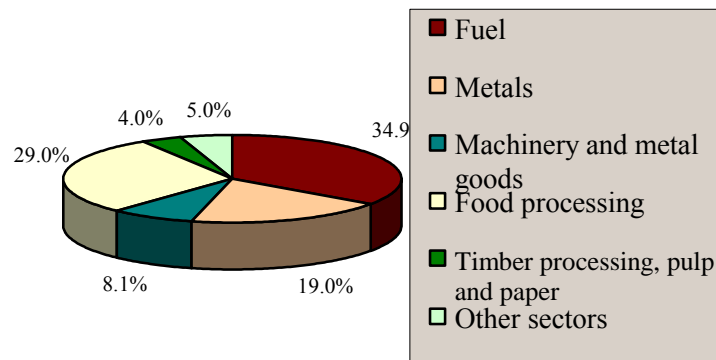
TABLE I

Foreign investment structure by sector

	1996		1997		1998		1999	
	\$US millions	per-centage share	\$US millions	Per-centage share	\$US millions	per-centage share	\$US millions	per-centage share
Manufacturing	2278	32,68	3610	29,36	4698	39,90	4876	51
Transportation and tele-communications	269	3,86	194	1,58	589	5,00	907	9,5
Trade and public catering	375	5,38	733	5,96	1201	10,20	1622	17
Commercial market services	1629	23,37	2299	18,70	1426	12,11	190	2
Finance, lending, insurance, pension provision	2024	29,04	4763	38,74	900	7,64	114	1,2
Other sectors	395	5,67	696	5,66	2959	25,13	1851	19,4

Source: RF Goskomstat

The structure of foreign investment in manufacturing in 1999

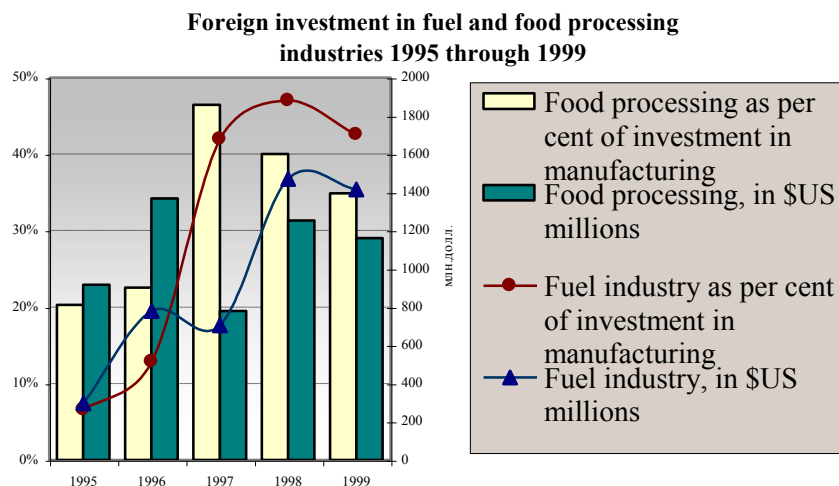


The share of investment in trade and catering, transport and communications and in management went up significantly in 1999 (to around 42 per cent of all foreign investments made in 1999). An analysis of the sectoral structure of foreign investments shows the

investors' preferences for industries yielding quick returns or for large "pinpoint" projects.

In 1999, nearly 53.4 per cent of total foreign investments in manufacturing were direct investments (as compared to 58 per cent in 1996 and about 35 per cent in each of 1997 and 1998).

The structure of investments in manufacturing was altered in 1999 as investors were abandoning the capital markets in favor of Russia's export-oriented industries, the fuel industry in the first place, and stepping up significantly investments in food processing. In particular, the fuel and food processing industries accounted for 82.7 per cent of total foreign direct investments made in manufacturing in 1999.

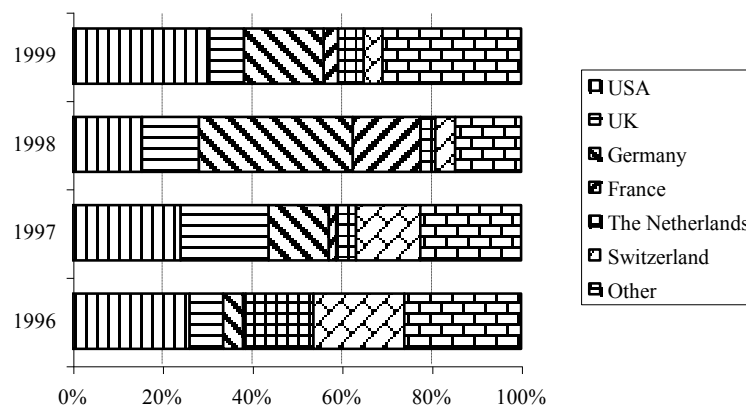


The growing share of foreign direct investment reveals foreign entrepreneurs' desire to set up their own manufacturing facilities in Russia, so they could cut their manufacturing costs considerably and respond more flexibly to prices on this country's markets.

The country-specific structure of foreign investments in 1999 was distinguished by a lower concentration level, with the United States retaining its lead and investment inflows from Germany thinning out. These two countries are followed, with a share half as large, by the United Kingdom, trailed by the Netherlands, Switzerland, and France.

In 1999, there was a considerable increase in capital inflows from the Asia-Pacific Region. On year-end results, Japan joined the ten biggest exporters of capital to Russia by country count. Japanese accumulated capital investments in the Russian economy amounted to \$357 million. The conference on Japanese-Russian economic collaboration in late October 1999 discussed, among other issues, preparations for seven large joint projects, including completion of the Bureya Water Power Plant project and construction of a gas pipeline on the Kamchatka Peninsula an EBRD loan.

The structure of foreign investment in the Russian economy 1996 through 1999



Most foreign investors from other countries are involved in establishing joint ventures. Where the amount of authorized capital is

not significant, foreign investors build up their interests by providing loans and guarantees of output marketing on the world market and by promoting the ventures' products on the domestic market. European companies give priority to processing and manufacturing enterprises in their investment policies.

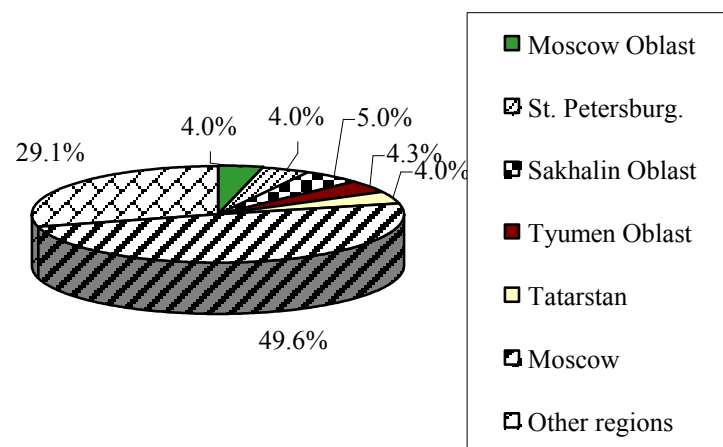
In September 1999, the US Congress voted to discontinue direct investment in the Russian economy from the federal budget. The USA-Russia investment fund, set up in 1995 to implement up to 30 projects in Russia (by investing in communications, trade, construction, and the food and woodworking industries) requiring an estimated \$200 million in total investment, plans to invest the remaining \$240 million appropriated by the US Congress for investment projects in Russia over the next few years and begin attracting private investments.

Economic development of Russia's outlying regions is accompanied by intensifying interregional contracts and foreign investors' continued focus on a limited number of the most dynamic and stable of them. The regional structure of foreign investments has been affected by their overwhelming concentration in the fuel and energy complex. Moscow, St. Petersburg and the Moscow Oblast have lost none of their erstwhile importance as business centers. Border areas, such as the Kaliningrad Oblast and the Primorsky Krai, are a third most important center of attraction.

One of the chief reasons for low investor activity is not fear of financial catastrophes, but expectation of more preferences and guarantees. An effective regional policy of attracting foreign investments, primarily as regards guarantees for the security of investments, pledge and insurance, and preferences in local taxes and other levies paid into regional budgets are the decisive factors for foreign investors. Local authorities in some regions act as the principal guarantors of projects on their local priority lists. Today, more

than 30 Federation members have enacted their own laws or other statutory acts containing detailed lists of investment projects and measures to stimulate and support them.

The regional structure of foreign investment accumulated in the Russian economy as at 1 July 1999



At the federal level, too, steps were taken in 1999 to establish a stable legislative and statutory framework (including taxation and customs control) to regulate inducements for foreign investments and investors' business activities in Russia.

On February 26, 1999, the Russian Government issued a Directive on leasing of engineering equipment in the country's agro-industrial complex from federal budget funds. It provides preferences, which, even if not related directly to foreign investments, can be claimed by enterprises with foreign investments and their operators.

A Federal Law on Foreign Investments in the Russian Federation enacted on July 14, 1999, specifies guarantees for the rights of

foreign investors carrying on business in the real sector of the Russian economy.

It is important to promote implementation of large-scale project in Russia, which serve to develop, in addition to core industrial projects, an appropriate infrastructure, contribute to socioeconomic development in the regions, and have a beneficial effect on the image of the recipient country. Such projects in Russia, for example, include the Sakhalin-1 and Sakhalin-2 oil projects. Work started in 1999 on the Sakhalin-3 and Sakhalin-4 projects, to be completed over a period of six years. The Sakhalin-3 project is designed to develop the Ayash and East Topinsk oil and gas fields. It required \$37.1 billion in total investments. The Sakhalin-4 project is aimed to develop the Astrakhan gas condensate deposit at an estimated \$2.5 billion in total investments.

A bill has been drafted with a list of industries, enterprises, business types and territories closed in full or in part to foreign investors. Work continues on a draft bill of concession agreements to be concluded with Russian and foreign investors and on an oil and gas draft bill, and amendments to the Minerals Law are being drawn up.

The worldwide practice of attracting foreign investors shows that legal guarantees offered to a foreign investor are a warranty of the investor's efficacy and reduction in the acceptable level of return on foreign capital.

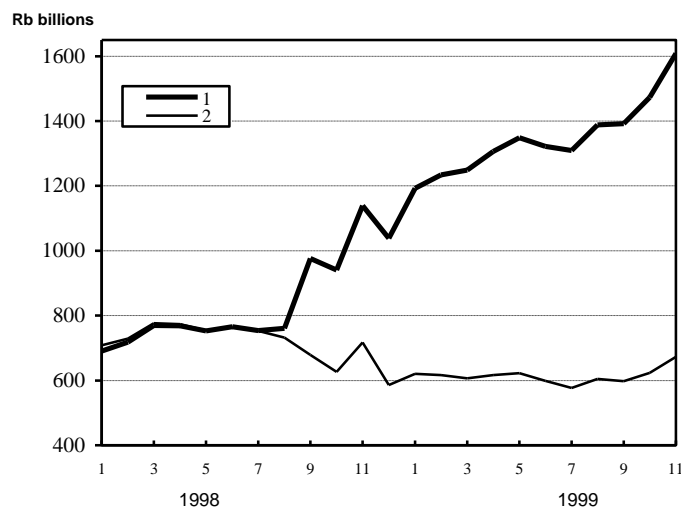
2.6. The Banking Sector

The systemic banking crisis that broke out in 1998 did not flash back dangerously in 1999 any more. Moreover, the banking system's total assets, in both current and fixed prices were growing. Fig. 1 shows the assets of operating banks to have grown almost 15 per cent in 11 months of 1999 in fixed prices, but still not enough

to return to the pre-crisis level. The year 1999 was not a record-breaker even for the reduction rates of the number of operating lending institutions. Licenses were withdrawn from 136 lending institutions during the year, far fewer than in 1998 when 232 licenses were canceled. Withdrawal of licenses from several banks, which had been among the top hundred for the size of assets, did not set off a new wave of panic either on the interbank lending market or among depositors.

FIG. 1

The movement of Russian bank assets 1998-1999



1 – assets in current prices

2- assets in constant prices (as deflated for the consumer price index, June 1998 = 1)

Between early August 1998 and the end of 1999, Russia's Central Bank withdraw licenses from 237 banks in all. Leaving out those among them that merged with other banks or won back the

right to carry on business, the surviving banks had about 15 per cent of total assets in the banking sector on the eve of the crisis (see Table 1). Their combined share in loans issued to non-banking sector customers was a little higher, 18.3 per cent, of which 28.2 per cent were overdue loans. The banks whose licenses had been withdrawn accounted for approximately 18 per cent of commercial banks' foreign exchange liabilities to nonresidents, or an equivalent of almost \$2.7 billion.

These banks together provided nearly 18 per cent of the settlement and cash services to enterprises and organizations. That was exactly their share in total balances in the settlement accounts of customers from non-banking sectors, their share in foreign currency account balances almost reaching a quarter. This group of banks had a relatively smaller share in term deposits, 9 per cent, including 6.5 per cent of household deposits and around 20 per cent of total corporate deposits. The budgets and off-budget funds were the worst hit: some 40 per cent of funds held in term deposits with banks were in those of them that had their licenses withdrawn between August 1998 and late 1999.

These number only provide a first impression of the aftermath of the crisis - players accounting for an estimated 20 per cent, or nearly a third without Sberbank, of the banking services market before the crisis were thrown out of business. Most of the banks deprived of their licenses were in the regions, the share of Moscow banks being under 40 per cent, but then regional banks only held 5 per cent of total assets in this group of banks.

A Bank Restructuring Agency (ARKO), with a budget of Rb10 billion, was set up in spring 1999 within the framework of measures to reorganize the financial sector. By year-end, it had taken control over 15 banks, which together accounted for about 8 per cent of the banking sector's assets in August 1998 (see Table 1).

The establishment of the Agency and its takeover of the banks do not signal the launch of a coherent program for reform in the banking sector. Meanwhile, an analysis of foreign experience in pulling the banking sector out of crisis shows that most of the countries that have succeeded in their efforts adopted comprehensive restructuring programs during the first year of the crisis. Russia has yet to make this move. Other opportunities “opened up” by the crisis, such as making the banking system more transparent to customers, improving the legislation and accounting principles, and enforcing the principle of the owners’ and managers’ liability for their banks’ affairs, will most probably be missed as well.

TABLE 1

Banks de-licensed between August 1998 and end-1999 and banks placed under ARKO management, and their respective shares of total amounts of bank performance indicators* as at 01.08.98 (in per cent)

Indices	The proportion of the group in the overall amount, as of 1.08.98	
	banks with license revoked	banks managed by ARKO
Assets	14.7	7.8
including in foreign exchange	20.1	10.7
loans to clients of non- banking sector	18.3	8.7
including in foreign exchange	23.6	8.7
outstanding	28.2	4.2
including in foreign exchange	29.4	4.3
debt obligations and shares	6.7	4.2
government bonds	6.0	3.7
of the federal government	5.2	3.7
including in foreign exchange	7.4	11.1
foreign liabilities	17.9	13.7
including in foreign exchange	18.3	14.3
banks- non- residents' funds in foreign exchange	16.7	15.2
including inter-bank credits	16.2	15.5
clients' transaction accounts and fixed deposits	12.3	6.2

Indices	The proportion of the group in the overall amount, as of 1.08.98	
	banks with license revoked	banks managed by ARCO
including in foreign exchange	22.1	8.5
the non- banking sector's accounts	17.8	7.0
including in foreign exchange	24.4	6.3
of budgets and extrabudgetary funds	16.9	8.2
enterprises and organizations	16.8	6.4
including in foreign exchange	21.1	5.2
deposits	9.1	5.7
including in foreign exchange	20.7	9.8
deposits of legal entities	27.0	4.8
including in foreign exchange	27.6	3.4
including budgets and extrabudgetary funds	40.1	5.1
including in foreign exchange	41.9	5.8
private individuals' deposits	6.6	5.8
including in foreign exchange	16.8	13.4
capital as per balance sheet	11.0	5.2
For reference: number of banks in the group	221**	15

* based on data provided by 1,564 banks, including Sberbank

** excludes banks that have restored their operational rights to and banks de-licensed in connection with acquisition.

The tasks of ending the banking crisis, which require budgetary outlays, clash inevitably with both the budgetary stabilization objectives and the policy of support for the ruble exchange rate. These were clearly given priority by the Government and the Central Bank. A time-honored method of keeping the enfeebled banking system afloat is by reducing required reserve ratios. The Central Bank increased them twice during the first half of 1999: first from 5 per cent to 7 per cent in March 1999 on corporate and household foreign exchange deposits; and then in June, from 5 per cent to 5.5 per cent on household ruble-denominated deposits, and from 7 per cent to 8.5 per cent on corporate and household forex deposits. By taking these two steps, the Central Bank actually restored reserve allocations to the level where they had been in August 1998 (see

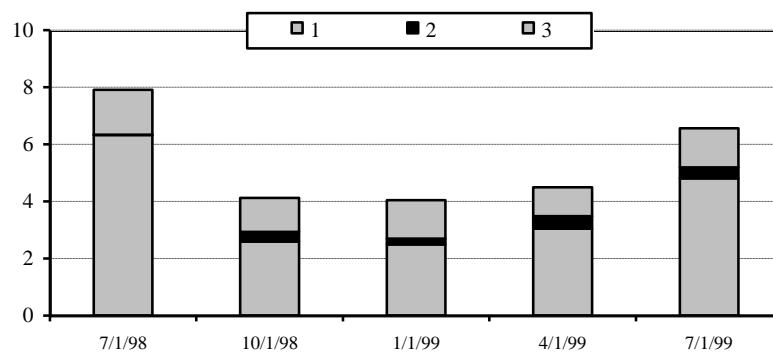
Fig. 2). The significant reduction in required reserve ratios made in December 1998 survived through the first quarter of 1999, when they were approximately half those imposed in March 1998 and in effect at the onset of the crisis. In January 2000, the Central Bank fell back on this measure again, this time applying the higher required reserve ratios back to December 1999 as well. Sberbank found itself again under a heavier burden than the average: by mid-year, its allocations to the required reserve fund (RRF) relative to its liabilities were 50 per cent higher than the average (not including Sberbank itself).

Economic policy in the period surveyed did not, at the very least, encourage improvement in the situation in the banking system. The high inflation rates were working to end the crisis sooner than could have been expected, given its depth. Financial instability is an environment Russian banks are used to. In an unstable macroeconomic situation, their incomes grow through revaluation of their assets in foreign exchange and short-term speculations on financial markets, the currency market, in the first place. In fact, revaluation of balance sheet items in foreign exchange is becoming, in the months after the crisis, the principal source of income, and the principal item of expenditure, too. A comparison of the situation after the 1995 crisis and that after the 1998 crisis shows that the degree of macroeconomic instability is higher during the current crisis than it was after the interbank crisis in 1995 (see Figs. 3-5) and has, to an extent, mitigated the worsening situation of some banks. The situation has not, however, reverted to the first half of the 1990s in either inflation rates or ruble exchange rate dynamics, so incomes from speculative operations can no longer become the mainstay of prosperity in the banking system. Moreover, the government bond market is still far from what it was before the crisis in terms of volume, while the Central Bank's administrative

measures put restraints on incomes that could be derived from currency market trading. Inflation rates, too, are not high enough to devalue overdue loans, allowing banks to dispose of the non-performing loan problem without the need to think up any emergency measures.

FIG. 2

Banks' reserve requirements as per cent of their liabilities



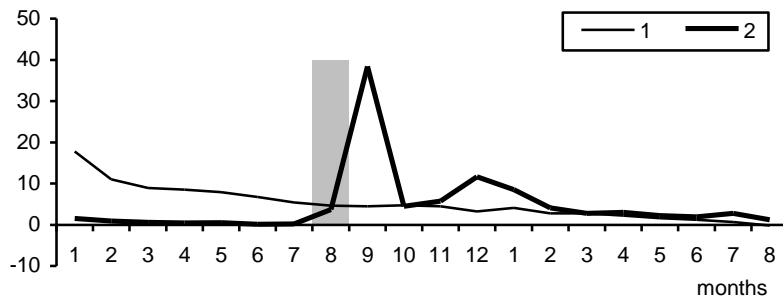
1 – amounts in the RRF (required reserve fund) account with the Central Bank
 2 – shortfall of banks' contributions to the RRF
 3 – banks' ruble cash in vault

Estimated from data on banks operating as at mid-1999

Before the 1998 crisis, the banking system dealt with the non-banking sector's bad debts generally by allowing them to go up in the flames of high inflation rates. This is why ideas, programs or mechanisms linking the banking crisis problems to the restructuring (not write-off, by any means) of real sector debts. A few resounding bank bankruptcies through loan defaults by some of Russia's biggest businesses did not set precedents for effective restructuring procedures. In the end, this situation is turning into an additional factor restraining a more efficient production and giving a long head start to the inefficient one.

FIG. 3

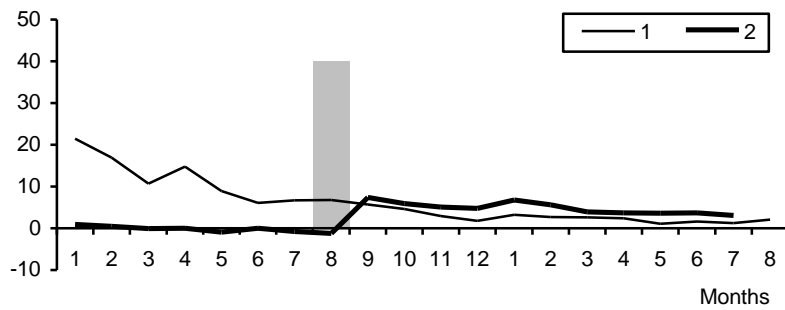
Monthly change in the consumer price index, in per cent



1- 1995-1996
2- 1998-1999

FIG. 4

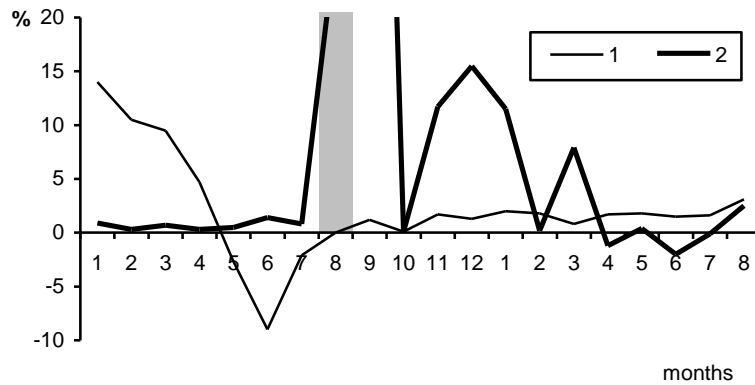
Monthly change in the producer price index, in per cent



1- 1995-1996
2- 1998-1999

FIG. 5

Monthly change in the dollar-ruble exchange rate, in per cent



1- 1995-1996
2- 1998-1999

Reduction in the Number of Banks

Over the first half of 1999, licenses were withdrawn from 80 banks, including seven banks for affiliation with other banks and one bank for failure to commence business on taking out a license. Banks that ceased operation in this period accounted for less than 5 per cent of the total assets of Russian banks immediately before the onset of the crisis. In this respect, the largest losses were suffered in early July 1999, when licenses were withdrawn from four biggest Russian banks that had more than 6 per cent of the Russian banks' total assets on August 1, 1998. Besides, during the first half of 1999, licenses were issued to three lending institutions, the smallest annual record since the birth of the Russian banking system in 1988.

The total number of lending institutions in Russia, therefore, decreased from 1,476 to 1,401 between January 1, 1999 and July 1,

1999. In geographic terms, 39 of the banks deprived of their licenses were situated in Moscow and the Moscow Oblast, and the remaining 39 in other regions. This is the largest share of the Moscow region in the license withdrawal list in recent years. Before the systemic crisis, casualties among Moscow's banks were generally lower than in the regions. During the half-year, the capital area lost 5.5 per cent of the 703 banks operating there at the start of the year. In the same period, six months of 1999, five banks were added to the existing banks in Moscow: three new banks were incorporated, one regional bank was registered in Moscow, and yet another had its license withdrawal order suspended. The largest percentage of Moscow bank closures, 13 per cent, was registered in 1997. Considering, however, that licenses were withdrawn from several leading banks in early July and from several dozen banks in the second half of 1999, the number of Moscow banks decreased at a higher rate than in 1998 (6.3 per cent). The current state of Moscow banks, on the one hand, and the Central Bank's policy toward registration rules for new banks, on the other, give reasons to assume that the numerical losses sustained by Moscow's banks in 1999 have reached a peak.

The dynamics of numbers of regional banks is shown in the Annex to this section. In almost 60 per cent of the regions (in 44 out of the 75 surveyed here), the number of banks did not change in the first half of 1999. One bank was closed in 19 regions each. The bank deprived of its license in the Astrakhan Oblast had 20 per cent of the total assets of all banks in the oblast at the start of the year (by mid-year, only four banks remained in the oblast). In St. Petersburg and in the Leningrad Oblast, the unfortunate bank accounted for only 2.2 per cent of the business (by mid-year, 45 banks survived in the region). Nine regions lost two banks each. While the Republic of Ingushetia, left with two banks, lost 50 per cent of the

banking business, the Tyumen Oblast, with 35 banks still afloat, lost 5.4 per cent only. The republics of North Ossetia-Alania and Daghestan lost three banks each. In these republics, too, the impact of their losses was widely different: while in North Ossetia, where the three small banks were reorganized into branches, the number of independent banks dropped by 33 per cent, the de-licensing of an identical number of banks in Daghestan reduced the number of lending institutions by 5.8 per cent only.

The pace of reduction in the number of operating banks slowed down somewhat in the second half of 1999, and, according to Central Bank figures, there were 1,349 operating lending institutions, including 1,315 banks, in the Russian Federation on January 1, 2000.

Recapitalization

Recapitalization remains a tremendous problem for surviving banks. To help them to deal with it, the Central Bank adapted its requirements to the new ruble exchange rate against the Euro. Beginning in the second half of 1999, requirements to the minimum size of authorized capital were lowered from 5 million Euro to 1 million. The requirements met halfway by the Central Bank, the banks are to cover the other half fully on their own and find sources of augmenting their assets. Increasing the authorized capital is one of the fastest, but by far not the easiest, ways of doing this. During the first three quarters of 1999, four hundred banks actually increased their authorized capital.⁹⁸ A single bank, Vneshtorgbank, among joint stock banks that issued stocks of shares in that period, accounted for nearly half (Rb7.5 billion) of the total authorized cap-

⁹⁸ This applied to the registered part of the authorized capital only, considering the fact that banks other than joint stock banks adhere to more liberal rules of authorized capital accounting.

ital increase. Menatep-St. Petersburg came second with 8 per cent. Among the unincorporated banks, only two banks, Reiffeisenbank and the International Industrial Bank (MPB), made the bulk of the increase, with 22 per cent and 16 per cent, respectively. They were followed by Bank Austria, in third place with 10 per cent. The Central Bank, the principal shareholder of Vneshtorgbank, was, therefore, the main donor among the shareholders. In the unincorporated bank group, foreign investors (as in the case of Reiffeisenbank and Bank Austria) and industrial enterprises (as in MPB) contributed most to authorized capital increases.

Both MPB and Vneshtorgbank also led in the total increase of their net worth.⁹⁹ Over the three quarters of 1999 almost a thousand banks of those in business at year-end augmented their net worth. Less than 400 of them, however, could increase their equity capital at rates above the inflation rate. Since assets grew in the same period as expressed in fixed prices, a reduction in capital adequacy was registered in the period surveyed. The ratio of balance sheet capital to assets declined from 13.4 to 11.8, the ratio itself being a very imperfect indicator of capital adequacy. In the same period, the ratio of the regulatory capital index to assets fell from 12 per cent to 9.3 per cent,¹⁰⁰ and there was significantly less idle money, about 3.2 per cent, because over 6 per cent of the banks' assets were immobilized in fixed assets invested in shares, investment units, and so on.

Liquid Assets

The freezing of the GKO-OFZ bonds and the banking system crisis were bound to initiate definite changes in the allocation structure of bank assets for two reasons. First, the government was no

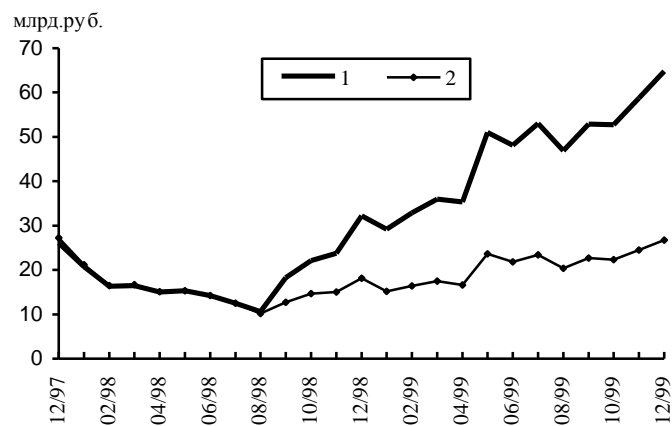
⁹⁹ Internal capital is the difference between assets and liabilities.

¹⁰⁰ Computed from data on 1,311 banks.

longer able to enter the loan market with offers of unrivaled terms and elbow out all other borrowers. Second, banks were deprived of a market to invest a significant proportion of their assets in (shortly before the crisis, their investments in FDOs, or Federal Long-Dated Bonds, averaged 7.5 per cent of their assets, not counting those of Sberbank). The dynamics of balances in correspondent accounts with the Central Bank illustrated in Fig. 7 shows that the amounts held in correspondent accounts, even if measured in current prices, were restored to their year-end 1997 level in the beginning of 1999 only. In constant mid-1998 prices, however, the late 1997 level was not reached even at end-1999. Meanwhile, the share of correspondent accounts in bank assets went up a little starting in mid-1999 (see Fig. 8). For all that, the postulate of Russian banks' surplus liquidity appears to be debatable.

FIG. 7

Commercial banks' correspondent accounts with the Central Bank, in Rb billions



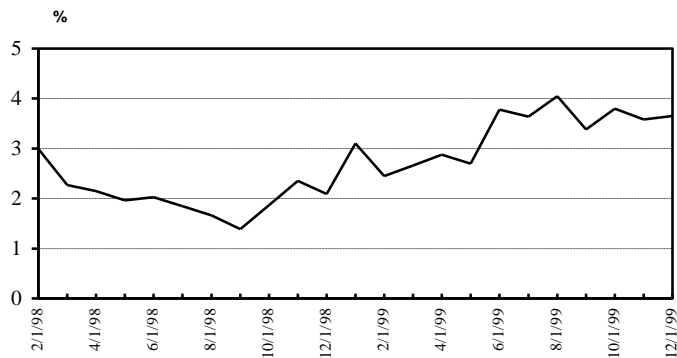
1 – in current prices

2- in mid-1998 prices

Note: end-of-month balances (ARKO excluded)

FIG. 8

**Ratio of banks' correspondent accounts
with the Central Bank and their assets**



Banks' deposits with the Central Bank are to be rated as highly liquid assets. No regular statistics are kept about the size of banks' deposit accounts with the Central Bank, and what is known, however, is that the balances in these accounts are considerably smaller than their funds in correspondent accounts. According to the Central Bank, the funds deposited by banks with the Central Bank amounted to Rb22 billion as of early June 1999, while the balances in correspondent accounts with the Central Bank equaled Rb51 billion at that very time. Toward late August, these amounts were put at Rb23 billion and Rb47 billion, respectively. Today, this segment is even more elitist than the post-crisis variety of the interbank loan market. Only a few dozen banks can afford to deposit their funds with the Central Bank. The bulk of banks' funds is kept in accounts with Sberbank and Vneshekonombank. For this reason, this market is largely controlled by the Central Bank and, therefore, the risk of

funds flowing out of this segment to the currency market is significantly lower than that of funds flowing out of correspondent accounts with the Central Bank. This problem appears to be somewhat broader than the swelling of accounts with the Central Bank. After August 1998, banking system assets have been increasingly concentrated within the banking sector itself, in both Russian banks and banks elsewhere.

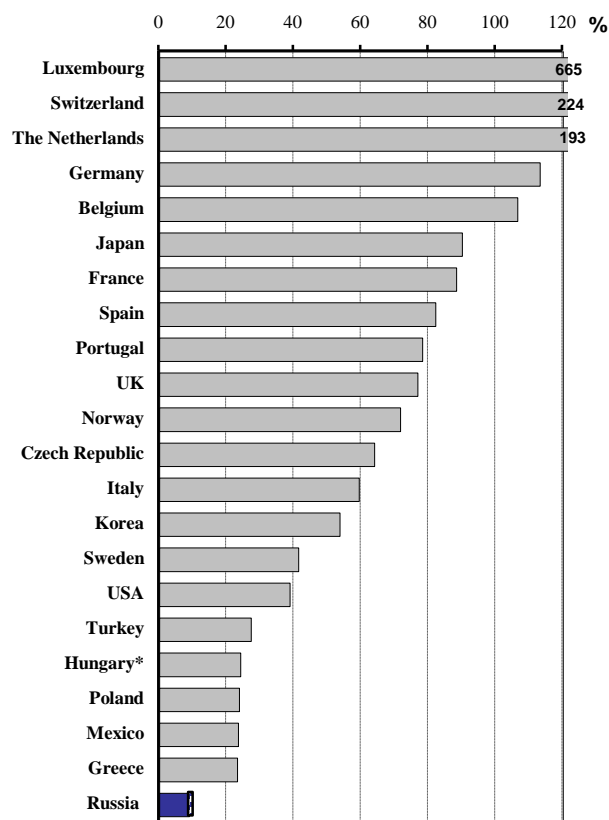
The weak link between the Russian banking system and the real economy was its sore point before the crisis as well. Notably, bank loans to the non-financial sector never reached even 10 per cent of GDP (see Fig. 9). According to last year's delivery, the banks, now deprived of the GKO-OFZ market, are in no hurry to modify their attitudes.

During the three quarters of 1999, the share of funds invested in the banking sector rose, by our estimates, by 8 percentage points, to just under 36 per cent of the bank assets.¹⁰¹ Adding on the last five months of 1998, the growth registered about 14 percentage points. Leaving out Sberbank, the increase went up to 17 percentage points for all other banks, and the average for funds invested in the banking sector came out at 43 per cent at the end of the third quarter of 1999. The Central Bank accounts for a little over a quarter of the total assets invested in the banking sector, almost a half of them being parked in foreign banks.

¹⁰¹ From data for 1,337 banks operating at end-1999.

FIG. 9

Loans in per cent of GDP as at end-1997

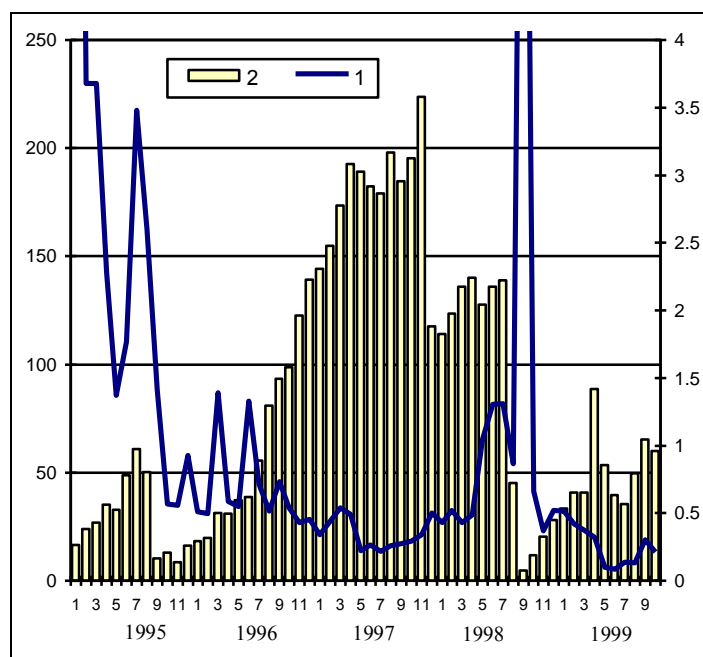


* 1996 data

Estimated from: Bank Profitability: Financial Statements of Bank, OECD. 1999 International Financial Statistics (for OECD countries). Data for Russia are as at 1 February 1998 and include *veksels* (blank area).

FIG. 10.

Volumes of trading in and yields on one- to three-day interbank loans



1 – interest rates on one- to three-day interbank loans (left axis, in per cent per annum, as adjusted for reinvestment)
 2 – average daily volume of trading (right axis, in Rb billions in 1998 prices)
 Note: INSTAR series based on MFD data.

The assets have been redistributed, above all, through reductions in loan portfolios. Over the same period, the share of loans issued to customers from the non-banking sector declined by 3.4 percentage points, without Sberbank; again, counting out Sberbank, the decline is even more significant, from 45.2 per cent of the assets on January 1, 1999 to 37.1 per cent on October 1, 1999, that is, by

8.8 percentage points. In another manifestation of the crisis, trading in interbank ruble-denominated loans within the MFD system continued on its protracted fall. In contrast to the 1995 crisis, when the average daily volumes of one- to three-day transactions, the most common variety of trading, overshot the pre-crisis level within a year of the crisis peak, MFD trading was far short of the pre-crisis level a year after the 1998 crisis (see Fig. 10). Moreover, the ratio of the daily floor turnover to the total end-of-month ruble-denominated amount of interbank loans went down as well. Whereas before the onset of the crisis, it steadily held above 10 per cent, it fluctuated with 3 per cent to 6.5 per cent in the ten months of 1999, which fact may be regarded as evidence of interbank transactions having become even more concealed.

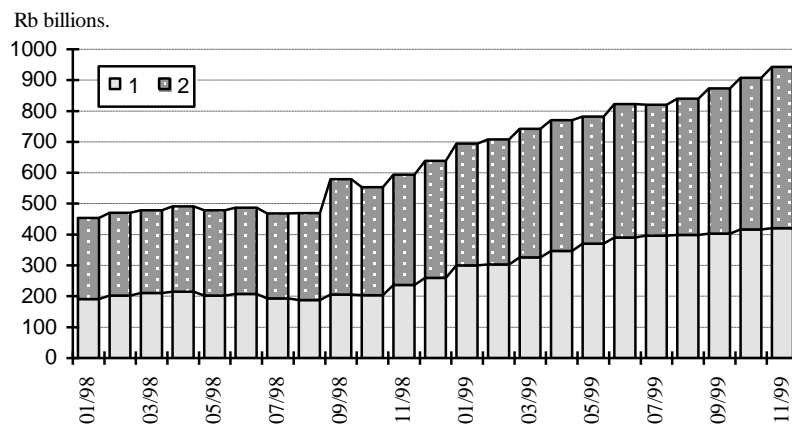
Bank Loans to the Government

The lingering crisis has yet another aspect - changes that have occurred in the structure of performing assets under the impact of the 1998 crisis. At first sight, the share of claims on the enlarged government in the total bank claims appeared to start falling in the autumn of 1998 (see Fig. 11). Actually, however, that fall was, *first*, very short-lived, being the slowest in September 1998. *Second*, it was caused not so much by a reduction in the government's debt to the banks as to the differences in the foreign exchange structure of the banks' claims on the government and businesses. On the eve of the crisis, the share of foreign exchange loans in the loans to enterprises and institutions was slightly over 40 per cent (see Fig. 12). In claims on the government, the share of foreign exchange loans was probably much lower and, under pressure from a precipitous ruble devaluation, the foreign exchange portion of the loans, denominated in rubles, was growing at higher rates so the banks' claims on enterprises were rising faster than their claims on the government. Through September 1998, the government's share dropped from

39.5 per cent to 35 per cent, and that of enterprises, institutions and individuals climbed from 59.2 per cent to 63.7 per cent. Beginning in October, the claim dynamics switched back in the government's favor. By the end of 1998, the share of claims on the government reverted to its pre-crisis level, reaching 47 per cent, a record-high figure for the entire period surveyed, on July 1, 1999 (see Table 2). The drop of the claim share to 44.6 per cent by December 1, 1999 does not affect the general picture. The rollback of borrowings in the form of market debts did not bring about a reduction in the scale of the government's displacement of other borrowers from the loan market, and the government's extensive borrowings remained a factor inhibiting economic growth. Fig. 13 illustrates a general growth dynamics of claims accumulated by commercial banks and the Central Bank on the enlarged government. From mid-1998 on, the government's debts to the banking system more than doubled, registering the fastest growth rate in the second half of 1998, and only 16.7 per cent in the first five months of 1999. In the same period, the share of commercial banks increased from 33.1 per cent on January 1, 1999 to 42.4 per cent on December 1, 1999.

FIG. 11

Bank claims on the non-financial sector



1- claims on enlarged government

2- claims on private sector and government-owned enterprises

FIG. 12

Foreign currency-denominated loans as a share of credit to enterprises

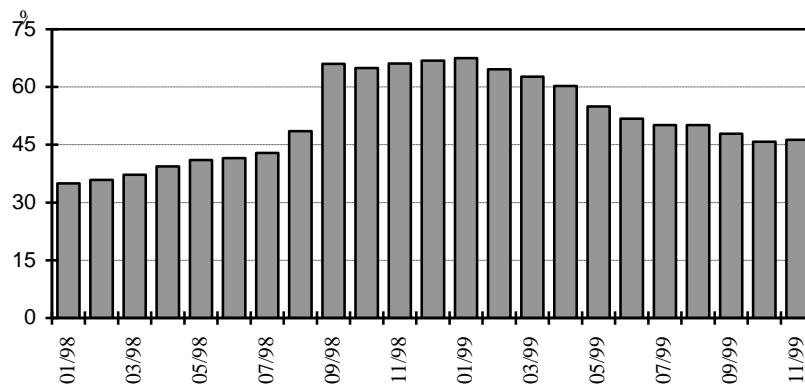
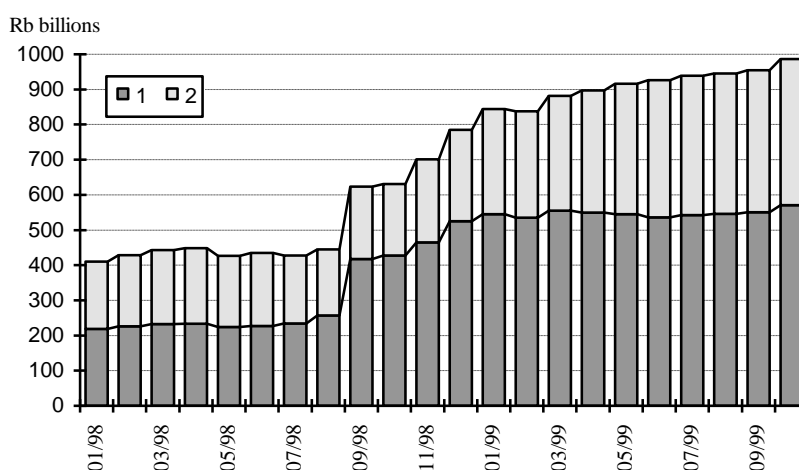


FIG. 13

Credit to enlarged government



end-of-month claims on enlarged government:

1 – from the Central Bank

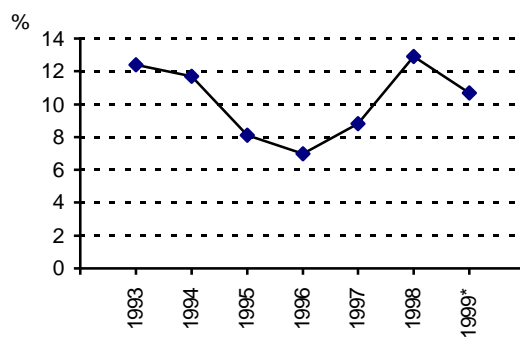
2 - from commercial banks

The government's share in the banks' claims was growing against the background of a general increase in the debt of the non-financial sector to the bank in current prices, though falling, until March 1999, in fixed prices. In particular, the banks' claims on the non-financial sector were 64 per cent higher than before the crisis, in current prices, and 22 per cent lower in constant prices. The foreign exchange component of the claims also obviously played a role in the dynamics of the relationship between nominal GDP and the banks' claims on the private sector. Toward the close of 1998, the proportion of claims on the private sector as a percentage of GDP had risen by 46.6 per cent from late 1997, when it was 8.8 per cent, and slightly higher than the 1993-1994 level, when the government debt market was relatively narrow (see Fig. 14). Compared

to other countries, however, it was still very low (cf. Fig. 14 and Fig. 15), and even started to fall again toward the end of 1999.

FIG. 14

Bank claims on the private sector, in per cent of GDP

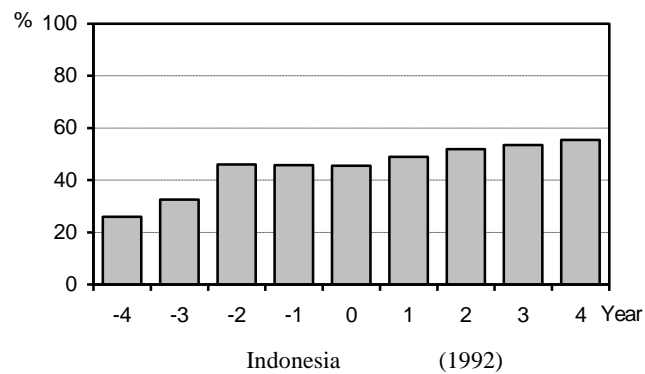


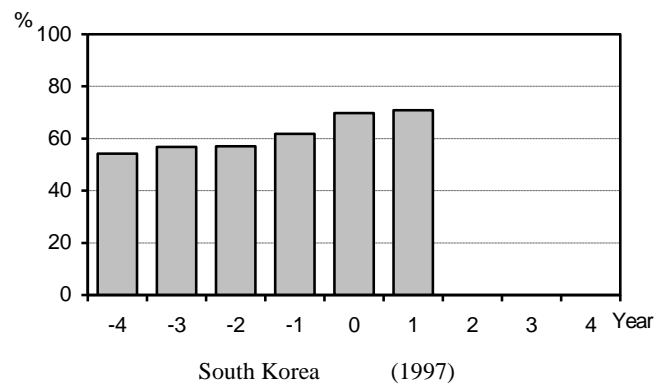
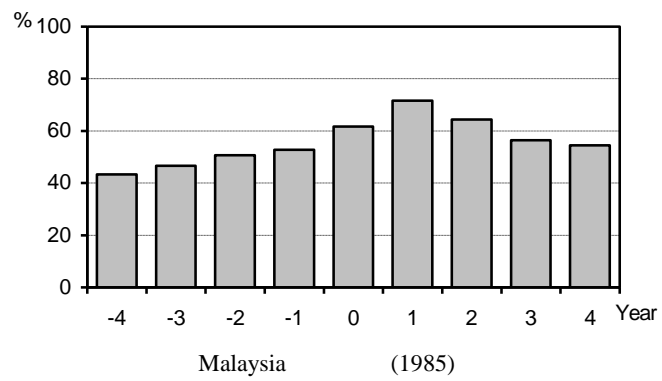
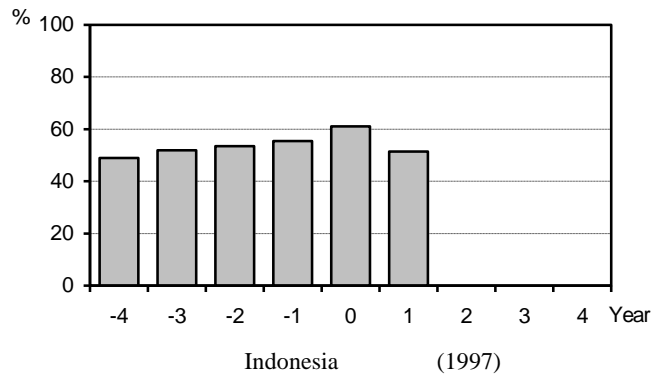
* based on preliminary data

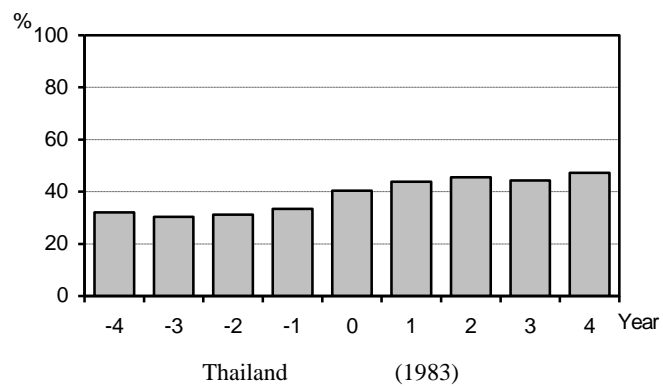
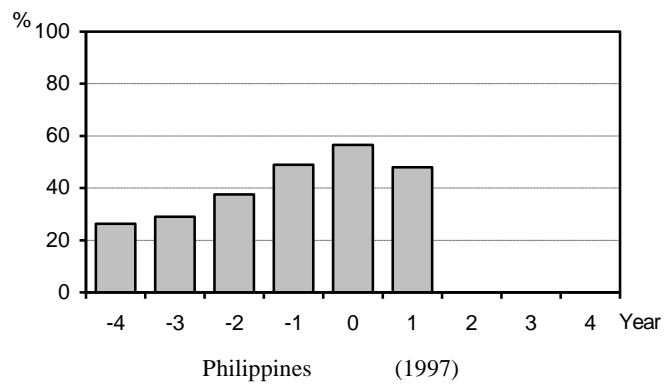
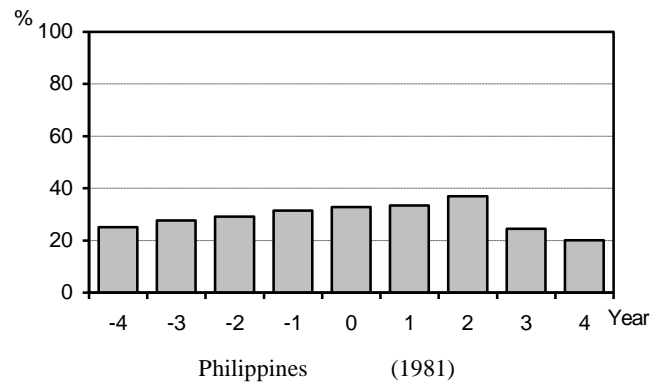
FIG. 15

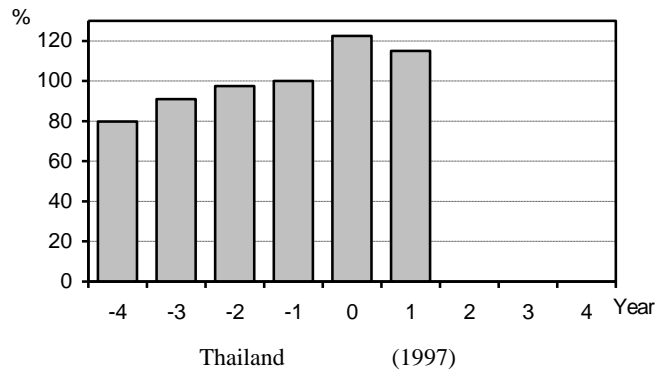
Bank claims on the private sector before and after the national banking crisis, in per cent of GDP

Southeast Asian countries

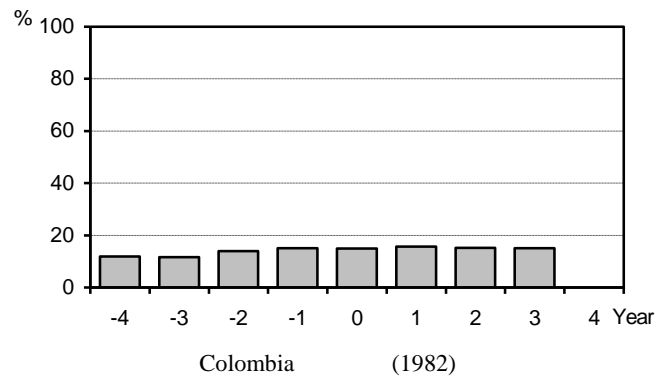
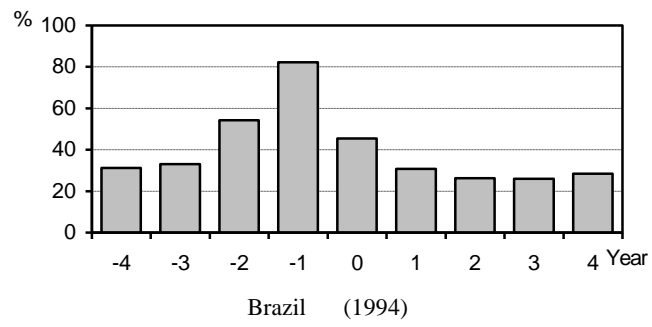


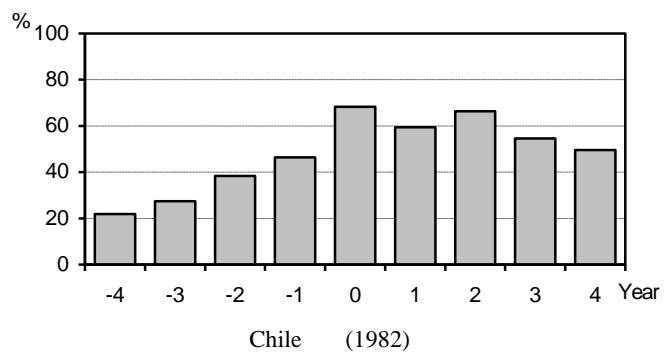
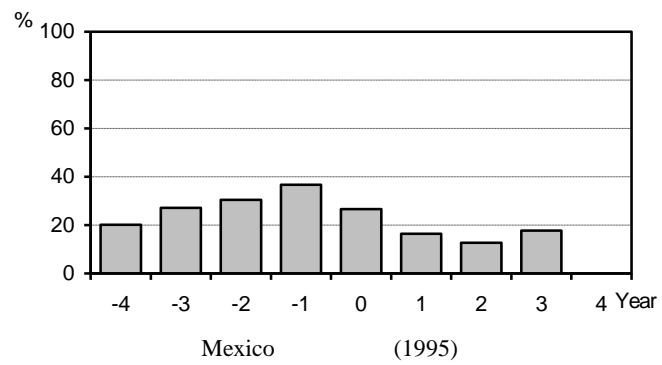
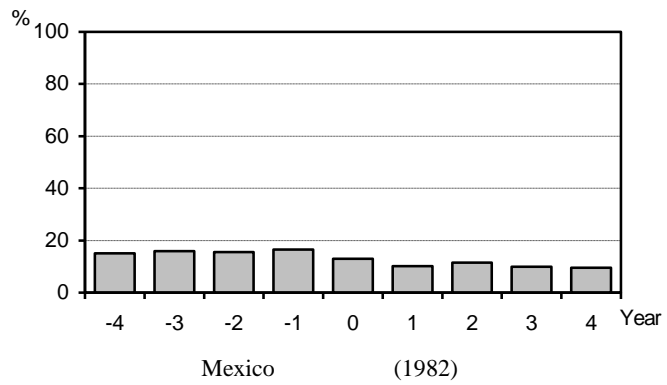




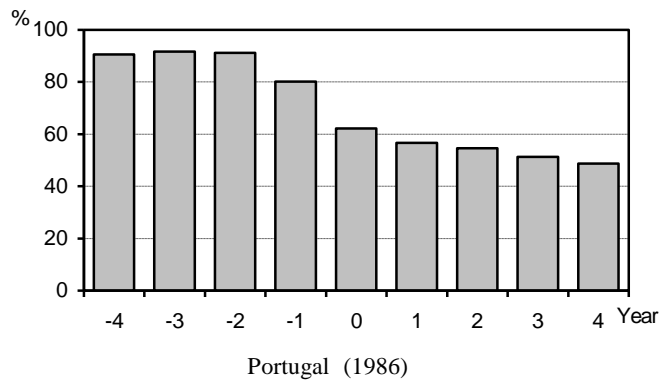
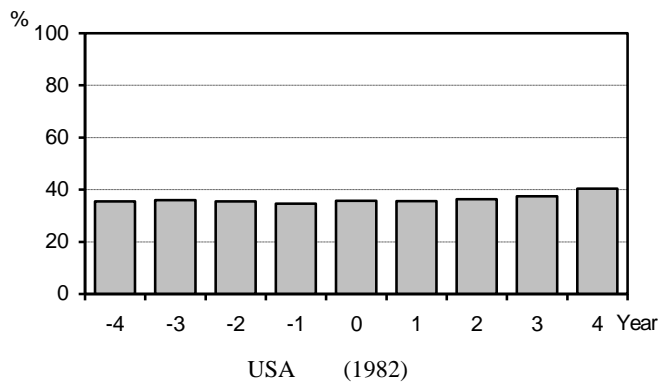
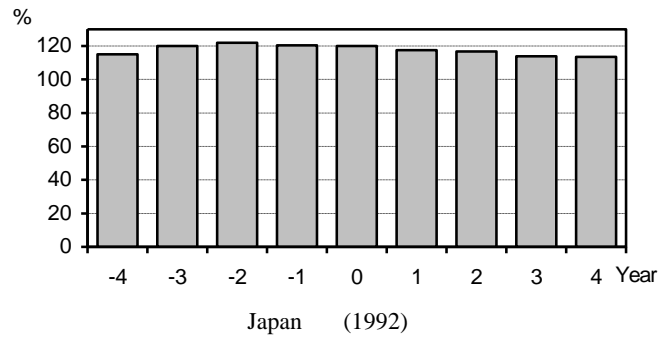


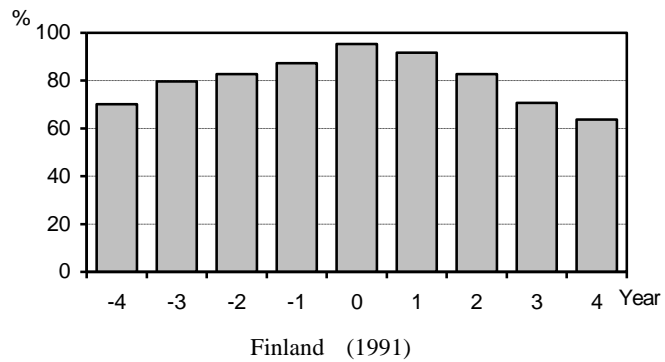
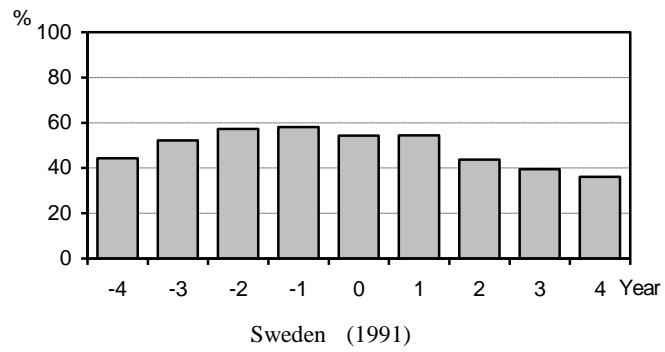
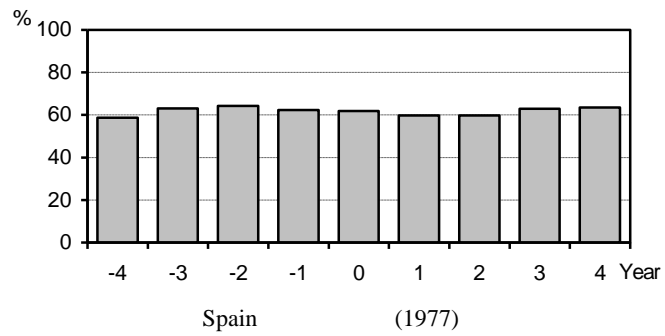
Latin American countries





Developed countries





Note: Year 0 is the year of the start of the banking crisis as specified in parenthesis after the name of a country
 Calculated from International Financial Statistics.

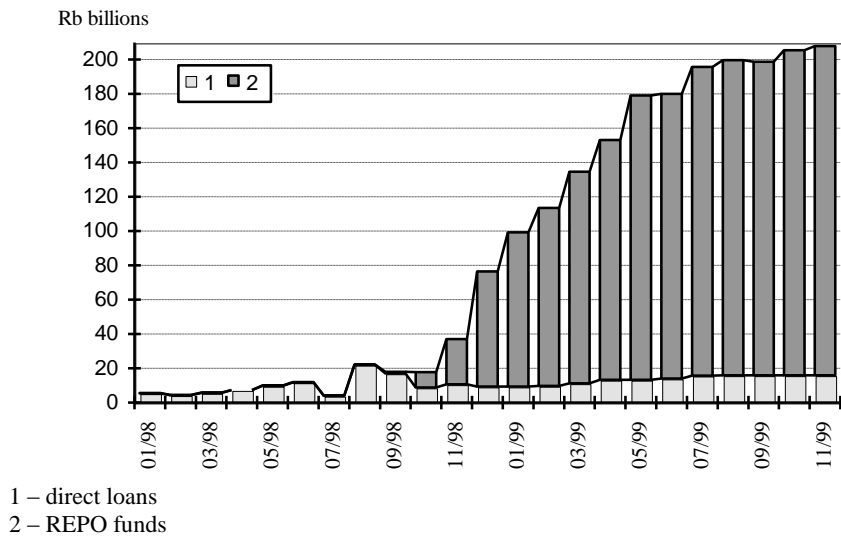
Another question: Where can the banking system, thrown into a deep crisis, muster funds to lend to the government? To meet its obligations, the government is relying on both direct loans from the Central Bank and loans made through banks under its control (Vneshekonombank, in the first place). It is relatively difficult to find out the exact scale of this kind of borrowing. According to widely publicized, though variously estimated figures, between August 1998 and mid-1999, the Central Bank advanced between Rb16 billion and Rb18 billion to commercial banks in stabilizing loans, some of which have already been paid off. The dynamics of this kind of expenditure incurred by the Central Bank to support the banks is probably most adequately reflected in the “loans to resident banks” line of its consolidated balance sheet (see Fig. 16). The diagram shows this indicator to peak in August and September 1998 (Rb22 billion and Rb17 billion, respectively). By year-end, the figure had fallen to Rb9.3 billion, and then picked up again, reaching Rb15.8 billion by August 1999, and held stable at that level till the end of November.

Central Bank loans are focused on a very small cluster of major banks, clear evidence of the Central Bank, with only limited resources at its disposal, having opted for a strategy of support for large banks. In turn, Central Bank loans became an important source of funds for these select banks. A trend toward “division of labor” between the Central Bank and the Bank Restructuring Agency, or ARKO, was discerned in the first half of 1999. The Central Bank was to support a few giant banks, SBS-Agro, above all, while ARKO centered on medium-size regional banks. This policy had to be abandoned at some point in mid-year, basically, it appears, under pressure from foreign creditors. ARKO’s new customers were now, first, Alfa-Bank, and soon afterward, Rossiisky Kredit and SBS-

Agro, and it is now exploring the possibility of reorganizing Promstroibank under its guidance.

FIG. 16

Central Bank loans to credit institutions

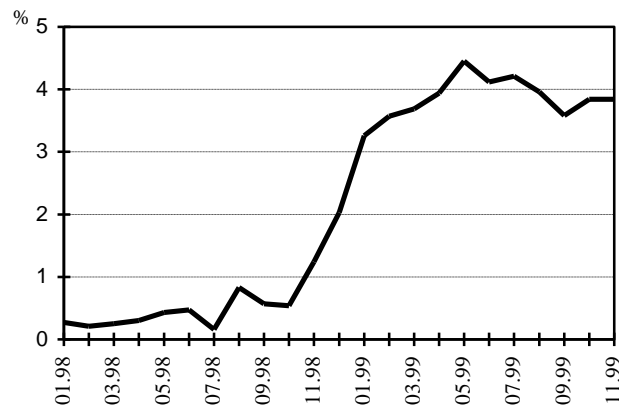


The Central Bank's total claims on lending institutions are significantly greater than its loans to banks as such. For example, on January 1, 1999, the Central Bank had Rb9.3 billion in loans out to correspondent banks, while its total claims on lending institutions ran into Rb76.4 billion. The difference of Rb67.1 billion was loans granted by the Central Bank to banks on REPO terms. It is larger than the total loans (Rb49.9 billion) the Central Bank had made for foreign debt servicing and, as we have said earlier, partly channeled through banks. By June 1, 1999, the difference stood at Rb166 billion. Data on the size of government securities packages held by banks provide no evidence of any reduction by a comparable amount, and yet, the Central Bank's total claims on banks apparent-

ly reveal more adequately the scale of Central Bank support for Russian banks than the total amount of its direct loans to banks. Under this approach, the costs of banking system support grow several-fold (see Fi. 17) and their dynamics does not suggest a conclusion that the problems besetting the banking sector have eased.

FIG. 17

**The movement of Central Bank claims on banks,
in per cent of GDP**



Note: Monthly GDP data are annualized.

TABLE 2

**The allocation structure of bank credit resources
1994 through 1999**

	Bank claims on the non-financial sector							
	1.01.94	1.01.95	1.01.96	1.01.97	1.01.98	1.01.99	1.07.99	1.12.99
on enlarged government *								
in Rb billions	0.8	10.6	62.6	150.7	194.7	259.4	390.4	420.6
in per cent	2.1	8.0	24.2	39.9	41.9	40.6	47.4	44.6
of which local authorities								
in Rb billions	-	-	0.7	2.8	18.7	24.4	22.9	19.1
in per cent	-	-	0.3	0.7	4.0	3.8	2.8	2.0
on enterprises								
in Rb billions	35.8	122.2	196.2	226.7	269.7	379.0	432.4	522.4
in per cent	97.9	92.0	75.8	60.1	58.1	59.4	52.6	55.4
of which government-owned								
in Rb billions	15.6	48.2	62.5	69.4	33.2	33.1	36.5	43.4
in per cent	42.7	36.3	24.1	18.4	7.2	5.2	4.4	4.6
Private sector **								
in Rb billions	20.2	74.0	133.8	157.3	236.4	346.0	395.9	479.0
in per cent	55.2	55.7	51.7	41.7	50.9	54.2	48.1	50.8
Total								
in Rb billions	36.6	132.8	258.9	377.4	464.3	638.4	822.9	943.0
in per cent	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Notes:

* federal government, local authorities, and extrabudgetary funds

** including credit to retail customers

Calculated from *The Bulletin of Bank Statistics*, absolute values in billions of redenominated rubles.

Sberbank is one of the few banks that really have considerable uncommitted funds it can use to expand lending. According to Sberbank leaders, the bank has stepped up lending to enterprises in the real sector by 300 per cent, with total loans to the real sector exceeding Rb100 billion. The media are, from time to time, circulating discomfoting news about the government's intention, reportedly formalized in decisions, to dip into Sberbank's assets for loans. In March 1999, for example, the Federal Government decided to borrow Rb10 billion from Sberbank to finance its farming machinery leasing program for agricultural producers. A similar report circulated in summer of that year about a loan being made to the Pension Fund. These facts signal an unsavory trend for lending

decisions to be made by the Government, instead of the Central Bank. This is a trend that will, sooner or later, end in bankruptcy for the Central Bank, if we go by the recent episode involving Vneshekonombank, Agroprombank, and Promstroibank.

Dynamics of Foreign Assets and Liabilities

The latest statistics allows the dynamics of Russian banks' foreign assets and liabilities to be followed right up to early June 1999.

In the time since the August crisis, there have been significant changes in Russian banks' foreign exchange position¹⁰² relative to world financial markets. Whereas Russian banks' *net foreign assets* were negative in the pre-crisis period, their liabilities to nonresidents in late 1998 were smaller than their overseas assets. Net overseas assets were growing through 1999, to above 60 per cent of the capital, according to the IMF definition, by late October (see Fig. 18). This dynamics of the banks' position on foreign operations shaped up under the effect of their declining liabilities to nonresidents, on the one hand, and a certain growth in their overseas assets, on the other. The greatest *reduction in foreign liabilities* occurred in 1998. Over the second half of 1998, they plunged, in dollar terms, by 42 per cent, from \$17 billion to \$9.8 billion, and dipped by another 6 per cent, to \$9.2 billion, in the first five months of 1999 (see Fig. 19). The banks' financial position, however, deteriorated faster than their liabilities to nonresidents decreased, so the ratio of their liabilities to nonresidents to their capital held at a level above 100 per cent in the months from October 1998 to August

¹⁰² The foreign exchange position on operations with nonresidents was computed as a difference between foreign assets and liabilities denominated in foreign currency. It disregards the banks' off-balance claims and liabilities, and, therefore leaves out of account the banks' forward transactions liabilities to nonresidents.

1999 (see Fig. 20). Even though it fell to 81 per cent toward late October 1999, it was still above the pre-crisis level.

In the first half of 1999, *foreign assets continued to gradually creep up* at an average 3.3 per cent a month, in dollar terms. Foreign assets play a significantly more important role in the Russian banks' total assets today than they did a year ago. Ruble devaluation automatically added more weight to the foreign exchange component of bank balance sheets, as a rule, against reduction in the total size of assets in dollar terms. As a result, the share of foreign assets in the Russian banks' total assets rose from 9.5 per cent on July 1, 1998 to 24.2 per cent on December 1, 1999 (see Fig. 21).

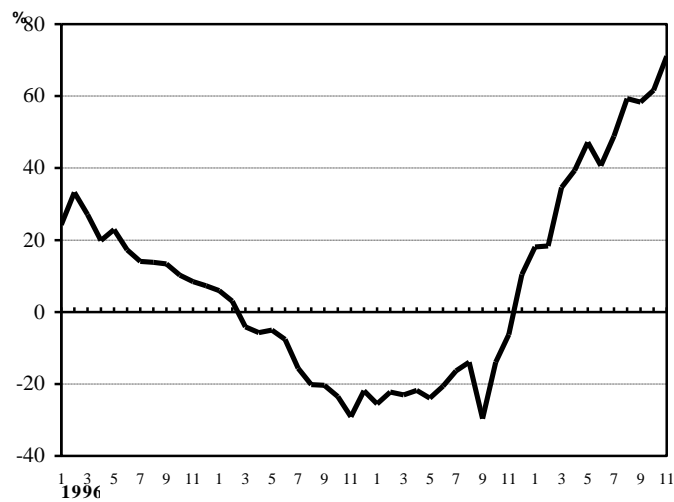
Less than a year after the onset of the crisis, the banking system's foreign exchange position on overseas operations ceased to be a factor exerting pressure on the country's gold and foreign exchange reserves (see Fig. 22), disregarding the banks' liabilities on long operations. There is only tentative data on the scale of these liabilities, and position regulation remains a concern for banks to attend themselves. It is hard, though, to argue with the view voiced by the *Euromoney* magazine in an article on the results of audits of 18 Russian banks conducted according to Western standards that a reform of the Russian banking system cannot begin until the problem of futures forex contracts is sorted out.¹⁰³ Estimates of Russian banks' liabilities under forward contracts with nonresidents range from \$3 billion to \$7 billion. In turn, the Russian banks' net overseas assets on balance sheet positions amounted to \$5.7 billion on November 1, 1999. But then, arbitration courts may modify their attitudes to these deals. In July 1999, the Arbitration Court of the Russian Chamber of Commerce and Industry created a precedent by

¹⁰³ *Euromoney Magazine*, June 10 1999

denying recognition to a forward contract as a “bet” deal, as was previously the case in a majority of similar disputes.¹⁰⁴

FIG. 18

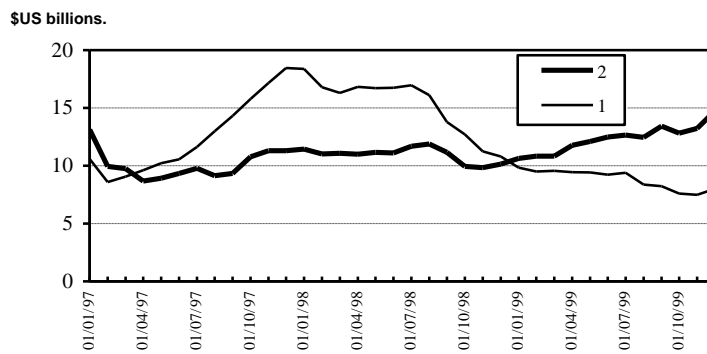
**Russian banks’ net foreign assets as per cent of their capital
(as defined by the IMF)**



¹⁰⁴ As was reported by *Kommersant-Daily* on July 9, 1999, Reiffeisenbank won awards from the Arbitration Court of the Russian Chamber of Commerce and Industry in its forward contract actions against the Menatep and SBS-Agro banks.

FIG. 19

Russian banks' dollar-denominated foreign assets and liabilities 1997 through 1999



1 – foreign liabilities
2 – foreign assets

FIG. 20

The ratio of foreign liabilities to capital (as defined by the IMF)

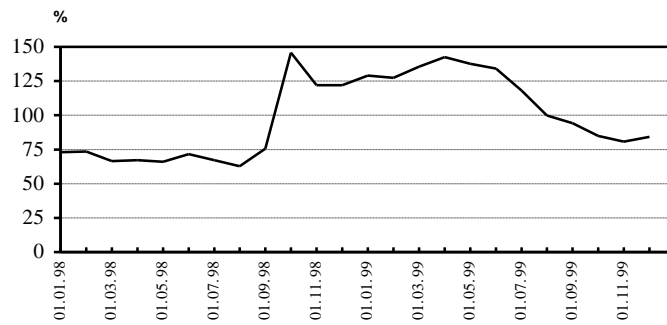
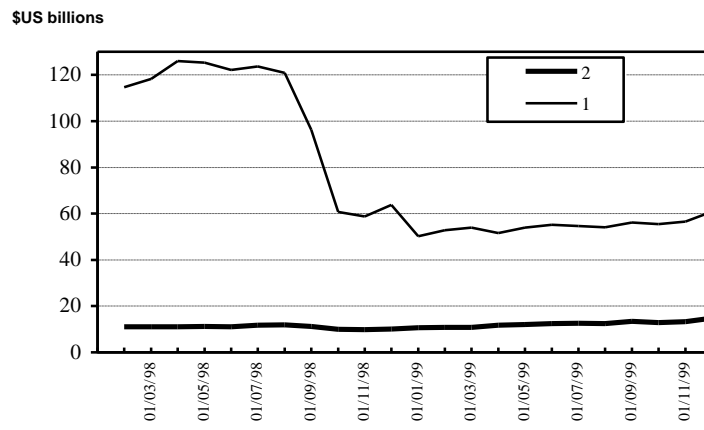


FIG. 21

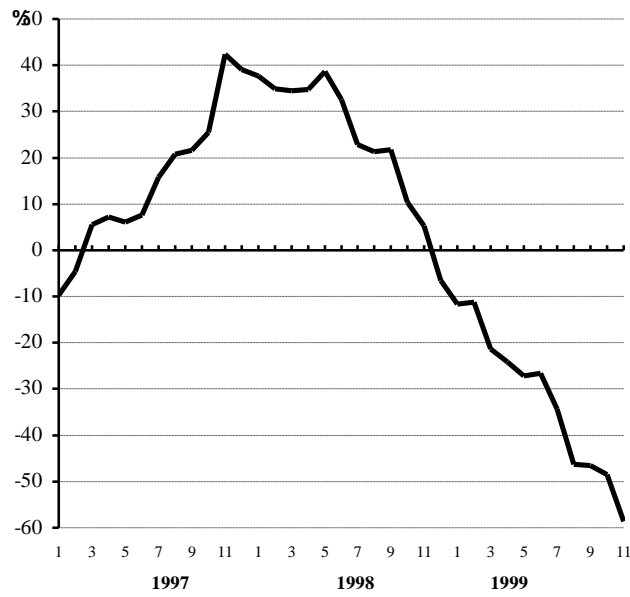
The movement of dollar-denominated assets



1 – assets
2 – foreign assets

FIG. 22

Russian banks' net foreign liabilities as per cent of Russia's gold and foreign exchange reserves



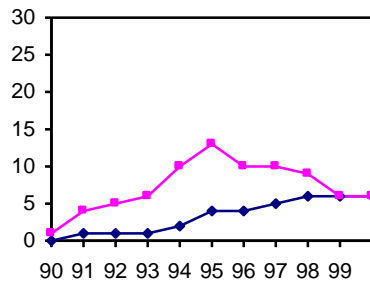
Calculated from The Bulletin of Bank Statistic and The Newsletter of the Bank of Russia.

Appendix. The Numbers of Credit Institutions in Various Regions

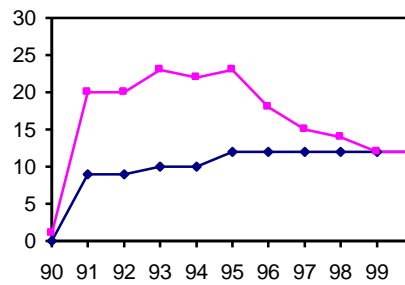
Legend

—■— total banks operating as of the corresponding period

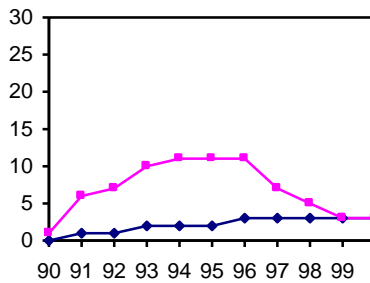
—◆— banks still operating as at 1 July 1999



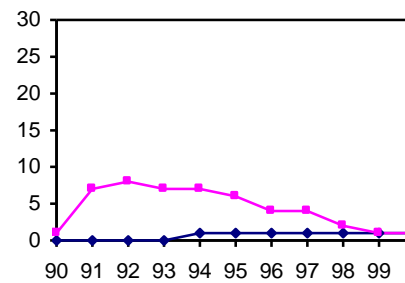
Arkhangelsk Oblast



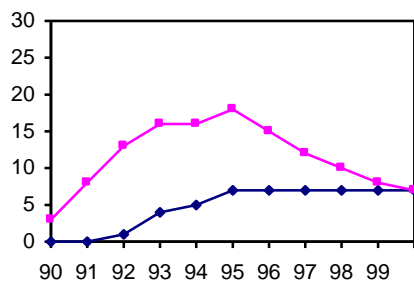
Volgograd Oblast



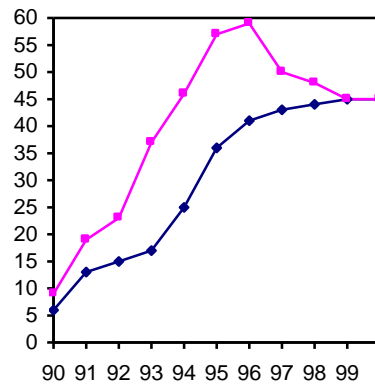
Murmansk Oblast



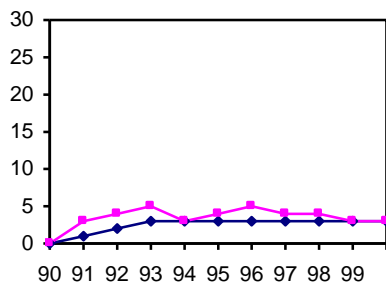
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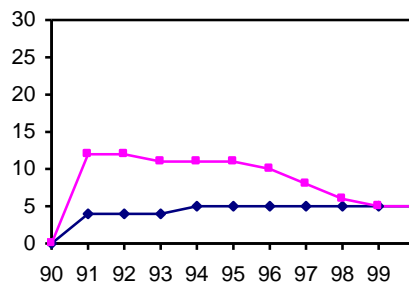
Komi Republic



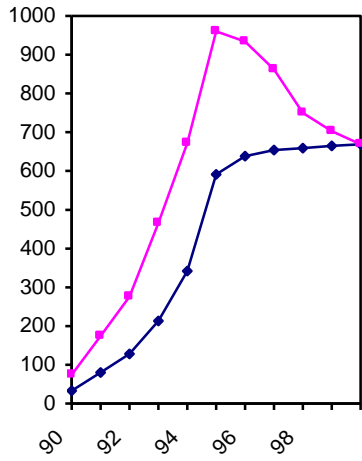
St. Petersburg
and Leningrad Oblast



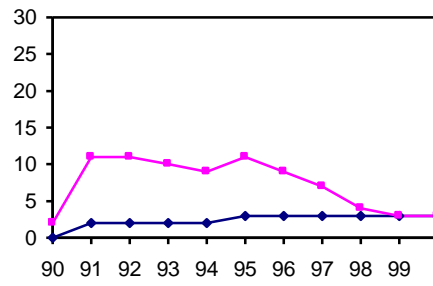
Novgorod Oblast



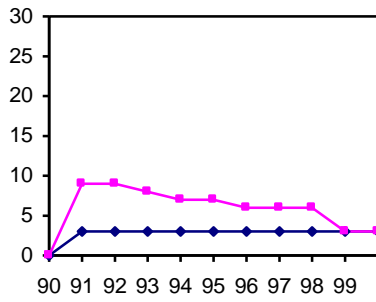
Pskov Oblast



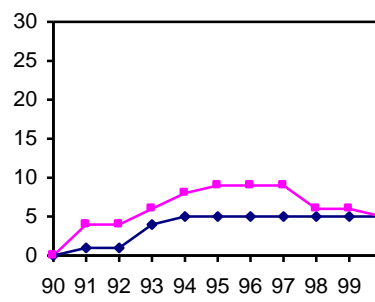
Moscow City and Moscow Oblast



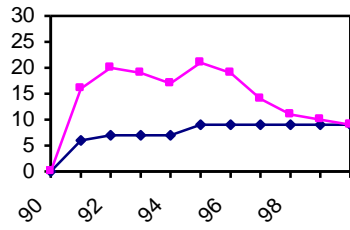
Bryansk Oblast



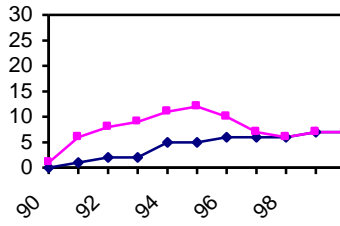
Vladimir Oblast



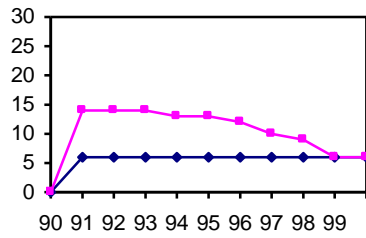
Ivanovo Oblast



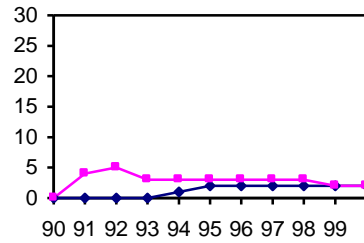
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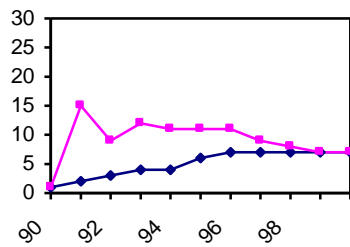
Kaluga Oblast



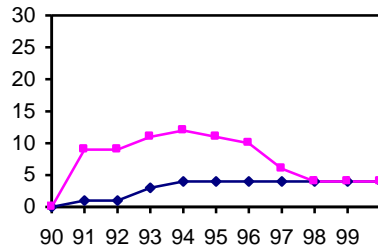
Kostroma Oblast



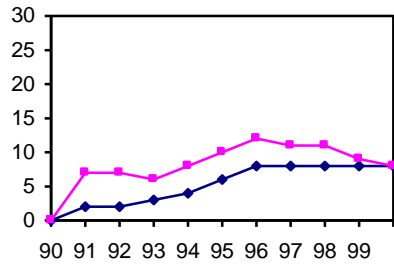
Orel Oblast



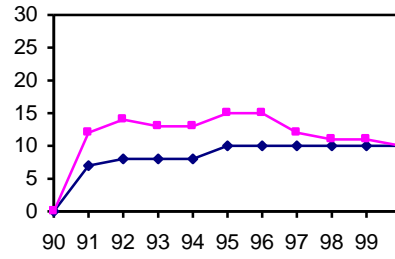
Ryazan Oblast



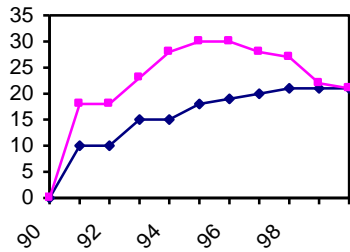
Smolensk Oblast



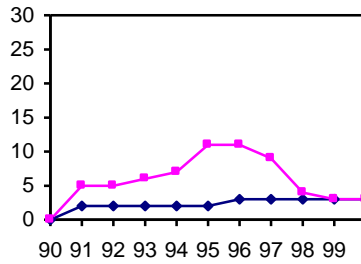
Tula Oblast



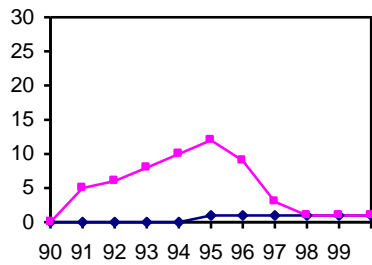
Yaroslavl Oblast



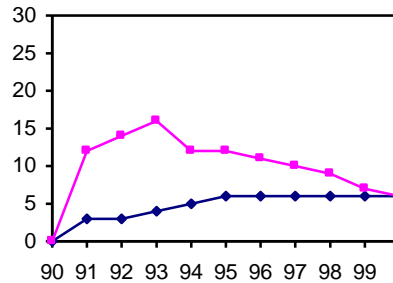
Nizhny Novgorod Oblast



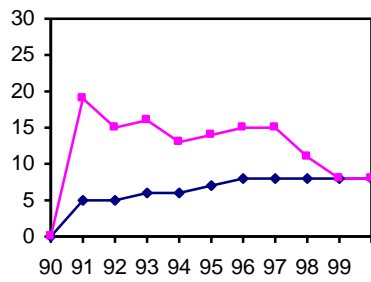
Kirov Oblast



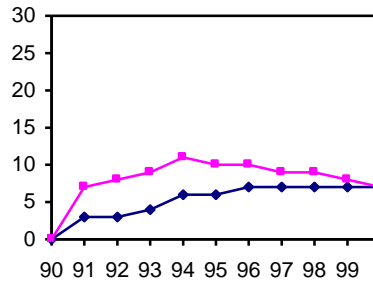
Republic of Mary-El



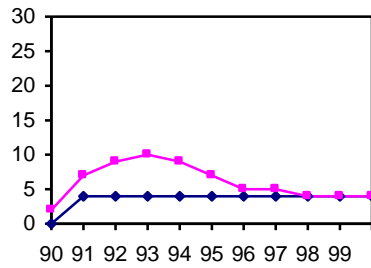
Republic of Mordovia



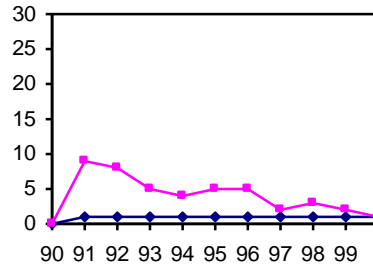
Republic of Chuvashia



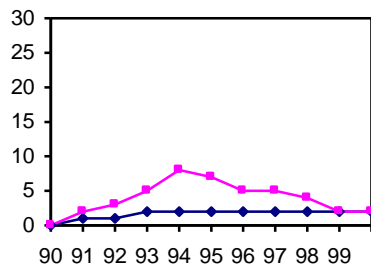
Belgorod Oblast



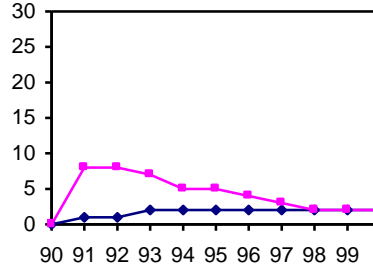
Voronezh Oblast



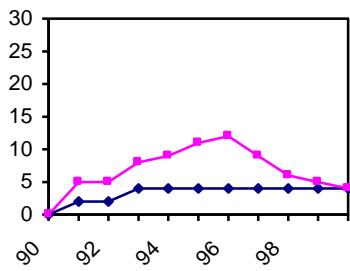
Kursk Oblast



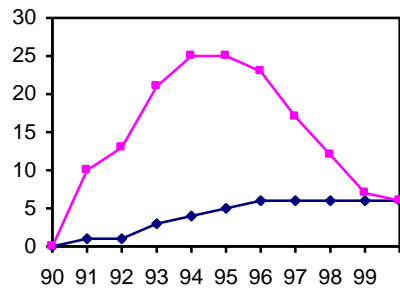
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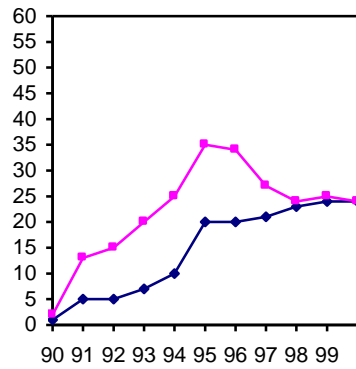
Tambov Oblast



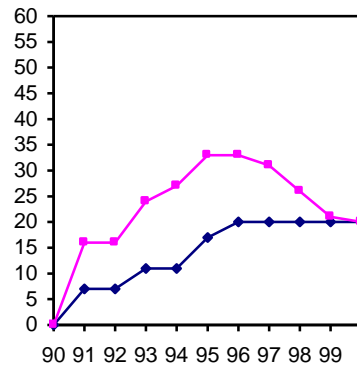
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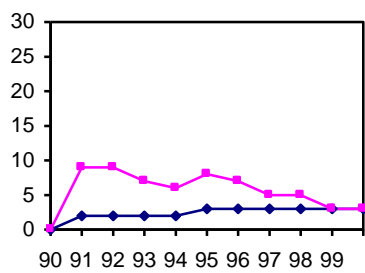
Volgograd Oblast



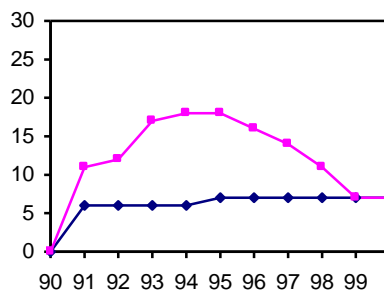
Samara Oblast



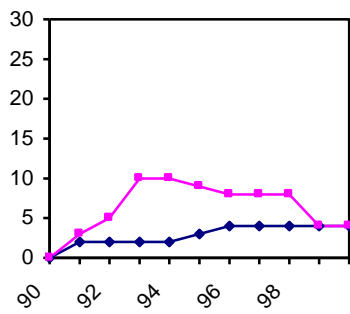
Saratov Oblast



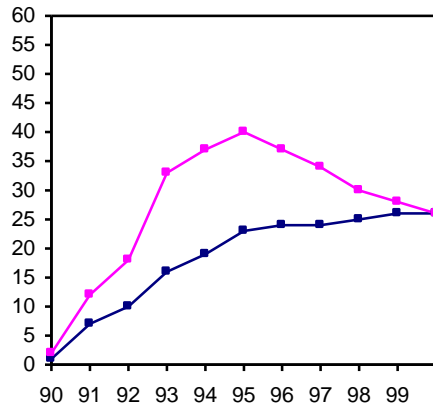
Penza Oblast



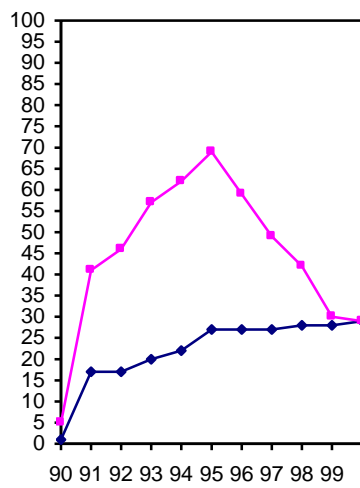
Ulyanovsk Oblast



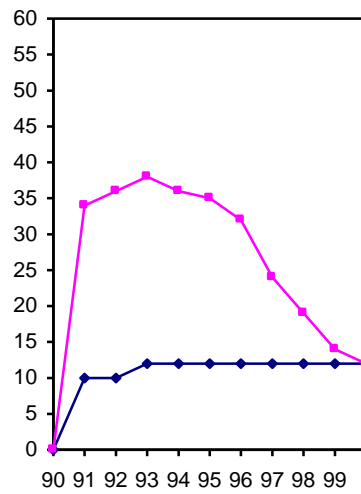
Republic of Kalmykia



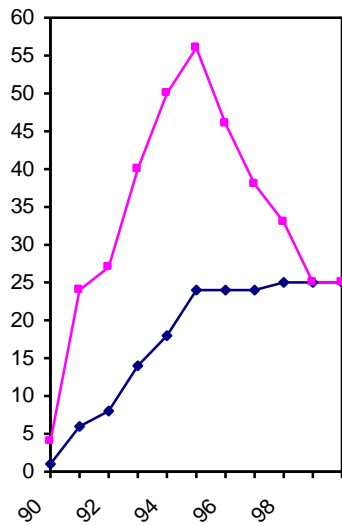
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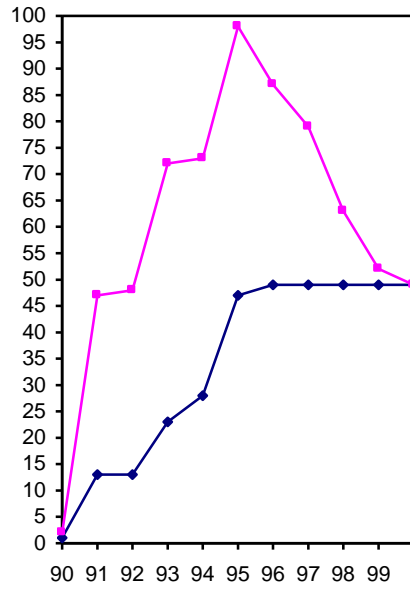
Krasnodar Krai



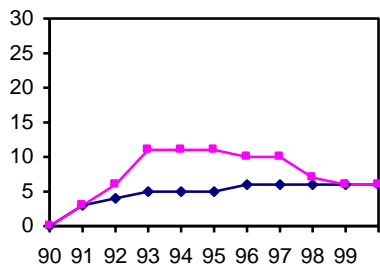
Stavropol Krai



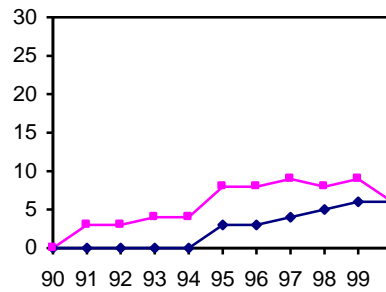
Rostov Oblast



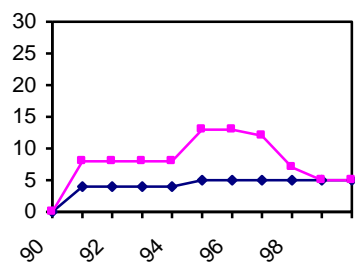
Republic of Dagestan



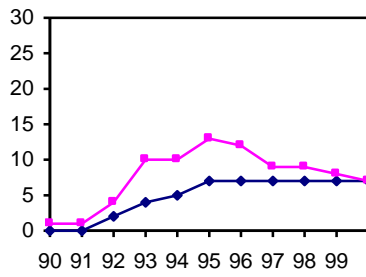
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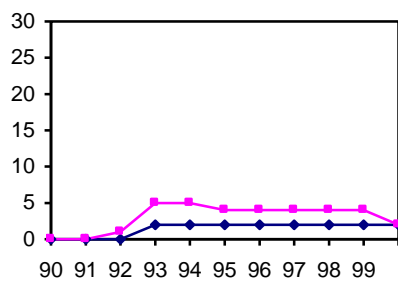
Republic of North Ossetia-Alania



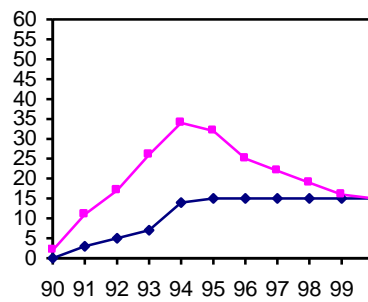
Republic of Adygeia



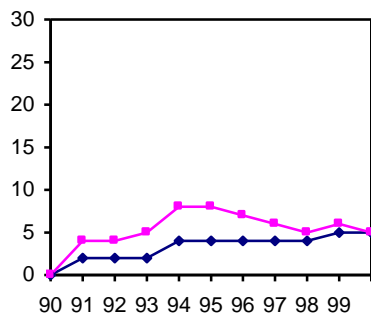
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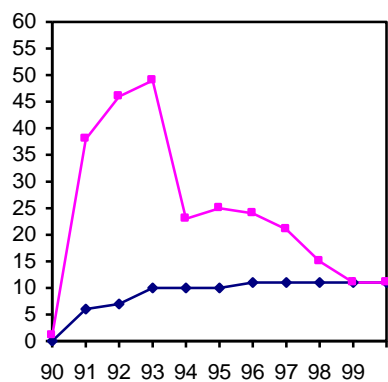
Republic of Ingushetia



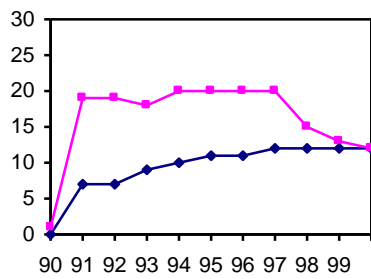
Republic of Bashkortostan



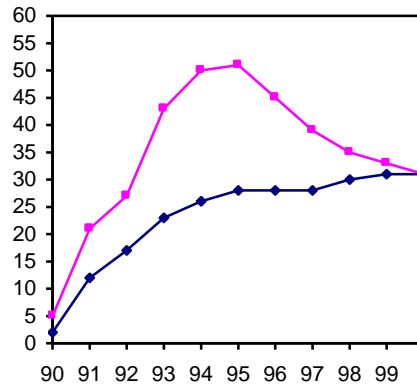
Kurgan Oblast



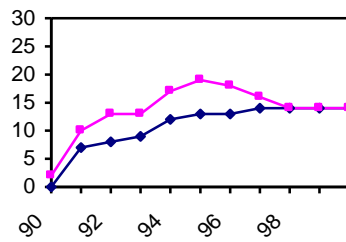
Orenburg Oblast



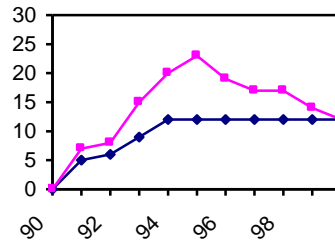
Perm Oblast



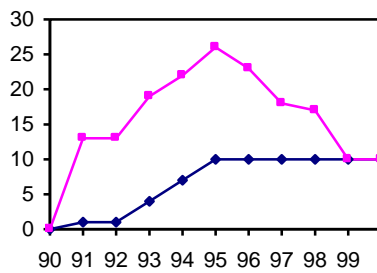
Sverdlovsk Oblast



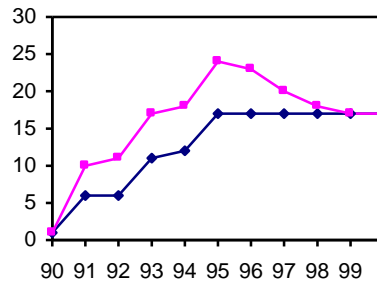
Chelyabinsk Oblast



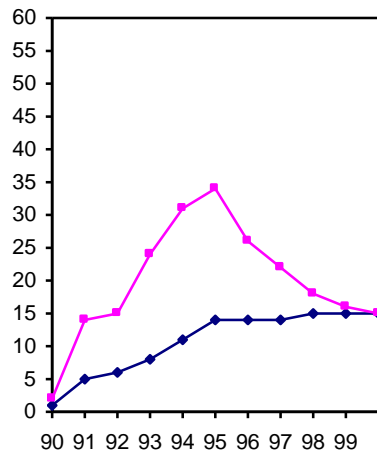
Republic of Udmurtia



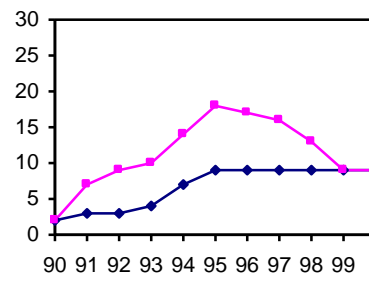
Altai Krai



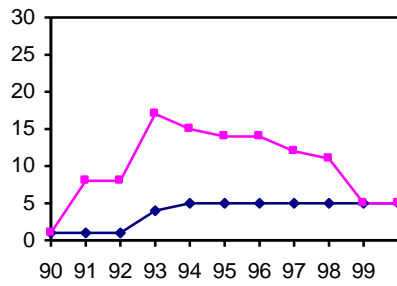
Kemerovo Oblast



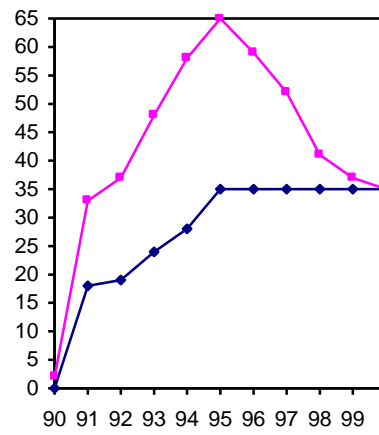
Novosibirsk Oblast



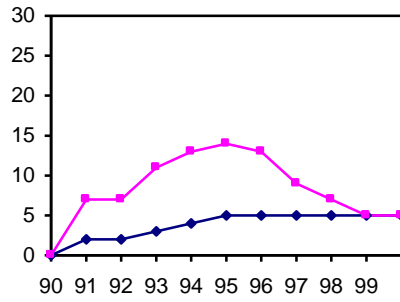
Omsk Oblast



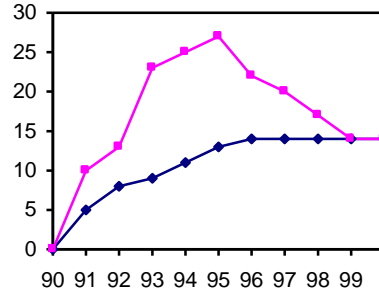
Tomsk Oblast



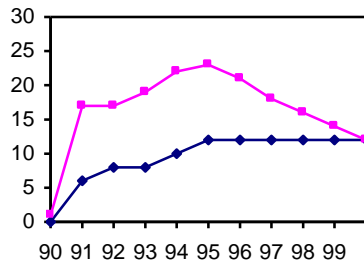
Tyumen Oblast



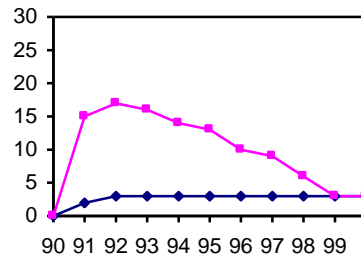
Republic of Altai



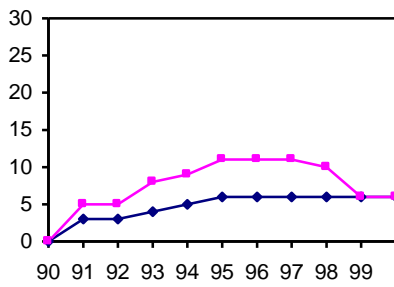
Krasnoyarsk Krai



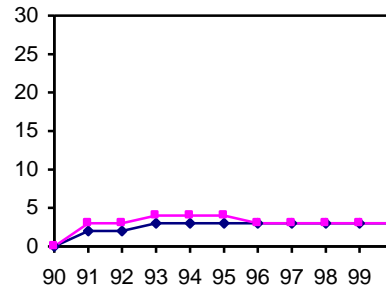
Irkutsk Oblast



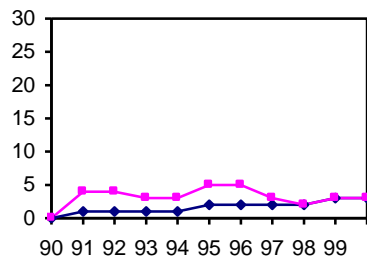
Chita Oblast



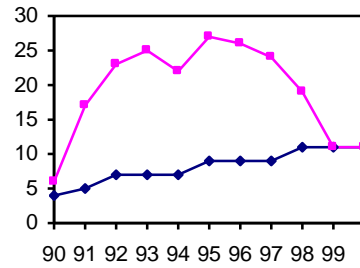
Republic of Buryatia



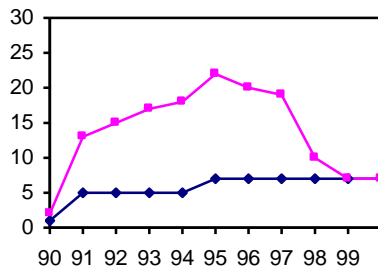
Republic of Tyva



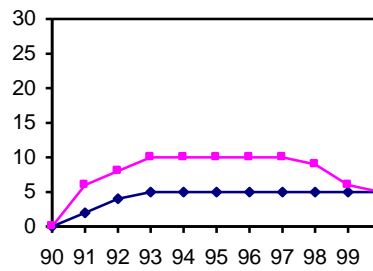
Republic of Khakassia



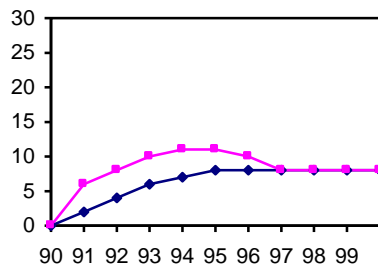
Primorsky Krai



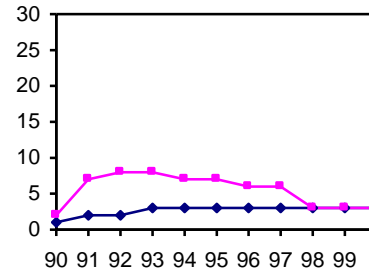
Khabarovsk Krai



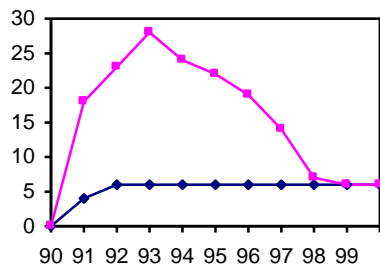
Amur Oblast



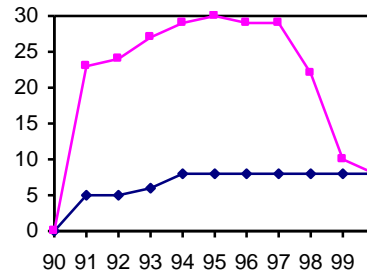
Kamchatka Oblast



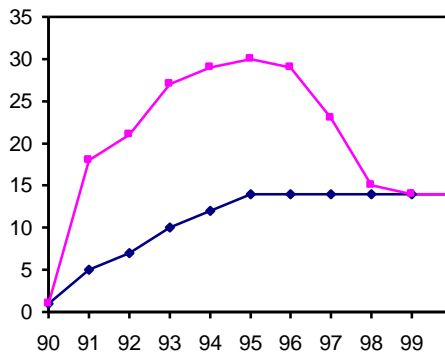
Magadan Oblast



Sakhalin Oblast



Republic of Sakha (Yakutia)



Kaliningrad Oblast

2.7. Social Services and Culture

The expenditure appropriated under the 1999 consolidated budget for social services and culture amounted to 6.1 per cent of GDP as compared to 6.5 per cent in 1998. Expenditure on education fell by 6 per cent in real terms. Appropriations for health care actually did not change in real terms, and those for culture and the mass media went up by 10 per cent and 16 per cent, respectively.

TABLE 1

Government expenditure on social and cultural services (1991 = 100 per cent)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Health care	100	80	108	98	72	71	81	67	67
Of which									
Government budget	100	80	91	81	59	57	65	51	51
Mandatory corporate insurance premiums	-	-	17	17	13	14	16	16	16
Education*	100	79	79	76	56	58	64	52	49
Culture, arts and mass media*	100	91	81	87	63	54	60	46	51

*government budget expenditure.

Source: estimated from RF Statistics Agency data using GDP deflators.

TABLE 2

Government expenditure on social and cultural services (in per cent of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Health care	2,9	2,5	3,7	3,9	2,9	3,1	3,7	3,1	3,0
of which									
Government budget	2,9	2,5	3,1	3,2	2,4	2,5	3,0	2,4	2,3
Mandatory corporate insurance premiums	-	-	0,6	0,7	0,5	0,6	0,7	0,7	0,7
Education*	3,6	3,6	4,1	4,5	3,4	3,7	4,3	3,6	3,3
Culture, arts and mass media*	0,5	0,6	0,6	0,8	0,6	0,5	0,6	0,5	0,5

* government budget expenditure.

Source: estimated from RF Statistics Agency data.

Budgetary Arrears in Social Services and Culture. Budgetary arrears in wages paid from budgets of all levels in social services

were reduced by a factor of above 2.7 through 1999, including 2.7 in education, 2.9 in health care, and 2.5 in culture. While the government cleared its debts in education from the budget by February 1999, arrears of regional and local budgets continued to be high. To resolve this problem, the government persuaded regional governments to allocate at least 40 per cent of their territories' own revenues, including federal transfers, to pay wages to employees in budget-dependent industries. This option allowed wages to be paid monthly and accumulated arrears to be cleared in education. In June and July, however, the budget fell deep into wage arrears again, because, in the first place, of the regions having started at exactly that time to repay the loans they had received from the budget, as was provided for in the agreement with the IMF. Beginning in July, the Russian Ministry of Finance began gradually to reduce its transfers to the regions by deducting the loan sums due for repayment. This move had an immediate effect on the payment rate of budgetary arrears. Some other forms of budget loan repayments (such as set-offs or prolongation of loan repayment terms) had, probably, to be used to sustain the emerging trend toward reduction of arrears in wages. The situation improved in the second half-year, when budgetary arrears in wages paid in social services from budgets at all levels decreased by Rb1,480 million, or by 42 per cent.

On the results of 1999, however, social services remain the main sore point as far as wage arrears are concerned: they account for 61.2 per cent of all arrears, which amount to 32.5 per cent in education and 16.4 per cent in health care. Insufficient receipts of territorial budgets, lack of legislation on earmarked federal transfers, and the left-over principle used in financing social services are still the principal factors behind the continuing budget wage arrears in social services and culture.

TABLE 3

Dynamics of budgetary wage arrears for social and cultural services в 1999

Budgetary wage arrears	as at 1.01	as at 1.02	as at 1.03	as at 1.04	as at 1.05	as at 1.06	as at 1.07
Total, in Rb millions	20051	19371	18998	16958	15288	14571	14605
of which:							
Social services	16675	15611	15135	13485	12088	11477	11555
<i>o/w:</i>							
Education	5522	4794	4638	4008	3444	3250	3437
Health care	2920	2537	2346	1944	1663	1558	1610
Culture and arts	776	685	636	547	482	461	475

Budgetary wage arrears	as at 1.08	as at 1.09	as at 1.10	as at 1.11	as at 1.12	as at 1.01. 2000
Total, in Rb millions	14995	13753	13692	13369	12358	10165
of which:						
Social services	11881	10726	10683	8302	7725	6223
<i>o/w:</i>						
Education	3506	2628	2641	2777	2597	2026
Health care	1825	1775	1795	1620	1412	1023
Culture and arts	502	458	450	436	400	312

Source: RF Statistics Agency

Strike Movement in Social Services and Culture. The strike movement in social services and culture peaked in January 1999, when more than 134,000 people employed in 5,000 educational institutions participated in strikes (or 98 per cent of all strikers). Their chief demands focused on economics and were precipitated by the continuing practice of delays in wages and by the vast backlog of wage arrears. The worst affected in this respect are the Altai Krai and the Bryansk, Smolensk, Chita and Orenburg oblasts.

TABLE 4

The strike movement in social and cultural services

	январь	февраль	март	апрель	май	июнь	июль	август	сентябрь	октябрь	ноябрь	декабрь
No. of organizations involved in strikes:												
TOTAL:	5305	972	95	169	69	11	11	15	192	359	341	729
of which:												
Education	5280	952	84	157	52	-	-	3	176	343	305	702
Health care	8	2	2	-	1	2	1	-	-	4	27	3
No. of employees involved in strikes ('000 persons):												
TOTAL:	134,3	31,1	4,5	6,5	4,7	0,7	2,7	3,6	5,7	11,4	5,7	28,5
of which:												
Education	131,7	25,9	3,1	5,8	2,4	-	-	0,1	3,9	9,2	4,3	25,5
Health care	1,0	0,6	0,4	-	0,2	0,2	-	-	-	0,4	0,4	0,3

Source: RF Statistics Agency

Health Care

In 1999, the incidence of many diseases, including intestinal infections, measles, rubella, viral hepatitis, and tuberculosis, among the population continued to rise. The trend toward lower mortality and longer life expectancy that emerged in 1995 continued, but whatever positive changes have occurred are minimal.

Government policy in health care in 1999 differed from that followed in previous years essentially in two respects: adoption of planning principles in providing government-backed guarantees of health care services for the population and expansion of pharmaceutical market regulation.

Implementation of the Government Guarantee Program. In the fall of 1998, the government approved a Program for Government Guarantees of Free Health Care Services for the Population of the Russian Federation (Federal Government Directive No. 1096 of September 11, 1998). There were no changes in the list of free health care services to be provided to the population. It specified, however, rates at which health care services were to be provided per 1,000 of the population with government financial backing. Adoption of the program was meant to specify the government's commitments and to set up a mechanism to make structural chang-

es in the health care system. The program is aimed at radically transforming the health care structure to make it less costly by reducing the scale of hospitalization and making wider use of outpatient and clinical facilities. The number of hospital beds has been declining during the last decade (Table 5). The program encourages continued movement toward these goals and reduction in the number of hospital beds, which have a low cost efficiency. The scale of hospital health care is to be decreased by 18.5 per cent and treatment of some diseases is to be provided in daytime hospital and outpatient clinics (Table 6). The share of government outlays on outpatient and clinical health care, now standing at an average 27 per cent for the country as a whole, is to rise to between 35 per cent and 40 per cent. As a result, outlays on health care services on a scale outlined in the government guarantee program will be smaller than they were in 1998. In particular, the costs of health care actually provided to the population in 1998 equaled 4.0 per cent of GDP, while the new government guarantee program adopted for 1999 accounted for 3.6 per cent of GDP.

TABLE 5

Indicators of the network of health care centers

	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998
No. of hospital-type institutions ('000)	12,5	12,8	12,7	12,6	12,6	12,3	12,1	12,0	11,5	11,2
beds therein (per 1,000 persons)	13,5	13,8	13,5	13,1	12,9	12,7	12,6	12,4	12,1	11,9
No. of out-patient health care centers ('000)	19,4	21,5	20,9	20,7	20,9	21,6	21,1	22,0	21,7	22,0
No. of physicians with various specializations Total, '000	620,7	667,3	632,2	637,2	641,6	636,8	653,4	669,2	673,7	682,0
Per 10,000 persons	43,2	45,0	42,6	43,0	43,4	43,3	44,5	45,7	46,2	46,9
Paramedical personnel Total, '000	1756,7	1844,0	1717,3	1709,1	1674,2	1613,2	1628,4	1648,6	1626,0	1615,0
per 10,000,000 persons	122,4	124,5	115,8	115,3	113,1	109,7	110,0	112,7	111,5	111,1

Source: RF Statistics Agency.

After the adoption of the federal government guarantee program, the government persisted in promoting planning practices in

territorial (regional and municipal) health care systems, determining their requirements for funding from different sources, and, for this purpose, coordinating the efforts of various government agencies. Federation members were asked to develop territorial programs of government guarantees on the basis of the federal program. The Federal Health Ministry and the Federal Mandatory Medical Insurance Fund (MMI) adopted, on October 16, 1998, Methodological Recommendations on the Formation and Economic Substantiation of Territorial Programs of Government Guarantees of Free Health Care for Citizens of the Russian Federation, which were endorsed by the Federal Ministry of Finance.

TABLE 6

Indicators of the program of government guarantees for free health care provision

Type of health care service	Scope per 1,000 persons			Design rate of health care unit cost in 2000, Rbs	Per capita cost in 2000, Rbs
	1998 actual	1999	2000		
Emergency aid calls	320	340	318	310,7	98,8
In-patient, bed days	3476,0	2901,5	2812,5	200,3	563,3
Daytime in-patient medical aid, bed days	29	660	749	70,6	52,9
Out-patient visits	8731	9198	9198	34,1	313,7
Health care system maintenance costs					147,4
TOTAL per capita					1176,1

Source: RF Health Ministry.

The adoption of the federal program did not, however, win overwhelming support from all Federation members. Criticism was focused on two points. First, the federal program did not differentiate quotas according to regions, so program numbers were at vari-

ance with actual morbidity figures for many Federation members. Second, doubts were voiced about the government's idea underlying the development and approval of a program lacking financial backing.

The program is financed from the Federation members' budgets and resources of the mandatory medical insurance (MMI) system. Outlays on health care from the budgets of Federation members have reached 2.1 per cent of GDP. According to data for nine months of 1999, MMI contributions by members of the work force and other receipts of MMI funds amounted to 0.7 per cent and 0.1 per cent of GDP, respectively. The federal program of government guarantees, therefore, had a financial backing of 81 per cent.

This estimate appears to be clearly exaggerated for two reasons. First, it is unrealistic to expect large-scale changes to be effected in the health care structure in accordance with the program within a single year. Second, the estimates of health care rates provided in the methodological recommendations to developers of territorial programs of government guarantees are below the funding requirements arrived at by the regions themselves. The federal rates were based on standard wages, costs of medicines, patient sustenance costs, and costs of maintenance services (such as utilities, for example) per health care service unit and the capacity utilization standards of therapeutic and disease prevention (TDP) institutions (such as an annual hospital bed occupancy rate, and so on). The actual capacity utilization rates of TDP institutions are below standard rates. Accordingly, the actual funding requirements to cover the maintenance service costs of the existing network of TDP institutions and to pay wages to their work force exceed cost estimate rates. In other words, federal cost estimates are not adapted to maintain the existing network of TDP institutions on its present

scale and at its present capacity utilization rates, but propose a restructuring of the network.

As territorial programs of government guarantees were developed in practice, the funds needed to implement them in 1999 were an estimated 40 per cent short of the actual requirements.

In order to carry through the federal program of government guarantees, it was decided to use the mechanism of tripartite agreements on cooperation in dealing with health care organization problems between the Federal Health Ministry, the Federal MMI Fund, and the executive government agencies in Federation members. The agreement provides for funds to be allocated within the framework of target programs financed from the federal budget, along with free treatment quotas at federal clinics, and Federal MMI Fund subsidies in exchange for a territorial government guarantee program to be adopted by each Federation members in line with the federal program and a pledge to restructure the health care system accordingly. In late 1998 and early 1999, work started in 52 Federation members to coordinate the objectives of territorial programs of government guarantees with federal program targets and to draft tripartite agreements on this basis.

The federal program targets for reductions in the hospitalization scale and pass on part of required health care to the outpatient clinic level, and the cost estimates contained in the methodological recommendations were received in the regions as totally unrealistic. The talks held with regional authorities resulted in agreement on numbers very close to what had initially been proposed by the Health Ministry and the Federal MMI Fund. These breakthroughs notwithstanding, the federal authorities cooled toward such agreements already in early spring 1999. One of the reasons was the slowdown in movement toward the signing of general framework agreements on a distribution of powers between the Russian Feder-

ation and its individual members. It turned out, besides, that the Federal Health Ministry was not prepared to give Federation members iron-clad guarantees of specific free health care quotas at federal health institutions and medicines and medical equipment to be provided within the framework of target programs. Continuing instability and, therefore, uncertainty of funds being appropriated under the federal budget to finance federal health care institutions and federal target programs were cited as reasons for hesitation at the Health Ministry. As a result, tripartite agreements were signed by year-end with 12 Federation members only, with another 25 ready for signing.

In the fall of 1999, the Government made adjustments in its program of government guarantees of free health care to the population (Federal Government Directive No. 1194 of October 26, 1999). The idea was to reduce the scale of guaranteed emergency aid (by 6 per cent) and hospital care (by 3 per cent), to be replaced in the latter case with one-day hospital care (Table 6). Table 7 illustrates two scenarios of proposed funding for government guarantees in 2000.

TABLE 7

Financial backing for government guarantees for free health care services for the population (in per cent of GDP)

	1998	1999	2000 forecast	
			1	2
GDP, in Rb billions	2684	4476	5370	5370
GDP deflator, per cent	111,5	160,9	124,4	124,4
Government expenditure on providing guarantees for health care services	3,06	2,91	2,98	2,98
of which:				
Budgets of RF constituent members	2,19	2,08	2,15	2,15
MMI contributions by the working population	0,75	0,73	0,73	0,73
Other revenues of MMI funds*	0,12	0,10	0,10	0,10
Requisite costs of providing government guarantees**	4,02	3,59	3,20	3,720
of which the cost of the basic MMI program	2,81	2,51	2,03	2,60
Level of financial backing for government guarantees, per cent***	76	81	93	80

* Revenues of MMI funds from bank deposits, fines and penalties, and other revenue.

** Estimates for 1998: the cost of the actual scope of health care services. Estimates for 1999 and Forecast 1 for 2000: the cost of the government guarantee program. Forecast 2 for 2000: the cost of health care services, the scope of which is consistent with the relevant indicators for 1998

*** The indicator is calculated by dividing the amount of expenditure from the budgets of RF constituent members, MMI contributions by the working population and other revenues of MMI funds by the estimated value of government guarantees for health care services for the population.

Source: estimated from data provided by the RF Statistics Agency, RF Health Ministry, RF Ministry of Economy, and the Institute for the Economy in Transition.

Both scenarios were based on statistical estimates of macroeconomic performance in 2000, prepared by the Institute of Economy in Transition (see above), which forecast a GDP growth of 2.0 per cent and an inflation rate of 124.4 per cent.¹⁰⁴ Budgetary outlays on health care in Federation members calculated as percentages of GDP are estimated at 2.15 per cent, or approximately equal to the average outlays in the past two years. Added up to MMI contributions by the working population and other MMI fund receipts,

¹⁰⁴ BEA. Bulletin of Information Analysis, No. 20, December 1999, p. 9.

this figure rises to almost 3.0 per cent of GDP. In the first forecast scenario, the costs of the officially adopted federal government guarantee program were adopted as the costs required to back up government guarantees. The second forecast scenario assumed that the structure and scale of health care would remain approximately the same as they were in 1998. In that case, the costs of health care for the population would reach 3.7 per cent of GDP.

In the first forecast scenario, financial support for government guarantees will come to 93 per cent of the requirements. If, then, health care financing from Federation members' budgets increases, in real terms, by 14 per cent from 1999, the government guarantees under the federal program will be brought into full balance with available financial resources. It is not to be forgotten, though, that implementation of this program would require the following steps to precede it:

Hospital would have to be scaled down by almost 20 per cent and shifted on to one-day hospitals and outpatient facilities;

The guaranteed volumes of free medicines available to hospital patients would have to be reduced;

No funds would be available to maintain the existing network of health care institutions, and instead health care would be paid for by volume; this would mean withdrawal of some therapeutic and disease prevention institutions, that are redundant as far as available funds are concerned, from the public health care system;

A comprehensive territorial health care planning system would have to be set up to ensure a rational commitment of the aggregate resources of regional and municipal health care institutions;

Transparency would have to be improved and stringent controls imposed with respect to targeted utilization of public funds.

It is highly problematic that budget outlays on health care can realistically be raised and all the above conditions are met till the

end of 2000 and over the next year or two. In approaching this option, however, attention is be paid to the fact that a profound restructuring of health care would require quite a considerable time.

Under the second forecast scenario, there would only be 80 per cent of the funds needed to provide health care services to the population on a required scale. In this option, government guarantees of free health care services to the population would have to be revised to create normal economic conditions for health care development. Such revision would propose legalization of fees charged to the population for health care services provided. Today, the shortage of public funding for health care services is made up by unofficial charges paid by the population. Evidence of this is provided by sociological surveys of Russian household spending on health care, which were conducted in January 1998 and January 1999 by the Institute of Social Studies within the framework of a project to support legislative proposals in health care of Boston University in 14 Federation members.¹⁰⁵ Drawing on the poll returns, household expenditure on medicines and health care in 1997 can be estimated at 4.1 per cent of GDP, and 4.5 per cent of GDP in 1998. Expressed in GDP percentages, public expenditure on health care fell from 3.6 per cent to 3.1 per cent in the same period. The total public and personal expenditure on health care, therefore, did not change appreciably at all (Table 8).

¹⁰⁵ V. Boikov, F. Fili, I. Sheiman, and S. Shishkin. "Personal Expenditure on Health Care and Medicines," *Voprosy ekonomiki*, No. 10, 1998, pp. 101-117; Report of the Institute of Social Studies, "Expenditure of the Russian Population on Health Care Services and Medicines (Sociological Monitoring Results)," submitted to USAID, Moscow, 1999.

TABLE 8

Expenditure on health care (in current prices)

No.		1997		1998	
		Rb trillions	% of GDP	Rb billions	% of GDP
1	Government budget	75,1	2,93	64,4	2,40
2	Employers' contributions to mandatory medical insurance	18,3	0,71	20,0	0,75
3	Total government expenditure (1 + 2)	93,4	3,64	84,4	3,14
4	Household expenditure on health care services	32,5	1,27	38,1	1,42
5	Household expenditure on medical drug purchases from pharmacies	71,7	2,80	83,1	3,10
6	Household expenditure on voluntary medical insurance	0,9	0,03	0,4	0,01
7	Total household health expenditure (4 + 5 + 6)	105,1	4,10	121,6	4,53
8	Total (3 + 8)	198,5	7,75	206,0	7,67

Source: estimated from data provided by the RF Statistics Agency and a report compiled by the Institute of Social Studies, "Expenditure of the Russian Population on Health Care Services and Medicines (Sociological Monitoring Results)," submitted to USAID, Moscow, 1999.

An important result of these polls was the shattering of the myth that the population pays most of health care charges unofficially, directly into the pockets of doctors and nurses. Actually, underhand payments by the population for health care services accounted for a smaller part, some 23 per cent, of total household expenditure on health care services in 1998. The respondents described the remaining 77 per cent of their expenditure as official payments. Actually, though, a significant proportion of this expenditure must be listed as semi-official, or quasi-official, payments: health care institutions officially ask patients to pay for their services, which have to be provided free under the law.

The results of these polls lead to the conclusion that the health care system is adapting itself to dwindling public funding and replacing it with the patients' money. Attempts are being made in some Federation members to legalize co-payments, despite their

obvious contradiction to federal laws. For example, the health care department of the Perm Oblast administration ordered fixed fees to be charged for each visit to the doctor and for each day of hospitalization. Soon, however, after protests from the oblast procurator office, the order was retracted. In the Kaluga Oblast, co-payment by members of the public are provided for in the draft law on government guarantees of health care services to the Kaluga Oblast population. In the Republic of Karelia, 80 per cent of the pensions of retirees receiving hospital treatment is remitted to the health care institution concerned.

This is certain evidence that the time has come for constitutional guarantees to be revised and co-payments by the public for health care services to be introduced. In the prevailing situation, people have to pay for what are officially free health care services. This reality puts low-income segments of the population and families living out of big cities at a great disadvantage. People living below the subsistence level spend three times as much, in proportion to their incomes, on health care services and medicines than the highest earning segment of the population. Moreover, people in low-income groups visit outpatient clinics less frequently than the well-to-do. Members of low-income groups remain in hospital for shorter periods than people in high-income groups.

The remaining gap between the constitutional guarantees of free health care services for the population and available government funding, therefore, leads in practice to replacement of government outlays on health care with private payments and to a greater social injustice.

A possible way to balance government guarantees and their financial backing is legalizing citizen sharing in financing public health care costs. There are several cost-sharing options:

1. Co-payment (supplementary payment) for health care services as they are provided to members of the population. The idea is that every time a patient visits the doctor (for outpatient clinic and hospital health care services) he pays a certain fixed fee that goes to the institution's gross income. A possible co-payment scheme provides for charging for hospital and outpatient clinic services those who come from families whose earnings per family member are above the subsistence level. To balance the costs of existing health care services against their financing backing in this option, patients with above-average incomes would have to pay approximately 129 rubles (in 2000 prices) per day of hospitalization, 18 rubles per visit to the doctor, and 25 rubles for day-time hospital services.

2. Co-payment of MMI contributions by people in the work force. For example, an employee pays a certain percentage of his wage as contribution, in addition to that paid in by his employer, to the insurance fund. An employee would have to contribute about 4.54 per cent of his wage so the existing scale of emergency aid, outpatient clinic services, and hospitalization could receive adequate funding.

3. Determination of a minimal package of health care services and medicines, provided free to each patient, for every kind of disease. Health care services above the minimal package are to be paid for by either the patients themselves, in a definite proportion, or by their insurance companies under voluntary medical insurance programs. In this option, however, guarantees of free health care services may be maintained in full for low-income patients, the disabled, and some categories of chronically ill patients.

The third option is by far the most complicated from the viewpoint of preparatory work and monitoring. In contrast to the first two options, however, it leaves untouched, and even legalizes, the

possibility of patients exercising economic control over the scale and quality of services provided to them. Should, however, the first or second option is adopted, the cost-sharing idea may simply result in patients paying an ever increasing share.

Regulation of the Drug Market

In the second half of 1999, the government adopted a series of measures to regulate the pharmaceutical market and general drug provision practices. Previously, government regulation in this area was merely confined to markups on drug prices. Federation members were free to set their own markup ceilings. It must be noted specifically that prices to which wholesale and retail markups were applied were those of the first wholesaler selling medicines purchased from domestic or overseas producers, rather than domestic producers' disbursing prices or prices of imported medicines stated in customs declarations. First wholesaler prices (trading markups set by the first wholesaler) were not subject to any regulation. This maximum markup setting practice made price regulation measures largely meaningless. This explains the wide differences in prices of identical medicines within individual regions, as well as from region to region.

In 1997, imports accounted for 59 per cent of the Russian pharmaceutical market.¹⁰⁶ In the wake of the August 1998 financial crisis, imports fell by 22 per cent, from \$1.8 billion to \$1.4 billion. Domestic pharmaceutical production declined, in dollar terms, in the same proportion, by 22 per cent, from \$1.3 billion to \$1.0 billion, because of the pharmaceutical industry's heavy dependence on imported ingredients. As a result, the share of imports on the Russian pharmaceutical market was unchanged, while drug prices shot up by 208.5 per cent in 1998, far ahead of general consumer prices

¹⁰⁶ RMBC (REMEDIUM GROUP) Pharmaceutical Market Volume Forecast, Moscow, 1999.

that rose by 184.4 per cent. Health care institutions were experiencing significant difficulties with obtaining medical drugs. The Government spent 15.4 billion redenominated rubles (from budget appropriations and MMI resources) to procure drugs in 1997, and Rb16.9 billion in 1998.¹⁰⁷ Comparing these figure to the price index shows that, in physical terms, the volume of drugs paid for from public funds, nearly halved in 1998.

This motivated the Federal Health Ministry into looking for ways to step up government control over pricing on the drug market. Its efforts were in consonance with the Primakov cabinet's general policy to tighten government regulation of the economy. On March 29, 1999, the Government adopted Directive No. 347, "Measures of Government Control over Prices of Medical drugs." These price control measures applied to drugs contained in the list of vitally essential and critical drugs and medical items approved by the Federal Government in its Directive No. 478 on April 15, 1996 for fiscal purposes. Producers of listed drugs are exempt from profit tax on the manufacture of these drugs. The list was expanded in May 1999 (by Federal Government Directive No. 546 of May 20, 1999) and today it contains over 750 drug descriptions. These are international unpatented names, corresponding on the Russian market to some 6,000 trade names of a total of nearly 14,000 registered medical drugs. The prices of all domestically or foreign-made drugs included in the list are subject to official registration. Registration is to be effected by the Federal Health Ministry after the applicant has received approval of his price from the Russian Ministry of Economy. The Government's directives have not affected the rights

¹⁰⁷ Summary prepared for a cabinet meeting, "Measures of Government Regulation of Drug Provision for the Population of the Russian Federation," January 14, 1999.

of executive government bodies in Federation members to set wholesale and retail markup on drug prices at their own discretion.

In practice, however, the registration process has been making a very slow headway. The Government's Directive of March 29, 1999, required registration of producer prices of listed drugs to be completed within two months. By September 1999, however, only 170 trade names of medical drugs had been registered.

The requirement of drug prices to be registered, and even price approval, is not, by itself, at variance with the common practice in market economies. Various measures of government price control on the pharmaceutical market are applied in all West European countries. To judge how justified a particular regulatory mechanism actually is, it is important to take account of the adequacy of applicable legislation and the kind of influence it has on producers' and distributors' motivations.

Criteria to be used in price approval are imprecisely defined in the Government's directives and bylaws of the Federal Ministry of Economy. In the case of domestically produced medical drugs, the applicant is required to file with the Ministry of Economy an economically substantiated support for his price, including output data and forecasts of the production scale, drug cost calculation, and book and planned profits. In the case of imported medical drugs, the applicant is to provide figures on the prices of his drug in the producer's country and in other countries where it is registered, and drug sales data on the Russian market in the preceding half-year. Approval may be denied on such grounds as filing of false information or significant overpricing of the drug over its prices in other countries for commensurate transportation and storage costs. These vague criteria give broad scope for their arbitrary interpretation and, therefore, an opportunity for bureaucrats to capitalize on their official position.

Prices for domestically produced medicines are registered in rubles, while those for imports are set down in both foreign exchange and rubles. Prices in rubles are to be adjusted following publication of producer's prices, at least once every quarter. This approach allows the registered price level to be brought up level with the inflation rate and encourages the producer to overstate his prices to prevent inflation-related losses.

Wholesale companies purchasing medicaments from foreign and domestic producers are now compelled to either fit their prices within the upscale markup brackets set by Federation members or claim a share in the redistribution of producer incomes.

In the end, the measures used to restrain prices and supply health care institutions with medicines may yield little effect, since producers and importers have a high stake in overstating their registered prices, helped in their ambitions by the existing registration mechanism. These apprehensions were confirmed with the commencement of official registration of prices for medicines: registered prices turned out to be an average 30 per cent above wholesale prices advertised in promotional publications.

The government's measures to regulate prices were supplemented with steps to regulate the designation and sale of medical drugs. Its Directive No. 393 of April 8, 1999 introduced yet another list of medicines: a minimum range of medicines essential in providing health care services and required to be carried by every drugstore. It is expected to be broader than the list of vitally essential and indispensable drugs. Simultaneously, the new list provides a basis for rationing drugs to people entitled to free or cut-rate medicines. Under the above directive, prescriptions for free or cut-rate drugs outside the official minimum range to eligible patients can now be written out by a physician only on the basis of a resolution of a commission of clinical experts at a clinical institution or by

physicians at cancer, tuberculosis, psychiatric, and other specialized health care institutions. The quantity of expensive medical drugs prescribed for free or at cut rates is, therefore, expected to be restricted by this more complicated prescription rule.

In principle, measures of this kind to hold down demand for publicly financed medicines are completely justified. They are particularly relevant in Russia's conditions today, for they actually reduce the scale of government guarantees in the provision of medical drugs and shorten the gap between government guarantees and the funds available to finance them. The question now is how the new rules are going to be applied in practice. It will be easy enough to monitor compliance with the new prescription rules and impose more restrictions on the quantity of medical drugs physicians and commissions of clinical experts can prescribe. It will not be that easy to monitor the stocking of the mandatory minimum range of medical drugs by drugstores. As a result, some medication may be in short supply. If things come to this turn, the availability of free or cut-rate medicines for eligible segments of the population may be reduced more significantly than was intended.

The Beginning of an End of Mandatory Medical Insurance? Back in 1996, the Russian Government submitted a draft law to the State Duma, with proposals to amend the RSFSR Law on Medical Insurance of the Population in the Russian Federation. It was intended to curtail the powers of MMI funds and medical insurance companies. These special interest groups successfully blocked discussion of the government's bill by the State Duma. The government was not pressing too hard for its adoption from the start either, and even gave the impression of having clean forgotten about the bill, once the presidential election was behind it. In 1999, however, it suddenly awoke to the problem. It put a heavy pressure on

the Duma deputies and bosses of the Federal MMI Fund. The State Duma passed the bill at first reading on June 11.

The majority of deputies unversed in the intricacies of medical insurance were persuaded that, if enacted into law, the bill would put the mandatory medical insurance system in order, save funds, cut out redundant intermediaries between the MMI funds and health care institutions, and reinforce public supervision over the targeting of MMI monies. Actually, however, the passage of the law will not so much put things in order, as place the MMI resources under undivided control of the executive branch, without a slightest guarantee that these resources will be committed as intended.

The bill provides for changes that radically alter the concept and content of the existing Federal Law on Medical Insurance of the Population in the Russian Federation. In actual fact, it is not about amendments to the existing law, but about its substitution with a law under a different name (Mandatory Medical Insurance) and different content. The bill gives medical insurance companies no role among mandatory medical insurance (MMI) providers. The functions of insurers within the MMI system will only be performed by territorial MMI funds. Each of these will enjoy a monopoly position on the territory of its respective Federation member. The bill allows a territorial MMI fund to recruit, at its own discretion, insurance companies to work as its insurance agents. The Federal Law on the Principles of Mandatory Social Insurance, No. 165-FZ, passed on July 16, 1999, bans any intermediary business within the MMI system. This means that the exclusion of medical insurance companies from the list of MMI providers will amount to their virtual banishment from the MMI system.

The bill proposes to deprive MMI funds of the right to engage in financial and lending business. This privilege aroused burning

irritation among bureaucrats in regional administrations and, in actual fact, bred abuse by the executive boards of some territorial funds.

The bill contains provisions allowing Federation members to modify the legal status of territorial MMI funds. The first part of the existing Regulations of a Territorial Mandatory Medical Insurance Fund, approved by the Supreme Council of the Russian Federation in its Resolution No. 4543-1 on February 24, 1993, expressly provides that a territorial MMI fund operates in accordance with the laws of the Russian Federation and the above Regulations. This provision deprived Federation members of authority to approve fund constituent documents substantially at variance with the Federal Regulations. Under the new bill, the Government only approves a model statute of a territorial MMI fund. The actual statutes of MMI funds are to be approved by executive government authorities in Federation members. Not a word is said about any disparities being ruled out between such territorial statutes and the model statute. If these modifications find their way into the final text of the law, this would signal devolution of a considerable portion of rights to regulate the legal status of territorial MMI funds to Federation members. In particular, nothing would keep Federation members from placing territorial MMI funds under their health care management agencies, replicating, at the regional level, an administratively integrated health care management system. To do this, it would be enough for a territorial MMI fund statute to include a provision that the fund chairman is to be appointed on representation from the head of the local health care management agency, and also to oblige the fund to seek approval for its detailed draft budget from the health care management agency and to provide the agency with monthly budget execution reports. In the end, the MMI fund

would find itself under the hard administrative heel of the health care management agency.

If a law of this sort is passed, no matter what, the MMI system will be robbed of a strategic perspective in a growing competition among insurers and instead a prospect would emerge of resurrection, even if in a new format, of the administrative health care control system to eradicate whose flaws the MMI system was set up in the early 1990s, in the first place.

In the second half of 1999, a working group of the World Bank, assisted by the Federal MMI Fund, carried out a survey of territorial MMI funds, their branches, and medical insurance companies.¹⁰⁸ The survey was conducted by questionnaire, with responses received from around 80 per cent of insurance companies and territorial MMI funds and half of these funds' branches. An analysis of the responses shows that medical insurance companies have significantly greater resources than branches of MMI funds, which also fulfill the functions of insurers within the MMI system. Insurance companies have relatively more specialists per thousand insureds and more advanced automated systems. There is actually no competition between medical insurance companies for underwriting health care institutions, but it exists over policyholders and insureds in many regions. Medical insurance companies are generally more assertive in performing the functions of insurers within the MMI system. True enough, this appraisal is valid in respect of approximately half of the insurance companies that responded to the questionnaire questions.

To enhance the potential of each insurance company within the MMI system to exert a positive impact on the quality of health care services to the insureds and the efficiency of fund utilization within

¹⁰⁸ Report on the World Bank project, "Research of the Intermediary Services Market in Medical Insurance," Moscow, 1999.

the MMI system, it is important to scale up requirements to medical insurance companies so that they can no longer derive incomes by merely siphoning off cash from the MMI funds to health care institutions. It is important to impose clear-cut rules requiring the insurers to provide necessary information to the insureds, examine their complaints, provide economically sound grounds for contracts with health care institutions, exercise supervision over the need for hospitalization of the insureds and compliance with economic and medical treatment standards, and so on. These rules must be incorporated in the list of conditions to be met for taking out a license to engage in MMI business. Put within this framework, the insurers' activities would be channeled in the required direction.

Education

Last year was, in general terms, a fruitful one for the education system both for the number of new legislative acts adopted to regulate this area and from the viewpoint of improvements in clearing the backlog of arrears in wages. A closer look is taken below at both these achievements.

In 1997 and 1998, the Government discussed a wide range of issues related to organizational and economic restructuring in education, including reallocation of managerial functions between the Federal Center and territorial authorities, greater economic independence for educational institutions, changes in ownership relations, involvement of extra-budgetary funding sources, and so on. Discussions gradually tapered off with a change of government in the fall of 1998. A new boost was given to efforts to reform education in late March 1999, when the President sent to the Federal Assembly his annual message "Russia at the Watershed," a section of which was devoted to "watershed" problems of education. The need for an urgent passage of a Federal Education Development Program was spotlighted as a general political objective "in restor-

ing respect for the teacher and creating decent living conditions for people in this profession.” Improvement in the organizational and economic mechanisms to sustain the viability of the educational system was formulated as a common mission for authorities at all levels. The annual Message emphasized that “it is a long time we moved to develop mechanism for promoting extra-budgetary funding... [and that] additional funding sources must only be introduced alongside, not instead of, budgetary sources.”

The Message outlined the following basic guidelines for reform in school and university education:

- aiming the education policy at making education accessible to every child and adult;
- sustaining the quality of education and giving more weight to its humanistic content, introducing a system of independent evaluation of the quality of acquired knowledge, and adopting education standards expanding the potentialities of school without restraining the teacher’s initiative;
- enhancing the flexibility of the educational system and its responsiveness to change.

Some challenging problems typical of education today, however, were left out of the reform framework drawn in general outline in the Message. First, interbudgetary relations, above all a lack of effective mechanisms to ensure the targeting of federal funds transferred to the regions to meet educational needs. Second, the call to sustain the quality of education is hard to accept, because it proceeds from the assumption that Russian secondary and post-secondary education boasts high quality standards. This is a long way from the truth. The claim often voiced by education officials, particularly in the middle echelon that “everything is fine in Russian education, except that there is not enough funds,” only betrays their unwillingness to really raise the quality of education, rather

than testifies to its really high quality. Third, no attention was given to an important issue related to the policies of municipal educational institutions. In particular, municipalities as local government agencies do not, under the existing Constitution, enjoy the status of state structures that only include two levels - federal and Federation members. This brings the guidelines into collision with the basic principles of the legislative framework of the educational system in the Russian Federation, within which the educational system has a predominantly public character.

On March 17, 1999, the State Duma passed a Federal law amending the previous Federal Law on the preservation of the status of public and municipal educational institutions and a moratorium on their privatization. The Law focuses on two important points: first, it puts a ban on privatization of educational institution for an unspecified time and, second, it expands the list of institutions exempt from privatization by adding infrastructure components of education to the list, such as experimental and shopfloor training facilities and other research, design and manufacturing enterprises, institutions and organizations conducting research and promoting the operation and development of education.

An important development that worsened conditions for non-public post-secondary educational institutions was the ruling made by the Federal Constitutional Court in October 1999, waiving military service deferral for students of non-public post-secondary educational institutions without state accreditation. Less than half of the 349 non-public post-secondary educational institutions having the required accreditation, a significant number of young people were faced with the prospect of being drafted right from the college classroom. This measure will most likely reduce appreciably the appeal of non-public higher education for young people, on the one hand, and will push colleges operating on a license only into

searching for new ways of protecting their students from military conscription during their years of studies.

On June 24, the Federal Government adopted a Federal Program for the Promotion of Education (FPPE) and sent it to the State Duma, which promptly passed the Program unanimously. Remarkably, the Program has a long prehistory. As early as 1992, the government invited tenders for an acceptable program. The winning project was canvassed at a cabinet meeting in April 1994 and sent to the State Duma to be enacted into law. The Parliament dragged out its passage for so long that a refreshed program was required in tune with the new times.

The FPPE, placed in the context of conceptual blueprints to reform Russian education, sets goals and lays guidelines, but fails to provide specific methods or mechanism to attain its goals, even though economic and organizational mechanisms are tremendously important for achieving the objectives it outlines. This generally vague character of the education program cannot, of itself, be viewed in negative terms: programs as tools for government regulation differ greatly from programs that existed in the centrally planned economy and were understood as a predetermined train of specified events. Since programs in a market economy are designed (more precisely, are to be designed) to foster coordination between public institutions and non-public organizations that do not obey orders from on high, specific measures can only be incorporated in such programs as they get under way, through regular talks and contracts between public management agencies and independent organizations. The quality of the FPPE as a program document can only be evaluated in terms of adequacy of its goals and guidelines to the current problems confronting education in the Russian Federation.

The FPPE comprises two stages -1999-2001 and 2002-2005. The first stage of the Program includes measures aimed at (a) maintaining the existing network of educational institutions and (b) staging a series of experiments in the regions, to be followed by large-scale innovations at the second stage of the Program. Specific measures are expected to be adopted within the program framework at government level, with necessary funds allocated annually from the budget to carry them out.

To maintain the existing network of educational institutions, the program developers take the beaten track of requests for funds being sent to the Federal Center. The total outlays needed to develop the educational system and put the innovative proposals of the program into effect are to be calculated on the basis of education-related laws, including provision of government guarantees to participants in the educational process. The budget section concerned with funding for the educational system proposes to “provide for a gradual growth in allocations for both the operation of the system [the “Education” section of the budget] and measures and projects (innovations) of the Program with the ultimate aim of meeting, by the year 2005, the estimated requirements for funding.” This approach casts serious doubts on the feasibility of the Program and, therefore, on the possibility of securing financing for all the measures outlined in the Program.

As regards the choice of a specific course of action and measures specified in the Program, it is typically lacking clearly articulated priorities whatsoever. In particular, a highly important goal lost among the general objectives of the Program is “improving the economic mechanisms sustaining the educational system.” In fact, it follows a long way behind such goals as “protecting and promoting the development of ethnic cultures in education” and “developing and comprehensively coordinating and regulating aca-

demic, scientific and technological activities of higher education establishments.” The list of development guidelines for individual levels of education includes such objectives critically important for stability in education funding as “adoption of statutory financing” or “maintaining independence of educational institutions,” which again trailing much less important goals as “conducting leading-edge research in social and humanitarian sciences,” “developing measures to stimulate a wide-scale involvement of students in scientific research projects,” and so on.

The structure of outlays to be provided, under the Program, from the Federal Budget and extra-budgetary sources to finance Program measures and projects (innovations) and year-to-year capital outlays inhibits correlation of these outlays at different education levels, suggesting the need for Program priorities to be put in focus.

Of all the experiments to be carried out during the first stage of the Program, attention must, in our view, be focused on two: (1) adoption of 12-year schooling in selected general education establishments in a full-scale experiment format (preparatory and initial stages) and (2) return of all unlawfully privatized educational institutions, torn out of their public context, to the educational system after comprehensive tests.

As we already said, the first of these innovations is profoundly important from the viewpoint of its economic and social implications for general education, while the second one is highly dubious from the perspective of elaboration of procedures and mechanisms for its implementation and its possible social implications. The inclusion of these two innovations in the FPPE for experimental trials is, to our mind, evidence of insufficient attention having been given to the results of discussions of Program concept proposals held in the fall and winter of 1998.

A major flaw of the Program is that it almost completely ignores the possibility of coexistence of different scenarios (hypotheses) for Russia's economic development in the medium term. With the Russian economy unstable as it is now and disregard for factors outside education, including macroeconomic forces, the feasibility of the measures it proposes looks uncertain.

Actually, the FPPE, therefore, only provides a framework for specific annual target programs that will, with proper amendments in priorities and economic organizational mechanism, allow real reforms to be carried through in education. The fact that, seven years after work started on the FPPE, the Program, a revised version of the original, has been given an official status is certainly a positive sign.

Decree No. 1134, Additional Support for General Education Institutions in the Russian Federation, signed by the Federal President on August 31, 1999, is an important milestone in the development of public management principles and economic and organizational backing for general school funding. As it is unlikely to expect a sharp increase in funding from local budgets in the short term off-budget financial inflows have come to play a prominent role in school life, the Decree attaches importance to a wide-scale establishment of school boards of trustees as public bodies stimulating an influx of additional off-budget funds to schools and supervising their commitment to intended uses.

It is significant that the Education Law passed back in 1992 raised a possibility of boards of trustees being set up at every school to encourage the flow of off-budget funds into school budgets and to enforce citizen control over their commitment. According to the Education Ministry, however, boards of trustees operated at some 8 per cent of all schools in Russia, at best, by the end of 1999. This small percentage is explained, first, by the absence of express laws

regulating the activities of such boards; second, the sponsors' low economic interest in investing funds in school needs; third, a lack of adequate organizational support from local and regional authorities; and, fourth, existing differentiation in opportunities the students' parents have to give financial support to boards of trustees.

To implement the presidential decree, the Federal Education Ministry has drafted model regulations for a board of trustees of a public or municipal educational institution. The regulations actually only list the key functions and possible work scope of a school board of trustees, leaving such matters as its elections and powers to be specified in the school statute taking account of the local specifics of each general education establishment. Moreover, focus is to be given to such elements essential for the operation of this novel body as (a) forms and methods of supervision over the spending of off-budget funds received by a school; (b) a mechanism of coordination and cooperation with local education management bodies and financial agencies; and (c) enforcement of openness and accessibility of reports on the performance of boards of trustees to the public.

Of course, the publication of the presidential decree cannot of itself guarantee a rapid rise in the influx of additional funds into school budgets. The objectives the decree sets, namely, legalization of off-budget inflows and work to enhance the efficiency of their utilization by broadening the range of local citizen control, highlight an important reserve capable of stabilizing the economic situation of general education establishments. To turn boards of trustees into really effective citizen control bodies, it is important that:

(1) the statute of each school specify exactly the kind of public self-management and supervision body operating in the school and its functions and powers, so that unwarranted duplication of func-

tions of the boards of trustees, parents' committees, school committees, and other bodies could be avoided;

(2) a complex of economic measures be developed and adopted at the municipal and regional levels to attract sponsor contributions and donations for the needs of schools;

(3) considering the wide-ranging opportunities different schools have for maintaining boards of trustees, regional and local authorities render organizational and methodological assistance to schools, such as (a) putting representatives of the local authorities, employers, patrons, and other interested parties on the school boards of trustees; and (b) setting up regional boards of trustees, such as those for a number of small rural schools, for example. Finally, any possible discrepancies are to be removed between the Budget Code of the Russian Federation, just put into effect, and the regulations of boards of trustees regarding the schools' powers and degree of freedom in spending off-budget financial funds.

The slow development of the new labor market institutions has seriously aggravated the problem of employment for graduates of higher education establishments, technical secondary schools, and vocational training schools. Apparently, in a situation when an overwhelming majority of potential employers are in the non-public sector, new approaches are required to develop and implement measures to improve the young people's adaptability and raise their competitiveness on the labor market. At the initiative of the Russian Association of Professional Organizations of College and University Students and Graduates, the Federal Education Ministry and the Federal Ministry of Labor and Social Development issued a joint Order (No. 175, of October 4, 1999) on Measures to Promote the Efficiency of a System to Assist Graduates of Vocational education Institutions in Finding Employment and Adapting to the Labor Market.

The chief measures to improve young people's conditions on the labor market include: (1) providing school leavers, junior and senior students, and graduates of educational establishments with guidance and counseling based on regional information science centers, new information technologies centers, consulting centers at educational establishments of the Federal Education Ministry and territorial youth counseling centers of the Russian Labor Ministry; (2) authorizing education management bodies in Federation members and territorial employment service agencies, jointly with government-run educational institutions, to identify, on the basis of forecasts of changes in the job vacancy structure, size and occupational skills of the work force on the territorial and sectoral levels, the needs of enterprises, offices, and organizations, regardless of ownership form and business organization, for skilled young graduates; (3) establishing in each Federation member a database on job openings, with access to an integrated national database network; and (4) developing regional and municipal programs to assist graduates of vocational education institutions in finding jobs and adapting to the labor market.

No doubt, implementation of these measures will require serious efforts to review the list of college specialties: to give an example, engineering colleges have cut their specialty lists from 305 to 72, in a bid to achieve a more flexible specialization through multi-level training.

It is common fact, however, that a law or any other statutory act passed in Russia these days is no guarantee that the law will be complied with. Besides some notorious facts (of which the fate of Presidential Decree No. 1 is the most striking example), this skepticism is reinforced by the results of a survey of educational establishments at all levels and with various ownership forms conducted by the Federal Ministry of Antimonopoly Policy. Its goal was to

verify compliance with the laws on protection of consumer rights to receive paid educational services. The survey was conducted in 62 of Russia's regions, in an average of two educational establishments (public or municipal and non-public) of each type - pre-school, general school, primary, secondary and higher vocational education - in each region, or ten educational establishments in each region (a total of 657 educational establishments, including 325 public, 159 municipal, and 173 non-public). No infringements of federal laws were found in only 56 (or 8.5 per cent) of all the educational institutions surveyed. Of the total 712 instances of infringement, 350 were infringements of consumer rights to know details about a service provider and the kind of educational services provided; 362 had to do with the execution of contracts for paid educational services and the incorporation of contractual conditions infringing consumer rights as compared to the rules specified in consumer rights protection laws. The survey materials testify to a rapid growth of the market for paid educational services, but mostly because an increasing number of public and municipal institutions begin providing paid educational services, while the number of non-public educational establishments has been rising only insignificantly in recent years. In other words, the survey confirmed the familiar conclusion that privatization and commercialization of public education has got under way spontaneously.

Another important conclusion to follow from that survey concerns numberless discrepancies between regional and local regulations and federal laws. Federation members are prone frequently to overstep the bounds of their constitutional regulatory powers as regards education. These discrepancies occur in the rules adopted in the regions regarding provision of paid educational services. Adoption of rules applying to civil law regulation of this kind of services

is contrary to Article 71 of the Russian Constitution, which makes civil law regulation an exclusive right of the Federal authorities.

An analysis of education-related laws undertaken by the Federal Ministry of Antimonopoly Policy has revealed a few discrepancies between the Education Law and some provisions of the Federal Constitution. In particular, the law leaves unanswered the question of who and at which level can lawfully regulate relations under contracts for the provision of paid educational services. Capitalizing on this legal uncertainty, some Federation members and local government authorities (such as the Republic of Tatarstan, the Vladimir Oblast, and the cities of Perm, Novosibirsk, and Chelyabinsk) have passed rules of paid educational services provision that regulate relations under civil law. To end law-mongering in defiance of the Federal Constitution, amendments are needed in the Education Law to make the right of legal regulation of relations involving provision of paid educational services an exclusive prerogative of the Federal authorities.

2.8. Household Sector Finances and Consumer Markets

Cash Incomes. The effects of the deep plunge in cash incomes in September 1998 continued to be felt in the early half of 1999. As a result, real disposable personal incomes in the first six months did not rise above 75 per cent of their level in the same period of 1998. On year-end results, real incomes fell by around 15 per cent, but in December 1999 they were 10 per cent higher than they were in December 1998, and 37 per cent higher in November 1999 than in the same month of 1998. This abrupt turnaround in December is explained, on the one hand, by compensatory measures pushed through the State Duma immediately before the Duma elections and, on the other hand, by the fact that the monthly pattern of income fluctuations typical of preceding years had been restored in

December. (The December upturn came in 1998 as well, but it was more of a low blip because of the September shock a couple of months before).

Overall, personal monthly incomes per capita averaged 1,563 rubles for the whole of 1999 (almost 2,500 rubles in December of that year). Interregional income differentiation continued to increase. In particular, average personal incomes per capita in Moscow registered 7 to 10 times as high as the estimate for Central Region oblasts (in 1998, the difference ranged between 6 and 9 times, and it was still narrower, 5 to 7 times, in 1997).

Real wages plunged even deeper in 1999 than did personal incomes: the average monthly wage dropped by 25 per cent, against a fall of 15 per cent for the personal income per capita. (A nominal monthly wage was, on average, 1,575 rubles in 1999 against 1,050 rubles in 1998.) The share of wages in total household incomes decreased insignificantly, by around 1 per cent. This is explained essentially by the fact that in its analysis of the income structure, Goskomstat now included hidden wages in the wage earnings¹⁰⁹ (hidden wages are not included in accrued wages that are used for calculating real wage dynamics). Even allowing for a 1 per cent growth (in annualized terms) in employment, such changes in the general structure can only occur when a more favorable dynamics in hidden wages is registered in comparison with officially accrued wages.

¹⁰⁹ Previously, hidden wages were recorded under the heading "Other household income."

TABLE I

**Household cash income structure 1992 through 1999
(in per cent)**

Year	1992	1993	1994	1995	1996	1997	1998	1999
Total cash incomes	100	100	100	100	100	100	100	100
Payment for work	69.9	60.5	46.6	40.7	41.9	39.3	42.4	38.0 (63.9)
Social transfers	14.0	15.1	15.4	12.4	14.2	14.9	13.3	13.4 (13.4)
Income from property and entrepreneurship, and other income	16.1	24.4	38.0	46.9	43.9	45.8	44.5	48.6 (22.7)

In parenthesis: official RF Statistics Agency data as adjusted for hidden payment for work; data comparisons with preceding years are estimates by authors of this review.

In late 1999, average wages were higher than average per capita incomes in a majority of Russian regions (according to statistics for November, except Moscow and the Samara and Novgorod oblasts). In Moscow, however, they were only 42 per cent of average per capita incomes (down from 48 per cent in 1998 and up from 41 per cent in 1997). Intersectoral average monthly wage differentiation increased slightly, for example, to 2.95 times the average for Russia in the fuel industry in late 1999 (from 2.37 times in 1998), while it dropped from the Russian average still further in relatively low-wage sectors financed from the Federal Budget. In health care, for example, the average wage stood at 60 per cent of the Russian average (down from 67 per cent in 1998), and in education, culture and the arts, it was 55 per cent (from 60 per cent in 1998).

In 1999, the situation of old-age pensioners continued to deteriorate. The ratio of the average monthly pension to the average monthly wage, which had fallen to 32 per cent in the last quarter of 1998 (from 38 per cent in the first quarter of 1998), did not exceed 26 per cent in late 1999. Whereas in the fourth quarter of 1998, the average pension was 10 per cent below the subsistence level of a

pensioner, it fell to approximately 25 per cent below the subsistence level in late 1999.

The ratio of the average wage to the subsistence level of the working-age population improved slightly in 1999, to around 170 per cent in November, from about 150 per cent a year before.

Statistics characterizing the *degree of differentiation* among the population in terms of cash incomes continued to rise in 1999. The Gini coefficient went up to 0.394 (from 0.375 in 1998), and the assets coefficient climbed from 13.42 in 1998 to 13.91 in 1999. To an extent, this can be attributed to the fact that, as we wrote above, the hidden share of wages (more evenly distributed among the different population groups) was growing faster than the officially accrued wages in nominal terms.

Table 2 shows Goskomstat's estimates of the distribution of the Russian population according to average income per capita in 1999.

TABLE 2

Household distribution by average per capita monthly cash income, in Rb '000 (as per cent of total)

Total households	100
With incomes up to 400.0	3,6
400.1-600	8,5
600.1-800	11,4
800.1-1000	11,9
1000.1-1200	11,0
1200.1-1600	17,6
1600.1-2000.0	12,0
over 2000.0	24,0

The distribution of total household incomes among the 20 per cent groups with different standards of living in 1999 did not change from 1998.

Early 1999 saw a relatively sharp jump in the subsistence level. In autumn months, as this happened in previous years, too, it went down because of a seasonal drop in prices of vegetables, and finally stabilized. Generally, the subsistence level rose by nearly a third over a year (in December 1999 against December 1998). All through the year, the share of needy people, with incomes at or below the subsistence level, was gradually contracting, from 37.7 per cent in the first quarter and 35 per cent in the second quarter to 26.3 per cent in the fourth quarter (mainly because of growth in incomes in December). It is to be expected that, unless Goskomstat's methodology of calculating this indicator changes, the share of the poor would be about 30 per cent in the first quarter of 2000.

Cash Expenditure. In the first half of 1999, household expenditure on buying goods and services continued to grow as a share of total earnings (up to 85 per cent from 75.5 per cent in 1998), while the share of savings in bank accounts remained uncomfortably low through the year (ranging from 2.4 per cent to 4.7 per cent in some months). In the second half of the year, the share of consumer spending in the total earnings started to slide: while it hovered above 75 per cent in the first quarter, it was just below 75 per cent in the fourth quarter. (This level was typical of the first six months of 1998 preceding the crisis).

In the months after August 1998, the share of public spending to purchase foreign exchange in the total cash incomes stayed approximately at the same level of 8 per cent to 9 per cent.

Over the three quarters of 1999, retail sales were steadily below their level in the same period of 1998. They had dropped by 10 per cent to 14 per cent, sufficiently uniformly from month to month

during that period (these rates of decline in retail sales were registered in the fourth quarter of 1998 as well, in contrast to the same period of 1997). In the fourth quarter of 1999, retail sales were about equal to the showing in the fourth quarter of 1998, and their further slide appears likely to slow down in 2000 judging by available estimates for the first quarter of 2000, with retail sales set to end at around Rb500 billion. The retail sales macrostructure has changed somewhat - with the share of foodstuffs having edged up from 47 per cent in 1998 to 48 per cent in 1999. The range of retail goods was slowly contracting, largely because of falling imports. The sales of alcoholic beverages, including beer, showed a change, too: in 1999, beer sales rose by 13 per cent and the sales of vodka slipped by 2 per cent on the 1998 figures, while the sales of brandy and ordinary and sparkling wines slipped by between 3 per cent and 7 per cent. On balance, the sales of ordinary and sparkling wines dropped by around a quarter from 1997, and those of beer and vodka survived at approximately the same level.

The bulk of the overall decline in retail sales fell on the turnover of retail outlets, which went down by around 10 per cent, with the market turnover having dipped by a mere 1.7 per cent.